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2023 Franchise Regulation Review conducted for Australian Treasury by Dr Michael Schaper

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Set questions.

### *General Questions*

#### **1. General observations about the regulatory framework**

- Franchise relationships are regulated through:
  - contracts drawn up to protect franchisors' interests. Through these contracts the maximum possible risk and expense is shifted onto franchisees.
  - the Competition and Consumer Act (CCA) (unconscionable conduct, misleading conduct, unfair contract terms),
  - The Code (a regulation under the CCA) whose purpose is stated in cl.4 as 'to regulate the conduct of participants in franchising towards other participants in franchising'.
    - It arguably does an adequate job of regulating the franchisor / franchisee relationship ex ante, except when the franchisor is already trading insolvent.
    - It fails to regulate the conduct of franchisors who are not interested in being regulated.
    - Cl 6 mandates an 'Obligation to act in good faith' – but cl 6(6) removes that obligation. The Franchising Code's definition of 'good faith' does not pass the pub test.
    - It fails to regulate the conduct of the administrators of failing franchisors, although it applies to them. Administration is the first step towards winding a company up insolvent.
    - It does not have jurisdiction to regulate liquidators of failed franchisors. They are regulated under the Corporations Act. Under the Corporations Act the process of winding up a failed franchisor hangs its franchisees out to dry. They are owed nothing.
  - the Fair Work Act, s 588A.
- The current suite of regulation ignores:

- corporate governance of a franchise network. It is akin to a private bureaucracy (see *Buchan and Gunasekara*) but the top 'bureaucrat', the franchisor, has no firm duties to its franchisees.
- franchisees' ability to respond to events that would be termed 'shock events' by an economist. For example, franchisor changing advisors, franchisor listing as a public company, sale of franchisor to private equity/ venture capital.
- the inability of franchisees to protect their investments by freeing themselves from a failing franchisor through use of an **ipso facto clause**. Contract clauses that permit termination of an agreement based on an insolvency event are often referred to as "ipso facto" clauses. Following Productivity Commission's recommendation, these clauses were made void. The PC accepted the insolvency practitioners' view that, they limit the prospect of an entity recovering from an insolvency event. Treasury adopted the same line of reasoning. There is now a small group of financial instruments exempt through regulation from the ban on ipso facto clauses, but this does not include franchise agreements.
  - In fact, if franchisees had an ipso facto clause enshrined through legislation in their franchise agreements, they could sever their contractual relationship/s with their failing/failed franchisor, renegotiate their lease with their landlord and potentially continue to run a profitable independent business without loss of their sunk capital.
- the ability of franchisees to secure a refund of **unused marketing funds** if their franchisor enters administration and/or becomes insolvent. The separate bank account now required under the Code is in the name of the franchisor. It should be held in trust.
- a franchisor's strategic insolvency is an example of "capricious termination" that was identified by Harold F Brown in 1973 as [the] Achilles heel of the entire franchising industry'.<sup>i</sup>

## 2. **Is the Franchising Code fit for purpose? Should it be retained? If so, should it be remade prior to sunseting?**

- The voluntary Code of Practice was introduced 30 years ago, in 1993. Over the past 3 decades franchising has evolved to become the complex business model it is today. There have been at least 14 relevant parliamentary and other government-initiated reviews since 1993. It is time to recognise that a Code under the CCA is not adequate to regulate this sector.
  - Reviews to date include 1994 (Gardini), 1996 (Reid), 2006 (Matthews), 2008 (PJC + WA + SA), 2009 (Unconscionable conduct), 2013 (Wein), 2015 (Productivity Commission – Small Business Set-up, Transfer and Closure), 2017 (Fair Work Act), 2018 (PJC, SA and WA), 2019, 2021, 2022 (PJC) and now, 2023.
- Franchise relationships should be regulated from gestation to grave, like an employer/employee or director/shareholder relationship. Currently the greatest focus is on pre-contract disclosure. Potentially intractable problems arise after the franchisee has incurred sunk costs.

- In its current form and its location within the CCA It is **not fit for purpose**. Ideally, franchising should be regulated in its own Franchise Act. This is the situation in many other jurisdictions, eg Malaysia. This would not deny participants in franchising the right to have breaches of the CCA addressed but would enable the creation of a statute that could address a wider range of issues that cannot be addressed under a regulation of the CCA. This would include breach of contract.
3. **Are there any emerging trends, such as technology or cultural innovations, which would affect the operation of the Franchising Code?**
- See pages 7 to end of this submission.

#### *Questions – The scope of regulation*

1. **Does the general scope of coverage of the Franchising Code remain appropriate? Is the scope of coverage flexible enough having regard to the diversity of the franchising industry?**
- It is not flexible enough. It needs to be stand alone and to govern the whole relationship from gestation to death. Currently it does not address issues that arise after the franchisee signs the franchise agreement, pays its money and invests sunk costs.
  - The Corporations Act has a role to play. It regulates employees' relationships with their company and shareholders, but not the people who replace shareholder investors and employees - franchisees. See the article by Gant and Buchan<sup>ii</sup> and the chapter by Buchan<sup>iii</sup>
  - See Figure 1 below.

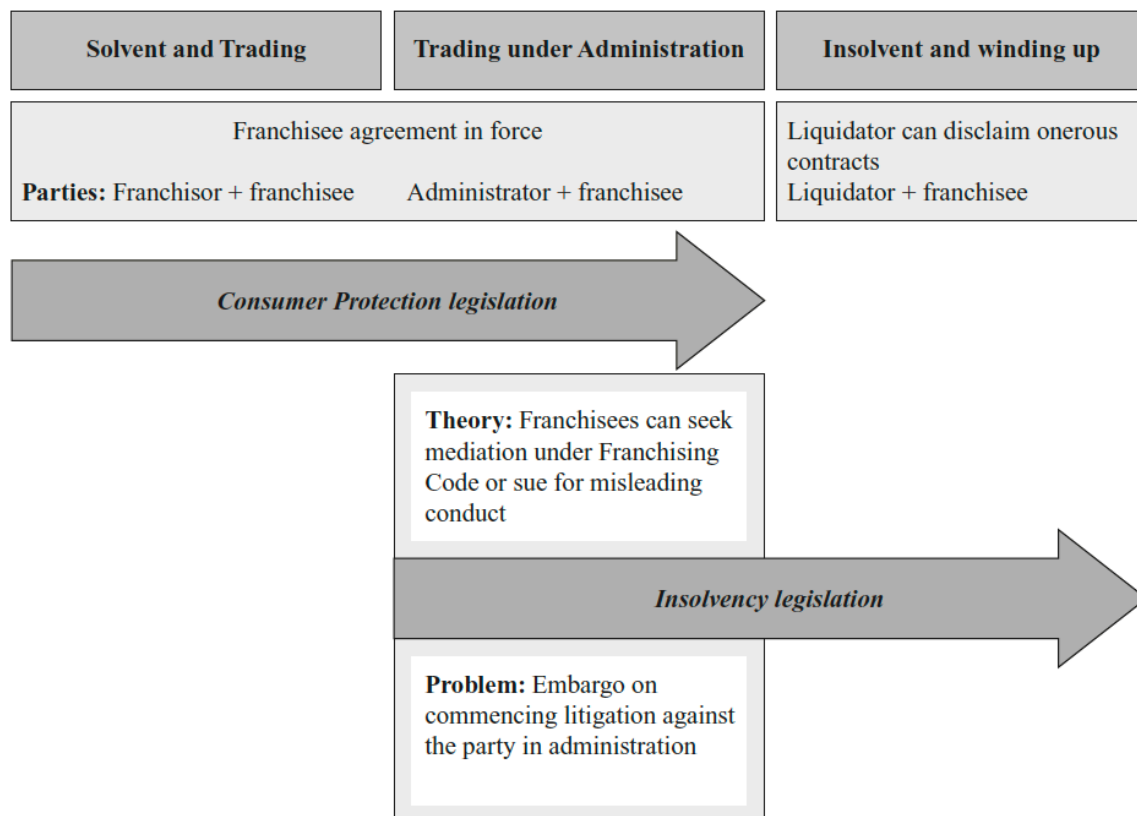


Figure 1: Statutory cover during franchise term

2. **Have the amendments regarding the exclusion of cooperatives from the provisions of the Franchising Code effectively clarified that they fall outside the scope of the Code?**
  - No comment
3. **What evidence is available to suggest additional protections in the Franchising Code for new car dealerships should be extended beyond new car dealerships (for example to truck, motorcycle and farm machinery dealerships)?**
  - It is too early to tell whether Part 5 (New vehicle dealerships) will be effective. One way to provide some clarity on this question would be to re-run the facts of *AHG WA (2015) Pty Ltd v Mercedes-Benz Australia/Pacific Pty Ltd* [2023] FCA 1022 against Part 5 of the Code to see whether the additional provisions could have generated a different result.
  - Part 5 should apply to all franchise agreements. Motor vehicle dealers do not have unique risks. Franchisees all have essentially the same risks.
4. **Should agreements between automotive manufacturers and dealerships that relate only to service and repair work (which do not cover matters relating to vehicle sales) be considered as franchise agreements and covered by the Franchising Code protections? Why or why not?**
  - Any solution depends on whether they operate as agents/ distributors and are free to work on other brands or whether they are restricted to only tooling their workshops and working

for one brand. If only one brand, they need more protection than if they are free to work for any brand they choose.

**5. Has the amended definition of *motor vehicle dealership* effectively clarified that agency sales models remain within the scope of regulation under the Franchising Code?**

- No comment.

*Questions – Before entering into a franchise agreement.*

**6. How effective are the requirements of the Franchising Code that ensure franchisors make information available to franchisees prior to entry into a franchise agreement? If**

possible, please comment on the effectiveness and content required for inclusion in each of the Franchise Disclosure Register, Information Statement, Key Facts Sheet and Disclosure Document.

- **Franchise Disclosure Register**

- The [Franchise Disclosure Register](#) mandated under Part 5A of the Code should have been a valuable resource. It could have saved franchisors and prospective franchisees and their advisers hours and dollars. It is a resource that researchers have sought for years. Until the existence of the Australian register, legal researchers have had to rely on data sourced from one of the 3 open-source US state registries.
- Sadly, currently, the Australian register is a dog's breakfast. Relatively few franchisors have posted entries. The information is provided in such an inconsistent format by different franchisors that it is virtually useless.
- The Code makes provision for civil penalties of 600 penalty units to be levied against non-compliant franchisors. Have any penalties been applied?
- It is too early to give up on the Registry.

- **Information Statement**

- The Information statement that franchisors are required to provide to comply with Part 2, Div 3, cl 11 of the Code.

- **Key Facts Sheet**

- The [Key facts sheet](#) is a requirement of Part 2, Div 2, cl 9A of the Code. Franchising still provides entry level business opportunities for new immigrants who do not speak English fluently. The suggestions I have are;
  - It is essential that the names and contact details of past/former franchisees be retained here as they are a valuable source of endorsement or enlightenment about the franchisor, the brand and the territory.
  - a version of the Key facts sheet that uses pictures and diagrams would be worth considering. It could show, for example, the direction of money flow between all parties: franchisor and franchisee, franchisor + suppliers + franchisee. This would help the franchisee's adviser work out how financially risky the business would be.

- Because so many franchisees in some systems are drawn from immigrant communities with potentially limited command of English I recommend the franchisor be required to provide the Key fact sheet translated in languages its prospective franchisees understand.
  - Eg: 7-Eleven has provided evidence in the past about the ethnic make-up of its franchisees. A high proportion did not speak English as a first language.
- **Disclosure Document**
  - This is a requirement of Part 2, Div 2, cl 8 of the Code.
- 7. **How have changes to unfair contract terms laws impacted franchise agreements? Is the approach in the Franchising Code to regulating certain types of contract terms still appropriate?**
- 8. **Do you have any other comments on how the Franchise Code regulates the relationship between franchisors and franchisees at the point of entry into a franchise agreement?**
  - No

***New vehicle dealership agreements***

9. This is outside my expertise.

***Questions – Enduring obligations in franchise relationships.***

10. No comment.
11. No comment.

***New vehicle dealership agreements***

12. **What impact have the 2021 amendments to the obligation to act in good faith in relation to new car dealerships had? Where possible, please provide detail on the costs and benefits the new car dealership sector has experienced because of these changes.**

***Questions – Ending a franchise agreement.***

13. **How effective are 2021 reforms to the Franchising Code which created a process for franchisees to formally request early exit from their franchise agreements?**
- Clause 26B of the Code allows a franchisee to propose termination at any time. Practitioners will be better placed to comment on whether, and how, any proposals under this clause have been dealt with. There is no penalty if the franchisor decides to turn down the proposal.
  - Clause 29 of the Code allows the **franchisor** to give a franchisee a notice of termination on particular grounds.
  - The **franchisee** should also have an absolute right that mirrors Clause. 29 Franchisees should be allowed to continue their business separate from the franchisor and the franchise brand if their franchisor has:
    - Lost a licence to conduct its business
    - Become bankrupt, entered administration or become insolvent

- Been deregistered by ASIC
- Abandoned the franchise relationship
- Been convicted of a serious offence
- Operated in a way that endangers public health or safety, or
- Acted fraudulently.

The 2008 Senate Committee report *Opportunity not Opportunism* recognised this problem. Its Recommendation 4 (paragraph 6.40) (below) was not adopted.

The committee recommends that the government explore avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure. Although the Code gives franchisors the ability to terminate franchisees, it does not provide reciprocal termination provisions for franchisees. In the event of franchisor failure, this can have serious consequences for franchisees who have no avenue to exit the business.

### ***New vehicle dealership agreements***

**14.** No comment

### ***Questions – Enforcement and dispute resolution***

#### ***ACCC and enforcement***

**15. Is the current role of the ACCC in relation to enforcement of the Franchising Code appropriate?**

- No.
  - The ACCC should be holding franchisors accountable to place correct details on the **Franchise Registry**. The Registry should be a credible source of information for the entire sector.
  - As franchise agreements are largely standard form contracts that contain many **unfair contract terms** when seen through the eyes of a franchisee, they should be evaluated more rigorously than currently against the provisions of the Australian Consumer Law, ss 24 (1) and 25.
  - Administrators are covered by the Code as they step into the shoes of the failing franchisor. They currently ignore the Code. The ACCC should encourage mediation with franchisees as part of the administration process. This would require an education program and probably amendment to the Corporations Act.

**16.** No comment.

**17.** Practitioners might have answers to this question.

#### ***Dispute resolution***

**18. Is the role and activity of the ASBFEO in relation to supporting dispute resolution under the Franchising Code appropriate?**



Anecdotal evidence suggests that some franchisee lawyers are dissatisfied with ASBFEO's reluctance to deal with/ really understand complex franchise problems. Franchisee lawyers can elaborate.

19. Mediators, arbitrators and legal practitioners are the best people to comment on this. Mediators traditionally participate very little in reviews so please seek their views out as they will be well informed on this issue.

### Ongoing problem areas

The Code regulates a relationship between a franchisor entity and a franchisee entity up to the moment an Administrator is appointed to one of the parties.

Administrators ignore the Code. Administration and liquidation (insolvency) is regulated under the Corporations Act. This offers no protection to franchisees. It should.

The complexity of today's franchise environment presents unmanaged threats to the security of franchisees' interests.

#### *Good faith*

The concept of good faith as set out in the Australian Franchising Code is out of step with the concept of good faith in an Australian administrative law context (*see Buchan and Gunasekara*<sup>iv</sup>), in other countries' franchise laws, and within the concept of good faith in civil law. The current clause 6(6) of the Code makes a mockery of good faith. It possibly misleads franchisees.

#### *Goodwill*

Goodwill continues to be problematic in franchising following the judgment of the single judge in *AHG WA (2015) Pty Ltd v Mercedes-Benz Australia/Pacific Pty Ltd* [2023] FCA 1022. Surely goodwill in a franchise has three components: the brand (goodwill belongs to franchisor), the site (goodwill shared between franchisor and franchisee, often with lease in franchisor's name but performance of obligations under the lease guaranteed by franchisee), and the business owned and run by the franchisee (goodwill should be attributed to franchisee for so long as franchise agreement is in place with franchisee is running the business and attracting loyal customers).

#### *Marketing funds*

Code, Cl. 31 Marketing and advertising fees

- (1) A franchisor must maintain a separate bank account for marketing fees and advertising fees contributed by franchisees.

The franchisee's understanding when making these payments is that the funds will be used for the benefit of the people who paid into the fund, including themselves. The failure to require franchisors to hold marketing funds in trust and has seen their being used to boost franchisors' profits, to make the franchisor appear to be better capitalised than it is. The separate bank account is in the name of the franchisor. It should be held in trust for all who contribute to it.

In *Re Stay In Bed Milk & Bread Pty Ltd (In Liq)v ('Stay In Bed')* Randall AsJ observed that in this system (and in the Code) '[t]he Franchise Agreement is silent on what happens with the Marketing Fund in the event that SIBMB stops trading'.<sup>vi</sup> The Stay in Bed Milk & Bread (SIBMB) franchisees were required to make payments into the marketing levy amounting to 5% of Gross Delivery Fees plus GST. The credit balance in the fund was significant.

Unless specified in the franchise agreement the 'separate account' is not a trust account although it is funded by franchisees, and any franchisor owned outlets. Marketing fund balances, potentially seven figures, are thus used by the liquidator to pay a failing franchisor's creditors rather than the unspent funds being returned to the franchisees.

To add salt to the wound, the marketing levy, as a contractual obligation, remains payable right through the period of administration until the franchise agreement is disclaimed by the liquidator. It is doubtful that franchisees receive any positive marketing value during the franchisor's administration.

Solutions to this are proposed on pp 15-16 following.

#### *Ipsa facto clauses*

'Contract clauses that permit termination of an agreement based on an insolvency event are often referred to as "ipso facto" clauses. The Productivity Commission recommended these clauses be made void, arguing that they limit the prospect of an entity recovering from an insolvency event. Liquidators claim that they need access to the full suite of assets of a failing business so they can sell them to repay the creditors.

In fact, the opposite can occur to franchisees when their franchisor becomes insolvent. If franchisees had an ipso facto clause in their franchise agreement, they could sever contractual relationship/s with their franchisor, negotiate direct with suppliers and potentially continue to run a profitable independent business. See Nicholls and Buchan<sup>vii</sup>.

See more under the **Options for Change** section that follows.

#### *Corporate franchisor insolvency.*

Insolvency includes the failure of the franchisor's parent company, and strategic insolvency.

The failure of regulators to take franchisor insolvency seriously in the past may possibly be attributed to several myths.

#### *Myth # 1: Franchisees have received all the information they need before investing.*

A franchise agreement is a relational contract that, by implication, will evolve as the relationship adjusts over time. The fallacy here is that no one can know for the duration of the term the franchisee has been granted what will transpire in the market. The franchisee cannot anticipate how the franchisor will respond to an opportunity, for example, to sell its business to a venture capitalist, or how it will deal with a pandemic that means its airport-based outlets have to cease trading until air travel resumes, or if it will over-spend in upgrading the corporate headquarters as franchisor Max Brenner did (and entered voluntary administration, shed some stores and re-emerged).

In addition to this, Uri Benoliel and I demonstrated that franchisees are optimistically biased<sup>viii</sup>. This means they recognise that some franchisees will fail, and some franchisors behave opportunistically but they don't think anything bad will happen to them personally. But, on signing a franchise agreement the franchisee's fate becomes tied to that of their franchisor, for better or for worse, regardless of the sickness or health of the franchisor's business or that of its parent company.

*Myth # 2: Franchisors only sell a tested, successful franchise opportunity.*

Lorelle Frazer's research has identified that up to 40% of franchisors offer franchises for sale before the franchisor has tested the concept for 12 months.

Some franchisors are already insolvent while they are still selling franchises.<sup>ix</sup>

*Myth # 3: Denial that franchisors fail.*

In Australia, "research analysing the advertiser list of a 1996 edition of Franchising Magazine indicated that of 113 franchisors then advertising for franchisees, 34 could no longer be found to exist just 10 years later – an attrition rate of 30%".<sup>x</sup>

Franchisees who receive negligible assistance from a franchisor are likely to quit the system before the franchisor fails. The fate of each franchisee that is still in the system when the franchisor fails will depend on many variables: some also fail, others rebrand as a franchisee of another system, and yet others become independent businesses'.<sup>xi</sup>

*Myth # 4: Franchisees cause the franchisor to fail.*

'In 1991 ... Australia's Franchising Task Force attributed franchisor failure to a combination of:

- under-capitalization of the franchisor,
- too-rapid expansion of the franchise system,
- poor product or service,
- poor franchisee selection,
- franchisor greed,
- external factors,
- devaluation of the Australian dollar,
- an increase in import duties,
- the withdrawal of an important source of products,
- an aggressive and cheaper competitor, and
- severe downturn in the economy.

In the US, Cross saw '[f]ailure as a result of "franchising-related" factors as falling into five key categories:

- business fraud,
- intra-system competition, involving franchise outlets being located too close,
- insufficient support of franchisees,
- poor franchisee screening, [and]
- persistent franchisor- franchisee conflict'.

For[a] financially troubled business, insolvency may be part of a considered business strategy. US attorney Craig Tractenberg identifies that:

[f]ranchisors file for bankruptcy to escape or postpone the consequences of mass franchisee litigation, shareholder litigation, and lender enforcement activities.

Other franchisor advisers concur with Tractenberg, acknowledging that:

voluntary administration can enable a franchisor to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital

structure. [It] may assist a franchisor in addressing ... overexpansion in the market and the need to eliminate units, an unworkable equity structure, desire to sell or merge with another entity, threat of franchisee litigation, [or a] desire to refinance [being hampered because] the lender has expressed concern about financial or other issues.<sup>xii</sup>

*Myth # 5: Franchisees are no different to other small businesses, so don't need special treatment under the insolvency provisions of the Corporations Act*

Avenues for accessing capital.

Franchisors can raise additional equity capital through selling more franchises and are thus able to hide their impending insolvency from stakeholders for longer than they could hide it from a finance source in a non-franchised business. Although they are required to sign a solvency statement as part of the pre contract disclosure some are prepared to do so, even though knowingly insolvent.

No governance oversight available to franchisees

There is [no] direct scrutiny and accountability of their franchisor available to franchisees because their respective governance structures are independent of each other. Franchisees cannot know the full extent of the franchisor's networks of corporations and trusts, or the financial strength of those entities.

No room for a franchisee voice throughout franchisor insolvency

No rights in franchisor insolvency (both administration and winding up stages), but employees and shareholders have rights under the Corporations Act.

No time during the insolvency for franchisees to pursue an unjust enrichment action against the insolvent estate. Franchise agreements are seen as an asset for the administrators to sell to highest bidder to satisfy franchisor's creditors. Insolvency practitioners owe no duty of care to franchisees to select a competent buyer. Franchisees are seldom creditors of their failing franchisor. So they have no right to representation at their failing franchisor's creditors meetings.

*Myth # 6: Franchisees should have negotiated better contracts.*

How? The terms of a franchise agreement are settled by a franchisor.

## **Options for Change**

The goals of franchise regulation should include:

- Maintaining confidence in franchising to continue to give people confidence in investing in the business model.
- Providing franchisees with the ability to respond to economic shocks of the franchisor's making (eg: insolvency).
- Equitable distribution of funds on insolvency.

The following are suggestions for achieving more robust franchise regulation.

*Expand directors' duties in a franchise network to duties towards franchisees.*

Amend *Corporations Act* ('CA') to expand franchisors' directors' duties so the franchisors directors owe franchisees duties under the CA. This would recognise the significant risk shifting franchisors undertake when they appoint franchisees, and the financial and personal investment franchisees make.

Franchisees rely on a franchisor to behave ethically and competently, but unlike the avenue available to shareholders, franchisees can't sell their shares and reinvest in a different company. Nor can they

quit their employment and look for another job. They are stuck at the mercy of their franchisor if the franchisor makes decisions detrimental to the franchisee or the system.

#### *Enable franchisee survival post franchisor failure.*

Allow franchisees to walk away from the brand and trade independently in the same premises if the franchisor fails and the administrator does not find a suitable buyer within a prescribed amount of time. Support for this solution came in a submission to the 2013 Wein Review.

The Wein Review in 2013 heard from 'The [SME Business Law] Committee [of the law Council of Australia] recommend[ed] that there should be reform to the effect that:

1. In the case of an insolvent franchisor, a franchise cannot be terminated except upon reasonable notice (for instance 30 to 60 days) unless there is an agreement to terminate with the franchisee or, alternatively, an order of the Court if it is demonstrated that the insolvent franchisor, through its insolvency practitioner, is not in a position to trade the franchise or continue to supply services, materials or intellectual property which is the subject of a franchise agreement. A moratorium of, say, 30 to 60 days would enable the franchisee to negotiate a possible purchase of their business, reconfigure their business or, alternatively, participate in a financial work out of the franchisor such as a Deed of Company Arrangement or Scheme of Arrangement.
2. In the case of a franchisee, a similar moratorium period would enable the insolvent franchisee, through the insolvency practitioner, to negotiate a sale of the franchise and realise potential value for the business.<sup>xiii</sup>

#### *Recognise and eliminate unjust enrichment of insolvent franchisors creditors.*

Acknowledge that the unexpired portion of any franchise fee becomes a priority debt payable to the franchisees in the franchisor's insolvency.

Eg if a franchisee paid \$100,000 franchise fee for a 5-year term, the franchisor fails after 3 years, then the franchisor owes the franchisee \$40,000. To categorise the unexpired portion any other way amounts to unjust enrichment of the creditors.

A complicating factor for franchisees contemplating [unjust enrichment] litigation is that on the appointment of an administrator or liquidator, there is a stay of proceedings so that no action or other civil proceedings may be begun or continued against the company without the leave of the court. The relevant legislation is *Corporations Act 2001* (Cth) ss 440D, 471(2); see also *Ibbco Trading Pty Ltd v HIH Casualty and General Insurance Ltd* [2001] NSWSC 490.

#### *Where franchisor sells franchise while insolvent make defrauded franchisees priority creditors*

One way a franchisor facing financial collapse can shore up its finances is to continue selling franchises. By doing this they can keep franchise fees rolling in, despite knowing they can never deliver on what they have sold. Eg: The Scafs' Aussie Farmers Direct (AFD) submission hinted at problems looming for AFD in the insolvency situation.

The financial auditors statement that Franchisors can get away with including currently is insufficient and even misleading – our Franchisor was still approving sales of franchises in 2018, signing the ... Disclosure document which stated they were able to pay their debts for the next twelve months, while simultaneously following a process to investigate insolvency options.<sup>xiv</sup>

The Aussie Farmers Direct situation is not isolated.

### *Franchisee representation in creditors meetings*

Currently franchisees have no statutory right to appear or be represented in creditors meetings. They should be at creditors meetings. They should have a vote that equates to their significant investment in dollar terms, risk adoption and potential loss.

### *Competent buyer of franchisor in administration*

The current law means liquidators sell the insolvent party's assets to the highest bidder. This can be disastrous for franchisees as the buyer may know nothing about franchising. Liquidators should be required to select competent buyers of the franchise chain, not simply anyone who can satisfy the franchisor's creditors demands.

### *Expand FEG*

Include the employees of franchisees of insolvent franchisors in the FEG scheme. This would take the burden of meeting statutory employee benefits off a franchisee who has lost its business because of the franchisor failure. In this situation the franchisor's employees would be supported by FEG so this would introduce an equitable solution to the risk sharing undertaken by franchisees when they bought into the franchise network.

### *Entrench ipso facto rights*

This could be achieved by acknowledging franchise agreements alongside the current exemptions applicable to some financial privileges via an amendment to the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* and its regulations.

Dr Rob Nicholls and I made the following recommendation in relation to the Treasury laws Amendment (2017 Enterprise Incentives No 2) Bill 2017

'Our recommendation was twofold:

- 1) **Our first recommendation** is that the Franchising Code should be amended to imply ipso facto clauses into franchise agreements for the benefit of franchisees, with conditions.

'A term would be implied into all franchise agreements that if an administrator is appointed to the franchisor or to any of the entities in the franchisor's network that threaten the viability of the franchisee's business, a 2-step process will be triggered:

Step 1: when an administrator is appointed to their franchisor any franchisee may give notice to the administrator that if a satisfactory resolution (restructuring that takes into account the franchisee's interests as well as those of the franchisor's creditors, or sale to appropriate buyer) is not found within x days, it will terminate the agreement,

Step 2: if the administrator does not meet the requirements in x days, the franchisee have the right to terminate the franchise agreement, without this being a deemed breach by the franchisee and without it compromising any other rights the franchisee may pursue. The franchisees may express their losses as unsecured creditors for an amount of their initial investment, adjusted by depreciation and other appropriate considerations, plus any amounts currently owed in the franchisor's administration/ subsequent insolvency.

This approach could be adopted in relation to both franchisor and franchisee failure. This would mean the current asymmetrical provisions in the Code and all franchise agreements favouring franchisors in the event of franchisee failure could be removed from franchise agreements, thus making them shorter. It would also eliminate the risk of franchisees being sued by the administrator or liquidator for anticipatory breach'.<sup>xv</sup>

Alan Wein considered the law in relation to franchise insolvency in depth in his review. We refer you to Review of the Franchising Code of Conduct, Mr Alan Wein, 30 April 2013, pages 43 – 48 of that Review. His review concluded with the following recommendation concerning insolvency.

Recommendation by Wein Review

1. The Code be amended to:
  - a. Provide franchisees and franchisors with a right to terminate the franchise agreement in the event that any administrator of the other party does not turn the business around, or a new buyer is not found for the franchise system, within a reasonable time (for example 60 days) after the appointment of an administrator. It should be made possible for the courts to make an order extending this timeframe in appropriate cases. It should also be clear that the parties can negotiate a right to terminate at an earlier stage.
  - b. Ensure the franchisees can be made unsecured creditors of the franchisor by notionally apportioning the franchise fee across the term of the franchise agreement, so that any amount referable to the unexpired portion of the franchise agreement would become a debt in the event the franchise agreement ended due to the franchisor's failure.

### Marketing funds

Require them to be held on trust for the franchisees and any franchisor contributor. This change can be brought about by amending [Clause 15](#) of the Code.

The opaqueness of franchise marketing funds and the consequential franchisor opportunism in relation to how these funds are accounted for to franchisees, and spent were strong, recurrent themes in the PJC 'Fairness in Franchising' Report (2019). Some submissions identified that franchisors are avoiding obligations with respect to marketing by structuring their marketing and advertising fund so that it does not meet the definition of a fund as set out in the *Competition and Consumer (Industry Codes—Franchising) Regulation 2014* ('the Code'). It was suggested that marketing funds should be kept in a separate account, such as a trust account. Apart from the clarity and administrative benefits of a separate marketing and advertising fund, one submission indicated that it is possible such an approach may provide franchisees with an explicit proprietary claim to money in the funds in the event of the franchisor's insolvency.<sup>xvi</sup> This reiterated one of the principles the Wein Report recommended be applied to marketing funds through the Code.

They were:

- a) a franchisor should separately account for marketing and advertising costs;
- b) contributions to marketing funds from individual franchisees should be held on trust for franchisees generally, with the franchisor to have wide discretion as to how to expend the funds (subject to principle 'e' below);**
- c) company-owned units must be required to contribute to the marketing and advertising fund on the same basis as franchised units;
- d) the marketing and advertising fund should only be used for expenses which are clearly disclosed to franchisees by way of the disclosure document, and which are legitimate marketing and advertising expenses;



- e) a once yearly independent audit should be conducted on marketing funds over a certain threshold value, with no capacity for franchisees to vote against such an audit; and
- f) the results of the audit (where applicable) and other detailed information about the expenditure of marketing and advertising funds should be made available to franchisees yearly.

The 2013 Wein Review recommended that marketing funds be held as trust funds. In the PJC review, when this possibility was raised, the stakeholders who prevailed argued requiring marketing funds to be formally treated as trust funds would be problematic as:

[T]he additional compliance burdens associated with keeping a trust account may deter franchisors from setting up marketing funds at all. This may deprive franchisees of the transparency provided for relating to marketing by other provisions of the Franchising Code. This could have an impact on taxation arrangements and the treatment from a taxation and accounting perspective. Some stakeholders argued this would significantly increase the legal and administrative burdens on franchisors.

If marketing funds were held in trust, this could impact franchisors credit worthiness or the cost of credit for a franchisor.

It was concluded by the PJC that this recommendation is unjustified when the potential costs are considered. So, the potential costs for franchisors were considered but no mention was made of potential benefits for franchisees and their creditors. See fact checking below.

*Fact checking stakeholder claims re disadvantages of Marketing Fund being held in Trust.*

It is worth testing the reasons given for failing to require franchisors to hold marketing funds in trust. Do they hold water? What are the benefits to franchisors and to franchisees? Analysis in the table below suggests the government's Task Force has accepted the view of franchisors without rigorously examining their veracity.

Justifications for not requiring franchisors to hold marketing levies in trust as outlined in the Explanatory Memorandum accompanying the Competition and Consumer Amendment (Industry Code Penalties) Bill 2014	Fact or not?
Given franchisors are not required to maintain a marketing fund, the additional compliance burdens associated with keeping a trust account may deter franchisors from setting up marketing funds at all.	True. Anecdotally the suggestion of Franchise Council of Australia is for franchisors to increase the royalty by the amount formally being the marketing fund to remain unaccountable.
This may deprive franchisees of the transparency provided for relating to marketing by other provisions of the Franchising Code.	Most franchisors collect fees under the heading of 'marketing fund' and thus must 'maintain a separate bank account for marketing fees and advertising fees contributed by franchisees'.



	<b>Compliance burdens:</b> The submissions to the PJC, and disclosure documents indicate there is little transparency currently, so this is not supported.
Potential impact on taxation arrangements and the treatment from a taxation and accounting perspective. Would significantly increase the legal and administrative burdens on franchisors.	The likely impact, from a tax law and tax law compliance perspective is set out in the four points below. This Review could seek advice about any accounting impact from accountants.
If marketing funds were held in trust, this could impact franchisors credit worthiness or the cost of credit for a franchisor.	A franchisor should not be describing money tagged for marketing for the franchisees' benefit as equity.

Firstly, the income tax law has some trouble with settling on the correct tax treatment of transactions where a payer pays money to a payee on the “understanding” (condition, requirement, expectation) the payee will use the monies for a particular purpose. The reason is the difficulty in characterising the transaction(s) and the precise legal rights of each party involved (e.g. is payee mere agent for payer in spending payer’s money, has payer’s money become property of payee). However, where the payee (the franchisor) is a trustee of the monies for the payer (the position unsuccessfully argued by the administrators in the *Aussie Farmers* case), the payee has not made assessable income.

The difficulty is when the arrangement contains conditions that fall short of a trust (e.g. charge over monies). It comes down to a case-by-case situation. However, given all the circumstances surrounding the marketing fund in the *Aussie Farmers* case and judicial comments made throughout the case, subject to one potential qualification, the franchisors will have made assessable income on those facts. The main reasons are that:

(a) the money is either the proceeds of its business or a receipt for services (arranging marketing of franchise system for part benefit of franchisee) or a return from letting the franchise use its system, and more importantly and

(b) the franchisor became the beneficial owner of the monies (e.g. no trust) because while there was an expected use, the franchisor had wide discretion in its use.

The one potential qualification is that because the services of arranging the marketing occur over time (after payment in by franchisees), the tax law may defer assessable income recognition by franchisor over the time it is arranging those services.

Secondly, assuming the potential qualification does not apply, based on just the above, in terms of income tax for the franchisor, the trust situation seems to provide a better tax situation for franchisors because the receipt of the monies from the franchisee is not a taxing point for the franchisor. The situation in the *Aussie Farmers* case does involve a taxing point for the franchisor.

Thirdly, again, assuming the potential qualification does not apply, where the funds are spent fairly quickly after payment in by the franchisee, it probably does not matter from a substantive income tax position whether there is a trust or not. In the trust situation, the receipt and the expenditure of the

funds by franchisor is not a taxable event for the franchisor (no assessable income and no deduction). Where there is no trust, the tax treatment should be assessable income to franchisor on receipt and a deduction when monies are spent.

But, when there is no trust in existence, a long time gap between receipt of money and its expenditure means the franchisor is taxed upfront as income, but the deduction is delayed until expenditure occurs. **It is here that the trust situation gives the franchisor a better income tax outcome compared to the no trust situation.**

And finally, what would be the regulatory impact under the *Tax Act* on the franchisor if the marketing fund was put on a trust footing (as opposed to current arrangements)? Assuming just franchisees' monies are in this trust, the trust provisions of the *Tax Act* would apply. The franchisor would be the trustee. The trustee (franchisor) would need to comply with tax record-keeping rules, lodge tax returns for the trust (there would be interest income on the fund balance) and work out who is to be taxed on the income in the fund. So, a small number of tasks may be required to be undertaken that would not otherwise arise in the absence of a trust. There may also be the need for a *Corporations Act 2001* report to ASIC. There would be no requirement to report to the overseer of trusts; as there is none, aside from State Supreme Courts.<sup>xvii</sup>

This level of compliance surrounding the trust situation needs to be compared with the level of compliance regarding the provision of an acceptable level of transparency and accountability when there is no trust (the current situation). There is arguably not much difference between the two situations from a regulatory impact perspective.

It also needs to be remembered that the parties are largely free to build in as little or as much transparency into the trust as they want, subject to compliance with the legislation. If the parties do not set this out in the trust deed, general law will apply (e.g. trustees must maintain accurate accounts of transactions, accounts must be available to beneficiaries to see). That is, having a trust need not mean depriving beneficiaries of required transparency.

### *The main differences for franchisees that go through their franchisor's insolvency compared to non-franchised small businesses.*

#### *Franchisees*

A franchisor's failure affects all its franchisees. Failure is a 2-step process under the *Corporations Act*. **Step 1** – an Administrator is appointed to see whether the business can be saved, restructured and saved, or is beyond hope and must be wound up.

**Step 2** – the Administrator becomes the Liquidator, winds the franchisor's business up, sells the assets, pays creditors and the franchise closes.

Franchisees cannot escape their franchise agreement if the franchisor enters administration. Even though they probably receive no support from their failing franchisor or the administrator, their franchise agreement and all other financial commitments relating to their franchise remain on foot – so they are bleeding right up until the liquidator winds the franchisor entity up.

The administrator can seek court approval to extend the period of administration, and this prolongs the pain for franchisees. Until the winding up the franchisees remain liable to pay rent, royalties,

marketing fees, to buy stock at probably less favourable rates than the economies of scale they were promised, and to pay their own employees.

'12 possible indicators of a franchisor's **impending failure** have been identified.

- 1) a large proportion of outlets being owned by the franchisor instead of franchisees, may be indicative of the return of failed franchisees to franchisor,
- 2) a long history of failures on the part of franchisees in the franchise network,
- 3) a breach of a franchisor's obligations to provide advertising support, equipment and inventory,
- 4) evasiveness following franchisor default. If the franchisee queries a problem the franchisor might, for example, blame a software hiccup – and the franchisee has no way to verify this answer
- 5) a landlord's notice of demand, - where the franchisor has the head lease this would be sent to the franchisor, not the franchisee-occupant of the premises,
- 6) a large number of court proceedings against the franchisor,
- 7) restructuring on the part of the franchisor, especially invoices from different companies,
- 8) franchisors not receiving previously favourable trading terms due to impending insolvency, especially [difficult for] franchisees [who] are 'required to source stock or other services through their franchisor,
- 9) information in the franchisor's balance sheet, the profit and loss statement, or announcements made to the stock exchange (where the franchisor is listed) pointing to an accumulation of significant debt when the franchise system is not expanding or the writing down of assets, or refinancing activities,
- 10) information from credit reporting services about a franchisor company's financial health,
- 11) a failure on the part of the franchisor to make timely commission payments, where the franchisee is the franchisor's commission agent; ...
- 12) '[p]oor financial performance, including the accumulation of significant debt when the franchise system is not expanding, growing operating losses, the writing down of assets and re-financings'.<sup>xviii</sup>

These indicators, while apparent to the franchisor and some third parties, may not be visible to franchisees or may be explained away by the franchisor who cites other reasons.

#### *Other small businesses going through insolvency.*

- 1) Independent owners have had the opportunity to shelter their personal assets, so may not lose everything.
- 2) They are likely to be the author of their own demise, or to understand why they failed. A franchisee is likely to be collateral damage in a franchisor's failure that they had no hand in creating.
- 3) Other small businesses have a better chance than the franchisee of identifying that they are heading for failure.
- 4) Lease arrangement will be between the independent small business owner and the landlord, so they know the risk of losing their premises if their business fails, whereas franchisees with a sub-lease/ licence pay their rent and outgoings to the franchisor who pays it (or does not pay it if they are nearly broke) to the landlord. This makes the franchisee vulnerable.

- 5) Can reduce staff level to reduce their losses whereas franchisees may not be able to do so because they may have minimum staffing levels in their operating manual.
- 6) Their employees are eligible for FEG assistance once the small business owner is wound up.

In summary – please use this review to review the whole of the franchise relationship, not simply the part that is addressed by the current Code.

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<sup>i</sup> Buchan, 'Franchising: A Honey Pot in a Bear Trap' (2013) 34 (2) *Adelaide Law Review*, 283.

<sup>ii</sup> Jennifer L L Gant and Jenny Buchan 'Moral Hazard, Path Dependency and Failing Franchisors: Mitigating Franchisee Risk through Participation' (2019) 47(2) *Federal Law Review* 261. **(attached)**

<sup>iii</sup> Jenny Buchan, Franchisees as externalities of insolvent franchisors: a windfall gain for employees? in Paul Omar and Jennifer L L Gant (eds) *Research Handbook on Corporate Restructuring* (Edward Elgar, 2021) 261-277.

<sup>iv</sup> Jenny Buchan and Gehan Gunasekara, (2015) 36 *Adelaide Law Review*, 541 **(attached)**

<sup>v</sup> *Re Stay In Bed Milk & Bread Pty Ltd (In Liq)* [2019] VSC 181.

<sup>vi</sup> *Re Stay In Bed Milk & Bread Pty Ltd (In Liq)* [2019] VSC 181

<sup>vii</sup> Rob Nicholls and Jenny Buchan 'The Law of Unintended Consequences: The Effects of Voiding Ipso Facto Clauses in Business Format Franchise Agreements' (2017) 45 *Australian Business Law Review* 433.

<sup>viii</sup> Uri Benoliel and Jenny Buchan, 'Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule' (2015) 13(3) *DePaul Business & Commercial Law Journal*, 411.

<sup>ix</sup> Jenny Buchan, Lorelle Frazer, Charles Zhen Qu & Rob Nicholls (2015) Franchisor Insolvency in Australia: Profiles, Factors, and Impacts, *Journal of Marketing Channels*, 22:4, 311-332.

<https://doi.org/10.1080/1046669X.2015.1113487>

<sup>x</sup> Jenny Buchan, 'Ex ante information and ex post reality for franchisees: The case of franchisor failure' (2008) 36(6) *Australian Business Law Review* 407, citing Gehrke J, When franchisors fail (17 June 2008), <http://www.smartcompany.com.au/Blog/Jason-Gehrke/20080617-When-franchisors-fail.html> viewed 13 July 2008.

<sup>xi</sup> Buchan, 'Franchising: A Honey Pot in a Bear Trap'

<sup>xii</sup> Buchan, 'Franchising: A Honey Pot in a Bear Trap'

<sup>xiii</sup> Law Council of Australia, Business Law Section, SME Business Law Committee, submission to the Wein Review 2013, 2 – 3.

<sup>xiv</sup> Abi and Trenton Scaf, Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Franchising, submission 28.

<sup>xv</sup> Jennifer Mary Buchan, 'Franchisor Failure: An Assessment of The Adequacy of Regulatory Response'. PhD Dissertation, 2010 QUT, 269.

<sup>xvi</sup> Jenny Buchan, submission to the 2013 Wein review, p 4.

<sup>xvii</sup> Thanks to UNSW academic Dale Boccabella for his assistance with the tax analysis.

<sup>xviii</sup> Buchan, J., Qu, C., & Frazer, L. (2011, September). 'Protecting franchisees from their franchisor's impending failure: A way forward for consumer protection regulators using indicators?' In the Proceedings of the First International Conference on Comparative Law and Global Common Law "Exchange and Integration of the Contemporary Legal Systems" (pp. 24–25). Beijing, China: College of Comparative Law, China University of Political Science and Law.

## **ADMINISTRATIVE LAW PARALLELS WITH PRIVATE LAW CONCEPTS: UNCONSCIONABLE CONDUCT, GOOD FAITH AND FAIRNESS IN FRANCHISE RELATIONSHIPS**

### **ABSTRACT**

In 21<sup>st</sup> century business format franchising, the search for solutions has taken the legislature and the courts into the areas of unconscionable conduct and good faith. To date these concepts have lacked the ability to curtail franchisor opportunism in exercising contract-granted discretions. Similar difficulties afflict administrative law approaches to good faith, lawfulness and rationality, errors of law and fact finding, and fairness — criteria against which contract-based discretions have been appropriately exercised by franchisors. We examine franchising cases against the administrative law approaches, acknowledging doctrinal differences (as well as similarities) and conclude that a common body of principle underlies both areas. This allows a fresh approach to interpreting the exercise of franchisor's discretions.

### **I INTRODUCTION**

**F**ranchising is a significant aspect of Australian commercial life.<sup>1</sup> Opportunities are marketed to franchisees as if they were consumer products, but are unaccompanied by statutory warranties. Once a franchise agreement is signed and the seven-day statutory cooling off period has elapsed, the arrangement is treated as a commercial one.

In Australia, the misleading and deceptive conduct legislation provides some protection for franchisees *ex ante* from exploitative conduct by franchisors. However, the reality of relationships between franchisors and their franchisees, manifested by the sometimes strong disconnect between what was sold in an environment akin

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<sup>1</sup> See Michael T Shaper and Jenny Buchan, 'Franchising in Australia: A History' (2014) 12(4) *International Journal of Franchising Law* 3.

to that of a consumer sale (and the actual relationship) has led to calls for better protection for franchisees and their businesses *ex post*. The 1998 expansion of the unconscionable conduct provisions of the then *Trade Practices Act 1974* (Cth) ('*TPA*'), by the addition of s 51AC, may have been able to rebalance the relationship. But, as we will see, it has not been done. The search for tools to fundamentally rebalance the power dynamic between a franchisor and its franchisees continues.

Power imbalance has long been the Achilles heel of the franchise model. As a structural weakness it has the ability to make the model less attractive to franchisee investors. It remains problematic for the following reasons. The ability to draft the standard form contract enables franchisors to cast their obligations in discretionary terms, and the franchisees' role in terms of predominantly non-negotiated, iron-clad obligations. Franchisees accept that the blatantly 'unfair' aspects of their franchise agreements are necessary to enable the franchisor to bring rogue franchisees into line and thus to protect the brand, but arguably they are more often used to force franchisees to 'behave'. Richard Hooley writes of controlling contractual discretions.<sup>2</sup> He acknowledges that contracts may be incomplete and that 'an unfettered contractual discretion may not properly reflect the intention of the parties at the time of contracting'.<sup>3</sup> He also, pertinently, accepts that 'in a long-term contract that depends on co-operation between the parties, an unfettered discretion afforded to one party may undermine the economic potential of the contract'.<sup>4</sup> Intractable problems that can undermine the economic potential of the contract for the franchisee arise out of the contract-entrenched power imbalance between a franchisor and a franchisee.

There are difficulties for the law in attempting to balance the franchisor-franchisee relationship in order to mitigate the effects of asymmetries.<sup>5</sup> These are partly a consequence of seeking to impose a traditional commercial contract paradigm, based on negotiation followed by mutual consent, on a 'necessarily and intentionally incomplete'<sup>6</sup> agreement. However, regulators in many jurisdictions have nonetheless attempted to impose balance on the relationship.<sup>7</sup> This article examines two responses. They are unconscionable conduct under the *Competition and Consumer Act 2010* (Cth) ('*CCA*'), and the much mooted good faith concept.

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<sup>2</sup> Richard Hooley, 'Controlling Contractual Discretion' (2013) 72 *Cambridge Law Journal* 65.

<sup>3</sup> Ibid 67.

<sup>4</sup> Ibid 68. See also H Collins, 'Discretionary Powers in Contracts' in David Campbell, Hugh Collins and John Wightman (eds) *Implicit Dimensions of Contracts, Discrete, Relational and Network Contracts* (Oxford, 2003) 231.

<sup>5</sup> Jenny Buchan, 'Ex Ante Information and Ex Post Reality for Franchisees: the Case of Franchisor Failure' (2008) 36 *Australian Business Law Review* 407.

<sup>6</sup> Gillian K Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927.

<sup>7</sup> See Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar 2011) 118–19. Table 4.1 identifies examples of legislation designed to variously 'guarantee non-discriminatory treatment for all franchisees of the same franchisor' (Mexico), remedying information disparity and power imbalance (USA).

Australia's Commonwealth consumer protection legislation was amended in 1998 in statutory recognition that small businesses could be treated unconscionably within the context of a commercial relationship.<sup>8</sup> Eighteen years of the possibility of a statutory unconscionable conduct action have, however, failed to reduce franchisor over-reaching. Concerns continue to be raised in relation to the asymmetrical elements of franchising,<sup>9</sup> and are also evidenced by the conduct of several governmental and parliamentary inquiries at both federal and state level.<sup>10</sup>

The adoption of standard form contracts by franchisors is unavoidable. In Australia, the average ratio of franchisors to franchisees is 1:60. It is unrealistic to expect a franchisor to negotiate a bespoke contract with each franchisee. Doing so would result in inefficiency. A further difficulty in franchising is that both contracting parties (franchisor and franchisee) have multiple legal relationships. These additional contractual and statutory relationships potentially place any of the parties in a situation of conflict vis-a-vis their obligations under the franchise contract. It may not, for example, be possible to respect the contract-based expectation of one's counterparty to a franchise agreement whilst also adhering to statutory duties to one's shareholders. It is timely to consider whether a different approach to measuring fairness in franchise relationships is required.

Despite the dissenting judgment of Kirby J in *NEAT Domestic Trading Pty Ltd v AWB Ltd*,<sup>11</sup> the majority of the Australian High Court left open the question of whether administrative law remedies were available against a private entity. Both

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<sup>8</sup> CCA sch 3 s 22 (formerly TPA s 51AC).

<sup>9</sup> See, eg, Albert H Choi and George G Triantis, 'The Effect of Bargaining Power on Contract Design' 98(8) (2012) *Virginia Law Review* 1665. See also Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer, 2013) 84-95.

<sup>10</sup> Franchising Code Review Committee, *Review of the Disclosure Provisions of the Franchising Code of Conduct: Report to Hon Fran Bailey MP: Minister for Small Business and Tourism* (2006) ('Matthews Report'); Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Inquiry Into the Franchising Code of Conduct* (2008) ('Cth Inquiry') resulting in Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Opportunity Not Opportunism: Improving Conduct in Australian Franchising* (2008) ('Opportunity not Opportunism Report'); Small Business Development Corporation, Parliament of Western Australia, *Inquiry into the Operation of Franchise Businesses in Western Australia: Report to the Western Australian Minister for Small Business* (2008) ('WA Inquiry'); Economic and Finance Committee, Parliament of South Australia, *Franchises* (2008) ('SA Inquiry') and Alan Wein, Submission to Minister for Small Business and Parliamentary Secretary for Small Business, *Review of the Franchising Code of Conduct*, 30 April 2013 ('Wein Review').

<sup>11</sup> 216 CLR 277, 300 [67] (Kirby J) questioning 'whether, in the performance of a function provided to it by federal legislation, a private corporation is accountable according to the norms and values of public law or is cut adrift from such mechanisms of accountability and is answerable only to its shareholders and to the requirements of corporations law or like rules'.



laws against unconscionable conduct and the developing doctrine of good faith have struggled when faced with the exercise of franchisor discretion; they are applied purely by reference to private law principles. Our thesis is that, by adapting the principles underlying administrative law to the consideration of whether a franchisor has exercised a contractual discretion appropriately, greater clarity can be brought to the assessment of whether a contract-granted discretion has been exercised in 'good faith' and fairly.

Many of the dilemmas faced in administrative law are also found within the ambit of private law. Unit franchise agreements, being standard form, executory, relational contracts that confer broad discretionary powers and few explicit obligations on franchisors, are one example. Administrative law has long possessed tools empowering the review of discretionary decision-making by public authorities. Reference to these approaches could guide franchisors, and enable judges and regulators alike, to formulate appropriate responses to problems arising out of franchise relationships.

This article is in seven parts, the first being this introduction. In the next we consider 21<sup>st</sup> century franchising, franchise agreements and the triggers for disputes that are resolved in court. We also identify the similarities that exist between the exercise of the franchisor's power and the officials exercising discretion. Part III addresses the current solution of statutory unconscionable conduct and common law good faith, and the new statutory duty of good faith. Part IV examines the administrative law jurisprudence surrounding good faith, lawfulness and rationality, errors of law and fact finding, and fairness. This is done against the possibility that the approach might be used to refine the private law concept of good faith in franchising. In Part V we observe that the solutions reached by judges applying a mix of statutory and common law rules to restrain the abuse of contractual discretions by franchisors, already draw on the framework of administrative law jurisprudence in ascertaining the presence of good faith. Doctrinal issues must be addressed and we do so in Part VI. Part VII is the conclusion.

## II 21<sup>ST</sup> CENTURY FRANCHISING

The economic reasons for the success of business format franchising are well understood.<sup>12</sup> The franchisee's capital and local knowledge is combined with the franchisor's know-how and brand reputation. The economies of collective purchasing power are harnessed. As a result, the franchisee should 'hit the ground running' rather than risking the pitfalls a nascent stand-alone business may experience.

The success of franchising has largely been founded on its flexibility and ability to deal with fast-changing market conditions. The franchisor necessarily retains the freedom to make changes to the system to enable it to respond to market conditions

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<sup>12</sup> Economists are, however, yet to include the cost of franchisor insolvency in the model. It remains an externality whose inclusion could challenge the rarely questioned popular notion of the success of the franchise model.



and remain competitive. To term franchise contracts ‘agreements’ is almost a misnomer. They are incomplete, drafted to protect the franchisor’s interests as well as to embed a power and risk imbalance that favours the franchisor.<sup>13</sup> The long duration of franchise agreements,<sup>14</sup> and the franchisees’ often large sunk investments, mean franchisees are vulnerable to opportunistic behaviour by franchisors. The nature of the grant enjoyed by the franchisee towards the end of its term consequently may bear little resemblance to that at the outset.

Disputes between franchisors and franchisees are of two main types. Firstly, there is a tendency by franchisors to oversell the franchise, the franchisor’s experience, ability to support its franchisees or its solvency, thus potentially misrepresenting the true nature of what the franchisee is purchasing.<sup>15</sup> This may lead to an action under s 18(1) of the *CCA*.<sup>16</sup> Secondly, and more relevant to the present discussion, are disputes based on performance of the franchise agreement. It is difficult for franchisees to successfully argue that their franchisor has breached a contract that imposes discretionary obligations that are few and vague. For example Hadfield notes that

the franchisee paid fees for a service that the service-provider retained full discretion to define in content and duration. ... the contract frames franchisor obligations in terms such as ‘reasonable’, ‘periodic’, and ‘from time to time’. The franchisor had no contractual duty to employ prudence or consideration in the making of decisions that directly affect the profitability of the franchisee.<sup>17</sup>

Indeed, Elizabeth Spencer states that ‘[c]lauses drafted to ensure discretion to a franchisor, leaving franchisees in a position of uncertainty and increased risk, are ubiquitous in franchising contracts.’<sup>18</sup> As a consequence, they create ‘little in the

<sup>13</sup> Buchan, above n 5. See also Elizabeth C Spencer, ‘Consequences of the Interaction of Standard Form and Relational Contracting in Franchising’ (2009) 29 *Franchise Law Journal* 31.

<sup>14</sup> The average length of a franchise agreement in Australia is five years but some franchisors grant licences and master licences for 25 years and some for an indefinite period. For details, see Lorelle Frazer, Scott Weaven and Kelli Bodey, *Franchising Australia 2012* (Griffith University, 2012) 35.

<sup>15</sup> See, eg, *Carlton v Pix Print Pty Ltd* [2000] FCA 337 (22 March 2000) where the franchisor misrepresented to the applicant master franchisee that the Pix Print business was successful and expanding in breach of s 52 of the *TPA*. See also *Billy Baxters (Franchising) Pty Ltd v Trans-It Freighters Pty Ltd* [2009] VSC 207 where the franchisee unsuccessfully claimed franchisor (Billy Baxter’s) had misled it about possible turnover. On appeal the Victorian Supreme Court in *Trans-It Freighters Pty Ltd v Billy Baxters (Franchising) Pty Ltd* [2012] VSCA 71 (20 April 2012) (Bongiorno and Hansen JJA and Kyrou AJA) unanimously reversed the decision.

<sup>16</sup> Formerly s 52 *TPA*.

<sup>17</sup> Hadfield, above n 6, 945-946.

<sup>18</sup> Elizabeth Spencer, ‘Consequences of the Interaction of Standard Form and Relational Contracting in Franchising’ in Elizabeth C Spencer (ed), *Relational Rights and Responsibilities: Perspectives on Contractual Arrangements in Franchising* (Bond University Press, 2011) 47, 57.

way of real obligation on the part of a franchisor and no contractual right in a franchisee.’<sup>19</sup> A further corollary is that although ‘[r]elational contracts accommodate uncertainty by leaving terms unspecified and providing high levels of discretion, ... [they] often fail to provide clear and specific answers in case of dispute’.<sup>20</sup> The courts, through recourse to doctrines such as good faith, and the legislature, through statutory remedies such as unconscionability, have applied solutions to accommodate such uncertainties that in many respects resemble the criteria for reviewing administrative action. We suggest the next step for regulators and courts is to look actively at how administrative law addresses disputes that originate from the exercise of discretion.

### *A Parallels between Franchise Networks and Public Bureaucracies*

It has been said in relation to the values underpinning administrative law that

[t]here seem to be few, if any, aspects of economic activity in contemporary society that are not supervised by some kind of statutory [ie without an element of choice] regulator with *powers to grant, withhold, suspend or cancel licences to engage in such activity and to approve or withhold approval for particular transactions*.<sup>21</sup>

Here the parallel with franchising is striking, as the emphasised words describe the powers franchisors possess to grant a franchise. And having done so, to amend the grant, revoke it, provide assistance to or sanction myriad transactions by their franchisees (such as purchasing stock from a third party or providing the franchise agreement as security for a loan). A franchise agreement and its accompanying documents create an environment of private regulation with the franchisor acting as both regulator and arbiter. Spencer argues that ‘discretion facilitates action on improper considerations, and permits the substitution of subjective, personal standards for agreed-upon ones’.<sup>22</sup> Uncertainty results from the current environment. For example, whilst the issues in *Automasters Australia Pty Ltd v Bruness Pty Ltd* were considered in the context of an express term of ‘absolute good faith’,<sup>23</sup> contained in cl 15 of the Automasters franchise agreement, this standard was diluted by the franchisor being obliged to do no more than ‘use its best endeavours to promote the performance and success of the franchise business’.<sup>24</sup>

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<sup>19</sup> Ibid.

<sup>20</sup> Ibid 54.

<sup>21</sup> Chief Justice Robert French, ‘Administrative Law in Australia: Themes and Values’ in Matthew Groves and H P Lee (eds) *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007) 15, 15 (emphasis added).

<sup>22</sup> Spencer, above n 18, 56.

<sup>23</sup> *Automasters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286 (4 December 2002) [14] (*‘Automasters’*).

<sup>24</sup> Ibid.

We contend that objective standards of fairness and reasonableness now exist in Australian administrative law<sup>25</sup> — unlike perhaps in the United Kingdom — and that the developing doctrine of good faith in Australia replicates essentially the same standard. This article evaluates the validity of this proposition by examining its application to franchisor-franchisee relationships. Before exploring the approaches within administrative law, we will examine two current private law tools: unconscionability and good faith.

### III THE SEARCH FOR SOLUTIONS

In a celebrated passage, Paul Finn (formerly a judge of the Federal Court of Australia) hints at the existence of a spectrum from self-interested behaviour (which nonetheless disallows exploitative conduct) to good faith and finally completely selfless behaviour encompassed by the fiduciary standard.<sup>26</sup> Andrew Terry and Cary Di Lernia observe that ‘clear dividing lines between concepts along that continuum are seldom provided’.<sup>27</sup> Nevertheless, several doctrinal tools have been employed or proposed to deal with the continuum in the context of franchise relationships. Here we consider two of these: the extant unconscionable conduct and current common law, and the new statutory duty of good faith.

#### *A Unconscionable Conduct*

Unconscionable practices by franchisors were first brought to the attention of Australia’s federal government in the 1976 ‘*Swanson Report*’.<sup>28</sup> These practices were cast as being ‘unfair or deceptive acts or practices’.<sup>29</sup> The Swanson Committee shied away from the notion of sanctioning unfair conduct because of the potential for the word ‘unfair’ to introduce uncertainty into commercial transactions. Peter Reith introduced a package of reviews in 1997 called ‘New Deal: Fair Deal — Giving Small Business a Fair Go’. By mid-1998 the *TPA* had been amended by the addition of s 51AC,<sup>30</sup> which prohibited unconscionable conduct in business-to-business transactions and the enactment of the mandatory *Trade Practices (Industry Codes – Franchising) Regulations 1998* (Cth) (‘*Code*’). Interestingly, as

<sup>25</sup> *Minister for Immigration and Citizenship v Li* (2013) 249 CLR 332, 337–52 (French CJ).

<sup>26</sup> Paul D Finn, ‘The Fiduciary Principle’ in T G Youdan (ed) *Equity, Fiduciaries and Trusts* (Carswell, 1989) 1, 4.

<sup>27</sup> Andrew Terry and Cary Di Lernia, ‘Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?’ (2009) 33 *Melbourne University Law Review* 542, 555.

<sup>28</sup> Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs* (Australian Government Publishing Service, 1976) (‘*Swanson Report*’).

<sup>29</sup> *Ibid* 66.

<sup>30</sup> Now *CCA* sch 2 s 22.

deduced from the ‘fair go’ wording of the 1997 review, the concept of ‘fairness’ was the topic of the debate. At the 11<sup>th</sup> hour it was decided to use the expression ‘unconscionable conduct’ rather than ‘fairness’ in the new legislation in order to

build on the existing body of case law which [was seen to have] worked with respect to consumer protection provisions of the [TPA] and which [it was thought] will provide greater certainty to small businesses in assessing their legal rights and remedies.<sup>31</sup>

Whether conduct was unconscionable was to be ‘determined by examining all the circumstances of the case’<sup>32</sup> with regard to listed non-exclusive, discretionary, cumulative criteria.<sup>33</sup> The franchisees’ sunk investment could arguably be taken into consideration as an aspect of measuring the extent to which the supplier (franchisor) acted in good faith under sch 2 s 22(1)(l) of the CCA when evaluating the unconscionability of a franchisor’s conduct. Nevertheless, this aspect of a franchisee’s vulnerability has yet to be considered.

However, uncertainty about the scope and application of the unconscionable conduct standard has continued, as evidenced by the seven government franchising and unconscionable conduct inquiries since 1998.<sup>34</sup> The Senate Standing Committee on Economics in December 2008 conducted a review on ‘[t]he need, scope and content of a definition of unconscionable conduct for the purposes of Part IVA of the [TPA]’. Notably, it was loath to attribute the fact that ‘there [had] only been two successful findings under section 51AC over the past decade’<sup>35</sup> to any overall improvement in conduct of businesses. It attributed the low number of successful prosecutions to the courts’ narrow interpretation of s 51AC. Because the legislative prohibition of unconscionable conduct in business transactions is not limited to the traditional equitable categories of special disadvantage, ‘the courts have come to different understandings of what constitutes “unconscionability”’.<sup>36</sup> The difficulties are, as Terry and Di Lernia maintain, compounded by the inclusion of the extent to which the parties acted in good faith as one of the criteria for determining whether unconscionable conduct has taken place. Since Terry and Di Lernia’s 2009 observations, s 21 of sch 2 (the unconscionable conduct provision of the CCA) replaced s 51AC of the TPA. In the new section, the definition of a ‘business consumer’ (found in the old s 51AC of the TPA) became the definition of a ‘customer’ (per the new s 22 of sch 2

<sup>31</sup> Commonwealth, *Parliamentary Debates*, House of Representatives, 30 September 1997, 8767 (Peter Reith).

<sup>32</sup> Explanatory Memorandum, Trade Practices Amendment (Fair Trading) Bill 1997 (Cth) 1.

<sup>33</sup> See *Australian Consumer Law* sch 2 n 22(1)(a)–(k) and sch 2 s 22 (2)(a)–(k).

<sup>34</sup> See *Matthews Report*, *WA Inquiry*, *SA Inquiry*, *Cth Inquiry* and *Wein Review*. See also Senate Standing Committee on Economics, Parliament of Australia, *The Need, Scope and Content of a Definition of Unconscionable Conduct for the Purposes of Part IVA of the Trade Practices Act 1974* (2008).

<sup>35</sup> Ibid 31.

<sup>36</sup> Terry and Di Lernia, above n 27, 555.

of the *CCA*). A new concept applicable to unconscionable conduct was included in s 21(4) stating that:

...

- (b) this section is capable of applying to a system of conduct or pattern of behaviour, whether or not a particular individual is identified as having been disadvantaged by the conduct or behaviour; and
  - (c) in considering whether conduct to which a contract relates is unconscionable, a court's consideration of the contract may include consideration of:
    - (i) the terms of the contract; and
    - (ii) the manner in which and the extent to which the contract is carried out;
- and is not limited to consideration of the circumstances relating to formation of the contract.

It is too early to conclude whether the 'system' or 'pattern' envisaged in s 21(4)(b) will be interpreted to encompass franchise-wide systems or patterns, or whether it will be interpreted as system or pattern of unconscionable conduct within the performance of an individual contractual relationship. Notably, the 'good faith' criterion has been retained in the *CCA* list of factors that can indicate the presence or absence of unconscionable conduct.

Elisabeth Peden warns that the pre-occupation with developing a doctrine of good faith in Australia (which is discussed further below) has had perverse effects in encroaching on and distorting existing unconscionability doctrines as well as diminishing contractual certainty, stating that:

it seems that with the recent decisions on good faith, the judges are moving closer to the position where they will interfere with the exercise of rights or powers because of unreasonableness, rendering unconscionability unnecessary ... this current position is robbing contract law of certainty in relation to what restrictions a court might impose on contracting parties seeking to exercise rights.<sup>37</sup>

It is in order to address these uncertainties that we examine the principles underlying control of administrative power. It will be seen that similar difficulties afflict administrative law, in particular the criticism made by scholars that reasonableness review lacks certainty and transparency.<sup>38</sup> Despite these obstacles, we argue that administrative law principles provide a framework as to how contractual provisions of uncertain ambit are *applied* — something traditional doctrines such as unconscionability struggle with — and ought therefore not to be disregarded too readily.

<sup>37</sup> Elisabeth Peden, 'When Common Law Trumps Equity' (2005) 21 *Journal of Contract Law* 226, 249.

<sup>38</sup> Jonathan Morgan, 'Against Judicial Review of Discretionary Contractual Powers' [2008] *Lloyd's Maritime and Commercial Law Quarterly* 230, 231.

*B Good Faith*

Much ink has been spilt by Australian jurists and commentators in examining the role that the doctrine of good faith plays in contract generally,<sup>39</sup> and in the context of franchising specifically.<sup>40</sup> The failure to achieve greater symmetry in the franchisor-franchisee relationship has led to calls by some<sup>41</sup> for an explicit enactment of a duty of good faith into franchise agreements as a panacea to the power imbalance. Good faith as a solution has also been criticised as Australia does not possess a settled jurisprudence in relation to the doctrine.<sup>42</sup> The imposition of an implied term of good faith has been cast as a ‘backward step’.<sup>43</sup> In the United States, the content and meaning of the previously settled concept of good faith is being questioned.<sup>44</sup> In the following sections we will venture some observations on this point.

*1 Good Faith at Common Law*

Our discussion primarily relates to franchise agreements. In the seminal non-franchise case of *Renard Constructions (ME) Pty Ltd v Minister for Public*

<sup>39</sup> See generally cases listed in Terry and Di Lernia, above n 27, 546–8. See also Bill Dixon, ‘Common Law Obligations of Good Faith in Australian Commercial Contracts — A Relational Recipe’ (2005) 33 *Australian Business Law Review* 87; Elisabeth Peden, ‘Implicit Good Faith — or Do We Still Need an Implied Term of Good Faith?’ (2009) 25 *Journal of Contract Law* 50; and Suzanne Corcoran, ‘Good Faith as a Principle of Interpretation: What is the Positive Content of Good Faith?’ (2012) 36 *Australian Bar Review* 1.

<sup>40</sup> See, eg, *Burger King Corporation v Hungry Jack’s Pty Ltd* (2001) 69 NSWLR 558 (‘*Burger King*’) and *Far Horizons Pty Ltd v McDonalds Australia Ltd* [2000] VSC 310 (18 August 2000) (‘*Far Horizons*’).

<sup>41</sup> Elizabeth Crawford Spencer, Submission No 39 to Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Franchising Code of Conduct*, 1 January 2008, 34–5; *SA Inquiry*, above n 10, 56–9, citing Frank Zumbo, Submission No 43 to the Economic and Finance Committee, *Franchises*, 3 March 2008. See also Philip Coleman, Submission No 16 to Government of Department of Industry, Innovation, Science, Research and Tertiary Education, *Review of the Franchising Code of Conduct 2013*, 12 February 2013, 5–7 and Elizabeth Spencer and Simon Young, Submission No 25 to Department of Industry, Innovation, Science, Research and Tertiary Education, *Review of the Franchising Code of Conduct 2013*, 14 February 2013.

<sup>42</sup> Terry and Di Lernia, above n 27, 542 and *SA Inquiry*, above n 10, 56–7, citing Franchise Council of Australia, Submission No 17 to the Economic and Finance Committee, *Franchises*, 21 January 2008.

<sup>43</sup> Peden, above n 39, 53.

<sup>44</sup> See Howard O Hunter, ‘The Growing Uncertainty about Good Faith in American Contract Law’ (2004) 20 *Journal of Contract Law* 50 for a discussion of the range of interpretations of the concept of good faith that US courts are adopting in relation to the concept of good faith in contracts. See also Corcoran, above n 39, 6.



*Works*,<sup>45</sup> the majority of the New South Wales Court of Appeal found an implied term that the principal had to act in good faith and reasonably. However, Meagher JA in the minority found a more straightforward basis for the ruling namely: that the non-compliance by the principal with an express term of the contract could be taken to require the principal to act on accurate information when forming a view as to whether the contractor had shown cause for the principal to cancel the contract.<sup>46</sup>

To Suzanne Corcoran good faith is conduct that is appropriate; '[t]o be appropriate the result must not be absurd and should also be fair and balanced in the circumstances'.<sup>47</sup> Her comments relate to the interpretation of contracts that may 'involve determining what the parties would credibly have agreed upon had they turned their minds to the question'.<sup>48</sup> To this point the analysis does not do franchise contracts, or other voluntarily executed, but non-negotiated, relational, commercial contracts, any disservice. But, as Corcoran continues, 'the principle of good faith is a guide to judging what can credibly be advanced as to a permissible motivation'.<sup>49</sup> We will see in Part III B (3) an example of a permissible motivation for one party being far outside the contemplation of the other.

Difficulties exist in attempting to introduce the concept of good faith into contractual relationships. First, the actual *mechanism* for introducing the duty must be settled; and secondly, the *content* of the duty must be defined.

In relation to mechanism, Bill Dixon identifies two 'quite disparate' approaches by courts: terms that reflect the presumed intention of the parties (that are dependent on the circumstances of each case) and terms based on imputed intention; that is, implied

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<sup>45</sup> (1992) 26 NSWLR 234; see also the summary of the long-running *Renard* saga in John Ingold, 'The Renard Saga — The High Court Refuses Leave to Appeal' (1993) 28 *Australian Construction Law Newsletter* 70, 70–1, where Ingold notes:

The Minister had improperly exercised the power to terminate the contractor's employment under cl 44.1, thereby repudiating the contract. Priestley and Handley JJA thought that the principal had to act reasonably under cl 44.1, both when considering the cause shown by the contractor and then, at the next stage, when considering whether to exercise the power to take over the works or cancel the contract. In this case, the Minister had not acted reasonably. Meagher JA thought that there was no requirement that the principal act under cl 44.1 in an objectively reasonable manner. However, he thought that the principal could not be "satisfied" within the meaning of cl 44.1 if he did not comprehend the factual background on which satisfaction is required. Here, the principal's mind was "so distorted by prejudice and misinformation that he was unable to comprehend the facts in respect of which he had to pass judgment". Meagher JA thus came to the same result as the majority, that there had been an invalid exercise of the power under cl 44.1 and that the Minister had thereby repudiated the contract.

<sup>46</sup> *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, 276.

<sup>47</sup> Corcoran, above n 39, 8.

<sup>48</sup> *Ibid* 8.

<sup>49</sup> *Ibid*.

by law as a legal incident of a particular class of contract.<sup>50</sup> The need in the first approach to satisfy the five criteria in *BP Refinery (Westernport) Pty Ltd v President, Councillors and Ratepayers of the Shire of Hastings*<sup>51</sup> ensures this high hurdle will be unlikely to be cleared where the contract has ‘efficacy’ without implying good faith. Further, in relation to any specific action it is likely that a franchisor and its franchisees have differing presumed intentions.

The second approach must also satisfy two requirements; an identifiable class of relationships and necessity. In terms of the present discussion, it has been judicially observed that ‘the classes of contracts in which the law will imply terms are not closed’.<sup>52</sup> It is not therefore farfetched to suggest that contracts that confer significant powers and discretions on the party drafting the contract, but not on the other, constitute such a class. The second requirement is ‘necessity’.<sup>53</sup> It must be established that ‘[u]nless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless or perhaps be seriously undermined’.<sup>54</sup> However, Dixon suggests that wider considerations of policy have also been used to support the implication of contractual terms as a matter of law.<sup>55</sup> In the franchising context these might include (a) the vulnerability of a class such as franchisees, (b) the standard form nature of agreements and (c) the need to protect franchisees from discriminatory treatment. These considerations would be balanced against the interests of the franchisees in having the integrity of the franchise system maintained by the franchisor. Similar policy considerations inform decision-makers in the public sphere.

Besides disapproving of such a wider ground, Dixon is critical of the manner in which courts in Australia have played fast and loose with the grounds for implying good faith as an obligation in contracts. He notes that consideration of the class of contract attracting the obligation and the necessity test are often ignored.<sup>56</sup> In addition, he states that the use of vulnerability as a test ‘raises doctrinal issues of ...

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<sup>50</sup> Bill Dixon, ‘Good Faith in Contractual Performance and Enforcement — Australian Doctrinal Hurdles’ (2011) 39 *Australian Business Law Review* 227, 233.

<sup>51</sup> (1977) 180 CLR 266, 283. These are listed by Lord Simon of Glaisdale as:

(1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that ‘it goes without saying’; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.

<sup>52</sup> *Castlemaine Tooheys Ltd v Carlton & United Breweries Ltd* (1987) 10 NSWLR 468, 487 (Hope JA).

<sup>53</sup> Dixon, above n 50, 234.

<sup>54</sup> *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410, 450. See also *Liverpool City Council v Irwin* [1977] AC 239.

<sup>55</sup> Dixon, above n 50, 234. See also *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151, 194–5.

<sup>56</sup> Dixon, above n 50, 238.



the interplay between common law and equitable remedies'.<sup>57</sup> Dixon's objections have less cogency if the outcomes are seen as applications of fundamental principles, such as the administrative law based duty to act rationally. For example, *Vodafone Pacific Ltd v Mobile Innovations Ltd*<sup>58</sup> might better be seen as a case involving abuse of or failure to exercise a particular discretion rather than the more strained finding of breach of an implied term to act in good faith.

The second difficulty identified by Dixon, Peden and other commentators is the content of the duty of good faith where it does exist:

'[w]e caution anyone who is confident about the meaning of good faith to reconsider', write two leading American scholars, White and Summers ... So far the courts have not offered much by way of explanation of the content of the implied term of good faith, other than emphasising that it requires contracting parties to act reasonably, at least when exercising express rights and discretions. Although there are many recent cases in which judges have expressed the requirement of good faith in terms of 'reasonableness', the concept of good faith is still not unambiguous.<sup>59</sup>

In particular, there appears to have been a "blurring" between the different standards of reasonableness, unconscionability and good faith'.<sup>60</sup> Many instances involving unconscionability in fact concern the exercise of contractual powers and discretions. The discussion that follows will also demonstrate that cases involving the alleged failure to act in good faith in franchising relationships also concerned the exercise of contractual powers and discretions. These common features hint at fundamental underlying behaviour — in the form of use of discretionary powers in a way that neither the weaker party nor the drafter originally intended — that also exists in the administrative law arena.

The administrative law framework exhibits many characteristics of these contractual doctrines. However, it contains both procedural requirements, as to fairness, as well as substantive requirements of honesty and rationality which are explored in Part IV. The utility of these doctrines for the exercise of contractual powers and discretions by franchisors in particular is examined in Part V.

## 2 *Legislative Definition of Good Faith*

Witnesses before several inquiries into franchising in Australia have opposed the introduction of an explicit defined duty of good faith<sup>61</sup> being adopted thus

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<sup>57</sup> Ibid 241.

<sup>58</sup> [2004] NSWCA 15 (20 February 2004).

<sup>59</sup> Peden, above n 37, 234 (citations omitted).

<sup>60</sup> Ibid 245.

<sup>61</sup> The ACCC is opposed to imposing a general obligation to act in good faith via the *Code* for three reasons: (1) The potential impact on the operation of the *Code* and the work of the ACCC; (2) The degree of uncertainty about the interpretation that may

far.<sup>62</sup> As a concession to the repeated calls for implementation of a specific good faith requirement, the *Code* was amended in 2010 by the introduction of cl 23A, which states: '[n]othing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith.'<sup>63</sup>

It 'preserves and recognises any developments in the case law on the concept of "good faith"'.<sup>64</sup> The reasons given for the then rejection of a more explicit standard in the *Code* are instructive. Whereas it was regarded as desirable to insert a set of statutory examples of 'unconscionable conduct', this was not thought possible 'with a concept like "good faith" ... which is an overarching principle guiding how parties *should* behave to each other'.<sup>65</sup> Another reason, articulated by Bryan Horrigan, was that apart from in New South Wales, the doctrine of good faith has not found general recognition throughout Australia.<sup>66</sup> Indeed Horrigan argued that there needed to be a more developed body of law on which a statutory definition could draw before a definition was viable, and that to attempt a definition before this would add uncertainty.<sup>67</sup>

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create ambiguity and confusion and increase conflict, and (3) The fact that nothing currently prevents parties from contractually agreeing to act in good faith: Australian Competition and Consumer Commission, Submission No 60 to the Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Franchising Code of Conduct*, September 2008, 19.

<sup>62</sup> See, eg, *Matthews Report*, above n 10, 13 where recommendation 25 states: 'A statement obligating franchisors, franchisees and prospective franchisees to act towards each other fairly and in good faith be developed for inclusion in Part 1 of the Code'. Two years later, the *Opportunity not Opportunism Report* recommended that a clause be inserted into the *Code* prescribing a good faith Standard of Conduct for franchisors, franchisees and prospective franchisees in 'relation to all aspects of a franchise agreement': at 115. It should also be noted that the Franchise Agreements Bill 2011 (WA) incorporating good faith before the Western Australian legislature was only defeated by one vote. Section 11 would have defined the duty to act in good faith as to the duty to 'act fairly, honestly, reasonably and cooperatively.' Section 2 would have required parties to a WA franchise agreement to act in good faith:

...

- (a) in any dealing or negotiation in connection with —
  - (i) entering into or renewing the agreement; or
  - (ii) the agreement; or
  - (iii) resolving, or attempting to resolve, a dispute relating to the agreement; and
- (b) when acting under the agreement.

<sup>63</sup> Introduced by *Trade Practices (Industry Codes — Franchising) Amendment Regulations 2010 (No 1)* (Cth).

<sup>64</sup> Explanatory Statement, Select Legislative Instrument 2010, No 125 (Cth) 5.

<sup>65</sup> Senate Standing Committee on Economics, above n 34, 40 [5.42] (emphasis in original).

<sup>66</sup> *Ibid.*

<sup>67</sup> *Ibid* 40 [5.43].

These objections make the proposed approach advanced in Part V of this article more pertinent. It provides not merely a stopgap solution to the deficits identified above, but principles against which to evaluate conduct as being ‘in good faith’ and ‘fair’.

### 3 *Good Faith following the 2013 Government Review*

In 2013, the Australian government commissioned another review of the *Code*.<sup>68</sup> Despite concerns over ‘good faith’, the 2013 reviewer recommended the introduction of an express obligation to act in good faith into the *Code*.<sup>69</sup> This recommendation was adopted and implemented in 2014 to replace the 1998 *Code*. The 2014 *Code* now provides:

#### 6 Obligation to act in good faith

##### *Obligation to act in good faith*

- (1) Each party to a franchise agreement must act towards another party with good faith, within the meaning of the unwritten law from time to time, in respect of any matter arising under or in relation to:
  - (a) the agreement; and
  - (b) this code.

This is the ***obligation to act in good faith***.

Civil penalty:                      300 penalty units.

- (2) The obligation to act in good faith also applies to a person who proposes to become a party to a franchise agreement in respect of:
  - (a) any dealing or dispute relating to the proposed agreement; and
  - (b) the negotiation of the proposed agreement; and
  - (c) this code.

##### *Matters to which a court may have regard*

- (3) Without limiting the matters to which a court may have regard for the purpose of determining whether a party to a franchise agreement has contravened subclause (1), the court may have regard to:
  - (a) whether the party acted honestly and not arbitrarily; and
  - (b) whether the party cooperated to achieve the purposes of the agreement.

##### *Franchise agreement cannot limit or exclude the obligation*

- (4) A franchise agreement must not contain a clause that limits or excludes the obligation to act in good faith, and if it does, the clause is of no effect.
- (5) A franchise agreement may not limit or exclude the obligation to act in good faith by applying, adopting or incorporating, with or without modification, the

<sup>68</sup> *Trade Practices (Industry Codes — Franchising) Regulations 1998* (Cth) (‘Code’).

<sup>69</sup> *Wein Review*, above n 10, x–xi.

words of another document, as in force at a particular time or as in force from time to time, in the agreement.

*Other actions may be taken consistently with the obligation*

- (6) To avoid doubt, the obligation to act in good faith does not prevent a party to a franchise agreement, or a person who proposes to become such a party, from acting in his, her or its legitimate commercial interests.
- (7) If a franchise agreement does not:
  - (a) give the franchisee an option to renew the agreement; or
  - (b) allow the franchisee to extend the agreement;

this does not mean that the franchisor has not acted in good faith in negotiating' or giving effect to the agreement.<sup>70</sup>

Clause 6 applies to 'parties to a franchise agreement'. It would afford franchisees no protection from decisions made by an ultimate owner of the franchise network. Significantly, many franchisors become insolvent.<sup>71</sup> Therefore, in the context of insolvency cl 6 is problematic. An administrator is an agent of the insolvent party.<sup>72</sup> The duty to act in good faith would be extended to an administrator of the franchisor or franchisee in any matter relating to the franchise agreement. An administrator has, however, an overriding duty under the *Corporations Act 2001* (Cth) to 'assist the creditors in recovering'<sup>73</sup> moneys owed to them. Clause 6(2) would give the counterparties of the insolvent party an entirely wrong expectation about the duty the administrator owed them.

This takes us to cl 6(6). It is hard to see how a franchisor would do anything other than prioritise its own interests ahead of the franchisees' interests if it could meet the good faith standard by acting purely in its own commercial interests. Clause 6(6) would not, for example, change the outcome for the franchisee in *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd*<sup>74</sup> where the franchisor was pursuing legitimate commercial objectives. A by-product of the franchisor's decision to exit the franchise model was that the franchisee lost the right to sell insurance products that accounted for 80 per cent of its revenue.<sup>75</sup> This rendered the franchisee business unviable. This would have been acceptable under cl 6(6). One can only speculate on the consequences of McDonald's telling its franchisees they could now sell everything except burgers, fries and Happy Meals®.

<sup>70</sup> *Competition and Consumer (Industry Codes — Franchising) Regulation 2014* (Cth) sch 1 div 3, cl 6.

<sup>71</sup> Buchan, above n 9, 115–17.

<sup>72</sup> *Corporations Act 2001* (Cth) s 437B.

<sup>73</sup> Christopher Symes and John Dunns, *Australian Insolvency Law* (LexisNexis Butterworths, 2009) 240.

<sup>74</sup> [2006] VSC 223 (21 June 2006).

<sup>75</sup> *Ibid* [6].

It is submitted that in light of the above, neither good faith, as an evolving common law standard, nor good faith in cl 6, can satisfactorily address the *ex post* legitimate expectations of franchisees. American commentator Howard Hunter put his finger on the problem when he observed that '[t]he substance of good faith derives from the expectations of the parties as expressed in the agreement itself, and so the scope of what is meant by good faith will change from agreement to agreement and party to party'.<sup>76</sup>

An assessment of good faith in the performance of a franchise agreement, based on the flawed premise that both parties contributed to the content of the franchise agreement, is doomed. Further, not only does the notion change from agreement to agreement, but also from context to context.

### *C Influence of Statutes on Common Law*

A fruitful line of inquiry relevant to the present article, but beyond its immediate scope, is the influence of statutory principles or the policies underlying statutes on the development of common law principles. The concept was explained by Lord Diplock in *Erven Warnink BV v J Townend & Sons (Hull) Ltd* as follows:

Where over a period of years there can be discerned a steady trend in legislation which reflects the view of successive Parliaments as to what the public interest demands in a particular field of law, development of the common law in that part of the same field which has been left to it ought to proceed upon a parallel rather than a diverging course.<sup>77</sup>

Professor Atiyah has questioned whether the courts may 'justify jettisoning obsolete cases, not because they have been actually reversed by some statutory provision, but because a statute suggests that they are based on outdated values?'<sup>78</sup>

The question has been answered affirmatively in New Zealand<sup>79</sup> and in the United States.<sup>80</sup> However, two important qualifications to the doctrine were stated by the United States Supreme Court: the courts must ensure the express limits on the changes implemented by legislation do not thereby imply approval of the common law as it applies beyond those limits, and secondly, they must ensure the protection of the doctrine of precedent and the validity of certainty in the law.<sup>81</sup>

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<sup>76</sup> Hunter, above n 44, 51.

<sup>77</sup> [1979] AC 731, 743.

<sup>78</sup> P S Atiyah, 'Common Law and Statute Law' (1985) 48 *Modern Law Review* 1, 6.

<sup>79</sup> See Gehan N Gunasekara, 'Judicial Reasoning by Analogy with Statutes: Now an Accepted Technique in New Zealand?' (1998) 19 *Statute Law Review* 177.

<sup>80</sup> *Moragne v States Marine Lines*, 398 US 375 (1970).

<sup>81</sup> *Ibid* 351.

When applied to franchising the relevance of these concepts is evident. As we have seen, there has been a steady legislative trend in Australia, however, the fulfilment of this change has been left largely up to the courts. Given the encapsulation of the doctrine of good faith within that of unconscionability, it is no longer possible to argue that the provisions pertaining to unconscionable conduct<sup>82</sup> and the parallel provisions of the *Code* – many catalogued below and requiring in essence fairness and transparency in dealings between franchisors and franchisee – signify legislative endorsement of the existing common law governing these relationships.

Against this backdrop particularly, attention is now turned to administrative law principles and their potential to provide criteria that would enable a common law court to measure whether discretion granted within a franchise relationship had been exercised within appropriate parameters.

#### IV RELEVANT ADMINISTRATIVE LAW JURISPRUDENCE

We outline below the main categories triggering the opportunity for, and the mechanisms enabling, review of administrative decisions. We suggest these afford alternative benchmarks against which franchisors could test their intended exercise of discretions.

##### *A Limits on the Use of Discretion*

Administrative decisions may proceed along two lines: review or appeal. A review to examine the legality of a decision focuses on the decision-makers' powers or authority, and on whether the decision was made within the authority conferred (*intra vires*) or was beyond its ambit (*ultra vires*).<sup>83</sup> Appeal, on the other hand, involves examining not just the legality of a decision, but its merits. This distinction has ramifications in the context of questioning commercial decisions such as those made by franchisors. A court examining a franchisor's abuse of a decision-making power conferred by contract ought not to question the decision's commercial or strategic merits. However, a court can legitimately inquire whether the decision was *intra vires* – within the scope of the power conferred by the contractual provision that confers the power in question.

The fundamental values of administrative law require decision-making authorities to be 'lawful, to act in good faith, to be [procedurally] fair and to be rational'<sup>84</sup> in the exercise of their powers. Franchisors are arguably, in a practical sense, in the position of decision-makers vis-a-vis franchisees, and exercise authority over them. A court assessing the validity of the exercise of the franchisor's powers under the agreement

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<sup>82</sup> CCA sch 2 s 22.

<sup>83</sup> *Attorney-General (NSW) v Quin* (1990) 170 CLR 1, 35–6 (Brennan J). See also Greg Weeks, 'Litigating Questions of Quality' (2007) 14 *Australian Journal of Administrative Law* 76.

<sup>84</sup> French, above n 21, 23.

is essentially involved in a process of construction not dissimilar to that involving the exercise of statutory powers.

*B Good Faith, Lawfulness and Rationality, Errors of Law and  
Fact Finding and Fairness*

The administrative law principles of good faith, lawfulness and rationality, errors of law and fact finding, and fairness are summarised below. In Part V we demonstrate how these principles could guide franchisors in their exercise of contractual discretions.

1 *Good Faith*

In the administrative law sphere good faith requires that decisions are made honestly and conscientiously.<sup>85</sup> However, under Australian administrative law, good faith signifies a broader concept than narrow dishonesty. Thus, decisions need to be made within the scope of the grant of power under which they are made. An unlawful delegation of the exercise of a power, or abdication of discretion, would constitute a breach of this requirement. There must be ‘an honest or genuine attempt to undertake the task’ to which the decision-maker has been assigned.<sup>86</sup> For Lord Russell, unreasonableness was found where delegated laws were ‘partial and unequal in their operation as between different classes: if they were manifestly unjust; if they disclosed bad faith; [or] if they involved such oppressive or gratuitous interference with the rights of those subject to them as could find no justification in the minds of reasonable men’.<sup>87</sup>

Two related criteria for review — when an administrative decision-maker acts under dictation or adopts overly rigid policies — are also relevant in the context of franchising. Franchise systems are hierarchical with national, regional and master franchisees having discretion to make decisions affecting franchisees. Corporate governance principles do not underpin the relationships between players in franchise systems.<sup>88</sup> Where a decision-maker adopts an overly-rigid policy preventing the exercise of discretion based on the merits of individual cases, this can be challenged through judicial review. For example, a government policy that there would be no additional universities in New Zealand conflicted with a legitimate expectation that a tertiary institution’s application for university status would be properly considered.<sup>89</sup>

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<sup>85</sup> Ibid.

<sup>86</sup> *NAAP v Minister for Immigration and Multicultural and Indigenous Affairs* [2002] FCA 805 (26 June 2002) [41] (Hely J).

<sup>87</sup> *Kreuse v Johnson* [1898] 2 QB 91, 99–100 (Lord Russell) cited in *Minister for Immigration and Citizenship v Li* (2013) 249 CLR 332, 365.

<sup>88</sup> Buchan, above n 9, 101–9.

<sup>89</sup> *Unitec Institute of Technology v Attorney-General* [2006] 1 NZLR 65. We note that the doctrine of legitimate expectation has been questioned in Australia. See also *Mercury Energy Ltd v Electricity Corporation of New Zealand Ltd* [1994] 2 NZLR 385, as discussed in Janet McLean ‘Contracting in the Corporatised and Privatized Environment’ (1996) 7 *Public Law Review* 223.



It is easy to envisage similar instances occurring within the franchising framework: for example, as occurred in *Burger King*, where the franchisor adopted the strategy of not approving recruitment of franchisees by its Australian area developer in the Burger King system (discussed below).<sup>90</sup>

Courts are reluctant to find the existence of bad faith in its narrow meaning of dishonesty or impropriety, and plaintiffs therefore rarely succeed on this ground. It has on occasion arisen in the franchising context.<sup>91</sup> For administrative lawyers, good faith means more than the ‘mere absence of dishonesty’.<sup>92</sup> Wade and Forsythe state ‘[a]gain and again it is laid down that powers must be exercised reasonably and in good faith. But, in this context, “in good faith” means merely “for legitimate reasons”’. Contrary to the natural sense of the words they import no moral obliquity’.<sup>93</sup>

In other words, good faith requires consideration of the ‘purposes and criteria that govern the exercise of the power’.<sup>94</sup> This in turn necessitates consideration as to the lawfulness of the power’s exercise (its terms and scope) and the rationality of the decision (whether relevant criteria were considered and irrelevant ones discarded). These further grounds for judicial review and their relevance to franchise relationships will be examined next.

## 2 *Lawfulness and Rationality*

In considering whether a decision-maker has abused a discretionary power, the administrative courts may consider whether the person has acted lawfully and rationally. Lawfulness and rationality often overlap although this bar is also set high:

Lack of rationality may manifest in illogicality that fails to take into account mandatory relevant considerations. In such a case, there may be an error of law for failure to apply statutory criteria or an improper exercise of power. Or it may yield a decision so unreasonable that no reasonable person could have made it. A factual finding without any evidentiary base may be irrational and reviewable ...<sup>95</sup>

We note that courts reviewing administrative decisions regard such matters as capable of measurement. Whether this basis for review is also capable of application to contractual performance and enforcement is contentious with strong opposition

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<sup>90</sup> *Burger King* (2001) 69 NSWLR 558.

<sup>91</sup> *Automasters* [2002] WASC 286 (4 December 2002). *Contra* discussion below of the franchisor’s conduct in *Far Horizons* [2000] VSC 310 (18 August 2000) in Part V.

<sup>92</sup> French, above n 21, 28.

<sup>93</sup> William Wade and Christopher Forsyth, *Administrative Law* (Oxford University Press, 10<sup>th</sup> ed, 2009) 354.

<sup>94</sup> French, above n 21, 29.

<sup>95</sup> *Ibid* 24.



being put forward to such an extension.<sup>96</sup> We suggest, however, that such opposition largely stems from misapprehension as to whether the grounds for review are the so-called ‘broad’ or ‘narrow’ ‘*Wednesbury*’ grounds.<sup>97</sup>

Thus, Morgan has no quarrel with application of the broader *Wednesbury* criteria to the exercise of contractual powers, writing:

It is orthodox in examining the way the decision has been taken (and so is, in that sense, “procedural”) rather than the quality of the decision arrived at. It requires the courts to decide, by interpretation of the relevant statutory power, which matters must be taken into account by the decision-maker, and which must not: and then to see that these have or have not been considered, accordingly. The court must also consider the motivation behind the decision, to see that this accords with the purpose for which the statutory power has been conferred.<sup>98</sup>

By contrast, Morgan finds the narrow formulation of *Wednesbury* unreasonableness — a decision so unreasonable that no decision-maker could make it<sup>99</sup> — objectionable ‘because it apparently enables the courts to review the substance of a decision, rather than focusing upon the decision-making process’.<sup>100</sup> We agree that application of this standard to the exercise of contractual powers would be ‘destructive of party autonomy and commercial certainty’.<sup>101</sup> We contend that the more orthodox *Wednesbury* formula does have its counterpart in the construction of contractual provisions conferring powers on one party.

Indeed the example cited by Morgan supports our thesis and is not dissimilar to ones found in the franchise arena. *Lymington Marina Ltd v MacNamara*<sup>102</sup> involved a contractual licence and its terms permitting the licensee to sub-licence its rights under it. In construing the wording of the licence the court ruled the only permitted criterion was the suitability of the proposed sub-licensee and that the commercial interests of the marina were not a relevant criterion. The statutory matrix overlaying franchise relationships (for instance a franchisee’s rights to assign its interests) in Australia contains similar criteria.<sup>103</sup>

Further, we cannot take exception to Morgan’s injunction that courts ‘must give full effect to a contractual term drafted to exclude any judicial review of discretion,

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<sup>96</sup> Morgan, above n 38.

<sup>97</sup> Named after the decision of *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223 (‘*Wednesbury*’).

<sup>98</sup> Morgan, above n 38, 233.

<sup>99</sup> *Wednesbury* [1948] 1 KB 223, 229 (Lord Greene MR).

<sup>100</sup> Morgan above n 38, 234.

<sup>101</sup> Ibid 235. See also *Minister for Immigration and Citizenship v Li* (2013) 249 CLR 332 (French CJ) in relation to the narrow version of unreasonableness.

<sup>102</sup> [2007] EWCA Civ 151.

<sup>103</sup> Code cl 20(3).

such as one conferring “absolute discretion”,<sup>104</sup> although we do not believe such broadly worded terms are desirable in franchise agreements as they can corrode relationships and trust. Neither do we support his overall conclusion that ‘the courts should go further and disclaim any jurisdiction to review the exercise of contractual discretions’.<sup>105</sup> Leaving solutions to the market alone, as he suggests, has clearly not worked where franchising is concerned, as evidenced by the large number of inquiries and legislative interventions in Australia.<sup>106</sup> The remainder of this article therefore proceeds on the basis that the broad *Wednesbury* grounds for reviewing the exercise of discretion have relevance to the exercise of contractual powers.

### 3 *Errors of Law and Fact-Finding*

Although being a common ground for review in administrative law, it may be thought that errors of law are unlikely to arise in a franchise relationship. Consider, however, the requirement in franchise operating manuals that franchisees must comply with all relevant health and safety regulations. An arbitrary decision by the franchisor that these requirements have not been complied with may amount to an error of law. In addition, a ‘conclusion of a fact-finding body can sometimes be so unsupportable — so clearly untenable — as to amount to an error of law’.<sup>107</sup> We suggest this thinking may be extended to decisions made by a franchisor.

Fact-finding is likely to be contentious where franchise relationships are involved. Franchisors and their agents are empowered to make findings of fact concerning aspects of the franchisee’s performance. A ‘carrot and stick’ approach sometimes involves franchisees being rewarded for attaining standards and criteria set by the franchisor, or penalised for failing to attain them. Often, however, the exercise of important rights and remedies hinges on findings of fact by a franchisor; these include the franchisee’s right to renew or assign the franchise and, most importantly, the franchisor’s right to terminate the franchise.

The criteria for fact-finding and grounds for its review devised by administrative lawyers could assist in franchising. It has been said that fact-finding falls into two categories in administrative law. In the first, the decision-maker is given the power to decide whether the requisite state of affairs exists — in other words to find out the actual facts.<sup>108</sup> As long as the fact-finding process is valid the actual finding cannot be challenged as this would amount to questioning its merits as opposed to its legality.<sup>109</sup>

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<sup>104</sup> Morgan, above n 38, 241.

<sup>105</sup> Ibid 242.

<sup>106</sup> See Schaper and Buchan, above n 1, Table 3 for a full list of reviews into the Australian franchising sector.

<sup>107</sup> *Bryson v Three Foot Six* [2005] NZSC 34, [26]. See also *Australian Broadcasting Tribunal v Bond* (1990) 170 CLR 321, 355–6.

<sup>108</sup> Geoff Airo-Farulla, ‘Reasonableness, Rationality and Proportionality’ in Matthew Groves and HP Lee (eds), *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007) 212, 216.

<sup>109</sup> Ibid.

In the second category, however, the power itself is contingent on the objective existence of the requisite facts:

the requisite state of affairs is a 'jurisdictional' fact on which the power's existence depends. A decision maker who acts on the basis of an incorrect finding that the fact exists has made a legal error about the power's existence. Similarly, a decision maker who refuses to act, on the basis of an incorrect finding that the fact does not exist, has also made a legal error about the power's existence.<sup>110</sup>

The distinction has arisen in franchising disputes such as the *Far Horizons* case in Part V.

#### 4 *Fairness*

Administrative law requires that decisions be reached fairly, meaning that they are made impartially and are seen to be impartial, after affording a proper opportunity to those affected to be heard.<sup>111</sup>

We can also reflect on the main rationale for the bias rule which is to encourage *good* decision-making, that is, rational decisions based on accurate findings of fact.<sup>112</sup> Such decisions are inherently likely to be superior to those influenced by ulterior considerations. Of course, in the franchising context, the franchisor's self-interest may well be one relevant consideration although it ought not to be the only one. Researchers have pointed to the perverse economic incentives franchise relationships afford for inefficient decision-making by franchisors that are able to leverage the sunk costs of franchisees.<sup>113</sup> This explains why franchisees may remain in business despite incurring losses.

Besides impartiality, the second major requirement of fairness is the requirement to follow due process and to afford the subject of the decision an opportunity to put forward their case. As Cameron Stewart states:

Procedural fairness is due where a person enjoys a substantial benefit and expects that it will continue...if a decision is made to take away the benefit, the decision maker is bound to hear the side of the person enjoying the benefit before they make the decision.<sup>114</sup>

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<sup>110</sup> Ibid 217–18.

<sup>111</sup> French, above n 21, 15, 23.

<sup>112</sup> Matthew Conaglen, 'Public-Private Intersection: Comparing Fiduciary Conflict Doctrine and Bias' [2008] *Public Law* 58, 73.

<sup>113</sup> See generally Hadfield, above n 6, 951–2; Roger D Blair and Francine Lafontaine, *The Economics of Franchising* (Cambridge University Press, 2005).

<sup>114</sup> Cameron Stewart, 'The Doctrine of Substantive Unfairness and the Review of Substantive Legitimate Expectations' in Matthew Groves and H P Lee (eds), *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007) 280-1.

The application of this principle to the circumstances where decisions are made by franchisors that affect franchisees is obvious. This is the case not only when penalties are imposed on a franchisee for non-compliance with the system, but in a myriad other instances where decisions are made by a franchisor that impact substantially on the benefits conferred by the grant.<sup>115</sup>

Where a franchisor exercises the right to terminate a franchise it is a requirement in Australia under the *Code* that the franchisee is given an opportunity to remedy the deficiency.<sup>116</sup> This is not the same as a right to a hearing, but it is implied that the franchisee will have the opportunity to communicate the fact and degree to which it has remedied any deficiency. In *Automasters*, discussed in Part V, it transpired that the franchisor had pre-judged the question of termination, being motivated by extraneous factors. The case squarely satisfies even the subjective requirement of honesty advocated by Hooley as a basis for controlling contractual discretion.<sup>117</sup> By way of contrast, in *Far Horizons*, the franchisor was not only transparent as to its decision-making processes but afforded ample opportunity to the franchisee to put its case.

A major tenet of administrative law is the balance struck by the courts between the decision's fairness and the public interest in upholding the administrator's decision, even when it is unfair.<sup>118</sup> In the franchise context public interest is akin to the interests of the franchise system as a whole, assuming the system is viable. Sometimes, a decision may appear to be unfair to a particular franchisee. When viewed from the point of view of the entire system, however, the decision may be justified. What this also suggests is that, when undertaking decisions prejudicial to its franchisees, a franchisor ought to consider not just its self-interest but rather the integrity of the franchise system. This should be balanced against factors relevant to the franchisee such as the amount of its non-recoverable sunk costs.

### *C Accommodating Flexibility*

Administrative law allows administrative decision-makers the flexibility to innovate and to adopt changes dictated by policy needs and other considerations. A decision-maker will, for instance, often amend guidelines as to how to comply with a policy. Once again, we believe that the framework provided by administrative law is adaptable to afford franchisors the freedom to make changes in response to market conditions, and to innovate, whilst ensuring that the value of fairness is preserved. As mentioned earlier, Aronson notes that 'the majority in the High Court of Australia decision *NEAT Domestic Trading Pty Ltd v AWB Ltd*<sup>119</sup> "specifically reserved for future consideration the question of whether a private

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<sup>115</sup> For instance to vary the territory or increase royalties and advertising levies.

<sup>116</sup> *Code* cl 21(2)(b).

<sup>117</sup> Hooley, above n 2.

<sup>118</sup> Stewart, above n 114, 283.

<sup>119</sup> (2003) 216 CLR 227, 297 [49]–[50] (Gleeson CJ, McHugh, Hayne and Callinan JJ).

sector body might be reviewable”.<sup>120</sup> We suggest that franchisors present this opportunity.

## V FRANCHISE DISCRETIONS THROUGH AN ADMINISTRATIVE LAW PRISM

Franchisors need clarity; so do franchisees. There is some English authority for the view that ‘administrative law principles are applicable in the consideration of [contract based] discretions’.<sup>121</sup> For example, in *Paragon Finance Plc v Nash*<sup>122</sup> the English Court of Appeal had to decide whether a mortgagee’s discretion to vary interest rates was subject to an implied term fettering its exercise. The Court found there was an implied term that the mortgagee was bound not to exercise the discretion ‘dishonestly, for an improper purpose, capriciously or arbitrarily’.<sup>123</sup> An example of capricious behaviour was given where interest rates were raised because of the colour of the borrower’s hair and an example of an improper purpose would be where interest rates were raised ‘to get rid of’ a nuisance borrower.<sup>124</sup> Hooley notes, in the context of genuinely negotiated contracts that ‘it can rarely be the intention of the parties that [apparently unfettered contractual discretion] may be exercised without restraint’.<sup>125</sup> Later English cases have cast doubt on the width of the Court’s dicta however.<sup>126</sup>

On the other hand it is now beyond doubt that in Australia, at least, the prevailing common law and statutory matrix have in substance resulted in principles akin to those existing in administrative law being applicable also in the franchising context. For example the *Code* stipulates that franchisors must not unreasonably withhold consent to the transfer of a franchise,<sup>127</sup> and stipulates criteria that may be considered by a franchisor in withholding or giving assent for a franchisee to transfer the franchise. The list<sup>128</sup> contemplates the addition of other criteria in the franchise agreement.

<sup>120</sup> Mark Aronson, ‘Is the ADJR Act Hampering the Development of Australian Administrative Law?’ (2005) 12 *Australian Journal of Administrative Law* 79, 88–9. See also for a discussion of *NEAT Domestic Trading Pty Ltd v AWB Ltd* (2003) 216 CLR 277. The case is of particular relevance to franchising, as the defendant was a statutorily created monopoly. A franchisor that is a supplier to its franchisees enjoys a role as a privately created monopoly vis-a-vis its franchisees. Its monopoly activities are subject to the lightest regulatory scrutiny via the process under s 47 of the *CCA* for notification of exclusive dealing that, without having been notified, would be a breach of the Act.

<sup>121</sup> Peden, above n 37, 238.

<sup>122</sup> [2002] 2 All ER 248.

<sup>123</sup> Ibid 261 (Dyson, Astill and Thorpe LLJ).

<sup>124</sup> Ibid.

<sup>125</sup> Hooley, above n 2, 67.

<sup>126</sup> See, eg, *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid Essex Hospital Services NHS Trust* [2013] EWCA Civ 200.

<sup>127</sup> *Code* cl 20 (2)–(3).

<sup>128</sup> Relating to such matters as the qualifications and suitability of the transferee and the transferor’s discharge of all outstanding obligations to the franchisor.

How far such additional criteria may go before being ultra vires the requirement to be 'reasonable' is pertinent to the discussion undertaken in this article.

Jeannie Marie Paterson notes that 'courts have drawn on principles familiar in the context of judicial review of the exercise of administrative power, to require contracting parties to conform to basic standards of good decision-making'.<sup>129</sup> A court may find that the exercise of discretion is impliedly subject to constraints. It is in this context that the legal principles informing the exercise of the franchisor's discretionary power might draw on the criteria traditionally drawn upon in judicial review cases. We now consider examples of how the principles outlined in Part IV could clarify how the same issues may be resolved in complex private law franchise relationships.

*Automasters*<sup>130</sup> is a case spanning practically all the grounds traditionally pertinent to judicial review, including good faith, lawfulness, rationality and fairness. A franchisor had sought to terminate a franchise agreement despite an independent quality assessment recommending otherwise, and even though it was not satisfied the information on which the decision was based was accurate. Furthermore, the franchisor was motivated by irrelevant matters.<sup>131</sup> Finally, the decision was procedurally unfair as the franchisor withheld details of an independent quality assessment report favourable to the franchisee, and failed to attend mediation as required by the *Code*.

Unsurprisingly, the Court found the franchisor acted unconscionably under s 51AC of the *TPA*. Had the franchisor been guided by the grounds of judicial review it would have been clear which considerations it could have taken into account.

An application of the good faith concept in the franchising arena can be seen in a United States decision. In *Dunfee v Baskin-Robbins Inc*,<sup>132</sup> site location decisions under the franchise agreement remained exclusively with the franchisor, and any site relocation had to be authorised by a Baskin-Robbins Vice President. The plaintiff, whose existing site had become unsuitable, sought relocation. The Vice President was never consulted. Instead, the District Manager, after consulting with Baskin-Robbins' Divisional Manager, advised (on the basis of erroneous information) that the relocation was not possible. Although the plaintiff succeeded on the basis the franchisor was in breach of the covenant of good faith and fair dealing implied into commercial dealings in the United States,<sup>133</sup> it would equally have been possible to challenge the outcome as an unlawful delegation were administrative principles applied. Besides improper delegation, the decision to deny relocation was also procedurally unfair under administrative law criteria: not only did Baskin-Robbins fail to

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<sup>129</sup> Jeannie Marie Paterson, 'Implied Fetters on the Exercise of Discriminatory Contractual Powers' (2009) 35 *Monash University Law Review* 45, 47.

<sup>130</sup> [2002] WASC 286 (4 December 2002).

<sup>131</sup> *Ibid* [210]. Justice Hasluck found these to be the franchisee's laying of criminal charges against a former manager, one of the franchisor's favourites and the franchisee's complaint to the Australian Competition and Consumer Commission.

<sup>132</sup> 720 P 2d 1148 (Mont, 1986).

<sup>133</sup> Now found in *Uniform Commercial Code*, 1 UCC § 304 (2001).



follow its own procedure for considering site relocations, but the franchisee was given inaccurate information as to the basis on which the decision had been made.

In *Dunfee v Baskin-Robbins Inc* it was also found that an alternative arguable basis for the liability of the franchisor was that it owed fiduciary duties to the franchisee in respect of the head lease. Despite discretion and power imbalances being a major focus of fiduciary duties, the imposition of such duties within franchising relationships has been rare.<sup>134</sup> Cases where fiduciary duties have been found to arise are outliers and involve, usually, aspects peripheral to the franchise agreement itself. One such example (as discussed below) is *Burger King*,<sup>135</sup> which involved a franchisee being cut out of a prospective joint venture involving a third party and the franchisor, amongst other matters.

Even here, the analogy with public law principles affords an opportunity for comparison. Although there have been instances where decisionmakers have been found to be in the position of a fiduciary these have been restricted to a narrow range of circumstances such as where an administrative discretion to apply funds exists.<sup>136</sup> An example was where a council was found to owe a fiduciary duty to ratepayers as to how rates moneys were spent.<sup>137</sup> In the franchising context it will be argued below that the enhanced transparency mandated by the disclosure provisions of the *Code* and the accountability this engenders largely removes the pressure for courts to import fiduciary duties into franchise relationships. On the other hand the *principle* of transparency can be seen to underlie both fiduciary relationships and administrative law in these instances.

A franchisor's discretionary contractual powers are often worded in identical terms to statutory powers employing unmistakably discretionary language such as 'may'. Consider, for example, the power to terminate a franchisee's grant for breaches of the agreement. It has been observed in relation to administrative law that '[e]ven the most discretionary powers are not taken to be arbitrary powers'.<sup>138</sup> In other words, 'discretionary powers must be exercised according to legal principles'.<sup>139</sup> We suggest that the principle could be similarly applicable where powers emanate from franchise agreements. In considering the *lawfulness* of a franchisor's actions, consideration

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<sup>134</sup> A claim that the franchisor owed fiduciary duties in connection with obtaining a lease for the franchisee was unsuccessful in *Blackmore Laboratories Ltd v Diskin Pty Ltd* [1989] NSWSC (20 December 1989) [7] where McLelland J held that the franchise agreement did not permit such a term to be implied.

<sup>135</sup> (2001) 69 NSWLR 558.

<sup>136</sup> See Christine Brown, 'The Fiduciary Duty of Government: An Alternate Accountability Mechanism or Wishful Thinking?' (1993) 2(2) *Griffith Law Review* 161, 175.

<sup>137</sup> *Bromley LBC v Greater London Council* [1983] AC 768, 815 (Lord Wilberforce).

<sup>138</sup> Matthew Groves and H P Lee, 'Australian Administrative Law: The Constitutional and Legal Matrix' in Groves and Lee (eds), *Australian Administrative Law: Fundamentals, Principles and Doctrines* (Cambridge University Press, 2007) 3.

<sup>139</sup> Louise Longdin, *Law in Business and Government in New Zealand* (Palatine Press, 2006) 119.



ought to be given to the terms in which the franchisor's powers are framed and the constraints expressly or implicitly imposed upon them.

In the franchising context, lawfulness would require examining whether the franchisor's actions are authorised by the franchise agreement. This is a matter of construction but not always a straightforward one.<sup>140</sup> The franchisor's decision would be lawful by analogy with an administrative law paradigm, provided it complied with the framework created by the grant of the power under which the decision is made.<sup>141</sup> This would take account of the kinds of changes in the external environment contemplated, for instance, by the operating manual.

A somewhat different issue arises when the franchisor's conduct does not emanate from the agreement, operating manual or other document but amounts to simple commercial pressure-tactics and leveraging off the franchisee's weak *ex ante* bargaining position. While we would not suggest stifling the normal 'give and take' of commerce or negotiating tactics that occur in the commercial world,<sup>142</sup> the reality is that opportunistic behaviour by franchisors is a concern where much of the interaction between franchisor and franchisee takes place 'off the [formal] contract'.<sup>143</sup>

Where the franchisor's conduct is connected to the exercise or threatened exercise of discretionary powers, review of the franchisor's actions ought to be permitted. It is precisely in these circumstances that the public law analogies are useful. A focus on the terms of the contractual discretion lends greater certainty than reliance on the 'unconscionable conduct' standard which, ultimately, suffers from the same deficiency as the Chancellor's foot.

A franchisor may have a contract-based discretion to determine facts and to make a decision based on its findings. For example, in *Far Horizons*<sup>144</sup> a franchisor's decision not to grant an existing franchisee an additional store licence was found

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<sup>140</sup> See, eg, *Maranatha Ltd v Tourism Transport Ltd* (Unreported, High Court of New Zealand, Rodney Hansen J, 3 April 2007) where a franchisor decided that the cost of an airport licence fee (which the franchisor had previously absorbed) should in future be passed on to franchisees and ultimately to customers through a 'user pays' surcharge when they used the franchisees' airport shuttle services. The franchise operating manual was altered to require that the user pays surcharge set by the franchisor would apply. In addition, the franchisees were required to display and use the franchisor's current maximum fare schedule. This case has been analysed in Gehan Gunasekara, 'Standard Form Commercial Contracts, Unilateral Variation and the Legal Response: the Case of Franchising' (2007) 13 *New Zealand Business Law Quarterly* 263. In *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 223, Dodds-Streeton J determined that the franchisor had acted within the discretionary wording of the franchise agreement, and had not acted in bad faith.

<sup>141</sup> French, above n 21, 23.

<sup>142</sup> *Australian Competition and Consumer Commission v G C Berbatis Holdings Pty Ltd* (2003) 214 CLR 51.

<sup>143</sup> Hadfield, above n 6, 928.

<sup>144</sup> [2000] VSC 310 (18 August 2000).

to have been made in good faith. An equally valid interpretation of the franchisor's power to grant the licence would be to ask whether the decision had been made in a *fair* manner? It had been. The franchisor, McDonald's, has a procedure for determining which franchises met the criteria for additional stores: regular QSC<sup>145</sup> assessments with feedback being given, and franchisees being graded. Under McDonald's documented policy:

An 'expandable' franchisee was one whose existing units had regularly earned at least a B grade on QSC. He or she also had to have sufficient financial and management resources to support expansion, in addition to a good record of community involvement and an attitude of cooperation with the company and other franchisees.<sup>146</sup>

In *Far Horizons*, an existing licensee would qualify as eligible to take a further licence where they satisfied the McDonald's requirements in respect of seven specified criteria. One of these was the extent to which the franchisee had demonstrated a 'positive' outlook on McDonalds and its system, a criterion which had not been met by the plaintiff.<sup>147</sup> The analogy with judicial review suggests that, provided consideration had been given to the listed criteria, it would be injudicious for a court to question a franchisor's determination of the matter. The decision in *Far Horizons* indicates the judge was cognisant of precisely this danger:

My task is not to determine whether Mr Tregurtha was correct in his assessment of Mr Hackett on Positive Contribution. .... I am to decide whether there was material upon which Mr Tregurtha could have made the decision he reached and, even so, whether the decision was based on irrelevant or improper considerations.<sup>148</sup>

Certain procedural steps must be taken before a franchisor can exercise the right to terminate.<sup>149</sup> Significantly, courts have found as a matter of construction that termination has not been reasonable where the franchisor failed to give the franchisee prior notice and an opportunity to rectify breaches.<sup>150</sup>

It might be questioned whether any instances arise in franchise relationships involving the second category of *fact-finding*; that is, the franchisor's right to exercise the power in question depends on the prior existence of the fact from an objective standpoint.

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<sup>145</sup> The acronym means Quality, Service and Cleanliness.

<sup>146</sup> John F Love, *McDonald's: Behind the Arches* (Bantam, revised ed, 1995) 398.

<sup>147</sup> [2000] VSC 310 (18 August 2000) [108].

<sup>148</sup> Ibid [70].

<sup>149</sup> Steps are usually set out in the relevant individual franchise agreement and, as applicable, in cl 27, 28 or 29 of the *Code*.

<sup>150</sup> See generally *Dymocks Franchise Systems (NSW) Pty Ltd v Todd* [2004] 1 NZLR 289, 309 (Lord Browne-Wilkinson), affirming the statements made by the New Zealand Court of Appeal; in this regard, see *Bilgola Enterprises Ltd v Dymocks Franchise Systems (NSW) Pty Ltd* [2000] 3 NZLR 169, 184 (Henry J).

An example is *KA Old v Snack Systems Limited*,<sup>151</sup> where the franchisor's decision to withhold consent to the assignment was effectively quashed because a breach of the agreement had not been objectively established.

A separate criterion for review would be whether the franchisor acted *fairly*? Such an approach would offer an alternative to the legislative responses to reducing asymmetry that have been adopted in Australia. These have focused on enhanced disclosure, for example, of the circumstances in which franchisors have previously unilaterally varied agreements.<sup>152</sup> This approach is reactive rather than prospective and offers less protection to franchisees than would simply requiring franchisors to act fairly.

The first element of administrative fairness – that there is no bias in decisions – is problematic where franchisors, often, are their own arbiters. For example a franchisor might determine whether franchisees have complied with the system or met franchisor-set criteria for obtaining some benefit. This is particularly the case when a franchisor has, as is likely, a pecuniary interest in the outcome. The franchisor may thus be incentivised to decide in a particular manner.<sup>153</sup> In *Picture Perfect v Camera House Ltd*,<sup>154</sup> for example, the franchisor used its powers to prescribe approved suppliers to change the franchisees' supplier of film products to a related company of the franchisor following a change in its ownership. The Court accepted, in interlocutory proceedings, that an arguable case existed that the purpose of the contractual power was to enable bulk buying advantages for franchisees and was not solely to benefit the franchisor or its related company. This was an instance of possible bias. The principle is thus relevant in the franchise context.

Ascertaining whether some types of decision might have been biased has been made easier by the *Code*. Franchisors are required to disclose such matters as franchisor ownership of interests in suppliers from which franchisees are required to acquire goods or services, and whether franchisors will receive any financial benefits from suppliers.<sup>155</sup> This does not prevent franchisors from making biased decisions about matters that fall outside the wording of the *Code*. An example is the decision by REDgroup Retail Pty Ltd, owner of franchisors Angus & Robertson, to appoint administrators when book retailing was in decline. The administrators concluded 'it is difficult to maintain an argument that the Group was insolvent for any material period prior to 17 February 2011'.<sup>156</sup> Administrators are placed in an awkward

<sup>151</sup> (Unreported High Court of New Zealand, Master Towle, 10 August 1994).

<sup>152</sup> *Code* cl 17A (inserted by *Trade Practices (Industry Codes-Franchising) Amendment Regulations 2010 (No 1)* (Cth)).

<sup>153</sup> Longdin, above n 139, 129.

<sup>154</sup> [1996] 1 NZLR 310.

<sup>155</sup> *Code* sch 1 cl 9(c), (j).

<sup>156</sup> S Sherman, J Melliush and J Lindholm, 'REDgroup Retail Pty Limited and Associated Companies (Administrators Appointed): Report by Administrators Pursuant to Section 439A(4)(a) of the *Corporations Act 2001*', (Ferrier Hodgson, 25 July 2011) 6.

position as they are bound by the *Code* but as previously noted, have concurrent overriding statutory duties under the *Corporations Act 2001* (Cth).

The disclosure obligations of the *Code* serve another purpose. Although they constitute a discrete obligation, breach of which may result in the granting of statutory remedies,<sup>157</sup> it has been observed from the public law standpoint that ‘disclosure is not an obligation, but rather a mechanism for obtaining insulation against the effects of bias law’s disqualification rule’.<sup>158</sup> It is unsurprising, then, that much franchise regulation is aimed at disclosure, particularly where conflicts are perceived to arise through franchisors having economic interests in third parties that franchisees are required to buy from. Disclosure, in these instances, removes the sting of any complaint that may otherwise arise, confirming that Australian franchise regulation conforms to the bias paradigm.

The objection that franchisors will always be found to be biased due to having a significant pecuniary interest in the exercise of their discretion can be met by the observation that, as is the case in the administrative law field, the basis for judicial intervention rests on a different ground such as improper purpose or taking into account an irrelevant consideration. Two examples will suffice.

The first example where bias arose was *Burger King*,<sup>159</sup> the culmination of a protracted dispute between Burger King and its Australian franchisee/area developer. Under a ‘Development Agreement’, Hungry Jacks was required to develop a stipulated number of restaurants each year. Having resolved to remove Hungry Jacks and resume control of the chain directly, Burger King imposed a ‘third party freeze’ by not approving recruitment by Hungry Jacks of franchisees. This ensured breach, by the latter, of its Development Agreement. Although the New South Wales Court of Appeal held that the agreement was subject to implied terms of cooperation, reasonableness and good faith, the case can also be seen as an example of procedural unfairness through lack of impartiality, in addition to irrationality due to the franchisor being influenced by improper considerations.

By contrast, the franchisor in *Far Horizons*, discussed above, ensured that the decision not to offer the additional licence was procedurally fair. Thus, the

decision as to Positive Contribution was not that of Mr Cork [a regional manager who had dealt with the franchisee]; it was [McDonalds director of operations] Mr Tregurtha’s decision. There is no evidence of personal antipathy between Mr Tregurtha and Mr Hackett....no evidence that Mr Tregurtha’s decision was the result of some direction from above or that it was affected by his knowledge that Mr Cork, and perhaps those above him, wanted to discipline Mr Hackett.<sup>160</sup>

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<sup>157</sup> See generally Australian Consumer Law sch 2 ch 5; *Master Education Services Pty Ltd v Ketchell* (2008) 236 CLR 101.

<sup>158</sup> Conaglen, above n 112, 69 (citations omitted).

<sup>159</sup> (2001) 69 NSWLR 558.

<sup>160</sup> *Far Horizons* [2000] VSC 310 (18 August 2000), [69].

## VI DOCTRINAL ISSUES

Two doctrinal matters will be addressed before we conclude. First, administrative law might be said to be distinguishable from contract law due to the role played by consent in the case of the latter. However, franchise agreements do not reflect a negotiated bargain between parties; they reflect the intention of the drafting party.<sup>161</sup> Just as legislative intent is that of the drafter at the time of enactment and cannot readily be changed *ex post*, the same applies in the sphere<sup>162</sup> of standard form relational contracts. This is even more so where the legislative provision is of wide ambit, conferring discretion on a party to enact subsidiary legislation: the discretion given should not be unfettered and absolute, whether the provision conferring it emanates in contract or statute.<sup>163</sup> Any scrutiny of the exercise of discretion must, likewise, examine the purpose for which the discretion was conferred.

Some might argue that an application of substantive standards not apparent on the terms of the contract undermines the balance of interests struck by the parties (as encapsulated in the express terms of the franchise agreement). Therefore, such standards interfere with the basic autonomy of the contracting parties. But, as we have seen, franchise agreements are essentially incomplete and are incapable of encapsulation through express terms alone.<sup>164</sup> It may be then that the balance of interests struck by the parties requires resort to the very types furthering the fundamental purpose of the contract rather than detracting from it.

A second, related issue is that courts often apply a de facto ‘business judgment rule’ to decisions made by franchisors, effectively quarantining them from scrutiny.<sup>165</sup> To Hadfield, this approach by courts is flawed as it fails to take account of the economic imperatives present in the relational arrangements that underpin franchising.<sup>166</sup> The rule is also inappropriate as it focuses exclusively on the franchisor’s interests (‘one half’ of the franchise relationship in Hadfield’s words) as opposed to recognising the mutually co-operative nature of the interests that underlie the business format.<sup>167</sup> We agree with Hadfield in this regard.

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<sup>161</sup> Spencer, above n 18, 35.

<sup>162</sup> See generally Stephen J Choi and G Mitu Gulati, ‘Contract as Statute’ (2006) 104 *Michigan Law Review* 1129.

<sup>163</sup> See *Minister for Immigration and Citizenship v Li* (2013) 249 CLR 332, 348–9 [23]–[25] (French CJ).

<sup>164</sup> Hadfield, above n 6.

<sup>165</sup> Ibid 980–4.

<sup>166</sup> Ibid 983.

<sup>167</sup> Ibid.

## VII CONCLUSION

Writing extra-judicially, the Chief Justice of the High Court of Australia observed:

Nature demonstrates that apparent complexity can be generated by uncomplicated rules. Fractal forms based on simple interactions are to be found in plants, animals, clouds, snowflakes, population patterns and galaxies. ... Like organic and inorganic forms in nature, the apparent complexities of different areas of the law, whether they be statute or judge-made, are frequently generated by a few underlying principles.<sup>168</sup>

In this article, we have shown the truth of this statement in relation to the basic principles underlying administrative law and the principles of contractual interpretation underlying franchising agreements. We have shown that standards akin to those found in public law have been applied to the exercise of contractual powers under franchise agreements. Corcoran identifies that ‘public law is the most obvious area to impose statutory good faith obligations [in legal relationships] because the relative position of the actors tend to be such that the possibilities for abuses of power are strong’.<sup>169</sup>

This article has shown that the possibilities, and the incentives, for abuses of power by franchisors (and even master franchisees), are equally compelling.

Sir Robin Cooke has stated that ‘the judicial role is ... to ensure that those responsible for decisions in the community do so in accordance with law, fairly and reasonably’.<sup>170</sup> We contend this is a principle capable of wider application, and ought to inform the interpretation of contractual powers of decision where a decision-maker acts in an administrative capacity. We have demonstrated the application of the principle to franchising relationships which fall squarely within this category.

The advantage of an approach based on administrative law principles is that it avoids having to determine whether the implication is through law or by fact — a distinction that has bedeviled Australian courts.<sup>171</sup> It also relieves the courts of having to determine whether the relationship between franchisor and its franchisees is a fiduciary one. If it were then each would be bound to take account of the ‘legitimate interests of the other party’.<sup>172</sup> The common law approach, and that enshrined in the 2014 *Code*, fall short because both provide an escape hatch for the contracting party that can justify its lack of good faith on the ground that the exercise of the particular

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<sup>168</sup> French, above n 21, 15.

<sup>169</sup> Corcoran, above n 39, 11.

<sup>170</sup> R Cooke ‘The Struggle for Simplicity in Administrative Law’ in M Taggart (ed), *Judicial Review of Administrative Action in the 1980s* (Oxford University Press, 1986) 5, 16–17.

<sup>171</sup> See generally discussion in the cases cited by Dixon, above n 50, 235–7.

<sup>172</sup> Corcoran, above n 39, 11.

discretion was for ‘legitimate commercial interests.’<sup>173</sup> This justification does not support a discretion evaluated against administrative law benchmarks.

At the same time, recourse to administrative law approaches preserves many of the best features of each mechanism by allowing the factual circumstances of each case to be taken into account along with broader issues of policy. In *Council of the City of Sydney v Goldspar Australia Pty Ltd*, Gyles J observed that

[t]he best way for a single judge to travel through this thicket [of varying opinions about implying terms as to reasonableness and good faith] is to concentrate upon the particular contractual provision in question, the particular contract, in the particular circumstances of the case.<sup>174</sup>

This indeed is the same process that occurs when a court reviews a decision made by an administrator in a public law context.<sup>175</sup>

In the franchising context the franchisor’s powers and discretions are usually stated in very broad terms. Does this mean the powers they confer are unlimited? As Shellar JA stated in *Alcatel Australia Ltd v Scarcella*, employing the reasoning of Barwick CJ in *Pierce Bell Sales Pty Ltd v Frazer*:<sup>176</sup>

[i]f a contract confers power on a contracting party in terms wider than necessary for the protection of the legitimate interests of that party, the courts may interpret the power as not extending to the action proposed by the party in whom the power is vested or, alternatively, that the powers are being exercised in a capricious or arbitrary manner for an extraneous purpose, which is another way [sic] of saying the same thing.<sup>177</sup>

The principles governing administrative law are generally well understood, whatever labels might be attached to them. Ultra vires has been described as the central principle of administrative law.<sup>178</sup> A logical application has been to examine what actions of a franchisor are within the powers conferred by the agreement, taking into account restrictions that may be imposed by the *Code*. We have seen that other principles of wide application in both public and private spheres include the requirement to act rationally, honestly and in a manner that is procedurally fair. In relation to franchising, we have argued that the criteria for judicial review provide an alternative framework for the courts to review the exercise of contractual rights by franchisors, in addition to that provided by the much-misunderstood doctrine of good faith in contractual performance and enforcement.

<sup>173</sup> *Competition and Consumer (Industry Codes — Franchising) Regulation 2014* (Cth) sch 1 div 3, cl 6.

<sup>174</sup> (2006) 230 ALR 437, 499.

<sup>175</sup> See generally Weeks, above n, 83.

<sup>176</sup> (1973) 130 CLR 575, 587.

<sup>177</sup> (1998) 44 NSWLR 349, 368.

<sup>178</sup> Wade and Forsyth, above n 93, 35.



We propose that clarity as to how discretion will be exercised enables both parties to align their expectations accurately. Franchisees need to appreciate that good faith and fairness cannot apply at all times, and to all parties. They do, however, need to know when it is reasonable to expect a franchisor will operate in good faith and fairly, and what that behaviour looks like. Neither the common law concept of good faith, nor the 2014 statutory measure can be the panacea their protagonists believe they will be. If, on the other hand, a franchisor's conduct was able to be assessed against the benchmarks of administrative law principles, their discretions would be able to remain in place – no change would be required to their standard contracts. But, there would be clear boundaries to curtail how they could interpret and use discretions.

Much of the uncertainty and conceptual confusion still surrounding good faith dissipates when it is observed that decisions based on it are in fact based on a more fundamental foundation of principles that also underlie administrative law. These principles would afford greater certainty to franchisors, franchisees and the courts when a dispute arises over the manner in which a franchisor exercises discretion. At the very least, it gives flesh and blood to the abstract notion of good faith. From a practical standpoint, being able to draw on administrative law paradigms in addition to contractual ones would help mediators and courts in assessing which actions of franchisors are legitimate.

In this article, we have shown that the ability to balance competing principles allows flexibility to courts when devising solutions in specific situations — such as relational contracts. As principles such as fairness under administrative law can be given greater or lesser weight than other competing principles — such as the common law principle of sanctity of contract — flexibility can be afforded to courts beyond strict adherence to the doctrine of *stare decisis* and traditional contract law doctrine.

We acknowledge that ‘judicial review is not quite as powerful in practice as it is in theory’.<sup>179</sup> However, the existence of the standard for reviewing unreasonableness is comforting. We believe it is timely for a conversation to take place between administrative law and private law. Franchise contracts provide an ideal starting place.

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<sup>179</sup> H W Arthurs, ‘The Administrative State Goes to Market (and Cries “Wee, Wee, Wee” All the Way Home)’ (2005) 55 *University of Toronto Law Journal* 797, 798.

# Moral Hazard, Path Dependency and Failing Franchisors: Mitigating Franchisee Risk Through Participation

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## Abstract

Employment relations are well understood. Business format franchising is a newer and rapidly evolving business expansion formula, also providing employment. This article compares the fates of employees and franchisees in their employer/franchisor insolvency. Whereas employees enjoy protection, franchisees continue to operate in conditions that have been described as Feudal. We identify the inherence of moral hazard, path dependency and optimism bias as reasons for the failure of policies and corporations laws, globally, to adapt to the franchise relationship. This failure comes into sharp focus during a franchisor's insolvency. We demonstrate that the models of participation available to employees in the United States, Australia and the United Kingdom could be used to inform a re-balancing of the franchisees' relationship with administrators and liquidators during the insolvency of their franchisor, providing franchisees with rights and restoring their dignity.

## Introduction

Organisations respond to intensive labour needs in several ways: departmentalising, creating corporate groups with key companies having few employees, engaging contractors and outsourcing. These strategies can be used to transfer the obligations typically associated with employee liabilities<sup>1</sup> through a decentralised structure that distances the business management from front-line operations. Checks and balances for related companies are governed by corporate law. Contractors negotiate and sign supplier agreements that address the risks of all parties, including the risk of any of the parties' businesses failing. Business format franchising ('franchising') is a form of outsourcing. In franchising, erstwhile employers of large labour forces become franchisors and

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outsource branch ownership, management, equity and debt financing, insurance, responsibility for employees and associated obligations to franchisees. This is achieved through standard form contracts presented to franchisees on a 'take it or leave it' basis. As Veronica Taylor noted as early as 1997, '[f]ranchising is another country... While the form is contractual, the franchise retains many of the features of the firm'.<sup>2</sup> But, through this form of outsourcing, corporate law obligations and scrutiny are avoided.<sup>3</sup>

Given the discrepancies between employment and franchising, our discussion draws on concepts from institutional theory. Institutionalisation refers to the process whereby certain processes, such as the mechanisms and flexibility of the franchise model, take on a rule-like status.<sup>4</sup> In the franchise model, institutional rules developed over time no longer reflect the reality of a mature franchise market. They are nonetheless embedded in the model. This suits franchisors well. Gillian Hadfield observed that '[u]nlike... an employment relation... the franchise relationship is characterised by the fact that franchisees own the bulk of capital assets of the franchise and franchisors retain the right to determine how franchisees will use those assets'.<sup>5</sup> Early franchising comprised a straightforward, albeit skewed, contractual relationship between a franchisor and each of its franchisees. Possibly because early franchisors were assumed to have tested the business thoroughly before offering franchises, the contracts did not provide for the franchisor becoming insolvent. As the system matures, the franchisor spreads its roles through numerous franchisor-related companies. When the franchisor expands internationally, sells its role to public shareholders or private investors, or takes any risky strategic decision like borrowing to acquire an additional brand, the original franchisor/franchisee relationship is placed at risk. For franchisors, the essential driver of franchisee profitability can quickly give way to shareholder or venture capitalist focus on growth of dividends and reduction of costs. Franchisor failure may be the outcome.

Employees regularly benefit from legislative and social protections that can include participation, consultation, requirement for fair treatment, and alternative employment or payouts when their jobs are at risk. Corporations law recognises employees as priority creditors in their employer's insolvency. But there is no specific provision, anywhere in the world, to accommodate franchisees' interest as their franchisor fails. We suggest the resistance to recasting franchising as a form of business requiring adjustment to insolvency rules can be explained by the theories of path dependency and moral hazard and by franchisees' own optimism bias. Optimism bias is explored later under the heading 'Justifying Franchisee Participation: Moral Hazard'.

Path dependence, 'paths shaped by a nation's political and cultural institutions or chaotic chance events',<sup>6</sup> helps explain how the rejection of the *Casnot* interpretation in Australia<sup>7</sup> led to franchising being regulated solely under the national competition and consumer law, rather than corporations law. This shifted the regulation from the possibility of regulation via the 'cradle to grave' approach of the *Corporations Act 2001* (Cth) ('*Corporations Act*') to franchising being regulated solely under the *Competition and Consumer Act 2010* (Cth) that governs competition and consumer protection. The latter has no role in business failure. It also helps us understand the difficulty of introducing change in regulatory frameworks. The franchise model, as a relative newcomer to business, has evolved under the radar of many legislatures, and often without regulatory constraint.<sup>8</sup> Franchisors naturally resist regulation that would inhibit the adaptable character of franchising. They cling to the mantra of growth and success. Such institutional behaviour shows a path-dependent tendency by placing importance on the status quo of flexibility of the basic franchisor/franchisee relationship remaining in a low regulatory environment. As the model has matured, it is arguable that franchisors also take advantage of franchisee

optimism bias, treating franchisees like tools of investment and financial gain, even to the point of delaying inevitable insolvency through capital injection by way of franchise fees. Although franchising has often been likened to a marriage, or a 'partnership', these analogies fail when franchise relationships are viewed through a legal lens. They fail spectacularly when we consider that the law provides rules governing the failure of a marriage<sup>9</sup> or a partnership,<sup>10</sup> but not the failure of a franchisor.

Conversely, Australia's franchise law does provide for the failure of a franchisee.<sup>11</sup> 'Much of the content of franchising agreements and the supporting ideology seems reminiscent of feudal contractual relationships'.<sup>12</sup> Today, the franchise relationship remains one of subordination of franchisees, who are more akin to employees who have bought their job than independent contractors. While academics have identified that moral hazard can exist on the franchisor's side,<sup>13</sup> none have examined the moral hazard that exists during franchisor failure. We base our arguments for the implementation of participative procedures and genuine stakeholder rights for franchisees in this area of moral hazard.

When a non-franchised company experiences financial difficulty, employees become a significant burden for administrators, and subsequently for liquidators, but the opposite applies when a franchisor is failing: franchisees become an unpaid labour force during the franchisor's administration. Administrators may discover that franchise agreements, binding while the administrator tries to sell the franchise, are their most valuable assets. Ultimately, franchise agreements are disclaimed as onerous contracts by liquidators if no buyer is found, leaving franchisees without the support of their franchisor, and potentially losing their businesses. This is the franchisors' insurance-like payout for the franchisees accepting moral risk.

With significant assets at risk for franchisees, the level of risk transference in the franchise model represents a moral hazard which occurs when franchisors increase their exposure to risk when 'insured'. The insurers are franchisees who bear the cost and provide 'insurance' for the franchisor's risky decisions. There is no disincentive to risk-shifting by franchisors. While franchisees can choose which brand to invest in: McDonald's, Hungry Jack's or Burger King; Hilton Hotels or Quest Serviced Apartments; Flight Centre, Harvey World Travel, itravel or the now insolvent Traveland; once the franchise relationship is established, franchisees lose independence. Their absence of independence is particularly evident when a franchisor fails.

While the franchise model has had a comparatively short existence, it continues to be used globally and, as previously noted, usually without specific regulatory constraint. Where regulations do exist, they make various provisions for registration, precommitment disclosure, mandatory terms and/or dispute resolution processes. Some address franchisee insolvency or bankruptcy through mandatory terms<sup>14</sup> but none address franchisor failure. There is a clear resistance to imposing enforceable regulation that would inhibit the innovative character of franchising. This behaviour shows a path-dependent<sup>15</sup> tendency by placing importance on the status quo of flexibility in a low regulatory environment over time, while ignoring the level of sophistication of 21<sup>st</sup> century franchise networks. It is difficult to implement change that would interfere with that status quo.

The franchise model also takes advantage of franchisee optimism bias, treating franchisees like tools of costless investment finance and financial gain. Fees generated through sales of new franchises sometimes provide capital injections during times of financial distress of which franchisees will be unaware.<sup>16</sup> Today, the franchise relationship tends towards subordination of franchisees, much like the position of employees. It is in this area of moral hazard in the use of the

franchise model that our arguments for the implementation of participative and consultative procedures are derived. It is timely that we break the institutional path protecting the flexibility of the franchise model to acknowledge the moral hazard present in the model and introduce changes to mitigate the risks to which franchisees are all exposed.

The purpose of this article is to explore the legal position of franchisees during franchisor insolvency<sup>17</sup> through the lens of moral hazard with a view to proposing solutions derived from existing employment regulation. There are many similarities between employees and franchisees, including the asymmetry of information available about the overall financial health of the employer/franchisor. While long recognised that these issues can be acute in employment relationships, we argue that franchisees are currently more vulnerable. A compounding factor is the aspect of optimism bias. This tendency of individuals to underestimate risks is strongly present in franchisees.<sup>18</sup>

We arrive at recommendations to resolve the moral hazard borne by franchisees by comparing the legal position of employees in collective redundancy arrangements with that of franchisees of insolvent franchisors in three jurisdictions: the United States (US), Australia and the United Kingdom (UK). As Australia has a uniform national regulatory framework for franchises, greater space is given to the Australian franchise environment. In our analysis, we ask whether franchisees should benefit from greater participation during their franchisor's administration and insolvency, introducing greater equity and diminishing the morally hazardous advantage-taking that the business model currently offers. We then argue for better recognition of the asymmetries and risks affecting franchisees and suggest how franchise laws could adopt solutions from employment law.

## Franchisees and Employees in Context

Franchising has been a part of the socio-economic landscape of Western economies for decades. Now, almost every corner of the global retail economy has franchising. In the US, Howard Johnson began franchising restaurants in 1935 and Sanders selling chicken in the 1950s,<sup>19</sup> while the McDonald brothers started selling burgers in 1937.<sup>20</sup> In Australia, each of the 1100 business format franchisors has an average of 60 franchisees; some have hundreds, and some only one. As employers, Australian franchisors and franchisees together provide employment for approximately 472 000 employees.<sup>21</sup>

In franchising, a franchisor develops a branded retail business, commits its day-to-day operation to manuals and grants licences to franchisees to replicate the business using the franchisor's brands and systems. Franchisees themselves have many different starting points. Some are like Aziz Hashim, former Chair of the International Franchise Association, who recalls his inexperience as a first-time franchisee, buying a Kentucky Fried Chicken (KFC) outlet in Atlanta prior to the 1996 Atlanta Olympic Games. Regarding metrics such as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) or Rate of Return, he admits: 'I was clueless! I was just happy that KFC gave me a franchise.'<sup>22</sup> Others are like an Australian franchisee whose starting point was to spend her student years as a franchisor's employee before becoming a multi-unit owner. As a franchisee, she saw a very different face of the brand, writing:

Not until I got down on the ground floor did I start to really see the bullying and deceit of the franchisor and their often deliberate demise of some franchisees. Typically the ones who had a voice until it was silenced in fear.<sup>23</sup>

Franchise relationships are documented in contracts. Gillian Hadfield observes that '[f]ranchising is problematic for contract law'.<sup>24</sup> For her,

the heart of the problem [is] the incompleteness of the contracts that structure such a complex relationship, one which requires high levels of commitment to protect [often] large sunk investments against opportunism.<sup>25</sup>

The potential for opportunism arises because franchisors and franchisees commit to their relationships by signing standard form executory contracts. These are drafted by franchisors to reflect their interests, mitigate their risks and maintain consistency throughout the franchise system. They place numerous controls and obligations on franchisees while expressing limited franchisor obligations, often in discretionary terms. The non-negotiable nature of the contract is symptomatic of the pervasive asymmetry that permeates franchise relationships.<sup>26</sup>

As Hadfield observes of franchising, 'such an odd-shaped beast tangles in many areas of the law'.<sup>27</sup> Through the process of navigating the tangles franchise law has now evolved as a discrete legal discipline. In jurisdictions that have introduced franchise-specific laws, the need to protect franchisees from exploitation was acknowledged. For example, a professed objective when Australia's original mandatory Franchising Code of Conduct was enacted in 1998 was to 'address the imbalance of power'<sup>28</sup> between the parties prior to and/or during the term of the franchise agreement. This has now been reoriented as regulation 'to regulate the conduct of participants in franchising towards other participants in franchising'.<sup>29</sup> The asymmetry of power continues into the political sphere. The franchisor voice often has the greater influence on legislation. For example, Division 3 of Australia's Franchising Code of Conduct ('Code') imposes a duty on the parties to act in good faith. But this does not extend to the franchisor's parent entity. While some consumer protection laws have acknowledged franchising, insolvency law has yet to adapt to the business model.

The American Federal Trade Commission (FTC) Rule is national regulation, supplemented in 24 states<sup>30</sup> by additional regulation.<sup>31</sup> Australia's franchise sector is regulated by the *Competition and Consumer (Industry Codes—Franchising) Regulations 2014* (Cth). The UK relies on general commercial law to regulate franchising. Where specific legislation does exist for franchise relationships, it focuses variously on pre-contract disclosure, cooling off rights, registration of disclosure and franchise agreements or agents, implying terms into agreements and dispute resolution methods. The risk to franchisors of franchisee insolvency has been addressed in some franchise regulations that identify franchisee insolvency as an event triggering the franchisor's right to 'terminate without notice'. Franchise agreements provide the same rights. No regulatory, and little academic attention, has been paid to the possibility of franchisees' rights in franchisors' insolvency.

The franchisor's role includes formulating network policy, making strategic decisions, managing the network and negotiating supplier agreements. The franchisees' role is to create a business following the franchisor's blueprint and adhere to the terms of the franchise agreement and any system changes introduced periodically through amendments to operations manuals or, in the case of significant amendments, new franchise agreements. Beyond a requirement of good faith in some jurisdictions, franchisors are not required to justify any strategic or operational decisions to their franchisees.

A key distinction between a relationship categorised as employment or as a franchise is that where the employer is a corporation, the conduct of its directors and officers towards employees is

measured against standards in corporate law. For franchisors, this additional layer of governance regulation is absent. Franchising is a contract-based relationship. In Australia, even the statutory duty of good faith is diluted by cl 6(6) of the Code, which provides: 'To avoid doubt, the obligation to act in good faith does not prevent a party to a franchise agreement, or a person who proposes to become such a party, from acting in his, her or its legitimate commercial interests.' Thus, there is no requirement for a franchisor to consider the impact of strategic decisions on its franchisees if this would be contrary to its legitimate commercial interests.

In the US, '[c]orporate lawyers have managed to draft contracts to eliminate the implied covenant of good faith and fair dealing in franchise agreements. They have also lobbied in every state to eliminate the fiduciary duty that franchisors should owe to their franchisees'.<sup>32</sup> However, cases are fact-specific and there remains some state legislation.<sup>33</sup> Similarly, in Australia, it has been argued that franchisors owe no fiduciary duty to their franchisees.<sup>34</sup> A franchisor's relationship with franchisees attracts no scrutiny under corporate law. This becomes a significant issue in insolvency.

There are some common features. Both employees and franchisees are usually protected by legislation prohibiting misleading or deceptive hiring practices. Employees often have additional protections associated with an employer's insolvency, including a statutory priority for pay entitlements,<sup>35</sup> national safety net insurance funds,<sup>36</sup> employment protection during business transfers,<sup>37</sup> information and consultation obligations for companies undergoing large-scale redundancies or lay-offs and redundancy pay,<sup>38</sup> and sometimes, government lifelines.<sup>39</sup> No such lifelines or protections exist for franchisees.

Despite the absence of empirical evidence, franchising benefits from the mantra that the business model is more successful than independent small business. Many franchisors start franchising before the franchise businesses are sufficiently established as proven successes. In Australia, 42 per cent of brands began franchising immediately, or within the first year of operation.<sup>40</sup> The evidence does show that both new and long-established franchisors can fail.<sup>41</sup>

## Franchisee Risks in a Failing Franchise

Employment relationships have long been recognised as having an inherent imbalance owing to the power an employer has in the provision of terms, wages and work to employees. Like employees, franchisees are beset by asymmetries of information, bargaining power, contractual negotiation, process, experience of adviser, premises, finance and regulation. It is in the asymmetries of information that the forces of the competitive marketplace are particularly disrupted, rendering it unequal as between franchisees and franchisors. A perfectly competitive market must not have asymmetries of information, or else market equilibrium will be disrupted in favour of the party with greater information, normally the franchisor in this case. While true that the franchise agreement is predicated on an assumption of some basic informational asymmetries, such as local demand and site of the premises,<sup>42</sup> this does not negate the fundamental economic requirements of a perfectly competitive marketplace requiring no regulation to ensure fairness. When faced with a franchisor's insolvency, the need for information upon which to base decisions that could save a franchisee's financial security is more acute. These asymmetries are not a part of the accepted assumptions of the franchise business model. Thus, decisions made by franchisees who are beset by information asymmetries of this nature may not be made in a truly utility or profit-maximising way,<sup>43</sup> leading to a failure in the competitive franchise market insofar as it should benefit a franchisee's business decisions. Such market failure will often indicate the need for some form of



regulation in order to mitigate the imbalance in competition.<sup>44</sup> The recommendations at the end of this article attempt to provide a potential mitigative regulatory framework for this imbalance.

Through franchise agreements franchisees take on significant risks that an employer lacking the opportunity to outsource to franchisees would otherwise bear. These include intangibles, such as market and location risk, as well as concrete costs, like fitting out the business premises, paying for insurance and advertising, carrying stock, hiring employees, accommodating leave entitlements, paying payroll tax and superannuation. Their franchisor's insolvency will often catch franchisees unawares. Having bought into a 'proven' system, neither they nor their transactional advisers normally consider the consequences of the franchisor's demise. Naivety to the risk of franchisor failure is made more acute by optimism bias and because franchisees are excluded from a role in the franchisor's insolvency process. As such, franchisee risk persists due to the lack of appropriate regulation.<sup>45</sup>

Strategic decision-making input into the franchisor's business is beyond the role of franchisees. For example, the franchised Sizzler restaurants in Australia were reduced to non-core businesses by parent company Collins Foods to enable Collins to focus on growing its KFC outlets. Consequently, Sizzler was not allocated any growth capital in 2016 following a \$37.5 million writedown of the brand.<sup>46</sup> This marginalising of franchisees from input into the franchisor's strategic decisions is also recognised by Hashim, who observed that unless a franchisee becomes a shareholder, they have no scope for participation in franchisor decision-making.<sup>47</sup>

Franchisees in Australia are warned *ex ante* that a franchisor or franchisee could fail in a range of ways. Both regulator-funded pre-franchise education and Code-mandated pre-contract disclosures warn that some franchisors and franchisees fail. Franchisees are informed that franchises have a lower failure rate than other businesses but acknowledge that franchising is not risk-free and that insolvency could be one of those risks, which 'may have significant impacts on your business, for instance, you may no longer be able to use the franchise system's branding'.<sup>48</sup> There is no empirical support for this assertion of a lower failure rate.

Inability to use the franchisor's branding will be the least of a franchisee's worries. An administrator owes statutory duties to the franchisors' creditors, including its employees. If the franchisor is head tenant and the franchisee is a subtenant of the franchisees' premises, entering administration is a breach of the head lease. The landlord can then terminate the head lease, leaving the subtenant franchisee without premises. The same is true for intellectual property assets that may be sold by an administrator to secure distributions to creditors. If these are sold to a competitor, the franchisees can no longer use them. This would destroy the brand value of the franchised business.

The Franchise Council of Australia (FCA) warns, downplaying the consequences of franchisor failure, that one should not engage in self-employment or franchising if one is not prepared to risk losing the investment made. 'There are no guarantees of success in any form of small business, and even though franchising is by far the most successful form of small business, it is still a business venture with the many of the same risks inherent to any other business venture.'<sup>49</sup> Warnings like these should at least serve to alert a prospective franchisee's transactional advisers to the possibility of franchisor failure. This is, however, predicated on three flawed assumptions. Firstly, transactional advisers are seldom versed in the complexities of insolvency. Secondly, it is widely assumed that franchisors only sell businesses that are proven. In fact, in Australia, as already noted, many franchisors start franchising without having experienced a full 12 months' trading.<sup>50</sup> Finally, it is assumed that franchisees are business people who should conduct proper due diligence, take professional advice, negotiate better contracts and that, having decided to buy a franchise, must

cope with their decision. Franchisees generally do conduct better due diligence than buyers of independent small businesses,<sup>51</sup> but not all do so. The ability to conduct thorough due diligence is hampered by an absence of information on public databases, which in Australia is exacerbated because a master franchisee, such as the 7-Eleven master franchisee for Australia, may be one of the 1500 'Exempt Proprietary Companies' exempt under the *Corporations Act* from annual filings in the Australian Securities and Investments Commission.<sup>52</sup> This makes conducting due diligence on that company's finances impossible. In addition, excessive cost, franchisees' optimism bias,<sup>53</sup> dependence asymmetry<sup>54</sup> and, recalling Hashim's comments, the franchisee being 'clueless', mean that new franchisees don't know what they don't know.

Novice franchisees behave more like first-time consumers. Even 'carefully crafted [legal or accounting] advice does not help when the blood lust is up'.<sup>55</sup> Being psychologically and emotionally committed to becoming a franchisee, the client does not hear advice to the contrary. As Alan Wein noted, 'an aspiring franchisee's desire to "buy a job" clouds the willingness to analyse objectively the commercial terms and risks or to make sure that expectations match the contractual reality'.<sup>56</sup> This mirrors the lack of choice that employees have in accepting employment; there really is no choice if there is only one job on offer.

In the UK, there are no franchise-specific regulations, though the British Franchise Association (BFA) has adopted the European Code of Ethics in its BFA Code. The BFA Code only provides guidance on its requirements for compliance and omits warnings of the risks of franchising. It requires a prospective franchisor to pilot the concept before starting to franchise, provides requirements as to the return of preliminary deposits, requires recruitment advertising to be free of ambiguity and requires parties to be fair towards each other.<sup>57</sup> The BFA Code is non-binding and there is no clear sanction for a breach.<sup>58</sup> This does not mitigate the risks undertaken by franchisees entering into a franchise agreement.

In the US, the FTC Rule mandates comprehensive disclosure in the form of the Uniform Franchise Offering Circular that all franchisors must adhere to, but this does not provide the franchisees with standing in their franchisor's bankruptcy. In addition, many US states have enacted franchise-specific regulation. The US-based International Franchise Association (IFA) Code of Ethics requires mutual respect among franchisees and franchisors, compliance with the law and appropriate conflict resolution in its Mission Statement. As in the UK, the IFA Code is non-binding and there are no required pre-agreement warnings about asymmetries of information or the risk of failure.<sup>59</sup> Thus, UK and US franchisees have similar risks to their Australian counterparts.

Franchisors have continued to advertise for franchisees while insolvent,<sup>60</sup> despite, in Australia, issuing the required pre-contract disclosure containing the solvency statement.<sup>61</sup> According to a survey conducted in 2014, among a sample of eight Australian administrators who had administered failing franchisors, 'three of the eight said there was evidence that this behaviour was present in the franchises they were administering'.<sup>62</sup> When all other sources of debt finance have dried up or become prohibitively expensive, the opportunity to inject a franchise fee, which ranged from \$0 to \$150 000 in Australia in 2016,<sup>63</sup> into its revenue can prove irresistible to a failing franchisor.

As franchisors expand their operations beyond their own borders they introduce intermediaries: master franchisees who are responsible for populating a specific territory with franchisees. Franchisees in that territory contract with the master franchisee who, in turn, contracts with the franchisor. At each level of the franchise system, there is a multiplier effect. A franchisor may, for instance, appoint 10 master franchisees in distinct territories. Each of these in turn signs franchise agreements with numerous unit or multi-unit franchisees who establish businesses

following the franchisor's blueprint. 'The interrelated nature of the franchisor and franchisee's businesses together with the pattern of contractual relationships that bind the franchise network are strengths that become weaknesses for franchisees if a franchisor fails.'<sup>64</sup> While the franchise agreement will be the main focus of the insolvency practitioners, there are other contracts that franchisees must execute so they can operate their businesses. These may include, for example, leases, subleases, licences, guarantees, supplier agreements, loan agreements and contracts with employees. The franchisee will remain bound to perform these contracts even after the franchise agreement itself is disclaimed by the franchisor's liquidator. The failure of one franchisor has a domino effect through to the franchisee-owned businesses. To their further disadvantage, unit franchisees have no privity of contract with the franchisor if there is a master franchisee between them, leaving them without rights as unsecured creditors in the franchisor's insolvency.

Most franchisors, master franchisees and franchisees need to borrow money to establish their business. In Australia in 2016, unit franchisees' 'start-up costs ranged from \$2,500 to more than \$1.225 million'.<sup>65</sup> Much of this investment is in sunk costs as shown in Table 1.

Table 1 shows the sums involved in establishing one retail franchise in Australia in 2016, and the participation available to the franchisee in the franchisor's administration. The borrowed amounts are secured over the franchisee's assets, including its director's home. Franchisees also provide personal guarantees for the head lease of their premises, which is often granted to the franchisor/master franchisee.

In contrast to the cost of the failing franchisor's employees, its franchisees and their employees are a costless source of labour for franchisors' administrators. Administrators can choose which contracts to either retain or decline to accept personal liability for<sup>68</sup> during an administration in most jurisdictions.<sup>69</sup> If an administrator retains franchise agreements, franchisees will be required to continue operations despite a franchisor's insolvency as they remain contractually bound to perform under the franchise agreements, unless otherwise provided for in the agreement. Because the costs of running a franchise, including wages, superannuation, insurances and other allowances and benefits, fall on the franchisee, the administrator incurs no additional cost to the franchisor in administration if it continues the franchise agreements and there is no urgency to prioritise the resolution of any issues relating to them. Thus, administrators can benefit from the profit-sharing aspect of the franchise agreements without incurring any of the business costs of the franchise operations.

Unlike employees, who are entitled to be represented in Committees of Creditors, franchisees may not be creditors of the franchisor; most are debtors.<sup>70</sup> Some administrators put franchisees into creditors' committees 'for a dollar', acknowledging that they do have an interest in the outcome of the administration. However, there is no requirement to do so. There is no clear mechanism for ensuring that franchisees are informed or consulted, as evidenced in a 2014 survey of administrators of Australian franchisor firms.<sup>71</sup> By contrast, employees of all three jurisdictions enjoy some form of regulatory protection and/or participation rights when jobs are at risk.

## Franchisees in Franchisor Insolvency

As is now clear, '[t]he law does not accommodate the franchisees' interests in a neat or predictable way if its counterparty's business fails'.<sup>72</sup> For them, the loss of a franchise can represent the loss of not only a large, sunk investment, but also their family's sole source of income,<sup>73</sup> possibly leading to financial ruin.<sup>74</sup> While true that franchisees have a choice and are required to engage in due diligence, their business experience, or lack thereof, may result in unwise choices influenced by

**Table 1.** Actual costs of an Australian franchisee buying into system in 2016, and outcome for those funds in franchisor's insolvency.<sup>66</sup>

1: Item paid by franchisee	2: Franchisee's investment	3: Relevant contract	4: Franchisee paid to...	5: Outcome for franchisee in insolvency of franchisor
Franchise fee paid to secure rights for five years	\$50 000	Franchise agreement between franchisee and franchisor signed	Franchisor in full before commencement of business	Franchisee has no statutory right to claim from administrator. Franchisee will be a creditor for an amount in damages for breach of the franchise agreement. The franchisor may seek leave to bring proceedings against the insolvent franchisor to quantify its claim. <sup>67</sup>
Sunk fit-out costs	\$550 000–\$750 000	Disclosure document	Franchisor for payment on to independent shop fitter	Lease (in franchisor's name) disclosed by administrator. Landlord would negotiate with franchisor for a continued tenancy agreement if franchisor gave up value of fit-out. Lost sunk cost of fit-out and portion of other costs.
Other fit-out costs (eg, design, point of sale systems)	\$260 000–\$425 000	Disclosure document	Franchisor or supplier	Lease (in franchisor's name) disclosed by administrator. Landlord would negotiate with franchisor for a continued tenancy agreement if franchisor gave up value of fit-out. Lost portion of other costs.
Franchisor's fit-out supervision	Est. \$50 000–\$80 000	Franchise agreement between franchisee and franchisor	Franchisor as a stated fee on top of invoiced fit-out cost	Service fully performed by franchisor; franchisee no right to claim.
Inventory/stock	\$45 000	As specified by franchisor in Operations Manual	Franchisor or supplier	Return, sell, depends on terms of supply
Security deposit on franchisor's head lease	Bank guarantee — est. \$45 000–\$60 000	Franchise agreement between franchisee and franchisor	Provided direct to landlord	In some jurisdiction franchisor's subtenant can negotiate with landlord if head tenant (franchisor) insolvent

(continued)

**Table I. (cont nued)**

1: Item paid by franch see	2: Franch see's investment	3: Relevant contract	4: Franch see paid to...	5: Outcome for franch see in insolvency of franch sor
Monthly premises rent and outgoings	\$12 000–\$13 000	Lease between franch sor and ord. Sub lease/ licence between franch sor and franch see	Franch sor for forwarding to and ord	Franch see debtor of franch sor. Franch sor in breach of lease because of appointment of administrator
Training costs	\$20 000	Franch see agreement between franch see and franch sor	To generate revenue of franch sor or franch sor-related company on day paid	Franch see not creditor or debtor. No claim possible
Store opening campaign	\$10 000–\$15 000	Franch see agreement between franch see and franch sor	Paid to franch sor up front	Franch see not creditor or debtor. No claim possible
Facility, telephone, electricity	Est. \$5 000–\$10 000	Franch see agreement	Supplier	Franch see not creditor or debtor. No claim possible
Legal & accounting costs	Est. \$10 000–\$20 000	Franch see agreement and Code	Supplier	Franch see not creditor or debtor. No claim possible
Options to open future franch see-owned stores @ \$20 000 per option	\$60 000	Agreement between franch sor and franch see	Paid to franch sor up front	No statute-based claim possible. Franch see not a creditor for \$60 000 unless it could claim breach of contract/quasi-contract at common law. Requires court consent to initiate civil proceedings. These norms are prevented under ss 440D or 471B Corporations Act 2001 (Cth) in Australia

their hopes for success and related optimism bias. Franchisor insolvency may also lead to the loss of franchisees' employees' jobs, indicating additional social costs. Where a franchisor is the supplier of goods sold by its franchisees, the loss quickly compounds as set-off against money owed to the franchisor is not available. Franchisee debts must be paid in full, while their credits in franchisor insolvency are unsecured.<sup>75</sup>

The bulk of franchisors' assets are intangible,<sup>76</sup> consisting of intellectual property<sup>77</sup> and use licences, head leases<sup>78</sup> and franchise agreements. As Mark A Kirsch and Lee J Plave note, '[f]or many franchise systems, the vast majority (or sometimes all) of the brand outlets are . . . owned and operated by independent franchisees. . . . Consequently, the franchise relationships — contractually ratified by the franchise agreements — are usually the most critical assets owned by a franchisor'.<sup>79</sup>

Franchisors are in a strong position to monitor the financial viability of their franchisees' businesses by being head lessee of the franchisee's premises, possibly suppliers of stock and receiving electronic point of sale reports of franchisees' takings. This puts the franchisor into a position where they can identify the risk of a franchisee's financial difficulty early. Their response, to avoid an insolvency procedure, can be to allege the franchisee has committed a breach of the franchise agreement by defaulting on a debt obligation. If the franchisee is unable to remedy the breach, the franchisor terminates the franchise agreement. This deprives the franchisee's creditors of the opportunity to recover debts through their own insolvency procedure with the franchisee. Franchisees do not have the same access to financial information about their franchisors' ongoing finances. Rather, '[t]he financial difficulties of a . . . franchisor may become apparent only when the franchisor's obligation to provide advertising support, equipment and inventory on a timely basis . . . are breached'.<sup>80</sup>

The foregoing demonstrates that franchisors have access to a wealth of information on their franchisees so that they can monitor and control how their business and brand are being used. Franchisees, however, have very little access to information about the franchisor's business and finances that could help them to come to decisions in their financial best interest. This information asymmetry, acute in a franchisor's insolvency, is a clear disruption in the competitive franchise market, justifying some form of interference in order to mitigate the unfairness present in the marketplace.<sup>81</sup> The following sections discuss what, if any, protections are present for franchisees in the United States, Australia and the United Kingdom if its franchisor becomes insolvent in order to determine whether further regulation is needed to introduce fairness in the franchise relationship.

## Jurisdictional Comparisons of Franchisor Insolvency

### *The United States*

Strategic insolvency 'arises where the bankruptcy is invoked due to strategic decision-making rather than being a passive response to market forces'.<sup>82</sup> This may be appealing to a franchisor to achieve any one of several possible objectives. US franchise lawyers note that '[b]ankruptcy . . . may assist a franchisor in addressing challenging business issues, such as overexpansion in the market and the need to eliminate units, an unworkable equity structure; desire to sell or merge with another entity; threat of franchisee litigation; desire to refinance but the lender has expressed concern about financial or other issues'.<sup>83</sup> Because franchise agreements are executory contracts, they cannot be terminated by reason of the filing for bankruptcy.<sup>84</sup>

Franchisees do not enjoy automatic standing in franchisor bankruptcy. Rather their degree of involvement remains at the discretion of the administrator. '[S]ome . . . administrators convene committees of franchisees. This creates a two-way information conduit and enables the administrators to gauge whether, perhaps, a group of franchisees is interested in buying the franchisor's business.'<sup>85</sup>

## Australia

Challenges confronting Australian franchisees of failing franchisors arise from uncertainty over ongoing rights to use brands and premises; risk of court-sanctioned extended periods of administration; lack of access to creditors' meetings; refusal of administrators to mediate disputes; having to continue trading because there is no *ipso facto* clause enabling franchisees to terminate their agreement in the event of insolvency;<sup>86</sup> inability to prosecute as the *Corporations Act* provides for a stay on proceedings by third parties during administration; and loss of customers who do not want to trade with a business they perceive (by brand association) is failing.

On the insolvency of the franchisor, franchisees may discover that their brand's intellectual property is owned by another company.<sup>87</sup> As a result, licence fees may be breached or present a liability that the administrator may not decide to adopt, or choose to sell, potentially invalidating the franchisees' IP licenses. Leases also 'present [an] area of recurring uncertainty'<sup>88</sup> to administrators to whom a five-day grace period is granted to deal with such leases.<sup>89</sup> An insolvent franchisor will likely default on the head leases of franchisees' trading premises, causing its franchisees to forfeit their rental deposits and lose the right to trade from their premises.

Normally the second creditors' meeting (at which the administrators make a final report with recommendations to creditors) must be held within 21 days of the appointment of the administrator.<sup>90</sup> However, the court has discretion to consent to this meeting being held later. In the *REDgroup Case*, the administrators appointed on 17 February 2011 were granted additional time to hold the second meeting of creditors. On 14 March 2011, Stone J ordered,

[p]ursuant to s 439A(6) of the *Corporations Act 2001* (Cth) (Act), . . . the period within which the Administrators of the second plaintiffs must convene meetings of creditors of REDGroup Retail Pty Ltd and each other company names in the Schedule under s 439A of the Act [is] extended up to and including 18 September 2011.<sup>91</sup>

This enabled the administrators to identify and negotiate with potential buyers of parts of the business. The extended time frame placed the franchisees in limbo for 213 days from the administrator's appointment to the second creditors' meeting, 192 days (nearly 28 weeks) longer than the usual statutory period. This time frame underscores the complexity of franchisor administration and emphasises the franchisees' vulnerability. Evidence shows that such extensions are common to maximise the administrator's opportunity to sell the franchise as a going concern.<sup>92</sup> A consequence of time extensions for franchisees who are not consulted is that they must continue operating their business while dealing with less advantageous supplier terms because they are now being supplied directly without the prior benefit of franchisor-negotiated bulk discounts. They must also juggle the instructions of the administrators, hoping that they will be able to remain in business.

A franchisee is not a creditor for the sunk portion of its investment (see Table 1) unless it can make a claim against the franchisor or liquidator through an equitable action for unjust enrichment.



A prerequisite to any such action would be obtaining a court's consent to the civil proceedings being initiated against the insolvent party.<sup>93</sup>

For agreements that fall within the ambit of the Code, *franchisors*, but not franchisees, are provided with what amounts to a statute-sanctioned *ipso facto* clause. This enables a franchisor to terminate a franchise agreement if the franchisee becomes bankrupt, insolvent under administration or an externally administered body corporate.<sup>94</sup> This puts the Code in conflict with the *Corporations Act* and is an example of the disconnect between consumer protection law and corporate law and their respective Australian regulators: the Australian Competition and Consumer Commission and Australian Security Investments Commission.<sup>95</sup> This right to terminate is not extended to franchisees. This is an example of legislation that purports to level the playing field, tilting it even further in favour of the stronger party.

### **The UK/EU**

Administration does not automatically terminate franchise contracts in the UK either. However, when the administrator chooses to continue the business, any expenses accruing under existing contracts will be counted as an expense of the administration.<sup>96</sup> Often, franchise agreements will be the franchisor's only saleable asset. An administrator will logically adopt them, intending to sell them to swell the pool of funds for distribution.

In a 2007 survey of members of the International Bar Association's committees on restructuring and franchising, participants were asked how franchisees could potentially be categorised in their franchisor's insolvency. Responses from Belgium were as a creditor or a debtor; Denmark, as an asset, creditor, debtor, franchisee or other; England, as a creditor or debtor; Finland, as a creditor, debtor or franchisee; France as other; Germany as a liability, creditor, debtor or franchisee; Greece as an asset, liability, creditor or debtor; Ireland as 'don't know'; and Spain as a creditor.<sup>97</sup> Only 10 of the 26 jurisdictions surveyed (Canada, Denmark, Finland, Germany, Mexico, the Netherlands, New Zealand, Scotland, Switzerland and Syria) recognised franchisees as a stakeholder in the franchisor's insolvency.<sup>98</sup> The range of responses suggests there is no settled approach to the categorisation of franchisees in this situation.

### **Justifying Franchisee Participation in Franchise Decision-Making**

In most jurisdictions, the employment relationship can be characterised by the subordination of an employee to the needs of the employer, who will generally have control over hours, workplace, tools and work performance. An inherent imbalance in employment relationships has historically allowed for the exploitation of employees,<sup>99</sup> and the intentional framing of some employees as franchisees in the US,<sup>100</sup> or as independent contractors in Australia.<sup>101</sup> Employment law today equalises the bargaining power in employment relationships through legislation, preventing employers from unfairly exercising their power over employees and protecting employees' right to continued employment. As indicated, no such mitigation of franchise relationship inequities yet exists, despite the clear moral hazard present in the business model.

### **Justifying Employee Protection in Insolvency**

The argument for protecting employees with some priority in insolvency stems from various justifications. In the US, the purpose of Chapter 11 of the United States Code (the Bankruptcy

Code) as a reorganisation procedure indicates the hope that the business will continue. Also, an employee's wages represent a large part of that person's wealth; they do not enter the relationship consciously factoring in the risk of their employer's default like a trade creditor negotiating a contract might. Prioritising employee claims may prevent valuable employees from seeking work elsewhere and taking corporate knowledge with them while a reorganisation is taking place.<sup>102</sup> In Australia, it has been suggested that '[e]mployees enjoy priority predominantly because they are involuntary creditors'.<sup>103</sup> Franchisees could arguably claim priority on the same basis.

Historically, it has been argued that social policy and regulations are an illegitimate interference with market relations.<sup>104</sup> While freedom, autonomy, liberty and individualism are central to the needs of free market capitalism and a growing commercial economy,<sup>105</sup> these positive characteristics are not always accessible. It is an inaccurate reflection of the real position of employees in the labour market, and by analogy, franchisees. If markets are truly competitive, information must be perfect to reach a true competitive equilibrium. This presumes that government intervention should not be necessary to maintain market efficiency in an optimally competitive situation.<sup>106</sup> However, labour markets, and by extension the market for franchisees, are imperfectly competitive due to inequality of bargaining power, unequal access to information and resources and unequal rights, as demonstrated.

While employment law often impedes the perceived efficiency of the free market, it is justified to restore balance to an otherwise potentially exploitative and imbalanced relationship that, without control, would be socially inefficient and unjust due to a unilateral reduction of employment rights.<sup>107</sup> One argument in favour of including progressive employment rights as a factor for improving market efficiency is the association of limited employment rights with market failures influenced by informational problems causing an inefficient allocation of resources.<sup>108</sup> It is only necessary to observe the exploitation of workers that does occur in developing countries to realise that such conditions persist.<sup>109</sup> Franchisees are easy contemporary subjects for similar manipulation.

Over the last few decades, information, consultation and participation requirements have been introduced when collective redundancies are envisaged. This is particularly relevant for our discussion about how the franchisee should be considered. Most employment law regimes apart from the US imply a term of 'mutual trust and confidence' or 'good faith' through either statute or common law into the employment relationship. Any breach can have legal consequences, which is one of several factors that differentiates employees from franchisees. Nevertheless, employees and franchisees have much in common.

## **Justifying Franchisee Participation: Moral Hazard**

There are several reasons why a business owner may choose to franchise, many of which relate to reducing their financial risks. When a business owner is required to hire more employees, increasing employee liabilities, franchising presents an opportunity to defray those costs and increase profitability by outsourcing employees to franchisees.<sup>110</sup> Further, maintaining a centrally organised company with several units separated geographically can be costly for developing effective means of controlling employees and managers.<sup>111</sup>

Other factors that favour franchising include low initial investment costs and more repeat customers.<sup>112</sup> Finally, the franchise contract itself is habitually drafted in favour of the franchisor with a view to increasing profit and control,<sup>113</sup> often at the franchisee's expense. Given the foregoing, one thing is clear: franchisors, whether intentionally or not, mitigate their personal business

risks by substituting franchisees as risk bearers. Passing risk freely in this way presents a moral hazard that, during a franchisor's insolvency, becomes all the more severe. There are many aspects of the franchise relationship and characteristics of franchisees that demonstrate this moral hazard.

### Decentralisation

Franchises are highly decentralised organisations whose degree of decentralisation comes into sharp focus during insolvency. The franchise network is designed to divide the globe into territories allocated to master franchisees and unit franchisees. Geographically dispersed franchisees may have no way to contact each other outside franchisor-controlled channels. The risks associated with their franchisor's insolvency crystallise for franchisees when the administrator is appointed. The situation takes them by surprise. A franchisee who does not know that, for example, having to pay cash on delivery for supplies can indicate their franchisor has not been paying suppliers, will not be alert to signs of impending insolvency.<sup>114</sup> Similarly, if the head lease of the franchisee's trading premises is held by the franchisor and the franchisee has paid its rent and outgoings on time, it will not know the franchisor has failed to pass those sums to the landlord until the landlord issues an eviction notice.

Franchisees cannot protect themselves *ex ante* through their standard form franchise agreements, nor through legislated protection. Legislation enacted to provide protection to franchisees operates largely as a form of precommitment information delivery. Some jurisdictions mandate registration on a government database of the franchise disclosure document, and/or franchise advisers, is required. Notably absent are statutory or contractual rights for franchisees if their franchisor enters the insolvency process. They are like the Cheshire Cat — visible and essential when all is going well, then fading as the administration proceeds.<sup>115</sup>

### Optimism Bias

There is growing evidence that people tend to be stubbornly optimistic, regardless of how well informed they are. Most are overconfident about the future, even when they understand the risks.<sup>116</sup> This is the 'optimism bias' referred to previously, which is one justification for introducing protection in the form of information and consultation for franchisees to mitigate the moral hazard presented by the franchise model. Although franchisees are given due diligence information, processing such information is replete with subjective problems. It can be difficult to respond to this information as people depend on their own experiences to judge information. These perceptions (and judgments based on them) may often exhibit overconfidence if a particularly positive outcome is possible.<sup>117</sup> The franchise sector's pervasive mantra of a successful franchise is one such widespread positive outcome. Optimism bias considers the illogical perceptions that individuals may have of themselves when undertaking certain risks, in this case, the risk of becoming a franchisee.

The extent to which warning franchisees about the risks associated with franchising will affect how rational their decisions are is questionable. Overoptimism is derived from a tendency to reject or downplay information that contradicts more favourable information.<sup>118</sup> Research on franchisees in the US has shown that they are strongly optimistically biased in relation to known and potentially damaging risks to their business.<sup>119</sup> Thus, it is arguable that franchisees are more likely to be positively influenced by the promise of success and profit than by the intangible and perhaps intellectually inaccessible risks associated with engaging in the business model. Individuals prefer

to believe that they are intelligent enough not to subject themselves to substantial risk.<sup>120</sup> Thus, optimism bias combined with asymmetries in information and bargaining power in the franchise relationship, the size and nature of the franchisees' investment, the absence of franchisor duties beyond the contract and the likelihood that franchisees are geographically remote from the franchisor leave franchisees more vulnerable than employees and present a clear moral hazard. As that relationship matures and the spectre of insolvency or restructuring that excludes them looms, franchisees may find themselves without enough information, time or access to suitable advisers to mitigate their risks.

### *A Fairness Argument*

While there is an imbalance in the relationship between franchisors and franchisees, whether there is also a macro-economic argument for providing protection is untested. The 'change in the way employing organisations work'<sup>121</sup> in the 21<sup>st</sup> century by shifting employees off the payroll and turning some of them into franchisees should not free creditors of these organisations or alleviate the responsibility of policymakers from creating a clear set of rights that recognise the stake of franchisees if their franchisor becomes insolvent. Franchisees are not nearly as numerous in the entire labour market as employees but do form a sizeable proportion of the workforce in some sectors.

Franchisors' strategic decisions may be to invest rashly, embark on distracting and expensive litigation, expand into unprofitable new markets or countries, or even become insolvent. If insolvency results, the franchisor's employees are protected by priorities in law and through union representation, but franchisees are not; nor are their employees except insofar as national regulations provide. Franchisees are currently subject to the whim of the administrator and the market. If their businesses are unable to continue, they probably also lose the fit-out of their premises, rental deposits, and lay their own staff off. It may be that the best argument in favour of additional protections would be a socially orientated one from the perspective of the franchisee as the weaker party in the franchise relationship. The question, then, is what model such protections should take. We suggest that some form of consultative rights may be adequate to provide an advanced warning mechanism, allowing franchisees time and information to operate collectively to mitigate their individual franchise risks.

It is acknowledged that such change is difficult to implement due to the path-dependent nature of the institutional rules that have developed in the franchise model. However, as the *laissez-faire* path in the labour market has been well and truly broken by most jurisdictions, it is not too far-fetched to suggest that a similar, if less onerous, protective framework be introduced to mitigate against the moral hazard we have demonstrated is present in the franchise relationship, particularly on the eve of insolvency.

### **Options and Recommendations**

To identify whether some participative procedure may be appropriate for franchisees, it is worthwhile examining what parallel procedures exist for employees who are subject to insolvency procedures in the jurisdictions under study. We may then borrow some elements from these procedures to create a participative framework for franchisees affected by the insolvency procedures of their franchisors.

There are limited participative procedures available to American employees, largely due to adherence to the employment 'at-will' doctrine. The only alleviation is the *Worker Adjustment and Retraining Notification Act*,<sup>122</sup> passed to mitigate social issues surrounding large-scale bankruptcies. Per §§ 2101–2102, the *WARN Act* does not require consultation, merely 60 days' notice by employers having over 100 employees. It applies to plant closures resulting in 50 or more dismissals and mass lay-offs of 500 or more employees or 33 per cent of the workforce at a single site. Realistically, the US does not provide participative procedures in the event of an employer's insolvency outside of what is provided in collective agreements. These vary from employer to employer and lack consistent application.

In Australia, the *Fair Work Act 2009* (Cth) ('*FWA*') provides for employee participative procedures. Collective redundancy provisions under the *FWA* pts 3–6, sub-div 2 are applicable. Employers must consult with employees and their representatives if 15 or more dismissals are proposed for economic, technical or structural reasons by notifying each registered employee association that could represent associated members of proposals and reasons for dismissals, the number of affected employees and the period over which dismissals should occur. Notice is to be given as soon as reasonably practicable after coming to the decision and before dismissal.<sup>123</sup> It has been recommended in Australia that franchisees of franchisors in administration should have the right to put the administrator on notice that if a suitable buyer for the franchise system is not found within a reasonable time, the franchisees should have the right to terminate their contracts.<sup>124</sup> This would impose an obligation on administrators to seek a competent replacement for the franchisor, not just a source of cash for the franchisor's creditors.

In the UK, participative procedures for collective redundancies have developed through the implementation of the EU Collective Redundancy Directive ('*CRD*').<sup>125</sup> It mandates employee participation through consultation obligations. When the *CRD* applies, an employer must consult staff representatives. It specifies the points these consultations must cover, the information the employer must provide, and imposes procedural rules. While the implementation has varied across Member States and led to some controversy within EU jurisprudence, the provision presents an interesting model for franchising. It requires that employees are consulted when such redundancies are contemplated<sup>126</sup> and that the consultation should include how collective redundancies can be avoided and how their consequences may be mitigated by considering other social measures, including redeployment and retraining.<sup>127</sup> Employers are required to provide employee representatives with relevant information and notify them in writing of the reasons, numbers and period over which redundancies are envisaged to take place.<sup>128</sup> Of use for our purposes are the requirements of notification and consultation, which would allow franchisees to involve themselves in some decision-making within the franchise and enable them to mitigate the risks posed by the franchisor's insolvency.

There is currently no requirement for franchisees to be involved in their franchisor's strategic decisions. Franchisees, however, would benefit from participation in the decisions that could impact on their livelihood. Some European jurisdictions, due to the make-up of their labour market and focus on collectivism and participation, offer far more participative opportunities to employees via works councils, which may provide a valid model for a similar franchisee participation procedure triggered during major events. Given the above, we set out the following general recommendations:

1. Oblige insolvency practitioners to keep franchisees informed;
2. Require franchisors to inform franchisees if a decision may adversely impact the solvency of (a) the franchise network, (b) the individual franchisor or (c) the franchisee;
3. Require that information about decisions that relate to (a) debt restructuring of the franchisor or any entity whose failure would adversely affect it, (b) organisational change or restructuring of the franchise or franchisor and/or (c) the insolvency or imminent insolvency of the franchise or franchisor, be given to the franchisee no longer than 14 days after the decision is made;
4. Provide that in any of the above situations the franchisee can require the franchisor (or the buyer) to buy back the franchisee's unit(s) if the change results in the franchisee being materially disadvantaged;
5. Adopt a variation of the EU 'works council' model and include franchisees on the board of any corporation that owns or operates a franchise network;
6. Expand the corporate franchisor's directors' duties to oblige directors to owe to franchisees the same duties as they currently have to their company's shareholders, employees and creditors;
7. Require that corporate governance includes a duty for directors to take decisions that factor in the well-being of the corporation's franchisees;
8. Remove Australia's 'Exempt Proprietary Company' exemption under the *Corporations Act* from any company that is issuing franchise agreements;
9. Amend corporate law to give franchisees the right, during the administration period, to collective representation at committees of creditors. An issue to resolve would be whether to allocate them voting rights 'for a dollar' per franchisee or for an amount that more nearly equates to the size of their investment; and
10. Require franchisors to inform the state and/or private institution governing or regulating franchises,<sup>129</sup> in advance if a decision may adversely impact the solvency of (a) the franchise network, (b) the individual franchisor or (c) the franchisee. Such information should be made publicly available to potential franchisees.

## Conclusion

Franchisees are a large group of stakeholders who are simultaneously profoundly affected by, and deprived of, the opportunity to respond collectively to opportunities and threats franchisor insolvency presents. Legislated rights would mitigate the moral hazard these circumstances represent.

'The state has one basic resource which in pure principle is not shared with even the mightiest of its citizens: the power to coerce.'<sup>130</sup> Observers have noted that the legislative process is skewed in favour of groups with lobbying power, usually special interest groups.<sup>131</sup> The ability to lobby effectively to achieve a break in the institutional path of the franchise model requires numbers and cohesiveness, a characteristic lacking among franchisees in all three jurisdictions.

While it was recognised that the power differential in the employment relationship needed balancing against the needs of business efficacy, franchisees have been left regulation-free in parallel circumstances. While true that franchisees have more choice than employees as to whether they want to take up a franchise, the same has been argued in the past about employees and continues to be argued in the US under the employment-at-will doctrine. Although current discourse on this topic adds that employment is a necessity that limits the choices that individuals can truly make in this regard, the fact remains that the argument is still in play in the US, the largest

Western economy. The FTC Rule in America requires franchisors to act fairly, to facilitate informed decisions by prospective franchisees and to prevent deception by requiring franchisors to provide prospective franchisees with extensive information about the franchise prior to the sale. Thus, there is also a justification for the introduction of some form of participative obligations for franchisees as these already exist in some form. The existence of such a rule recognises that there is a risk of abuse. Given the problem of optimism bias in a franchisee's perspective and that even balancing information asymmetries may not prevent franchisees from entering a poor deal, introducing information and consultation obligations in instances of financial distress or other structural decision-making will help to mitigate the significant risks undertaken by franchisees.

Before the franchise agreement is executed, the market has the appearance of competitiveness. However, numerous asymmetries favouring the franchisor and, in Australia, legislation providing rights to franchisors in the cases of franchisee failure, but not the reverse, demonstrate that it is arguably not as competitive as would be a more easily researched market. Once the agreement has been executed, the franchisee is committed to dealing with the franchisor who arguably becomes a monopolist.<sup>132</sup> The forces of the competitive marketplace have failed franchisees.<sup>133</sup> Without the existence of franchisees, the solvent and failing franchisor would have to provide a significant amount of the operational infrastructure, hire staff and 'assume a significant . . . [additional] business risk'.<sup>134</sup> To more equitably position franchisees, we recommend that they should have the right to participate in the franchisor's insolvency as outlined above. This would not significantly complicate insolvency procedures occurring in decentralised corporate organisations but would be a positive incremental step towards providing a level of participative protection that is currently absent in franchise law.

## Notes

1. Sir Brian Langstaff, 'Changing Times, Changing Relationships at Work . . . Changing Law?' (2016) 45(2) *Industrial Law Journal* 131.
2. Veronica L Taylor, 'Contracts with the Lot: Franchises, Good Faith and Contract Regulation' (1997) *New Zealand Law Review* 459, 460.
3. Franchising in Australia broke free of corporations law oversight after a Western Australian franchisee won the right to be provided with a prospectus that complied with the then *Companies Act 1981* (Cth), finding that the franchise fell within the definition of 'prescribed interest': *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) CLC 40 704 ('Casnot'). The regulatory response was to exempt franchisors. See Michael T Schaper and Jenny Buchan, 'Franchising in Australia: A History' (2014) 12(4) *International Journal of Franchising Law* 3, 9 for more details.
4. John W Meyer and Brian Rowan, 'Institutionalised Organisations: Formal Structure as Myth and Ceremony' (1977) 83 *American Journal of Sociology* 340, 341.
5. Gillian K Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42(4) *Stanford Law Review* 927, 991.
6. Mark J Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 641, 646
7. Roe provides an analogy to explain the profound effect of path dependency: describing the winding walking path that detoured to avoid a wolves' den, eventually becoming a winding road that led to cars being designed to deal with high speed cornering capacity. A better solution would have been to build a straight road as people in modern vehicles do not risk being attacked by wolves.
7. Penny Ward, 'Legal and Legislative Directions Relating to Franchising' in B Bell (ed), *Franchising Down Under in the Lands of Oz and of the Long White Cloud: An Historical, Educative and Biographic*

- Review 1983–2003 of Franchising in Australia and New Zealand* (Wilberforce, 2003) 187–92: ‘The Western Australian Supreme Court held in *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) CLC 40–704 that a franchise needed to provide franchisees with a prospectus because the offering fell within the description of a “prescribed interest” form of securities in the then *Companies Act 1981*. Following the *Casnot* decision the (then) corporate regulator, the National Companies and Securities Commission, recognized that the franchise relationship of the early 1980s differed from the relationship between offerors of most prescribed interests and investors in important respects. As a result, it exempted franchisors from the requirement to enter into a trust deed, appoint a trustee and register a statement of their “securities” offering. However, they were required to apply for the exemption and were required to include prescribed provisions in their franchise agreement, provide a prior disclosure document to franchisees and obtain a securities dealer’s licence. This regime was repealed by an amendment in 1987.’
8. By 2016, 39 of the 195 countries in the world had enacted specific franchise laws: DLA Piper, *Countries with Specific Franchise Laws* (January 2016) International Franchise Association <[https://www.franchise.org/sites/default/files/uploaded\\_images/DLAINTLFRANLAWS2016.JPG](https://www.franchise.org/sites/default/files/uploaded_images/DLAINTLFRANLAWS2016.JPG)>.
  9. *Family Law Act 1975* (Cth).
  10. *Partnership Act 1892* (NSW) div 4.
  11. *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) cl 29(1)(b).
  12. Taylor, above n 2, 467.
  13. Francine Lafontaine, ‘Agency Theory and Franchising: Some Empirical Results’ (1992) 23 *RAND Journal of Economics* 263; Kabir C Sen, ‘The Use of Initial Fees and Royalties in Business Format Franchising’ (1993) 14 *Managerial and Decision Economics* 175; Frank A Scott Jr, ‘Franchising vs Company Ownership as a Decision Variable of the Firm’ (1995) 10 *Review of Industrial Organization* 69.
  14. For problems newly created by Australia’s *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth), see Rob Nicholls and Jenny Buchan, ‘The Law of Unintended Consequences: The Effects of Voiding Ipso Facto Clauses in Business Format Franchise Agreements’ (2017) 45 *Australian Business Law Review* 433, 444–6.
  15. Douglass C North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990).
  16. Jenny Buchan et al, ‘Franchisor Insolvency in Australia: Profiles, Factors and Impacts’ (2015) 22 *Journal of Marketing Channels* 311, 323.
  17. The term insolvency is used in Australia and the UK for the failure of a corporation. The term bankruptcy is used in the US.
  18. Uri Benoliel, Jenny Buchan and Tony Gutentag, ‘Revisiting the Rationality Assumption of Disclosure Laws: An Empirical Analysis’ (2016) 46 *Hofstra Law Review* 469.
  19. Alexander M Meiklejohn (ed), *Franchising: Cases, Materials and Problems* (American Bar Association, 2013) 9.
  20. John F Love, *McDonald’s: Behind the Arches* (Bantam Books, 1986) 12.
  21. Lorelle Frazer et al, ‘Franchising Australia 2016’ (Report, Franchising Australia, 2016).
  22. Don Sniegowski, *IFA Chairman Aziz Hashim Says Franchise Profits, Rates of Return are Key* (28 June 2016) Blue Maumau <<http://www.blumaumau.org/15230/ifa-chairman-aziz-hashim-says-franchise-profits-rate-return-are-key#comments>>.
  23. Tracy Leggett, Submission No 199 to Parliamentary Joint Committee on Corporations and Financial Services, *Operation and Effectiveness of the Franchising Code of Conduct*, 2018, 1.
  24. Hadfield, above n 5, 929.



25. Ibid.
26. Jenny Buchan, 'Ex ante Information and ex post Reality for Franchisees: The Case of Franchisor Failure' (2008) 36 *Australian Business Law Review* 407, 422–30.
27. Hadfield, above n 5, 928.
28. Explanatory Statement, *Competition and Consumer Act 2010, Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) 57.
29. *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) sch 1 sub cl 2.
30. Ark Code Ann § 4 72 201; California Corp Code § 31005 (2017); Hawaii Rev Stat § 482E (2017); Conn Gen Stat § 42 133e (2017); 6 Del Code Ann § 2551 (2017); Fla Stat § 817.416 (2017); *Franchise Disclosure Act of 1987*, Illinois 815 ILCS 705/1; Ind Code § 23 2 2.5 1 (2017); Iowa Code § 523 H.1, 537A.10 (2017); 14 Maryland Code Ann § 14 201 (2017); Michigan Comp Law § 445.1501 (2017); Minn Stat § 80C.01 (2017); Miss Code Ann § 75 24 51 (2017); Mo Rev Stat § 407.400 (2017); Neb Rev Stat § 87 401 (2017); NJ Stat Ann § 56:10 1 (2017); NY Gen Bus Laws § 681 (2017); ND Cent Code § 51 19 01 (2017); Or Rev Stat § 650.005(4) (2017); RI Gen Laws § 19 28 3(c) (2017); SD Codified Laws § 37 5B (2017); Va Code Ann § 13.1 559(b) (2017); Wash Rev Code § 19.100.010(4) (2017); Wis Stat § 553.03(4) (2017); see Babette Märzheuser Wood and Brian Baggott, *Franchise Law in the United States* (2015) Dentons <<https://www.dentons.com/en/insights/articles/2015/june/12/franchise-law-in-the-united-states>>.
31. Meiklejohn, above n 19, ch 9.
32. Stanley Turkel, *Are Franchisees Agents of Franchisors?* (13 August 2013) Blue Maumau <<http://www.blumaumau.org/are-franchisees-agents-franchisors>>; American law is split as to whether a fiduciary relationship exists between a franchisor and franchisee but most sources deny the existence of this relationship. However, cases are fact specific and there is some state legislation. See Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004 05) 109(1) *Penn State Law Review* 105; Meiklejohn, above n 19, 664 7, 704 6, 726 7.
33. Meiklejohn, above n 19, 726 7.
34. See, eg, the Australian view in *Jax Franchising Systems Pty Limited v State Rail Authority (New South Wales)*; *Jax Tyres Pty Limited v State Rail Authority (New South Wales)* [2003] NSWLEC 397; *Poulet Frais Pty Ltd v The Silver Fox Company Pty Ltd* (2005) 220 ALR 211 (Branson, Nicholson and Jacobson JJ). The possibility of McDonald's owing a fiduciary duty was pleaded by the franchisee but not argued in *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310. In *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 43, a case about good faith and unconscionable conduct, the parties agreed that '[t]he Franchisee is an independent contractor and no fiduciary relationship exists between the franchisor and the Franchisee'.
35. See, eg, *Insolvency Act 1986* (UK) c 45, sch 6, category 5: Remuneration, etc. of employees; Australian *Corporations Act* s 556; and the *United States Bankruptcy Code*, 11 USC § 507(a)(4).
36. See, eg, EU Council Directive 80/987/EEC of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of their employer's insolvency [1980] OJ L 283/23, as implemented among the Member States of the EU and the Australian *Air Passenger Ticket Levy (Collection) Act 2001* (Cth) enacted following Ansett's failure to fund the government lifeline for its employees' pay entitlements. The franchisees had to collect the levy as they watched takings slow in their own businesses.
37. See, eg, EU Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses [2001] OJ L 82/16; *Fair Work Act 2009* (Cth) pts 2–8.

38. See, eg, the United States *Worker Adjustment and Retraining Notification Act of 1988*, 29 USC §§ 2101–09; the *Fair Work Act 2009* (Cth); and in the EU, pursuant to the Collective Redundancies Directive: *Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies* [1998] OJ L 225/16, as implemented in each Member State.
39. Ansett Airlines had 15 000 employees when it failed in 2002; 4500 were represented by the Ansett Services union (ASU). The administrators of Ansett negotiated a Federal Government scheme (Special Employment Entitlements Scheme for Ansett) under which some employee entitlements could be advanced. The scheme advanced \$382.4 million to Ansett and by 21 September 2011 \$363 million had been reimbursed. See Korda Mentha, 'Ansett administration makes final landing with 96 cents in the \$ for employees' (Media Release, 2 September 2011). Similarly, the Federal Government injected up to \$22 million as a partial bailout to keep ABC Learning child care centres open until a buyer was found.
40. Frazer, above n 21, 20.
41. Jenny Buchan, *Franchisor Failure: An Assessment of the Adequacy of Regulatory Response* (PhD Thesis, Queensland University of Technology, 2010) 42. For example, Angus and Robertson failed as a franchisor after over 100 years of being an Australian bookseller.
42. G Frank Mathewson and Ralph A Winter, 'The Economics of Franchise Contracts' (1985) 28 *Journal of Law and Economics* 503, 507.
43. Robert Cooter and Thomas Ulen, *Law & Economics* (Berkeley Law Books, 6<sup>th</sup> ed, 2012) 38–41.
44. Richard A Posner, 'Theories of Market Regulation' (1974) 5(2) *Bell Journal of Economics and Management Science* 335.
45. Buchan, above n 26.
46. Jason Gherke, 'Sizzler on Life Support as Stores Shut', *News.com.au* (online), 28 June 2016 <<http://www.news.com.au/finance/business/retail/sizzler-on-life-support-as-stores-shut/news-story/754dfaa661aa32479cbe2396dcd9909c>>.
47. Sniegowski, above n 22.
48. *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) Annexure 2.
49. Franchise Council of Australia, 'Buying a Franchise: Guidelines' <<http://www.franchise.org.au/buying-a-franchise.html>>.
50. Frazer, above n 21, 20.
51. Jenny Buchan et al, 'The Effectiveness of Undertaking Due Diligence Prior to Starting Up or Purchasing a Small Business or Franchise' (Report for CPA Australia, 2015).
52. Ben Butler, 'Behind Closed Doors: An Exclusive Club is Determined to Stay Private. A Clause Allowing Companies to Keep Accounts Secret Looks Set to Stay', *The Sydney Morning Herald* (online), 21 July 2012 <<https://www.smh.com.au/business/behind-closed-doors-an-exclusive-club-is-determined-to-stay-private-20120720-22fne.html>>.
53. Benoliel, Buchan and Gutentag, above n 18.
54. James R Brown, Robert F Lusch and Carolyn Y Nicholson, 'Power and Relationship Commitment: Their Impact on Marketing Channel Member Performance' (1995) 71 *Journal of Retailing* 363.
55. As observed in a letter dated October 2016 from then franchise lawyer Philip Linacre to Buchan.
56. Alan Wein, 'Review of the Franchising Code of Conduct' (Report to The Hon Gary Gray AO MP, Minister for Small Business and The Hon Bernie Ripoll MP, Parliamentary Secretary for Small Business, Commonwealth of Australia).
57. British Franchise Association, 'European Code of Ethics for Franchising' <[http://www.thebfa.org/Content/FileManager/2016 european code of ethics and bfa extension and interpretation.pdf](http://www.thebfa.org/Content/FileManager/2016%20european%20code%20of%20ethics%20and%20bfa%20extension%20and%20interpretation.pdf)>.

58. Chris Wormald, 'Domestic and International Franchising, Master Franchising, and Regulation of Franchise Agreements in the UK (England and Wales): Overview' (1 Nov 2018) <[https://uk.practicallaw.thomsonreuters.com/06329722?transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/06329722?transitionType=Default&contextData=(sc.Default))> notes that the only sanction for noncompliance by a member is exclusion from the BFA.
59. International Franchising Association, 'Our Mission Statement, Vision & Code of Ethics' <<http://www.franchise.org/missionstatementvisioncodeofethics>>.
60. For example, the administrator of former Australian franchisor Beach House Group Pty Ltd wrote under the heading Insolvent Trading 'there are sufficient grounds to suspect that the company was insolvent from at least February 2008. . . . There is also evidence to suggest that the company was likely insolvent prior to February 2008. In particular, statutory debts owed to the Australian Taxation Office [statutory demands totalling \$1,409,785] relates [sic] to debts incurred as far back as 2005 and 2006' (Bruno A Secatore, Cor Cordis, Beach House Group Pty Ltd (Administrators Appointed) ACN 098 577 667 Administrators Report 16 December 2008, 14.). The authors have on file evidence of one franchise agreement entered by Beach House Group on 22 September 2006.
61. Per the *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) sch 1 annex 1 cl 21.1, the following is required for pre contract disclosure: 'A statement of the franchisor's solvency that:
  - (a) reflects the franchisor's position:
    - (i) at the end of the last financial year; or
    - (ii) if the franchisor did not exist at the end of the last financial year at the date of the statement; and
  - (b) is signed by at least one director of the franchisor; and
  - (c) gives the directors' opinion as to whether there are reasonable grounds to believe that the franchisor will be able to pay its debts as and when they fall due.'
62. Buchan et al, above n 16, 323. The same conduct by different franchisors was reported in Jenny Buchan, 'Franchising: A Honey Pot in a Bear Trap' (2014) 34 *Adelaide Law Review* 283, 312.
63. Frazer, above n 21, 37.
64. Buchan et al, above n 16, 318.
65. Frazer, above n 21, 37.
66. Table from Buchan, above n 41, 61–4, and updated with 2016 data. Items in Columns 1, 3 and 4 were supplied to one of the authors by a former franchisee of the failed franchisor Danoz Directions Pty Ltd.
67. In *Cheque One Pty Ltd v Cheque Exchange (Australia) Pty Ltd (in liq)* [2002] FCA 593, 12 applicant franchisees sought leave of the court under s 471B of the *Corporations Act* to join proceedings commenced against the franchisor in 2000.
68. By giving notice under s 443B(3) of the *Corporations Act*. See Orla M McCoy 'Administrators and Leases: Obligations and Options' (2012) 24(2) *Australian Insolvency Journal* 24, 26.
69. Otto Eduardo Fonseca Lobo, *World Insolvency Systems: A Comparative Study* (Thompson Reuters, 2009). See the chapters on France, Germany and the United States, for example.
70. Buchan et al, above n 16, 324.
71. Ibid 322–4.
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73. Jennifer Dolman et al, 'Unique Circumstances in Litigating Franchise Class Actions' (Paper presented at the Canadian Institute's 12<sup>th</sup> Annual National Forum on Class Actions Litigation, Toronto, Canada, 21–22 September 2011).

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120. Hanson and Kysar, above n 116.
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123. *FWA* s 531(2) (3).
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125. *Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies* [1998] OJ L 225/16.
126. Ibid art 2(1).
127. Ibid art 2(2).
128. Ibid art 2(3).
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Franchise Association should be informed; in the UK, the British Franchise Association should be informed.

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# Franchising and Small Business

Editor: Jenny Buchan

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## AUSTRALIA'S FRANCHISING CODE OF CONDUCT REVIEW – A CONTINUATION DOWN THE PATH OF JAMMING A SQUARE PEG INTO A ROUND HOLE?

Jenny Buchan\*

### HISTORY

Franchising was introduced to Australia in about the 1960s. Early appearances were made by some of the United States (US) fast food franchisors, plus motor vehicle and petroleum sellers. Americans had experienced State legislation in California since 1971.<sup>1</sup> There was no specific regulation here. By 1980 it was apparent that Australia was indeed the Wild West for the petroleum giants. Some were ruthlessly exploiting their franchisee dealers by charging them more for product than the same distributor was charging to supply unbranded petrol stations in the same towns. The model was unsustainable. A suite of petroleum franchise legislation was introduced in 1980.<sup>2</sup> It was accompanied by Oil Code.

Not much time passed before a franchise in Western Australia came to the attention of the Commissioner for Corporate Affairs, who believed the offer of a franchise should come under the then Companies Act. The court agreed. In the *Commissioner for Corporate Affairs v Casnot Pty Ltd*<sup>3</sup> (*Casnot*) the Court held that the franchise fell within the definition of prescribed interest. Franchisees were thus entitled to a prospectus under the *Companies Act 1981* (Cth). The “corporate regulator, the National Companies and Securities Commission, recognized that the franchise relationship differed from the relationship between offerors of most prescribed interests and investors in important respects. ... it exempted franchisors from”<sup>4</sup> the requirement to comply with securities law. “This regime was repealed by an amendment in 1987.”<sup>5</sup> The non-petroleum franchise relationship reverted to one regulated solely by the franchise agreement.

It was not long before it became clear to some that it was not just petroleum franchisees who needed protection from over-reaching franchisors. More government inquiries culminated in the creation of the first soft law approach to the regulation of business format franchises in Australia; the *Franchising Code of Practice, 1993*. It quickly proved to be a failure, incapable of achieving full sector coverage despite significant administrative effort, publicity, and financial support from government. Franchise agreements remained the only regulatory tool setting the framework for each franchisor’s relationship with its franchisees until 1998.

By 1998, with the objective of providing protection for all business format franchisees, the *Franchising Code of Conduct 1998* became the first mandatory code under the *Trade Practices Act 1974* (Cth). It was amended several times following additional government inquiries but has remained substantially unchanged. The current version is now the 2014 Code under the *Competition and Consumer Act 2010* (Cth). It treats the incoming franchisee as a consumer, providing for pre-contract disclosure, a seven-day

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<sup>1</sup> California Franchise Investment Law, 1971 imposed an obligation on franchisors to register their franchise offerings in California before offering or selling a franchise there.

<sup>2</sup> The *Petroleum Marketing Retail Franchise Act 1980* (Cth) and *Petroleum Retail Marketing Sites Act 1980* (Cth) were repealed in March 2007.

<sup>3</sup> *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) 5 ACLR 279; [1981] CLC 33,122 at 40,704.

<sup>4</sup> Michael Schaper and Jenny Buchan, “Franchising in Australia: a History” (2014) 12 IJFL 9, citing P Ward, “Legal and Legislative Directions Relating to Franchising” in B Bell (ed), *Franchising Down under in the Lands of Oz and the Long White Cloud: An Historical, Educative and Biographic Review 1983-2003 of Franchising in Australia and New Zealand* (Franchise Council of Australia, 2003) 187–192.

<sup>5</sup> Schaper and Buchan, n 4, 9.

cooling off period, and some mandatory clauses concerning aspects of the relationship. These include imposing a watered down “good faith” requirement on the parties, and providing for compulsory, confidential mediation if negotiation fails to lead to a resolution of a dispute.

Before proceeding to unpack the current state of the Parliamentary Joint Committee on Corporations and Financial Services (PJC’s) recommendations, it is useful to try to understand how the regulatory regime for franchising shifted from Corporations Law to contract only, and then to finally be located where it currently sits as a square peg in a round hole, under the consumer protection law. Why has the *Corporations Act 2001* (Cth) or stand-alone law not been brought into the frame by the Taskforce?

A likely historical explanation is the theory of path dependence which explains that “paths [are] shaped by a nation’s political and cultural institutions or chaotic chance events”.<sup>6</sup> Once a path is laid down it becomes entrenched, like a habit, even if a more effective solution is available. A second reason may be that the *Trade Practices Act 1974* (Cth), now replaced by the *Competition and Consumer Act 2010* (Cth), specifies that one of the seven Commissioners must have consumer protection experience.<sup>7</sup> This is not a requirement of the *Australian Securities and Investments Commission Act 2001* (Cth), that administers the Corporations Law. It is important to recognise that “because franchise relationships are too complex to reduce to precise statutory terms, the heart of franchising’s legal structure is still contract”.<sup>8</sup> It always will be.

## WHAT DO FRANCHISES LOOK LIKE TO LAWYERS AND ECONOMISTS?

Legal academic, Veronica Taylor, recognised in the late 1990s that “franchising is another country ... while the form is contractual, the franchise retains many of the features of the firm”.<sup>9</sup> More recently, recognising that a firm needs funds and labour, and that when the firm with the role of franchisor fails the franchisee is the most vulnerable and invisible of all stakeholders, Jennifer LL Gant and I observed that “through this form of outsourcing [franchising], corporate law obligations and scrutiny are avoided”.<sup>10</sup> This is in contrast to laws concerning shareholdings, securities or employment arrangements.

Through the economist’s lens a franchisee’s lot is one of sunk costs, incomplete contracts, numerous asymmetries<sup>11</sup> and relational complexity. The law that is meant to provide some protection for franchisees is premised on franchisees being rational consumers and the market for franchises being perfect. Neither premise is accurate.

That said, many of today’s franchisees are multi-million dollar enterprises, while their franchisors range from being public listed companies (RFG, YUM! Brands and Domino’s for example), Exempt Proprietary companies (such as the company behind 7-Eleven in Australia) or trusts, to \$2 companies. The franchisor drafts the franchise agreement which quickly becomes a standard form agreement that is amended only when a court finds against a franchisor, or when the Code is amended. The current recommendation that the unfair contract terms provisions of the *Australian Consumer Law* should be extended to all franchise agreements would force numerous franchisors to revise their agreements.

## THE 2018 PJC INQUIRY

Well-documented and well-publicised instances of egregious behaviour by franchisors including Caltex, 7-Eleven, Dominos, Retail Food Group and others triggered Australia’s 17th parliamentary inquiry<sup>12</sup>

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<sup>6</sup> Mark J Roe, “Chaos and Evolution in Law and Economics” (1996) 109 HLR 641.

<sup>7</sup> *Competition and Consumer Act 2010* (Cth) s 7(4). At least one of the members of the Commission must be a person who has knowledge of, or experience in, consumer protection.

<sup>8</sup> Gillian Hadfield, “Problematic Relations: Franchising and the Law of Incomplete Contracts” (1990) 42 SLR 939.

<sup>9</sup> Veronica Taylor, “Contracts with the Lot: Franchises, Good Faith and Contract Regulation” (1997) NZLR 459.

<sup>10</sup> Jennifer LL Gant and Jenny Buchan, “Moral Hazard, Path Dependency and Failing Franchisors: Mitigating Franchisee Risk Through Participation” (2019) 47(2) FLR 261.

<sup>11</sup> Jenny Buchan, “Ex ante Information and Ex post Reality for Franchisees: The Case of Franchisor Failure” (2008) 36(6) ABLR 407.

<sup>12</sup> Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth of Australia, *Inquiry into the Operation and Effectiveness of the Franchising Code of Conduct* (2018).



into franchising since the mid-1970s.<sup>13</sup> The PJC conducted the inquiry in 2018 and issued its unanimous report “Fairness in Franchising”<sup>14</sup> in March 2019. The PJC noted that when the same committee inquired into franchising in 2008 issues of opportunistic behaviour by franchisors were not widespread. “By contrast, the evidence to this [2018] inquiry indicates that the problems ... are systemic.”<sup>15</sup>

As many of the issues identified by the PJC would require carefully thought out policy responses the PJC’s first recommendation was that an inter-agency Franchising Taskforce be created to examine the feasibility and implementation of a number of the recommendations.<sup>16</sup>

## FRANCHISING TASKFORCE

When constituted, the Franchising Taskforce (Taskforce) comprised senior officers from three government departments, being Employment, Skills, Small and Family Business; Treasury, and the Prime Minister and Cabinet. The Taskforce released an Issues Paper in August 2019, with a 4-week consultation period.

After falling into the trap of claiming that “[F]ranchising is mainly regulated by the Franchising Code of Conduct ... as well as by the Australian Consumer Law and the Corporations Act 2001”<sup>17</sup> it presented a set of distilled issues in seven broad themes that were identified as “policy principles”<sup>18</sup> with issues, recommendations and questions following each.

<sup>13</sup> Previous franchise inquiries were: Trade Practices Act Review Committee and TB Swanson, *Report of the Trade Practices Act Review Committee to the Minister for Business and Consumer Affairs* (Australian Government Publishing Service, Canberra, August 1976) (the Swanson Committee); Trade Practices Consultative Committee and RG Blunt, *Small Business and the Trade Practices Act* (Australian Government Publishing Service, December 1979, Canberra) (the Blunt Committee); Trade Practices Commission, *Price Discrimination in the Petroleum Retailing Industry* (Australian Government Publishing Service, Canberra, 1980); D Beddall, *Small Business in Australia – Challenges, Problems and Opportunities, Report by the House of Representatives Standing Committee on Industry, Science and Technology* (Australian Government Publishing Service, Canberra, 1990) (the Beddall Report); R Fitzgerald, *Franchising Task Force Final Report* (The Task Force, Canberra, 1991); Australia Industry Commission, *Inquiry into Commercial Restrictions on Exporting (Including Franchising)* (Australian Government Publishing Service, 1992); R Gardini, *Review of the Franchising Code of Practice: Report to Senator the Hon. Chris Schacht, Minister for Small Business, Customs and Construction* (Australian Government Publishing Service, Canberra, 1994) (the Gardini Report); Franchising Code Council Limited, *Disputes Prevention and Solutions: Report of the Franchising Code Council’s Disputes Review* (1996); House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance: Towards Fair Trading in Australia*. (1997) (the Reid Report); Franchising Policy Council (Australia), *Review of the Franchising Code of Conduct: Report of the Franchising Policy Council* (Department of Employment, Workplace Relations and Small Business: Office of Small Business, Canberra, 2000) (the MacKellar report); Franchising Code Review Committee (Australia), G Matthews, and FE Bailey, *Review of the Disclosure Provisions of the Franchising Code of Conduct: Report to the Hon Fran Bailey, MP, Minister for Small Business and Tourism* (Office of Small Business, Canberra, 2006) (the Matthews Report); Economic and Finance Committee, Parliament of South Australia, *Final Report: Franchises: Sixty-Fifth Report of the Economic and Finance Committee* (Parliament of South Australia, Adelaide, 2008); Joint Committee on Corporations and Financial Services, Parliament of Australia, *Opportunity not Opportunism: Improving Conduct in Australian Franchising* (Senate Printing Unit, Canberra, 2008) (the Ripoll Inquiry); *Inquiry into the Operation of Franchise Businesses in Western Australia: Report to the Western Australian Minister for Small Business* (Small Business Development Corporation, Perth WA, 2008) (the Bothams Report); Professor Bryan Horrigan, David Lieberman and Ray Steinwall, *Strengthening Statutory Unconscionable Conduct and the Franchising Code of Conduct – Expert Report* (2010); Economics and Industry Standing Committee, Legislative Assembly, *Inquiry into the Franchising Bill 2010*, Report No 7 in the 38th Parliament (Parliament of Western Australia, Perth, June 2011); A Wein, *Review of the Franchising Code of Conduct: Report to the Minister for Small Business and Parliamentary Secretary for Small Business* (Department of Industry, Innovation, Climate; Change, Science, Research and Tertiary Education, Canberra, 2013) (the Wein Report).

<sup>14</sup> Parliamentary Joint Committee on Corporations and Financial Services (PJC), *Fairness in Franchising* (2019) <[https://www.aph.gov.au/Parliamentary\\_Business/Committees/Joint/Corporations\\_and\\_Financial\\_Services/Franchising/Report](https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Franchising/Report)>.

<sup>15</sup> PJC, n 14, xiii.

<sup>16</sup> PJC, n 14, Recommendation 1.1, 7.

<sup>17</sup> Franchising Taskforce, Australian Government, *Franchising Taskforce Issues Paper: Developing the Government’s Response to the Fairness in Franchising Report of the Parliamentary Joint Committee on Corporations and Financial Services* (2019) 3 (Franchising Taskforce Issues Paper).

<sup>18</sup> Franchising Taskforce Issues Paper, n 17, 1.

The principles identified by the Taskforce were:

1. Prospective franchisees should be able to make reasonable assessment of the value of a franchise before entering into a contract with a franchisor.
2. Franchisees and franchisors should have “cooling off” time to consider whether the relationship is right for them after signing.
3. Each party to a franchise agreement should be able to verify the other party is meeting its obligations and is generating value for both parties.
4. A healthy franchising model fosters mutually beneficial cooperation between the franchisor and the franchisee, with shared risk and reward, free from exploitation and conflicts of interest.
5. Where disagreements turn into disputes, there is a resolution process that is fair, timely and cost effective for both parties.
6. Franchisees and franchisors should be able to exit in a way that is reasonable to both parties.
7. The framework for industry codes should support regulatory compliance, enforcement and appropriate consistency.<sup>19</sup>

These seven policy principles were naive, we could generously say they are aspirational. By narrowing the scope of its inquiry, and announcing it would not publish submissions it received, the Taskforce started down a track that inevitably led to the creating of options that cannot address the systemic problems identified by the PJC. For a start, franchising is mainly regulated by the franchise agreement and other contractual commitments between franchisors, franchisees and third parties. The *Corporations Act 2001* currently has no role in regulating franchising. It regulates relationships within companies and corporate groups, not relationships like franchises formed purely by contract. Principle 4 provides another example that demonstrates a lack of understanding by the Taskforce of the nature of franchising. The franchise relationship is replete with conflicts of interest; they are unavoidable. What needs to be found are ways to address them so that neither party exploits the other without consequences.

Although the Taskforce had access to all public submissions made to the PJC, it did not have access to the confidential ones. The mission of the Taskforce was to “use the consultation findings to inform the development of the Regulation Impact Statement (RIS) and provide advice to the Government on its response to the [PJC] Report”.<sup>20</sup> Curiously, as its job was not to reinvent the PJC’s inquiry but to “examine the feasibility and implementation of a number of the [PJC] recommendations”,<sup>21</sup> the Taskforce stated that, “[t]o encourage broad participation from the franchising sector, [it] will maintain the confidentiality of feedback and *not* publish responses to the Issues Paper”.<sup>22</sup> Surely the Taskforce process should have been a time for open debate, airing possible solutions to wicked problems and robustly testing those solutions?

The only clue as to the origin of the responses comes from Senate Hansard where a Motion for Presentation of Documents was first tabled on 13 November for the Senator who was Deputy Chair of the PJC throughout most of the 2018 Inquiry.

The Franchising Taskforce Order for the Production of Documents was formally tabled in the Senate on 14 November.

Senator URQUHART (Tasmania – Opposition Whip in the Senate) (12:29): At the request of Senator O’Neill, I move: That there be laid on the table by the Minister for Employment, Skills, Small and Family Business, by no later than 3.30 pm on 25 November 2019: (a) the 75 submissions received by the Franchising Taskforce; (b) the names and titles of the people and organisations who submitted to the Franchising Taskforce; (c) the minutes of the 31 roundtables and 57 bilateral meetings the Franchising Taskforce undertook; (d) the minutes of the meeting with the Franchising Council of Australia; (e) the minutes of the meeting with McDonalds Australia; (f) the minutes of the meeting with the Australian Association of Franchisees; and (g) the minutes of the meeting with Professor Jenny Buchan.<sup>23</sup>

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<sup>19</sup> Franchising Taskforce Issues Paper, n 17, 7–17.

<sup>20</sup> Franchising Taskforce Issues Paper, n 17, 1.

<sup>21</sup> PJC, n 14, Recommendation 1.23.

<sup>22</sup> Franchising Taskforce Issues Paper, n 17, 1.

<sup>23</sup> Commonwealth, *Parliamentary Debates*, Senate, 14 November 2019.

It met with the following response:

DUNIAM: The government will not be supporting this motion, as the regulatory impact statement is still open for consultation. Publication of these documents prior to the consultation period ending could result in unfair prejudice and negatively impact the process. Importantly, some submissions were made anonymously, and it would be unfair to disadvantage or punish stakeholders who made submissions on this basis. The government is committed to achieving the best outcome that strikes the right balance between franchisees and franchisors.<sup>24</sup>

The RIS was released with a shortened timeframe of 6 December provided for comment.

## FRANCHISING SECTOR REFORMS. RIS

It is important to reflect upon the purpose and framework for a RIS. It “is a tool designed to encourage rigour, innovation and better policy outcomes from the beginning”.<sup>25</sup> The Guide states. “Even if you’re not the principal policy officer, you should use the RIS questions as a tool for analysing policy problems.”<sup>26</sup>

The seven key RIS questions are:

1. What is the problem you are trying to solve?
2. Why is government action needed?
3. What policy options are you considering?
4. What is the likely net benefit of each option?
5. Who will you consult about these options and how will you consult them?
6. What is the best option from those you have considered?
7. How will you implement and evaluate your chosen option?<sup>27</sup>

The RIS categorised the franchise relationship into four business phases. The first three were “Entering a franchising agreement” which housed the Taskforce’s Principles 1 and 2, Operating a franchise, which housed Principle 3, 4 and 5, and Exiting a franchise, Principle 6. The fourth business phase was an all-encompassing “Regulatory framework across all phases”.<sup>28</sup> It offered three options for each of the seven. With each first option being described as “Status quo” there were effectively two options put forward for each principle. The status quo is what has put the sector through 17 inquiries, more of the same is not needed.

Two of the problem areas identified will now be used as an example of how the RIS has missed the mark. We will look at Options to address “Problem 1.2: The reliability of information provided to prospective franchisees may be difficult to access”,<sup>29</sup> and “Problem 3.1 Transparency of marketing funds”.<sup>30</sup>

### Problem 1.2

The ability to triangulate data to ensure it is both correct and provides the full story serves several purposes; the obvious one being as a basis for making a decision whether to commit to the franchise or not, and the second but equally important purpose of understanding whether the franchisor is a “straight shooter” or not. Option 1.2.2(b) is the establishment of a national franchise register. This is something that has been proposed numerous times through the 16 previous inquiries. Yet now, the options put forward are not to register the franchisors, but that:

<sup>24</sup> Commonwealth, *Parliamentary Debates*, Senate, 14 November 2019.

<sup>25</sup> Australian Government, Department of the Prime Minister and Cabinet, *The Australian Government Guide to Regulation* (2014) 4.

<sup>26</sup> Australian Government, n 25, 8.

<sup>27</sup> The Mandarin, *PM&C Releases Guide on How to Finalise Regulation Impact Statements* <<https://www.themandarin.com.au/116827-pmc-releases-guide-on-how-to-finalise-regulation-impact-statements/>>.

<sup>28</sup> Franchising Taskforce, Australian Government, *Franchising Sector Reforms: Regulation Impact Statement* (2019) 7–8.

<sup>29</sup> Franchising Taskforce, n 28, 16.

<sup>30</sup> Franchising taskforce, n 28, 27.

A national franchise register would be established by government, and all franchisors would be required to lodge their disclosure documents and template franchise agreements.<sup>31</sup>

Predictably concerns have been raised that information on the register might compromise a franchisor's business secrets – in reality, any secrets are contained in operating manuals and there is no suggestion that these would ever be registered. Stakeholders have also suggested that the existence of a registry could lead aspiring franchisees to believe the system had been vetted by the government. This is disingenuous as much information already exists on public registers and it is obvious that government does not have the resources to check it, nor does it have the obligation to do so.

Some suggest a register would impose an unfair burden on franchisors. Another perspective is that centralising data could benefit franchisors in that they could provide web links to documents, and could recruit franchisees confident that they and their advisers have settled on their chosen franchise after having the opportunity to compare several offerings through access to a government registry.

Turning now to the thorny issue of marketing funds which has also been raised and the subject of recommendations in previous franchise reviews.<sup>32</sup>

### Problem 3.1

Marketing funds can hold significant sums of money, sometimes many millions of dollars. This money has been paid by franchisees, and by franchisors if they own and operate company owned outlets that contribute to the marketing fund. In response to Option 3.1.2 we read that:

A number of stakeholders have stated that a potential unintended consequence of increasing the administration requirements of managing marketing funds is that, should the costs and risks of administration become too onerous, franchisors may choose not to operate shared marketing funds and instead recoup marketing costs through other means (such as franchise system fees).<sup>33</sup>

It is hard to understand how this differs from the current situation in some franchises when one reads a marketing funds disclosure stating clearly that:

Monies standing to the credit of the Fund may be applied to the costs of Marketing ... and promotion activities including all agency fees, overheads and administrative costs connected with the administration and audit of the Fund, and the costs of all consultants and staff involved in the operation and administration of such activity.<sup>34</sup>

In answer to the disclosure question “Whether the Franchisor must spend part of the Fund on marketing, advertising or promoting the franchisee’s business” the franchisor clearly states:

No. Monies standing to the credit of the Fund from time to time are applied in a discretionary manner in satisfaction of the objectives set out in Section 7 of the Franchise Agreement.<sup>35</sup>

Turning now to s 7 of the Franchise Agreement, it concludes with:

The parties acknowledge and agree that there is no guarantee that the Franchisee or any other XXXX franchisee will receive any quantifiable benefit from, or the use of, any portion of the funds paid or standing to the credit of the National Marketing Fund Bank Account from time to time.<sup>36</sup>

The Taskforce’s recommendations that the franchisor be forced to increase frequency of reporting or be liable for civil pecuniary penalties is not going to help franchisees who, legitimately, want to have a say in how their marketing funds are spent. Option 3.1.2 (e) identifies the need to “Clarify the distribution of marketing funds in the event of franchisor insolvency”. The result in, *Re Stay in Bed Milk & Bread Pty Ltd (in liq)*<sup>37</sup> should have provided a clarion call to the Taskforce that nothing short of the entire

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<sup>31</sup> Franchising taskforce, n 28, 16.

<sup>32</sup> For example, Alan Wein, *Review of the Franchising Code of Conduct* (2013) 54–57 (Wein Review).

<sup>33</sup> Franchising Taskforce, n 28, 28.

<sup>34</sup> Disclosure document dated 2017 on the authors file.

<sup>35</sup> Disclosure document, n 34.

<sup>36</sup> Specific clauses from a franchise agreement in possession of the author.

<sup>37</sup> *Re Stay in Bed Milk & Bread Pty Ltd (in liq)* [2019] VSC 181.

marketing fund being held in trust would provide the required clarity. It is important to protect the fund from a franchisor's creditors and, ultimately in this case, the Australian Government Department of Jobs and Small Business (the Department). The Department administers the Fair Entitlements Guarantee scheme that was set up under the *Fair Entitlement Guarantee Act 2012* (Cth). Despite the liquidator's preference for returning the unspent moneys in the marketing fund to the franchisees, it was held that the moneys were not held on any form of trust. The franchisees lost out.

## WHAT'S MISSING?

The Government's 2017 Best Practice Consultation Guidance note states:

Consultation plays an important role in ensuring that every practical and viable policy alternative has been considered. Stakeholders and those closest to a problem can sometimes suggest useful ways to solve it. Your RIS should therefore reflect the feedback received on all genuine and viable options.<sup>38</sup>

It is arguable that the current RIS does not meet the standard set out in the 2017 Guidance.

Government employees tasked with creating a RIS are provided with further guidance, including a reminder that:

[Y]our RIS ... informs a decision maker by providing an objective assessment of the impacts of various options to address an identified problem. Making public the various options, and commensurate impacts, considered by a decision maker is an important aspect of transparency.<sup>39</sup>

This RIS has not provided decision makers with solutions to the deep-seated challenges facing franchising. These include the important issue of how to make franchisors take their franchisees into account when fundamental decisions are being made about the system. Franchisees are investing significant sums of money, and effort into their businesses. In a good system, their legitimate interests should feature in the franchisors' decision-making – both short term and strategic. If they discover the system is flawed or becomes flawed there should be ways of them exiting without losing their entire investment.

The franchise of the 21st century is almost unrecognisable from the franchise that was first regulated in 1993. Franchise policy and law needs to address the franchise market of the immediate future. Many of the original franchisors have retired or are contemplating retirement – they need to implement the best exit strategy possible for themselves and their families. That might be to accept venture capital, or to float. These decisions introduce new stakeholders (venture capitalists and public company shareholders) into the mix. It is important to present decision-makers with solutions addressing how new stakeholders can co-exist profitably with franchisees. It is critical to accept that the opportunities for exploitation unearthed by the PJC are not isolated incidents.

Franchising is sophisticated now. It needs cradle to grave legislated solutions. Those solutions will recognise that the statutory duties the franchisors' directors owe are to their shareholders and employees, and that any duties owed to franchisees through a contract will remain secondary. The RIS should have included a wider range of options including stand-alone legislation and, ideally, presented a method for embedding the franchise relationship into the only environment that could provide cradle to grave recognition of the important role franchising has in our economy, the *Corporations Act 2001* (Cth).

<sup>38</sup> Australian Government, Department of Prime Minister and Cabinet, *Guidance Note, Best Practice Consultation* (February 2016) 1.

<sup>39</sup> Australian Government, Department of Prime Minister and Cabinet, *Guidance Note, Finalising and Publishing a Regulation Impact Statement* (September 2019).