Australian Government

Franchising Taskforce – Regulation Impact Statement

The Australian Government is considering changes to the way franchising is regulated. With an estimated revenue of $184 billion[1], franchising is a popular business model in Australia and makes a significant contribution to the economy. There are approximately 1,344 franchise brands in Australia, providing employment for more than 598,000 people.

The relationship between Australian franchisors and franchisees is regulated primarily by the Franchising Code of Conduct (Franchising Code), a mandatory industry code prescribed under Part IVB of the *Competition and Consumer Act 2010* (Cth).

In line with the first recommendation of the Parliamentary Joint Committee (PJC) on Corporations and Financial Services' *Fairness in Franchising* report, the Government has established an inter-agency Franchising Taskforce. The Taskforce is examining the feasibility and implementation of a number of the report's recommendations.

The Taskforce's Regulation Impact Statement (RIS) considers the potential impacts of regulatory changes on the franchising sector. Submissions will provide guidance to government and ensures decision-making is transparent and informed by evidence.

Stakeholders are invited to provide views on options to address the range of problems identified by the PJC's report on the franchising sector. It sets out possible policy options and questions and seeks information and data about their relative costs and benefits. It does not limit or prescribe the options that the Government may decide to take in relation to the regulation of franchising, nor should it be taken as an indication of the views of the PJC, the Taskforce or the Government.

Have your say

The Taskforce will be accepting submissions on the RIS until 6 December 2019. Information obtained through this consultation will be used to inform the Taskforce's advice to the Government. The Taskforce is able to receive submissions through the online RIS consultation form available at the Franchising Taskforce web page and via phone or email.

Email: franchising@employment.gov.au
Phone: 1800 314 677

[1] IBISWorld, *Franchising in Australia,* Industry Report X0002 (September 2019)

Franchising principles

A set of principles underpin the RIS. The Taskforce is using these principles as a way of grouping the PJC's recommendations and to provide a framework for considering options for reform.

Questions from the RIS

The questions below are taken from the RIS for ease of reference. You may respond to any or all of the questions, and if you would like you can also provide any additional information for the Taskforce's consideration.

Principle 1. Prospective franchisees should be able to make reasonable assessments of the value (including costs, obligations, benefits and risks) of a franchise before entering into a contract with a franchisor

Options considered under this principle include simplifying disclosure by requiring franchisors to provide important information to franchisees in a summary document, and government establishing a national franchise register where franchisors would be required to lodge their disclosure documents and template franchise agreements.

1. What are the critical pieces of information that should be contained in a summary document?

    a. Organisation chart of franchisor's entire network, clearly identified by entity name and number

    b. Key players in every entity – directors, shareholders, managers and their roles, qualifications, relevant business experience and any former or current insolvency issues

    c. Date the franchise was first formed – because according to Griffith survey many started selling franchises before the franchisor had been trading 12 months

    d. Diagram showing direction of money flows between franchisor, master franchisees and franchisees

    e. Details of any security franchisor has given over the intellectual property assets

2. If a national franchise register is established, what information should it contain? What would be the benefits and costs of a national franchise register?

    a. Must be publicly owned, not owned/run by a private entity

    b. Free or very inexpensive access – no barriers to accessing unedited information

    c. Legal identity of franchisor and name/s of franchised brands they trade under

    d. Standard disclosure document/s. If they have more than one model (e.g. mobile and store/hub) then copies of all

    e. Standard franchise agreements

f. Benefits – mentioned numerous times in numerous submissions and inquiries – please refer to them – not the least is the opportunity for Australian academics to use Australian data for research, not to have to rely on data about US franchise systems.

g. Costs

    i. Franchisors house their special recipes etc in Operations manuals, not in franchise agreements and disclosure documents so don't believe them when they claim potential damage to commercial in confidence material.

    ii. I suggest you ask the regulators in California, Minnesota and Wisconsin as all have open access websites. Web addresses are on my submission to the PJC.

3. There are a number of existing educational resources on franchising. What additional education options for prospective franchisees should be made available? If there was an online educational resource which brought together the available franchising education options, what would its costs and benefits be?

    a. Franchis**ors** and their head office staff, territory managers and sales agents are the ones who need education every bit as much as franchisees. They need to understand about 'misleading and deceptive conduct', unfair contract terms, unconscionable conduct and they need to have it drummed into them that they can be sued if they are involved in any of the prohibited conduct.

    b. The FCA's Franchisee info is a good start but is too full of glossy happy people and the text is at too high a level. The FCA's insolvency examples brush over the fact that the franchisors had massive unsustainable debt levels – nothing to do with how the franchisees performed or the type of products they sold. Kleenmaid sold whiteware – every home still has a fridge, washing machine, stove – so Kleenmaid's failure was not caused by whiteware going out of fashion.

    c. Good idea to have a central hub for all online resources. Get the person who designed the CBA website to create it (because it is the easiest to use consumer website in Australia), and house it on the ACCC or ASIC's website – or link to both.

    d. No idea what 3 c would cost, but it would be a great resource. Over time resources could be translated into the spoken languages of franchisors and franchisees, and pictograms could be added.

Principle 2. Franchisees should have time to consider whether the relationship is right for them before committing to an agreement

Options considered under this principle discuss changes to the current seven day cooling off period in the Franchising Code. This cooling off period is separate to the 14-day disclosure period which operates before a franchise agreement is entered into, renewed or extended.

4. What are the practical implications (costs and benefits) for prospective franchisees and franchisors of increasing cooling off or disclosure periods?

    a. Might give franchisees time to cool their emotions and start thinking with their head about whether they want the business.

b. Franchisors don't want or need disengaged franchisees so it would be smart for them to give the franchisee a free pass to exit each time a major change is made that disadvantages the franchisee – e.g. cut their term in half on renewal, or list the franchise on the stock exchange

5. How easy is it for franchisors to provide reasonable estimates of leasing costs before they are finalised?

    a. Very easy if they are an experienced franchisor. Possible if they are inexperienced. The problem with +10% is that it will be really easy for franchisors to 'game' and they will have no incentive to haggle hard to get the best deal for their franchisee.

6. How often are leasing arrangements finalised after the cooling off period expires? What are the implications of having the cooling off period commence after a lease is finalised?

    a. Often, but if they are disadvantageous to the franchisee the franchisee should not have to proceed as they will loose money.
    b. If franchisor has not produced suitable premises at an affordable price within, say, 6 weeks of the franchisee signing up the deal should be off and the franchise $ refunded.

Principle 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

Many franchise systems have a central marketing fund, made up of fees paid by franchisees to franchisors, to support marketing and advertising activities. Options considered under this principle include changes to the way marketing funds operate.

Marketing funds can hold significant sums of money, sometimes millions of dollars; no kidding! 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).[2]

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.[3]

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:

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[2] Franchising Taskforce, Franchising sector reforms. Regulation Impact Statement. Australian Government, 28.

[3] Disclosure document dated 2017 on the authors file.

> 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.[4]

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

> The parties acknowledge and agree that there is no guarantee that the 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.[5]

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, *In the matter of Stay in Bed Milk & Bread Pty Ltd (In Liq)*[6] should have provided a clarion call to the Taskforce that nothing short of the entire marketing fund being held in trust would protect it from the franchisors creditors. Ultimately in the *Stay in Bed* case, the Australian Government Department of Jobs and Small Business ('the Department'). The Department administers the Fair Entitlements Guarantee ('FEG') 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.

7. What would 'meaningful information' look like in terms of marketing fund disclosure?

    a. Precise spend per outlet, per region, and explanation of what the $ was spent on – with an analysis of whether the spend generated increased sales.

8. How does the benefit of increased frequency of reporting of marketing funds compare to the costs of increased administration?

    a. It does not even bear consideration as until the marketing funds are held in trust for the franchisees and any other contributors will never be safe from a franchisor who wants to use them for staff wages, to borrow from the fund and, ultimately from the government (to pay the franchisor's employee entitlements that can't be met by the insolvent franchisor) if the franchisor goes broke.

    b. If the $ is held on trust it should not be treated as income for the franchisor so the franchisor should pay less tax.

Principle 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

Conflicts of interest are unavoidable in franchise relationships. The challenge is how to manage them.

Options considered under this principle address supplier rebates (where a franchisor receives rebates based on the purchases made by its franchisees from suppliers), significant capital expenditure (which is generally understood as relatively large sums of money the franchisee is

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[4] Disclosure document, n 33.

[5] Specific clauses from a franchise agreement in possession of the author.

[6] [2019] VSC 181.

required to reinvest in the business some time after entering the franchise agreement), and unilateral variation (where the franchisor changes the franchise agreement without the explicit consent of the franchisee).

9. What information should franchisors disclose in relation to supplier rebates? Are there any barriers to providing this?

    a. Who are the suppliers – all dirs. and shareholders

    b. Why they have been chosen

    c. Who gets the benefit of the rebates – e.g. are they used to fund the franchise system's annual conference?

    d. How much would the same products cost, delivered, on the open market?

10. If franchisors are required to ensure franchisees get a return on their significant capital expenditure, how might this be done in practice?

    a. Provide a term that allows them to get a return – accountants can work this out.

    b. If significant investment is required to e.g. change branding, the franchisor should agree to pay a proportion if the franchisee could not recoup the cost during the remainder of its term.

11. If franchisees are given a right to review capital expenditure business cases (which must be presented to franchisees by the franchisor under clause 30(2)(e) of the Franchising Code for expenditure that the franchisor considers is necessary for capital investment), how would this right be exercised?

Principle 5. Where disagreements turn into disputes, there is a resolution process that is fair, timely and cost effective for both parties

Options considered under this principle discuss alternative dispute resolution models such as arbitration, where an arbitrator can make a binding decision about a disagreement, and conciliation, where a conciliator directs parties towards an agreement.

12. A number of stakeholders have told the Taskforce that the cost of arbitration can be comparable to going through the court system, and that conciliation may be a preferable alternative alongside mediation. In what circumstances could conciliation be an effective alternative dispute resolution process?

    a. Conciliation could replace mediation. In the Franchising Code of Practice 1993 the options for ADR were mediation *or* conciliation. A mediator has no power to impose a resolution, a conciliator can do so. Both processes end up with the parties signing a contract if they reach agreement.

13. Would you consider including arbitration to resolve disputes in your franchising agreement, if a clear voluntary option were provided?

    a. No.

b. It’s no use having another system where resolutions are confidential. Incoming franchisees need to be able to do due diligence on disputes including what they are about and how they are resolved. Currently the franchisor can hide its dirty linen inside the confidentiality of a mediation – arbitration would be more of the same and can be very expensive.
c. It’s hard to appal an arbitral decision, at least if one of the parties doesn’t abide by a mediated or conciliated decision the innocent party can take an action for breach of the contract they signed at the end of the mediation or conciliation.

Principle 6. Franchisees and franchisors should be able to exit in a way that is reasonable to both parties

Options considered under the principle discuss franchisees exiting their agreements, including on a ‘no fault’ basis where the business is unviable.

14. Under what circumstances should franchisees be allowed a no-fault exit from the franchise system?

    a. When the franchisor changes or changes its adviser and it becomes clear to the franchisee that the business is no longer what they signed up for.

    b. When it is clear the franchise itself is a lemon.

    c. When any shock event occurs – see my submission to the PJC.

    d. When the franchisor is found guilty of fraud or another crime.

    e. When an administrator, appointed to the insolvent franchisor, has not found a suitable buyer (acceptable to franchisees) within a month of being appointed.

15. If goodwill was required to be fully clarified in the franchise agreement, how might this be done in practice? What would be the costs and benefits of this approach?

    a. Brand goodwill to franchisor

    b. Site goodwill to whoever bears the risk of the site – maybe shared between franchisor and franchisee

    c. Local goodwill – either all to franchisee or shared if the brand has very strong recognition – e.g. MacDonald’s

    d. All above depends on how long there remains in the term – if term nearly up and not being renewed then franchisor gets greater %, if term continuing and franchisee wants to sell to a new franchisee then franchisee gets more of c.

Principle 7. The framework for industry codes should support regulatory compliance, enforcement and appropriate consistency

Options considered under this principle discuss the Oil Code of Conduct. Like the Franchising Code, the Oil Code of Conduct is a mandatory industry code prescribed under Part IVB of *the Competition and Consumer Act 2010* (Cth) that applies to fuel wholesalers and retailers.

16. What are the implications of amending the Oil Code of Conduct to increase the number of common provisions between the Oil and Franchising Codes? What would be the costs and benefits of this approach?

    a. No comment

17. What are the implications of repealing the Oil Code of Conduct and adding specific fuel retailing provisions to the Franchising Code?

    a. No comment

Conclusion

The main instrument regulating the franchise relationship is the franchise agreement, it always will be. Once that is signed and the cooling off period has passed the franchisee currently relies totally on the franchisor to behave. The franchisee has invested sunk costs, often given up their safe employment and has been sold a product that they are led to believe is proven. It may not be.

There are only 3 ways the law can offer franchising to achieve a better-balanced relationship:

1. Completely separate franchise legislation that covers pre-entry- during and the termination phase
2. Being really radical and recognising that a franchisor creates a private bureaucracy (see ALR article by Buchan and Gunasekara). This would mean their actions are judged under administrative law models, and in Tribunals, with possible right of appeal to the Court.
3. Best case scenario is to incorporate franchising back into the Corporations Act – recognising that franchisees have interests similar to investor-shareholders, and employees (see FLR article by Gant and Buchan)

Without radical change and a move to proper cradle to grave protection for franchisees we will have an 18th franchise inquiry before long.

This government has an opportunity to do something meaningful for the 79,000 franchisee-owned businesses in Australia. There are more votes in that 79,000 + their families than there ever will be in the 1200 or 1400 franchisors, many of whom are overseas and can't vote in Australian elections.

Best wishes

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Article

Australian National University

Federal Law Review
1–27
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sagepub.com/journals-permissions
DOI: 10.1177/0067205X19831841
journals.sagepub.com/home/flr

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[1] 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, 'Franchising is another country . . . While the form is contractual, the franchise retains many of the features of the firm.'[2] But, through this form of outsourcing, corporate law obligations and scrutiny are avoided.[3]

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.[4] 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.'[5] 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,'[6] helps explain how the rejection of the *Casnot* interpretation in Australia[7] 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.[8] 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[9] or a partnership,[10] but not the failure of a franchisor.

Conversely, Australia's franchise law does provide for the failure of a franchisee.[11] 'Much of the content of franchising agreements and the supporting ideology seems reminiscent of feudal contractual relationships.'[12] 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,[13] 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[14] 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[15] tendency by placing importance on the status quo of flexibility in a low regulatory environment over time, while ignoring the level of sophistication of 21st 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.[16] 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[17] 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.[18]

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,[19] while the McDonald brothers started selling burgers in 1937.[20] 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.[21]

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.'[22] 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.[23]

Franchise relationships are documented in contracts. Gillian Hadfield observes that '[f]ranchising is problematic for contract law.'[24] 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.[25]

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.[26]

As Hadfield observes of franchising, 'such an odd-shaped beast tangles in many areas of the law.'[27] 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'[28] 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.'[29] 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[30] by additional regulation.[31] 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.'[32] However, cases are fact-specific and there remains some state legislation.[33] Similarly, in Australia, it has been argued that franchisors owe no fiduciary duty to their franchisees.[34] 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,[35] national safety net insurance funds,[36] employment protection during business transfers,[37] information and consultation obligations for companies undergoing large-scale redundancies or lay-offs and redundancy pay,[38] and sometimes, government lifelines.[39] 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.[40] The evidence does show that both new and long-established franchisors can fail.[41]

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,[42] 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,[43] 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.[44] 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.[45]

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.[46] 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.[47]

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.'[48] 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.'[49] 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.[50] 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,[51] 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.[52] This makes conducting due diligence on that company's finances impossible. In addition, excessive cost, franchisees' optimism bias,[53] dependence asymmetry[54] 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.'[55] 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.'[56] 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.[57] The BFA Code is non-binding and there is no clear sanction for a breach.[58] 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.[59] Thus, UK and US franchisees have similar risks to their Australian counterparts.

Franchisors have continued to advertise for franchisees while insolvent,[60] despite, in Australia, issuing the required pre-contract disclosure containing the solvency statement.[61] 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.'[62] 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,[63] 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.'[64] 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.'[65] 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[68] during an administration in most jurisdictions.[69] 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.[70] 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.[71] 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.'[72] 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,[73] possibly leading to financial ruin.[74] 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.[66]

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 commence 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 franchisee may seek leave to bring proceedings against the insolvent franchisor to quantify its claim.[67]
Sunk fit-out costs	$550 000–$750 000	Disclosure document	Franchisor for payment on to independent shop fitter	Lease (in franchisor's name) disclaimed by administrator. Landlord would negotiate with franchisee for a continued tenancy agreement if franchisee 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) disclaimed by administrator. Landlord would negotiate with franchisee for a continued tenancy agreement if franchisee 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 jurisdictions franchisee subtenant can negotiate with landlord if head tenant (franchisor) insolvent

(continued)

Table 1. (continued)

1: Item paid by franchisee	2: Franchisee's investment	3: Relevant contract	4: Franchisee paid to…	5: Outcome for franchisee in insolvency of franchisor
Monthly premises rental and outgoings	$12 000–$13 000	Lease between franchisor and landlord. Sublease/licence between franchisor and franchisee	Franchisor for forwarding to landlord	Franchisee debtor of franchisor. Franchisor in breach of lease because of appointment of administrator
Training costs	$20 000	Franchise agreement between franchisee and franchisor	To general revenue of franchisor or franchisor-related company on day paid	Franchisee not creditor or debtor. No claim possible
Store opening campaign	$10 000–$15 000	Franchise agreement between franchisee and franchisor	Paid to franchisor up front	Franchisee not creditor or debtor. No claim possible
Facility, telephone, electricity	Est. $5 000–$10 000	Franchise agreement	Supplier	Franchisee not creditor or debtor. No claim possible
Legal & accounting costs	Est. $10 000–$20 000	Franchise agreement and Code	Supplier	Franchisee not creditor or debtor. No claim possible
Options to open future franchisee-owned stores @ $20 000 per option	$60 000	Agreement between franchisor and franchisee	Paid to franchisor up front	No statute-based claim possible. Franchisee 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 normally 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.[75]

The bulk of franchisors' assets are intangible,[76] consisting of intellectual property[77] and use licences, head leases[78] 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.'[79]

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.'[80]

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.[81] 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.'[82] This may be appealing to a franchisor to achieve any one of several possible objectives. US franchise lawyers note that 'Bankruptcy . . . 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.'[83] Because franchise agreements are executory contracts, they cannot be terminated by reason of the filing for bankruptcy.[84]

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.'[85]

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;[86] 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.[87] 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'[88] to administrators to whom a five-day grace period is granted to deal with such leases.[89] 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.[90] 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.[91]

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.[92] 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.[93]

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.[94] 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.[95] 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.[96] 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.[97] 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.[98] 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,[99] and the intentional framing of some employees as franchisees in the US,[100] or as independent contractors in Australia.[101] 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.[102] In Australia, it has been suggested that '[e]mployees enjoy priority predominantly because they are involuntary creditors.'[103] 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.[104] While freedom, autonomy, liberty and individualism are central to the needs of free market capitalism and a growing commercial economy,[105] 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.[106] 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.[107] 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.[108] It is only necessary to observe the exploitation of workers that does occur in developing countries to realise that such conditions persist.[109] 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.[110] Further, maintaining a centrally organised company with several units separated geographically can be costly for developing effective means of controlling employees and managers.[111]

Other factors that favour franchising include low initial investment costs and more repeat customers.[112] Finally, the franchise contract itself is habitually drafted in favour of the franchisor with a view to increasing profit and control,[113] 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.[114] 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.[115]

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.[116] 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.[117] 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.[118] 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.[119] 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.[120] 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'[121] in the 21st 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*,[122] 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.[123] 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.[124] 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').[125] 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[126] 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.[127] 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.[128] 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,[129] 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.'[130] Observers have noted that the legislative process is skewed in favour of groups with lobbying power, usually special interest groups.[131] 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.[132] The forces of the competitive marketplace have failed franchisees.[133] 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.'[134] 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>.
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.bluemaumau.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.bluemaumau.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 'The 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, 6th 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>.

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/0-632-9722?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/mission-statementvisioncode-of-ethics>.
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.
72. Jenny Buchan, 'Deconstructing the Franchise as a Legal Entity' (2014) 21(3) *Journal of Marketing Channels* 143, 153.
73. Jennifer Dolman et al, 'Unique Circumstances in Litigating Franchise Class Actions' (Paper presented at the Canadian Institute's 12th Annual National Forum on Class Actions Litigation, Toronto, Canada, 21–22 September 2011).

74. Steven H Goldman, 'Tackling Troublesome Insolvency Issues for Franchisees' (Unpublished, 2003).
75. Gherke, above n 46.
76. Bruce E Schaeffer and Susan J Robins, 'Valuation of Intangible Assets in Franchise Companies and Multinational Groups: A Current Issue' (2008) 27(3) *Franchise Law Journal* 185.
77. Jenny Buchan, 'Franchisors' Registered Trademarks — Empirical Surprises' (2009) 21(7) *Australian Intellectual Property Law Bulletin* 154.
78. Jenny Buchan and Bill Butcher, 'Premises Occupancy Models for Franchised Retail Businesses in Australia: Factors for Consideration' (2009) 17(2) *Australian Property Law Journal* 143.
79. Meiklejohn, above n 19, 716.
80. Craig R Colraine, 'Franchises: Insolvency and Restructuring' (Paper presented at the Distribution Law: Catch the Wave, Avoid the Rocks, Ontario Bar Association Continuing Legal Education, Toronto, Canada, 26 May 2003).
81. Posner, above n 44.
82. Peta Spender, 'Scenes from a Wharf: Containing the Morality of the Corporate Law' (Proceedings of the 9th Annual Corporate Law Teachers Association Conference, Monash University, Melbourne, Australia, 1999) 21–9.
83. Sarah B Foster and Carolyn Johnsen, 'The war of the worlds: Bankruptcy versus . . . ' (American Bar Association, 28th Annual Forum on Franchising, Florida 2005).
84. 11 USC § 365(e)(1). Detailed information about franchise insolvency law in the US is available in Jason B Binford and Daniel M Eliades (eds) *The Bankruptcy Handbook for Franchisors & Franchisees* (ABA, 2018).
85. Buchan, 'Franchising', above n 62, 314.
86. Nicholls and Buchan, above n 14.
87. Buchan, above n 72.
88. McCoy, above n 68, 24.
89. *Corporations Act* s 443B(2)–(3).
90. Ibid s 439A(5)(b).
91. *Re REDGroup Retail Pty Ltd ACN 108 801 127 and the Companies Listed in the Attached Schedule (All Administrators Appointed)*, No NSD 279/2011, Sealed Order, Federal Court of Australia, Sydney (14 March 2011) para 3.
92. Buchan et al, above n 16, 322.
93. This is normally not possible because of *Corporations Act* ss 440D or 471B.
94. *Competition and Consumer (Industry Codes—Franchising) Regulation 2014* (Cth) cl 29 provides for termination in special circumstances. The *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* inserted provisions into the Corporations Act to stay the enforcement of ipso facto clauses against relevant entities.
95. Nicholls and Buchan, above n 14.
96. *Insolvency Act 1986* (UK) cl 45, sch B1, para 99.
97. Jenny Buchan, 'Reducing Collateral Damage in Franchisor Insolvency' in Paul Omar (ed), *International Insolvency Law: Themes and Perspectives* (Ashgate, 2008) 391.
98. Ibid 392.
99. Jennifer L L Gant, *Balancing the Protection of Business and Employment in Insolvency: An Anglo-French Perspective* (Eleven International Publishing, 2017) 33–78.
100. *PD 10276, Inc. v. Commissioner of Labor (In Re Baez)* 520746 (NY App Div 2016).
101. See, eg, Caroline Colton, 'Professional Misconduct: The Case of the *Medical Board of Australia v Tausif (Occupational Discipline)*' (2015) 22 *Journal of Law and Medicine* 534.

102. Donald R Korobkin, ‘Employee Interests in Bankruptcy’ (1996) 4 *American Bankruptcy Institute Law Review* 5, 7.
103. Christopher Symes and John Duns, *Australian Insolvency Law* (LexisNexis Butterworths, 2009) 310.
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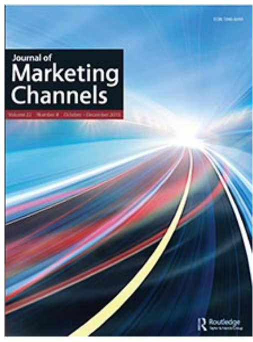

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Journal of Marketing Channels

ISSN: 1046-669X (Print) 1540-7039 (Online) Journal homepage: https://www.tandfonline.com/loi/wjmc20

Franchisor Insolvency in Australia: Profiles, Factors, and Impacts

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To cite this article: 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, DOI: 10.1080/1046669X.2015.1113487

To link to this article: https://doi.org/10.1080/1046669X.2015.1113487

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Journal of Marketing Channels, 22:311–332, 2015
Published with License by Taylor & Francis
ISSN: 1046-669X print/1540-7039 online
DOI: 10.1080/1046669X.2015.1113487

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Franchisor Insolvency in Australia: Profiles, Factors, and Impacts

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Franchisor failure is enduring and important in terms of cost, nationally and internationally. This article presents research into Australian franchisor firms that went into a form of bankruptcy protection known in Australia as "voluntary administration." The research was driven by the commonality and divergence of the interests of franchisors and franchisees. The article provides an insight into franchisor failure and its effect on franchisees. It presents the substantial literature survey that was used to frame questions for franchisor administrators to understand issues associated with franchisors in administration. The limited data demonstrate diversity in the treatment of franchisees during the franchisor's administration. In Australia, franchisees remain a captive, financially committed counterparty during insolvency and potentially deliver a great financial benefit to the franchisor's creditors. The article concludes that administration of franchisors does not take into account the distinct relationship between franchisors and their franchisees and provides policy recommendations to address this matter.

Keywords: *Australia, bankruptcy, business format franchising, franchise business processes, franchisee insolvency, franchisor failure, franchisor insolvency*

Business format franchising is an important method of distribution of goods and services and, as such, is a form of marketing channel that is one of the exclusive subjects for articles in the *Journal of Marketing Channels* (2015). Business format franchising continues to expand throughout the world as evidenced by articles in this journal (e.g., Dant & Grünhagen, 2014). In Australia alone in 2014 (Frazer et al., 2014), there were 1,160

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business format franchisors. There were an estimated 70,000 franchisee-owned business units. More than 460,000 people were employed directly in franchising. And with sales turnover estimated to be AU$144 billion, this sector is an important actor in the Australian economy.

Franchisees are key stakeholders in a franchise system. Franchisors protect themselves from the risk of being sued for engaging in misleading or deceptive conduct by warning their prospective franchisors that the success or failure of their individual franchisee business will be up to them. However, franchisees invest in what they believe to be the franchisor's proven and solvent business.

In Australia, franchisors and franchisees are legally separate entities with some interests in common and others that diverge. Franchisors and franchisees rarely contemplate franchisor failure (Frazer & Winzar, 2005). The legal instrument designed to regulate the conduct of participants in franchising toward other participants in franchising is the Competition and Consumer (Industry Codes–Franchising) Regulation 2014, the Franchising Code of Conduct (''the Code''). Franchise agreements provide rights for franchisors on franchisees' failure, but the Code ignores *franchisor* failure, and agreements rarely provide specific rights to franchisees on the failure of the system's lynchpin, its franchisor (Buchan, 2013; Garrisson, 2008).

The number of failed franchisors also masks the number of franchisees impacted by each franchisor's demise. We contend that understanding the challenges and cost of franchisor failure is as important as understanding franchise success. The roles franchisees occupy within a franchise system (including, e.g., as suppliers of equity and borrowed capital to promote the franchisor's brand, as suppliers of labor, and as takers of risk) and the potential for franchisees to be severely adversely affected by their franchisor's failure give rise to questions that include whether the current positioning of franchisees within the insolvency regime as, typically, unsecured creditors, is appropriate.

The research question behind the research presented in this article was ''What are the consequences of franchisor failure on franchisees?'' As a result, the article focuses on failure studies. Franchise failure can mean either the collapse of the franchisor's business or failure of the franchisee's business (and sometimes both). The majority of research has concentrated on failure at the franchise-unit level, often comparing franchising with independent small business. Fewer studies have focused on franchisor failure. Also, there is a paucity of research about the effect of franchisor failure on franchisees, thus underscoring the research question.

This article commences with an extensive literature review as there does not appear to be such a review in the literature. First, the sporadic studies of franchisor failure that have been undertaken since the 1970s are reviewed, with the most important studies being acknowledged. The second theme developed in the article raises issues related to potential limitations in previous studies of franchise failure.

The article then moves to the theoretical perspectives of franchise failure. In particular, our discussion turns to whether the extent of franchisor failure is substantial enough to warrant further research. The theory section concludes that the impact of franchisor failure is far reaching and affects the health of the sector. The section of the article on results of research on franchisors examines the impact of franchisor failure on franchisees—an area that has largely been neglected in the literature—and assesses the vulnerability of the franchisee under such circumstances.

This article presents the effects of franchisors in administration in Australia. It finally provides a discussion of the findings before presenting some conclusions and recommendations for further work. The experience of the franchisor administration process, and the fate of most franchisees whose franchisors enter administration, is unknown and is the focus of our research.

LITERATURE REVIEW

Overview

The past few decades of research have concentrated on the unique characteristics of franchising, such as contractual arrangements, the nature of the franchising relationship, economic incentives for franchising, and expansion strategies. Most attention has been devoted to the positive benefits of franchising to the economy, small business, and consumers. Some researchers have also explored the negative aspects of franchising, including franchising relationship conflict (e.g., Spinelli & Birley, 1996; Tikoo, 2005; Weaven et al., 2010), the propensity for opportunistic behavior among franchisors and franchisees (e.g., Davies et al., 2011; Gassenheimer et al., 1996), asymmetry (e.g., Doherty, 1999; Lapiedra et al., 2012; Sen, 2001), and the incidence of failure (e.g., Castrogiovanni et al., 1993; Hunt, 1977; Ozanne & Hunt, 1971/2011).

This literature review on franchisor failure provides a synthesis of the current knowledge about this issue and identifies common themes and gaps in our understanding of this phenomenon. A multidisciplinary approach is taken to review the literature, including research from the disciplines of accounting, economics, entrepreneurship, law, management, marketing, and politics.

Introduction to the Literature

A central objective behind the initiation and operation of a commercial enterprise is to provide a financial return to its owners. In the franchisor context in Australia, this means a return to its shareholders. Choosing to establish a commercial enterprise as a vehicle to achieve a financial return is motivated partially by an expectation of a higher rate of return than that achievable by remaining as an employee. As market conditions and achievable returns on investment are not constant, the objective of financial return is sometimes constrained by the need to survive as an entity to make a future return. It could therefore be stated that the purpose of a commercial enterprise is first to *survive* and second to provide a *return* on input resources of capital and time that meets the shareholders', and the financier's, expectations.

The dual aims of survival and return have been brought into sharp focus during the global financial crisis. The franchise sector has not escaped the impact of that crisis (Einbinder & Dunn, 2011). One of the effects of this impact on franchising is some well-publicized franchisor failures (Gehrke, 2012a).

In franchising the initiator of the franchise, called the *franchisor,* and the entity that replicates the business system specified by the franchisor, called the *franchisee,* have fundamental interests that are in some respects alike and in others diverge. Both of these legally separate entities have a similar purpose in surviving and providing an acceptable return. Yet they cannot fully have the same purpose, as their business models are different, as are the expectations of each party. This divergence of purpose and expectation is likely to cause tension and reflects some of the risks and challenges that are inherent in franchising and the franchisor–franchisee relationship (Hoy, 1994).

Some of this tension is managed through the franchise agreement upon which each franchise relationship is based. The franchise agreement is a legally enforceable and complex contract (Justis & Judd, 2002) and is usually in a standard form (Spencer, 2008). The agreement is drafted by the franchisor's legal advisors or representatives and offers little room for negotiation of changes by individual franchisees. Franchise agreements usually canvas aspects of the franchisor–franchisee relationship and will often provide a series of obligations on the franchisee in the case of the termination of the agreement by the franchisor or following the demise of the franchisee. The standard form of the franchise contract makes sense from the franchisor's perspective as consistency of terms (for potentially hundreds of franchise agreements in a system) makes day-to-day administration of the franchise system more manageable.

However, the franchise agreement seldom addresses franchisor failure and its consequences or provides specific rights to the franchisee on the franchisor's failure (Buchan, 2010, 2013; Garrisson, 2008). The franchisee rarely has a right to terminate the franchise agreement in the event of the insolvency or bankruptcy of the franchisor (Goldman, 2003). Indeed, exercising that right may seriously disadvantage the franchisee whose investment is in the system and brand, known within the law as the *franchisor's intellectual property,* that the franchisor controls. Those same franchise agreements and valuable items of intellectual property will be viewed as assets with the potential to satisfy the insolvent franchisor's creditors, irrespective of franchisees' investment.

Consistent with the tenor of franchise agreements, franchises are bought on the basis of predicted success as was found in the review of the Code (Wein, 2013). The scale and the international reach of this apparent success has driven important research on franchising, although much of franchising research in the 20th century responded to a relatively narrow focus on the unique characteristics of franchising (Dant et al., 2011; Elango & Fried, 1997), particularly ownership-redirection theories (Dant, 2008). Relatively little research has been directed at commercial failure within franchises. We contend that understanding the causes and impact of franchise failure is as important as understanding franchise success.

To investigate franchise failure this article develops five important themes arising from an extensive examination of extant literature. First, it follows the somewhat intermittent debate concerning franchise failure from the early 1970s to the present by considering the important studies that span this period of time. The review then addresses some fundamental research problems constraining the debate on franchise failure that are identified by a consideration of those studies. We then assess the extent and significance of franchise failure to determine whether it represents a serious problem worthy of research or if its importance is more peripheral.

Having made this assessment, the article concludes by adopting a specific position in the debate by examining the impact of franchisor failure on franchisees and also assessing defensive strategies that franchisees might consider upon the failure of their franchisor entity. Future possibilities for theoretical and empirical research are indicated based on the outcomes of this review of literature. The review of literature thus framed is not only thorough and intensive but also is considered the first substantial attempt to complete such a review referencing franchising in the context of disciplines as diverse as economics, law, and media studies.

The Debate on Franchisor Failure

As early as 1971 franchise failures were noted in the literature, with 54 fast-food franchises having failed in

the United States (U.S.) during 1968–1969, thus spelling possible disaster for their many franchisees (Ozanne & Hunt, 1971/2011). Ozanne and Hunt (1971/2011), originally published in 1971, proposed that measures should be adopted to protect franchisees from franchisor ineptness and failure. Hunt (1977) repeated this assertion in noting that evidence was beginning to mount that many franchises were failing. This assertion by Ozanne and Hunt seemed to have resulted in a muted response as robust debate on franchise failure is not evident during the 1980s.

Bates examined survival patterns of franchisees as early as 1988 and offered an informed comparison of franchise failure with independent small business failure in his examination of business start-ups (Bates, 1998). By analyzing small firm formations from 1984 to 1987, he found that franchise discontinuance rates were "dramatically different" (p. 27) from those cited by media commentators, franchisors, and franchise associations. He cited Castrogiovanni et al. (1993) as academics who have maintained an expectation for lower risk when comparing franchises with independent start-ups.

Bates (1998) was critical of the assertion made in a study commissioned by the International Franchise Association that declared that 96.9% of franchise units opened in the U.S. in the previous 5 years were still in operation. He also cast doubt on the "conventional wisdom" (p. 26) in a statement in *Business Week* magazine that illustrated what a safe bet a franchise was by suggesting that a franchise had a 4 times greater chance to succeed than an independent business. From a sample of 1,276 franchise start-ups and 19,278 independent business start-ups, Bates found that franchise start-ups exhibited both higher rates of discontinuance and lower mean profitability than independent businesses.

Castrogiovanni et al. (1993) made one of the first methodical analyses of franchise failure. They considered that the primary referent for the risk of franchise failure indicated "that less than four per cent of all franchises fail each year" (p. 105). They sought to corroborate this assessment and isolate franchisor-specific factors influencing franchise failure rates, where a failure was defined as a closure within a franchise organization. Castrogiovanni et al. reported that data were collected from a random sample of 140 franchisors from an International Franchise Association directory because, as the authors noted, there was no central repository of franchisor information. They concluded that the annual franchise failure rate "most likely is close to 4 percent" (Castrogiovanni et al., 1993, p. 112).

In 1994 Hoy continued the argument surrounding franchise failure and observed that "franchising has received friendly attention in the media, both popular and academic" (Hoy, 1994, p. 26). Despite the title, his article was not aimed at profiling the dark side of franchising so much as using the predictive theory of Bull and Willard (1993) to find that there are risks as well as advantages inherent in franchising. He specifically identified the halo effect surrounding franchising in that the "widely heralded" (p. 29) low failure rate for franchises of less than 5% in comparison to independent small businesses is taken as a proxy for franchising being perceived as far more successful and less risky than independent businesses. He concluded that franchise failure rates were understated and independent small business failure rates were overstated. Hoy's article did not reference Bates (1995) but did cite the related article of Castrogiovanni et al. (1993) in identifying a small study by Justis et al. (1992) that confirmed the low franchise failure rate of less than 5%.

Ozanne and Hunt (1971/2011), as well as Hunt (1977), identified franchise failure as a problem worthy of consideration and explanation and asserted that, although the franchise failure rate could not be accurately determined, it was much higher than previous estimates indicate. Castrogiovanni et al. (1993) departed from these views in confirming the low failure rate of 4% prevalent in academic and nonacademic assessments during the period of their study, although Bates (1995) and Hoy (1994) argued against Castrogiovanni et al.'s comparatively low assessment. Shane (1996) found franchisor start-up failures similar to nonfranchise start-up failures, thereby adding a slightly different dimension to the debate. Michael and Combs (2008) extended the debate in marketing channel research by investigating how franchisors affect franchisee failure, but only in established franchisors.

Shane (1996) published one of a series of articles that considered the survival of new franchisors. His research applied agency theory to determine whether organizational forms, such as franchising, allowed firms to grow faster and improved the likelihood of survival. Shane examined a sample of 138 franchises that first published franchise-offering documents in 1983 and analyzed their progress over 10 years. He asserted that his sample was representative of the population of U.S. franchises that started in 1983 and found that franchising enhances firm survival and growth. Shane also found that the failure rate of franchises was over 75% for the 10 years that he studied; he considered this similar to nonfranchise organizations.

The first decade of this century saw a repeat of the 1980s hiatus in the debate concerning franchise failure. The debate has been more evident in legal academic and practitioner journals than those from the fields of marketing, management, and economics. Tractenberg (2000) advised on what the franchise lawyer needed to know about bankruptcy. Tractenberg's article is written to advise the franchisor on franchisee bankruptcy, but he suggested that similar strategies would apply to

franchisor bankruptcies. He also suggested that "knowledgeable drafting will yield dividends and more predictable outcomes in the event that bankruptcy is filed" (p. 7). Abell et al. (2009) also sought to advance understanding of insolvency, but again they advanced that understanding from the franchisor's point of view on a franchisee's insolvency. Einbinder and Dunn (2011) considered the franchisee's position on the bankruptcy of the franchisor.

Perrigot and Cliquet (2004) commenced inquiry into franchisor failure outside North America by calculating the number of franchisor failures in France over a 10-year period. They provided an explanation of the bankruptcy process, examined the possible effect on a franchisee's business, and offered practical recommendations to franchisees to respond to franchisor bankruptcy. Michael and Combs (2008) provided a contribution to the muted debate from the marketing channels perspective by analyzing 88 restaurant chains, focusing on the failure of franchisees and the use of agency- and resource-based theories to determine how franchisors affect franchisee failure. Michael and Combs specifically constrained their research to study franchisee failure in established franchises, thus avoiding franchisor failure entirely. It is perhaps telling that of 55 articles and reports referenced by Michael and Combs, only 9 were published in the current millennium and of these 9, none specifically addresses franchisor failure.

These studies, between 1971 and 2011, seek to explain different aspects of the complex process of franchise failure, yet many of their arguments diverge (e.g., as to the effects of failure) and not all are examining the same event (e.g., some examine the failure of the franchisor and others the bankruptcy of franchisees) or the same subjects (i.e., the economic analysis is likely to differ from a legal one). We will return to the events and subjects in the next section of this article.

Beyond the evidenced attempts to establish how many franchises, franchisors, or franchisees fail, franchisor failure has received little academic (Morris, 2006), practitioner, or government attention (Buchan, 2013). We assert that the divergence of approach in the cited studies reflects some of the fundamental research problems that have constrained the important debate on franchisor failure thus far.

Seven Fundamental Problems in Researching Franchisor Failure

Attempts to compare the findings of the studies by Ozanne and Hunt (1971/2011), Hunt (1977), Castrogiovanni et al. (1993), Bates (1995), Hoy (1994), Shane (1996), Tractenberg (2000), Perrigot and Cliquet (2004), Michael and Combs (2008), Abell et al. (2009), and Einbinder and Dunn (2011) highlight some of the fundamental problems confronting researchers of franchisor failure. We identify these problems to both inform the review of the literature and to establish parameters and constraints to condition a research design for future empirical research. We have identified seven such problems, setting them out next.

Meaning of "failure". The term *franchise failure* demands clarification. Failure is a complex matter as there is uncertainty as to what franchise failure means. A franchise failure may refer to the failure of an entire franchise network (including the franchisor and all its franchisees), a failure of a franchisee, or a failure of a franchisor. It may also refer to a partial failure of any of the just mentioned aspects of a franchise. It may include failure that is rectified when it is followed by restructuring through a process such as the U.S. Chapter 11 process or Australia's Deed of Company Arrangement (DOCA). The U.S. Chapter 11 is designed to provide a company with protection from its creditors as it reorganizes. The DOCA is a binding agreement between the company, creditors (but generally excludes secured creditors, such as the bank), the deed administrator, and the company's shareholders. The DOCA has an effect similar to U.S. Chapter 11 protection and provides for debts to be compromised or paid over an extended period. A clear and specific definition of what is meant by franchise failure is essential (Eljelly & Mansour, 2001).

Timing. Having defined the concept of franchise failure, it is necessary to specify when a franchise failure occurs. Failure is unlikely to be a binary opposite to success; it is more of a process that spans a period of time. Failure may relate to a negative equity position, a loss of solvency, or liquidation. It is necessary to define that part of the life cycle of the selected franchise entity where failure is deemed to occur.

Geography. Although franchise failure has been researched in the United Kingdom (UK) (Lafontaine & Shaw, 1998), France (Perrigot & Cliquet, 2004), and Australia (Buchan, 2006b, 2010), most peer-reviewed articles on franchise failure are restricted to franchise failure in the U.S. The arrangements in these different jurisdictions may vary.

Research design. There are research design constraints in describing and specifying the population to be researched and the manner that the sample is selected from the identified population (Eljelly & Mansour, 2001). This may be due to the lack of centralized and complete information concerning franchises and the consequent reliance by academics and industry

commentators on databases that are sourced from representative and partial organizations as opposed to government-sourced data (Stanworth et al., 1997).

Data collection. There is uncertainty of data collection methods relating to the prevalent use of samples of existing franchise organizations, thus excluding failing or failed franchises (Hoy, 1994) and their franchisees and a further inadequacy in studies that collect data solely from franchisors, as they may be unwilling to report franchisee failure. Dant et al. (2011) observed that failure numbers at franchisee level can be masked by franchisors deciding to acquire underperforming units rather than allowing the franchisee to become insolvent. This further serves to "muddy the waters" in that it can distort failure figures and definitions.

Disciplinary differences. Hoy (1994) also observed that the references available to inform research on franchise failure were derived from the marketing literature and noted that research on franchising is thematically dominated by examining the franchising process through marketing channels. Hoy advocated a multidisciplinary approach using a wider range of theoretical perspectives that could be applied to analyze franchising including, but not limited to, legal theory, contract law, organizational theory, information theory, and financial theory. Dant (2008) echoed the need to think critically about the applicability of various theories to the specific context of franchising.

Terminology. Terminology is an ongoing source of confusion for franchise practitioners and researchers (Buchan, 2013, 2014a, 2014b). This problem is one that also confounds research into franchisor failure. Some studies refer to franchise failure but focus uniquely on franchisee failure, although other studies deal with franchisor failure, also terming it franchise failure. Yet others frame their research in terms of "success" but describe a success rate lower than 50% (Perrigot & Cliquet, 2004). Despite the media reporting on failure at a national level in Australia (e.g., Carter, 2013), there appear to be no studies that address master or area franchisor failure or their consequences.

The confusion over terminology does not end with the question of whose business failed. Failure itself is termed *bankruptcy* in U.S. law, whereas in other jurisdictions corporate failure is termed *insolvency*.

The initial, divergent presentation of arguments surrounding franchise failure, illustrated by the cited articles, and the fundamental problems affecting research on franchise failure, may have contributed to the observed decrease in the intensity and even the maintenance of the debate. It is possible that the strong growth exhibited by franchising in many of the decades since the 1950s (and in many countries) has resulted in franchising achieving excessively generous attention in the popular and academic media (Hoy, 1994) so that a halo effect has developed with respect to franchising. Although no causality is suggested between the friendly attention observed by Hoy (1994) and the absence of sustained and vigorous debate on franchise failure, it is noted that research on franchise-related topics that might have supported further investigation along initial lines drawn by Hoy have been conspicuously absent.

Response to the Seven Fundamental Problems

This literature overview specifically responds to the fundamental problems detailed previously by:

a. Specifying that part of the complex debate of franchise failure at which it is directed as the failure of the franchisor entity at the time the administrator is appointed. From that moment the franchisor directors cease to be in absolute control of the future of the network.
b. Defining the exact moment of franchisor failure as the time when an administrator is appointed to the franchisor entity. Corporate insolvency instruments are a set of statutory procedures that a company can move through, or be moved through, from a situation of financial stress to a resolution of that stress. In Australia, one of these is voluntary administration and this form of administration is distinct from receivership or liquidation.

   The appointment of an administrator is the first of these statutory procedures that affects all of the debtor's creditors and can be compared with the granting of a Chapter 11 status in the U.S. An administrator is appointed to determine whether the company is (1) able to be returned intact to the control of the directors, (2) restructured and returned to the control of the directors, or (3) put into liquidation. Strict time frames are accorded to each step in the insolvency process.

   In Australia, for example, from the time the administrator is appointed, the first meeting of creditors must be held within 8 business days. Following the first meeting of creditors the administrator has up to 30 business days to evaluate the potential for the company, formulate a recommendation to creditors, and hold the second creditors' meeting. At the second creditors' meeting the creditors vote to pursue one of the three outcomes just mentioned as required by the Australian Corporations Act 2001, s 439A(1). Similarly, in the U.S., the Chapter 11 route

facilitates reorganization for companies in distress that believe continuing in business is a viable option.

The process allows the subject enterprise time to rearrange its business pursuant to a plan of reorganization so that it can exit bankruptcy as a viable, continuing operation (Einbinder & Dunn, 2011). This may involve a future for the company without franchisees.

c. Situating the current research within the Australian franchise sector and referencing internationally, thus not only progressing research on franchisor failure in the Australian franchise sector but also adding to the internationalization of the debate.
d. Establishing a data set. Research on the impact of franchisor failure on franchisees and the economy has been hampered by lack of data, the cost of buying data, and the difficulty of locating and interviewing former franchisees who are often financially and emotionally traumatized by their experience and do not wish to participate or are unable to participate in research for fear of breaching the nondisclosure contracts they have signed as a condition of exiting the franchise (Buchan, 2006b). They, like the Cheshire cat, often disappear from view with alarming speed when the franchisor fails (Buchan, 2006a; Gehrke, 2012a, 2012b).

This inability to access data as a base for empirical research has hampered the evolution of policy to address any deficiencies in the law (Buchan, 2013). This article identifies a population of failed franchisor entities by comparing successive Franchising Australia biennial surveys[1] and identifying the franchises that ceased to exist.

This review has not restricted itself to one discipline. We have sourced empirical, theoretical, and practitioner-oriented articles from accounting, business organization, economics, entrepreneurship, finance, labor relations, law, management, marketing, public policy, and the business press. The Appendix summarizes the literature that has informed the review and provides a ready reference for other researchers.

Of the 66 publications identified in the Appendix, 16 are from Australia, 3 are from Canada, 1 is from Finland, 2 are from France, 1 is from Spain, 1 is from Sudan, 4 are multijurisdictional, 6 are from the UK, and 32 are from the U.S.; 26 are concerned with franchisee failure and 40 with franchisor failure. The discipline focus of the articles referred to is as follows: 2 from accounting, 12 based in the field of economics, 3 are by academics from within enterprise studies, 5 from entrepreneurship, 1 from finance, 2 from labor and urban affairs, 22 from law, 13 from management, 4 from marketing, and 2 are cross-disciplinary. The large number from law is likely to be a consequence of a number of legal practitioners taking an active role in writing in this field.

[1]The biennial Franchising Australia surveys have been published since 1998.

In addition to specifying the way that the seven fundamental problems identified are approached, this section of the article elucidates the particular consequences of franchisor failure on franchisees. We now turn to that topic.

The Importance and Extent of Franchisor Failure

One attribute of the business model is that franchisees outnumber franchisors (Buchan, 2013). Each franchisor has between one and thousands of franchisees. The average ratio of franchisors to franchisees is about 1:60 in Australia (Frazer et al., 2012). This ratio assumes that one franchisee operates one outlet, although multiunit franchisees are common (Buchan, 2013). It can be concluded that the complete failure of a franchisor entity is likely to have a domino effect on many of its franchisees.

In Australia, estimates of the size of the problem of franchisor failure are varied. McCosker and Frazer (1998) found that in the 6-month period from checking firm details in the Telstra White Pages on the Internet to follow-up of nonrespondents to a survey that they conducted, 127 out of 946 franchisor entities could not be located: they were presumed to be no longer operating. The Franchising Australia 2014 survey revealed that some 89 franchise systems ceased operating and a further 48 ceased franchising in the 2-year period from 2012 to 2014 (Frazer et al., 2014).

Connors (2010) speculated that there was a ratio of six franchisor failures to one success over a period of 20 years. Buchan et al. (2011) found that the Franchise Council of Australia's Australian Franchising Yearbook and Directory 1999 (Franchise Council of Australia, 1999) listed 347 franchisors and of these 251 (72%) were no longer franchising by 2011. Although this assessment of 72% included franchisors that had exited franchising but possibly remained in business, many of the franchises in the assessment of 72% can be identified due to the public notification requirements surrounding insolvency processes. Eight identified franchises carried the potential to seriously affect the survival or profitability of slightly less than 1,000 franchisee businesses.

The identified franchises included Kleenmaid with 15 franchisees, Kleins Jewellery with 134 franchisees, Traveland with 270 franchisees, Beach House Group with 60 franchisees, Healthzone Limited with 80 franchisees, Refund Home Loans with 320 franchisees, Tyrecorp with 33 franchisees, and Worldwide Online Printing with 85 franchisees (Buchan et al., 2011). Any attempt to analyze the failure of franchisors in Australia suffers from problems similar to those identified in relation to data collection in the U.S. No public database of franchisors or franchisees is available in Australia, let alone those of failed franchisors; consequently researchers must develop their own data sets.

In the U.S., Cross (1994) found that the only systematically compiled statistics on franchise failures have been provided by the Franchising in the Economy reports. These reports were produced up until the late 1980s by the U.S. Department of Commerce but have since been discontinued. Cross also cited periodic membership surveys by the International Franchise Association as a source of information on franchise failure but recognized that both data sets are based on potentially incomplete and inaccurate data submitted by franchisors.

Shane and Spell (1998) found that fewer than 25% of franchise systems begun in the first year of their longitudinal study were still around 10 years later. Blair and Lafontaine (2005) used U.S. Department of Commerce data from 1988 to report the number of franchisor failures and departures out of an estimated population of 2,177 franchisors in 1986. They assessed that a total of 104 franchisors operating 5,423 outlets failed during 1987. That the problem of franchisor failure is continuous in the U.S. is instanced by Einbinder and Dunn (2011), who named eight large and three small U.S. franchisors that became bankrupt in 2010.

In the UK, Stanworth et al. (1997) could only describe one franchise in four as an unqualified success over a 10-year period; Lafontaine and Shaw (1998) observed that around half of their initial sample was judged to have failed completely and utterly. Similarly, in France, Perrigot and Cliquet (2004) studied 952 franchising networks during the period 1992–2002 and found that only 42.13% survived.

The studies we have just reviewed considering Australia, U.S., UK, and France indicate that the problem of franchisor failure is continuous, international, and important. It is of particular importance to franchisees that may have no warning of the impending failure of their franchisor. The failing franchisor will be unlikely to meet any of its contractual obligations to its franchisees (Einbinder & Dunn, 2011) and the franchisees will find little or no remedy in the franchise agreement (Buchan, 2010; Spencer, 2008).

THEORETICAL PERSPECTIVES

Impact of Franchisor Failure on Franchisees

The franchisee's business is inextricably linked to that of the franchisor, yet, as demonstrated for Australia, U.S., UK, and France, not all franchisors succeed in business. The demise of a well-known franchisor is often mentioned in the business pages of the press, but the demise of a franchisee may not even warrant the attention of the local newspaper (Gehrke, 2012a). Blair and Lafontaine (2005) concluded that in the case of franchisor discontinuance, whether it is a departure from franchising or a business failure, there will be an impact on the survival or growth of the franchisee units that are tied to that franchisor.

For a franchisee in Australia, the loss of a franchise can represent the loss of not only a relatively large investment but also their family's sole source of income (Dolman et al., 2011), possibly leading to financial devastation for the franchisee and their families (Goldman, 2003). For franchisors, as they clearly rely heavily on franchisees as a group for the continued success of their business, the loss of a single franchisee is a comparatively minor setback. If a franchisee defaults, franchisors will often have an opportunity to buy back the franchisee's business, thereby greatly mitigating their losses (Dolman et al., 2011). Foster and Johnsen (2005) wrote that

> Bankruptcy is most often an opportunity for a troubled company to solve its operational or financial problems and emerge as a more viable company. Bankruptcy provides a useful business tool for a company to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure. For example, bankruptcy may assist a franchisor in addressing the following challenging business issues: 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. . . . (p. 1)

More than 40 years ago, Gilson (1971) noted that as "franchising matures during a torpid economy, trademark problems of failing franchisors are beginning to rise" (p. 467). The interrelated nature of the franchisor and franchisee's business together with the pattern of contractual relationships that bind the franchise network are strengths that become weaknesses for franchisees if a franchisor fails. The standard form of the franchise agreement limits the ability of the franchisee to self-protect (Jenvey, 2006) and insolvency legislation, in existence long before franchising became popular, exposes the full extent of the franchisees' vulnerability.

If a franchisor fails, there are important differences between the effects on the franchisor's employees, suppliers, and independent contractors on the one hand and on franchisees on the other. Holding (1995) rightly observed that employees are vulnerable in their employer's insolvency, but the law plays out even more opportunistically when franchisees are left out of the insolvency equation.

The "currency" that liquidators trade in is debtors and creditors, assets and liabilities: a franchisee may not be any of these to its franchisor. Eljelly and Mansour (2001) provided an example of how articles about business failure do not consider franchisees to be affected by such failure. They referred to business failure as being a subject of concern for many parties, including those who have a direct interest in the business (such as shareholders, employees, and creditors) and those who are less directly related to the business (such as regulators and governments). Yet a franchisee, although directly affected by a franchisor failure, does not meet the specification offered by Eljelly and Mansour and within Australian law may not be considered a direct stakeholder in the administration process.

Franchising is often promoted as being a less risky alternative to independent small businesses. In particular, first-time business operators often become franchisees because of the benefits attached to a recognized brand and the support promised by the franchisor. In Australia, consumer protection legislation within the Competition and Consumer Act 2010 (No. 51, 1974, Compilation No. 100) provides for a franchisor's duty of disclosure through the Code. This includes the duty to provide a signed statement of solvency of the franchisor entity.

Empirical evidence shows that a surprisingly large number of franchisors do fail and that their franchisees may suffer grave consequences from such failure, notwithstanding the existence of the previously mentioned provisions. Neither franchisees nor prospective franchisees will be able to respond to a franchisor's impending failure if they do not have access to reliable and up-to-date information on the franchisor's state of solvency (Buchan et al., 2011).

Advance notice of the financial difficulties of the franchisor may be critical to the ability of the franchisees to organize and coordinate an effective strategy to deal with a pending insolvency. In *re Country Style Food Services Inc* (2002 O.J. No. 1377), Madam Justice Feldman of the Court of Appeal for Ontario, on an application for leave to appeal a court order approving a proposal under the Companies' Creditors Arrangement Act (CCAA), wrote,

> I note that the franchisees as a group were not considered to be people to be officially served with and included in the CCAA process. . . . Although the process under the Act contemplates the participation and protection of creditors, the debtor company and possibly the shareholders, in cases where the debtor company is a franchisor, the franchisees may have an interest in the ultimate structure of the franchise operation as proposed by the Plan process. . . . It may therefore be appropriate where a franchisor seeks CCAA protection, to consider whether the franchisees ought to be given notice of the proceedings and the opportunity to request the ability to participate on an appropriate basis. (Colraine, 2003, p. 14)

Prudent franchisors are able to shelter their personal assets through their structuring of their franchise system. It is much more difficult for franchisees to shelter assets as they need to convince the franchisor that they have sufficient funds for the purchase and operation of the franchisee business (Buchan, 2008b). Existing franchisees may not be aware that the franchisor is experiencing financial difficulty. In the case of the Kleins Jewellery franchise, one franchisee noticed a substantial drop in stock deliveries that were controlled by a company related to the franchisor entity 6 months before the administrator was appointed (Buchan, 2008b). As a result, it had some advance notice of the appointment of the administrator although another Kleins franchisee had no warning at all from Kleins concerning the instigation of the insolvency process, receiving a brief notice directly from the administrator subsequent to his appointment. Another franchise entity in administration, Strathfield's, did not consult with franchisees before the administrator decided on a course of restructuring (Thomson, 2009).

Not only franchisees but also their professional advisors (i.e., lawyers, accountants, and franchise consultants) may not be able to predict the future solvency of the franchisor. This was indicated by the National Australia Bank, described as Klein's largest secured creditor, that was still identifying Kleins as one of its Accredited Franchise Systems on its website even after the administrator had been appointed (Buchan, 2008a). In any event, although the appointment of an administrator to a franchisor entity triggers a requirement under the Code that the franchisor advises the franchisee, it does not usually represent a breach of the franchise agreement. Thus, it does not give rise to an action for breach, and anticipatory breach is a difficult cause of action in Australia (Aitkin, 2012).

The number of franchisees at the time of the franchisor failure is often an underrepresentation of franchisees affected by the failure as many may have already left the network, disenchanted at the lack of franchisor support, slow stock deliveries, or other problems symptomatic of

the impending business failure of the franchisor. For example, Strathfield Car Radio was placed in administration at a time when it identified 75 outlets, some franchised, but 20 unprofitable stores had already been closed in the year prior to the administration process (Thomson, 2009). Similarly, pet shop retail franchise Wonderland of Pets had 10 franchisees at its peak but only 3 at the time it failed (Buchan, 2013).

The impact of franchisor failure on franchisees is shown to be potentially severe on a franchisee and the average ratio of franchisors to franchisees, internationally, predicts that this severity will be multiplied many times over. The impact of franchisor failure is exacerbated by the lack of protection that the franchisee has through the franchise agreement, statute, and common law. Although the impact of franchisor failure can be severe and legal protection for the franchisee's business limited, the franchisee can sometimes implement some defensive strategies to avoid or mitigate the full effects of an impending or actual franchisor failure.

Defensive Strategies for Franchisees on Franchisor Failure

The probability of success for franchisee investors in the 3,000 plus franchise systems operating in the U.S. varies greatly by system (Wadsworth & Cox, 2011) and it is virtually impossible to predict *a priori* those that will succeed and those that will fail (Lee et al., 2011). These observations are fundamental to risk assessment, irrespective of national boundaries, but how does a prospective franchisee maximize the chance of his or her success within a particular franchise and avoid joining a franchise that may become involved in the administration process? Once joined, how does a franchisee advance the sustainability of their franchise business if the franchise entity to which they are enfranchised is trading poorly or becomes insolvent?

Many of the actions that may point to the likelihood of a franchisor entity's poor trading or potential or actual insolvency need to be undertaken prior to making a commitment to the franchise by executing the franchise agreement. This requires thorough due diligence by the prospective franchisee and the franchisee's professional advisors prior to commitment. It must be acknowledged that a franchisee's ability to conduct due diligence *ex ante* or *ex post* also suffers from a lack of access to comprehensive, objective data.

Ongoing due diligence can be seen as a defensive strategy to facilitate the identification, as early as possible, of a franchisor's poor trading or financial difficulty. These ongoing defensive strategies will increase in number and intensity as the financial and trading condition of the franchisor is observed to deteriorate. Australian courts have developed a set of 13 indicia of a company's impending insolvency and Buchan et al. (2011) have noted franchise-specific indicia including

> a breach of a franchisor's obligations to provide advertising support, equipment and inventory on a timely basis (Borradale, 2009; Colraine, 2003); an evasive answer to the franchisor's queries when a franchisor default has taken place; a landlord's notice of demand; or restructuring on the part of the franchisor. Where restructuring has been arranged for the franchisor company, the franchisees may see invoices from different companies (Hughes, 2011). Also, when the probability of company's insolvency increases, both the operating costs and the revenues of the firm will be adversely affected. (Jensen & Meckling, 1976, p. 341)

A franchisee should investigate the franchisor's accounting methods to determine whether or not the company is using generally accepted procedures (Cheng & Kregor, 1973). The franchisee should look for signs of the franchisor's reduced liquidity and profitability. Various ratios, especially the current ratio and the asset-test ratio, should be accessed, provided that the franchisor is obliged, by agreement or by public listing procedures, to make them available. Attention should also be directed to the leverage of the company, as it may be heavily in debt. Analysis of these ratios and debts of the franchisor entity may assist the franchisee to identify possible financial problems for the future (Cheng & Kregor, 1973) or identify a trend earlier than would otherwise be possible.

Australian credit firm Dun and Bradstreet finds that companies that have had legal action taken against them are nearly 11 times more likely to fail than those that have not (Gome, 2008). Thus, willingness to resolve disputes through litigation may provide an early indicator of increased risk for franchisees. Disruption to supply chains, stock dumping, and diminished franchisor support are other indicators that the franchisor has financial problems (Buchan, 2006b; Gehrke, 2012b). Unfortunately, the restricted availability of accurate information concerning many franchisor entities, such as those that are proprietary limited-liability companies or trusts, makes it more difficult for franchisees to measure such risk accurately (Lafontaine & Bhattacharyya, 1995).

In the absence of such specific information, decision hierarchies wherein higher-level agents ratify and monitor the decision initiatives of lower-level agents and evaluate their performance can also limit damage to a franchisor entity. This implies observing if the franchisor entity has an appointed board of directors and developing an awareness of their qualities, qualifications, and experience. A board of directors, particularly one that includes independent directors, will establish an apex of decision-control systems wherein decision agents do

not bear a major share of the wealth effects of their decisions. An apex structure can also help to ensure separation of decision-management and control. Unfortunately such decision hierarchies are not common in franchises where the owner or owners of the franchise entity and the board are often the same (Fama & Jensen, 1983).

Franchisees also have a statutory right of association, certainly in Australia and Canada, and franchisees should use this right to pool information and formulate a strategy for dealing with the possible insolvency of the franchisor. Information, and the ability to act on it quickly, are of fundamental importance in insolvency, particularly when reorganization proceedings may be under way (Colraine, 2003).

It is possible that if the franchisor has a close relationship with its franchisees the franchisor may be able to avoid formal insolvency. This may be effected by a group of franchisees, with the franchisor, formulating a rescue plan that may include negotiating with the franchisor's bank, landlord, and other creditors (Mackie & Owen, 2012). It is conceivably more likely that a group of franchisees will be able to support themselves, their franchise, and even their franchisor through the administration process compared with one or a number of franchisees working independently toward the same end.

Conclusions from the Literature and Theory

Franchising will continue to be a business model that crosses the boundaries between the corporate distribution model of the franchisor and the small (independent) business model of the franchisee. The impact of franchisor failure on franchisees remains underresearched. Given that only two of the publications referred to in the Appendix reflect cross-disciplinary research and only a small number are cross-jurisdictional, we suggest that it is timely for properly funded multidisciplinary and cross-jurisdictional research to be conducted in the field of franchisor failure. Both the academic community and industry participants will benefit from a more comprehensive understanding of the complexities and nuances of franchisor failure.

This literature review and theory leads us to a clearer understanding of the potential problems for franchisees arising from franchisor failure as well as providing insights into franchisee failure. It forms a backdrop for our substantive research in Australia that is set out next.

OUR RESEARCH IN AUSTRALIA

Overview

The research undertaken in Australia was to explore the issue of franchisor failure and the flow-on effects to franchisees. This research focused on franchisors under administration. Throughout the period of administration, the administrator and franchisees are bound by the provisions of the Code enforced by the Australian Competition and Consumer Commission. The administrator also has statutory obligations under the law that governs the operation of businesses in Australia, known as the Corporations Act 2001 (Cth). This act is regulated by the Australian Securities Investments Commission (ASIC).

This dual regulatory oversight can cause tension. For example, some franchisees in the Kleins Jewellery franchise tried to exercise their right under the Code to request mediation with the administrator. Under the legislation that regulates the conduct of insolvency, the Corporations Act 2001 (Cth), franchisees have no such right.

Although the period of administration is ideally short, the opportunities created by the existence of franchisees can lead to the administration being prolonged. An example is found in the matter of Kleins when it was tried in an Australian Federal Court case. This results in considerable but undocumented uncertainty for franchisees.

During the period when a business is "in administration" there is a possibility it will exit administration and continue trading. For franchisees this possibility exacerbates the already pronounced information asymmetry of the franchisor–franchisee relationship. Once the liquidator is appointed the possibility of continued trading no longer exists and any ambiguity concerning the future of franchisees within the brand is past.

Data in our empirical study were sourced from administrators of franchisors. As a consequence, the research enhanced our understanding of franchisor administration by providing a better understanding of the impact of the franchisor in administration on franchisees and related stakeholders and by identifying tensions experienced by administrators in meeting conflicting statutory obligations.

Method

First, we listed franchisors that had self-identified as within the cohort of 1,025 franchisors (62,000 franchisees) in the Franchising Australia 2010 survey (Frazer et al., 2010) but that were not present in the corresponding cohort of 1,180 franchisors (65,000 franchisees) in the Franchising Australia 2012 survey (Frazer et al., 2012). That is, the comparison was drawn from data in each of the 2010 and 2012 Franchising Australia surveys. We identified 50 franchisors in the 2010 Franchising Australia survey found to have ceased franchising in the period from 2010 to 2012. These formed our primary sample.

On completing the data collection we discovered a further list of 55 franchisors that had declined to

participate in the 2010 survey. These formed our auxiliary sample. Although these were included in the number of 1,025 franchisors existing in Australia in 2010, they were not included in our primary sample. We subsequently reviewed the auxiliary sample to identify if there were further potential franchisors that had entered administration in that list. One of the failed franchisors (i.e., Strathfield) appeared in both lists.

Second, we sought to identify the individual administrators handling the administration of the sample franchisors with the intent of obtaining their contact details to conduct a survey about their experience in relation to the franchisor's administration. Franchisors are identified by their trading name in the 2010 and 2012 surveys.

The identity of the legal trading entity is not captured. Where we could discover the entity name, we grouped these franchisors according to their current legal and financial status–whether they had ceased trading, entered administration, become insolvent without entering administration, or were no longer franchising (and what their entity names were).

We could not verify the legal entity for 4 franchisors in the sample. A further 14 franchisors had been deregistered without appointing an administrator. That is, the research identified that some franchisors ceased trading without going into administration. (This may be by direct liquidation.) In these cases, it is not clear what became of their franchisees. As a consequence, they merit future investigation.

We then telephoned the identified administrators. In some cases we made two calls before we connected with someone who agreed to take a message or complete the survey. In two cases the relevant administrator had left the firm and no one felt able to answer the survey. In a small number of cases no one answered the phone. Fifteen administrators initially agreed to answer the survey and one of them subsequently declined. Eight responded and this sample size permits us to make only very tentative conclusions (see Table 1).

Findings

All eight administrators notified the franchisees of their appointment. The balance of this section sets out their responses.

Business continuity. When asked, "If you were appointed as receiver, was an administrator subsequently appointed?", two replied in the affirmative, three in the negative, and three did not respond. The appointment of an administrator after a receiver suggests that either there was some prospect of recovery from insolvency or that there were certain assets over which a secure creditor was asserting an interest.

When asked, "Did you seek a time extension for the convening period of the second creditors' meeting?", three replied in the affirmative and five in the negative. All three extensions were granted for periods ranging from 90 days to a few months. In each case, the franchisees were notified of the extension. In each of the three cases, the reason provided to the Court was to maximize the possibility of selling the business (including the franchise network) as a going concern. These responses indicate that the administrators were trying to maximize the opportunity to sell the franchisor as a going concern, but the effect of this may or may not be to the benefit of franchisees.

When asked, "Did you obtain a list of franchisees when you were appointed?", seven of the eight administrators answered in the affirmative. The one respondent who did not obtain a list initially did not subsequently attempt to acquire a list of franchisees because the company advised that it had only two premises. These responses indicate that the administrators recognized

TABLE 1
Status of "Failed" Franchisors Administrators' Survey March 2014

	Status of survey					
			In sample but not surveyed		Surveyed	
Solvency status	Cannot verify legal entity	Verified but not in sample	Could not identify administrator	Could not contact administrator	Surveyed no response	Surveyed and responded
In administration between 2010 and 2012	3	0	2	10	7	8
Deregistered between 2010 and 2012 without entering administration	1	13	2	0	0	0
Insolvent before 2010	0	1	0	0	0	0
Ceased trading, deregistered before 2010 or after 2012	0	7	0	0	0	0
Still trading	0	1	0	0	0	0

the importance of the franchisees, even if only as prospective unsecured creditors.

When asked, ‘‘How did you communicate with the franchisees during the administration/receivership process? (More than one response may be selected)’’, the answers were as shown in Figure 1. The figure suggests that franchisees were not contacted directly to a great extent and were likely to have been treated as if they were merely unsecured creditors.

When asked, ‘‘Which of the following strategies did you adopt?’’, the answers were as shown in Figure 2. In Figure 2, the term ‘‘Other’’ indicates termination of some franchisees and sold the franchisor and its arrangements to new operators not associated with old directors and receivership–all franchisees debadged.

The effect of both of the ‘‘Other’’ outcomes was the loss of the franchise by the franchisees. The extent that the liquidation option was applied suggests little opportunity for franchisees to protect their businesses in other ways.

When asked, ‘‘Were all franchise agreements treated in the same way?’’, there were three positive responses and five administrators did not respond. When asked, ‘‘Did the franchisor hold the head lease for a majority of franchisees?’’, there was one affirmative response, two negative responses, and five administrators did not respond. When asked, ‘‘What action did you take in relation to the leases?’’, the answer was that they were transferred where possible. Where the decision was made to terminate the lease of an individual franchise, the administrators used the liquidation of the company (franchisor) to break the lease. The affirmative response and the approach to breaking leases confirms the difficult position of franchisees without their own property interest in the event of franchisor failure as set out next.

Two administrators confirmed that they specifically invited the franchisees to make an offer for the franchisor’s business, one did not make such an invitation, and five did not respond. The potential for an administrator to sell the franchisor’s business to either individual franchisees or to a joint venture of franchisees is a little explored option that could potentially be beneficial to both the franchisees and to the other creditors.

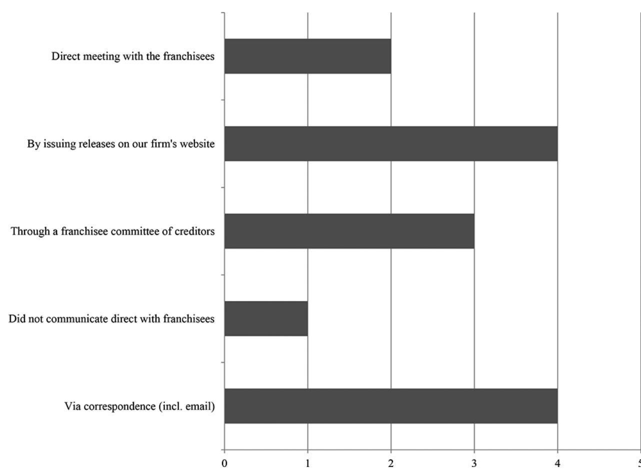

FIGURE 1 Communication with franchisees.

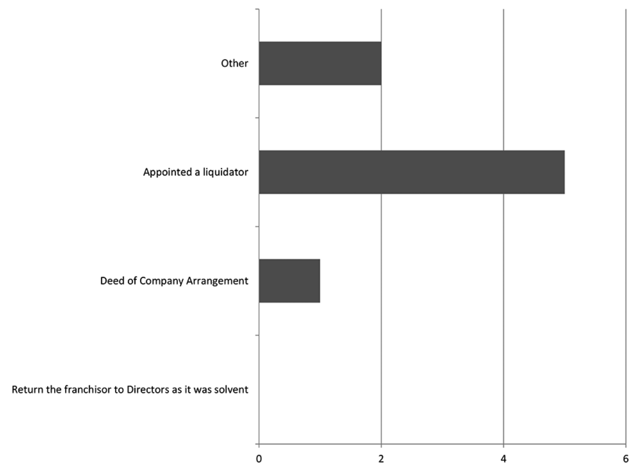

FIGURE 2 Strategies adopted.

There were a variety of responses as to why a liquidator was appointed. They were that company was trading insolvent; no DOCA was proposed; there was no DOCA presented and the company was insolvent, hence winding-up was the only option available; no proposal for a DOCA and company was insolvent; and the underlying businesses of the companies had been sold, preserving the businesses and the majority of employees in the hands of a new (properly capitalized) business.

A concern that had been observed in earlier research (Buchan, 2010) was that in some cases franchisors had continued to sell new franchise units even though they themselves were insolvent. In at least one previous case the franchisor had knowingly been trading insolvent for longer than 12 months and had continued to sell franchises during this time. Three of the eight administrators replied that there was evidence that this behavior was present in the franchises they were administering.

The sale of franchises gives franchisors access to immediate cash in the form of fees for franchises and, in some cases, payment for options to open future outlets. A franchisor facing the prospect of insolvency that is a head tenant may collect rent and outgoings from the franchisee subtenant but pay it to a ‘‘squeaky wheel’’ creditor rather than to the landlord. This puts the franchisor, and thus the franchisee, into default under the lease.

Trademarks. One of the most valuable assets a franchisee gains is a license to use the franchisor’s trademarks, but franchisors do not always own their own

marks. Consequentially, the franchisor might lose access to the marks through having breached the relevant license by becoming insolvent. One of the eight franchisors in the sample did not own its own trademarks. This response is at odds with previous research findings about trademark ownership (Buchan, 2009) and merits further investigation as it presents a further risk to franchisees.

Statutory obligations. Franchisors have statutory obligations under the Code. An administrator in theory assumes these obligations that only end when the liquidator is appointed or the company is put back into the hands of the directors. We asked the administrators, "How did you manage your statutory obligations under the Code during the administration period?" Four answered this question.

One answered, "Through careful advice as to our obligations and ensuring we worked to protect the overall franchise and maintain the value of the group." The second answered, "By ongoing reporting to the franchisor and providing some underwriting of franchise losses during the receivership to hold the network together through the sale process." For the third the Code was not seen as relevant as the business ceased to trade upon the appointment of the administrator. The fourth stated he or she had operated in full statutory compliance. (This last response was ambiguous but we assume that the administrator was confirming compliance with statutory obligations under the Corporations Act 2001 (Cth) as breach of these obligations would create a personal liability for that administrator.)

All eight administrators notified the franchisees of their appointment. Three of the eight were initially appointed as receivers. Of those, one franchisor subsequently had an administrator appointed.

Under s 436E Corporations Act 2001 (Cth), the first creditors' meeting must be convened within 8 business days of the administrator's appointment. The second creditors' meeting is generally required to be held within 20 days of the appointment of the administrator but the court has discretion, under s 439A(6) of the Corporations Act 2001 (Cth), to delay this meeting if the administrators provide compelling reasons. Two of the eight administrators sought an extension of time for the convening of the second creditors' meeting. The meeting time was extended by 90 days in one case and several months in the other. All franchisees were advised of the extension.

Communication between administrators and franchisees. Although franchisees are stakeholders in a franchise system to the extent that the franchise agreements will be assets or liabilities, franchisees themselves are not always creditors or debtors. Accordingly they may not be in direct communication with an administrator in the same way as, for example, creditors would.

As four of the five administrators obtained a list of franchisees when appointed, we asked them what methods they used to communicate with franchisees during the administration. More than one method could be identified. Two administrators communicated via direct meetings with franchisees, four issued releases on the administrator's firm's website, and/or three communicated through a franchisee committee of creditors. Four administrators communicated via correspondence (including e-mail) and one administrator did not communicate with franchisees directly.

Real property interests. It is common for landlords of shopping centers to require franchisors to hold the head lease. In this situation the appointment of the administrator to the franchisor would potentially entitle the landlord to terminate the head lease and would place the franchisee's tenure as subtenant/licensee at risk. This may not be a default event under the franchise agreement. We asked, "When no liquidator was appointed, did the franchisor hold the head lease for a majority of the franchisees?" Three responses were received: one "yes" and two "no."

Franchisee as creditor. Three of the administrators answered the question "Were any franchisees creditors of the franchisor?" All answered "no." In those cases the franchisees were debtors of the franchisor. In two of those cases the administrator specifically invited the franchisees to make an offer to buy the franchisor's business; the third administrator did not make that invitation.

Post administration. The failure of the franchisor is not always a death knell for its franchisees' businesses, so we asked whether the franchisees continued trading. In one case all did, in two cases some did, in two cases none did, and the final three administrators were unsure.

Data on public record. The report completed to comply with s 439A Corporations Act 2001 (Cth) is the major report to creditors wherein the administrator sets out the progress of the administration, makes recommendations, and seeks the creditors' input on the administrator's proposed strategy for the company. Our understanding is that the s 439A report is automatically provided to all creditors but is not filed with ASIC unless ASIC itself is a creditor. This means it cannot always be obtained from the regulator via a (paid) search.

Some firms providing insolvency services routinely provide access to the s 439A report, along with all other communication relevant to the administration, via their

websites: most, however, do not maintain such comprehensive websites. Of the eight in our sample, four provided us with a copy of the s 439A report and one declined to do so.

Although we did not survey the administrators of the auxiliary sample of 55 franchisors, we did search the company records for as many of them as we could identify. Interestingly, 23.6% of these 55 were no longer in a position to accept notices by the time we conducted our research. This compares with 4.4% of the franchisors who did participate in the Franchising Australia 2010 survey (Frazer et al., 2010). When the two groups are combined this brings the number of franchisors identified in the Franchising Australia 2010 survey (i.e., 50) and those subsequently entering administration before the Franchising Australia 2012 survey (Frazer et al., 2012) was conducted (i.e., 55) to 105 (10.2% of the population of 1,025 franchisors reported in the Franchising Australia 2010 survey).

The median number of franchise units in a system was 22 in 2009 although nearly a third of systems had 50 or more franchisee-owned units (Frazer et al., 2010, p. 27). In 2010, start-up costs for franchised units ranged from AU$1,600 to AU$1.2 million (Frazer et al., 2010, p. 47), with the average for those operating from retail premises AU$275,000. Readers will quickly appreciate the multiplier effect the administration of each franchisor has on franchisees, their financiers, and landlords.

DISCUSSION

Few prospective franchisees would consider the prospect of the failure of the entire franchise system prior to entering the franchise agreement. Although in Australia the Code now requires a Risk Statement to draw attention to the possibility of franchisor failure, the concept of risk is far removed for an inexperienced franchise investor. Gatekeepers, however, are often in a position to know how profitably a business is trading. In franchising gatekeepers include funding bodies making a decision to fund a venture, regulators, accountants authorizing franchisors to confirm they are solvent, lawyers, retail landlords, and industry bodies promoting franchisor members.

Franchisees are faced with a dilemma, in that, although they may have negotiated an *ipso facto* clause providing a right to terminate the franchise agreement in the event of the insolvency or bankruptcy of the franchisor (Goldman, 2003), such a termination may seriously disadvantage the franchisee whose investment is in the system and brand (including the franchisor-controlled intellectual property) and its own franchisee-owned outlet. Those same franchise agreements and franchisor's intellectual property are assets with the potential to satisfy the insolvent franchisor's creditors, irrespective of franchisees' investments. The franchisee has funded the purchase of the outlet and needs it to continue to generate income.

As we have shown, the scale and international reach of franchising has inspired considerable research on the model. Research in the franchise failure area has, to a great extent, concentrated on failure of franchisees, often comparing franchising with independent small business. Fewer studies have focused on franchisor failure. Moreover, there is a paucity of research about the effect of a franchisor's failure on its franchisees.

We do not have enough evidence at this preliminary stage of data collection to arrive at conclusive findings. But even our limited data demonstrate the considerable diversity in the treatment of franchisees during the franchisor's administration.

Where administrators secure extra time from the court to conduct the administration, this enables them to negotiate with parties interested in purchasing parts of the troubled business. A franchisor in administration seldom follows the path of being returned in its original form to its original directors. The appointment of an administrator also places the franchisees in a state of limbo for the duration of the extended administration as franchisees remain bound by their franchise agreement until a liquidator disclaims it as an onerous contract (Buchan, 2013). Under the Corporations Act 2001 (Cth) s 568(1) liquidators (but not administrators) have the power to disclaim onerous contracts. This means that the franchisees are a captive, financially committed counterparty.

Where franchisees are the lessees of their premises they impose little burden on the administration but potentially deliver a great financial benefit to the franchisor's creditors (Buchan, 2013). They are, for instance, a motivated sales force for the franchisor's unsold stock. As there is a chance they might be able to stay in business following a successful sale of the system or may be released to rebrand independently, franchisees have an incentive to treat their own customers well so as not to lose them to competitors.

We are not aware of the courts seeking input from franchisees as to whether to grant extra time for the administration. Although a court needs to be satisfied that the extensions would benefit the franchisor's creditors, the franchisees themselves would not have standing to inform the court of the potential impact of these extensions of time on their businesses. In the context of the application to court, the franchise agreements, intellectual property rights, and premises leases/subleases are assets or liabilities on the franchisor's balance sheet.

Where franchisees are not creditors they will have no statutory right to attend creditors' meetings, even

though they do have a vital interest in the progress of the administration. It is interesting to note that one of the eight administrator respondents did not have a list of franchisees: further investigation would reveal whether the franchisor itself had a current list. It could also be used to reveal whether the franchisees participating in the committee of creditors passed information about the administration to noncreditor franchisees.

The nature of the franchise model means that franchisees are likely to be widely dispersed across a country or even dispersed internationally. This makes face-to-face meetings difficult. In earlier research some franchisees reported only hearing about the administration through the media (cf. Buchan, 2006b). This leaves them with many questions. Communication throughout the administrator's term can occur through a designated intranet or by postings on the administrator's website, resulting in a more neatly managed information-dispersal process and a reduced chance of unfounded rumors. Franchisees have chosen franchising for its "command and control" style of management. It is suggested they would respond well to an orderly information-dissemination process throughout the administration.

Not all franchisees operate from fixed premises, but about 73.5% did in 2008, with the remainder operating from home or from mobile units, vans, or trailers (Frazer et al., 2008, p. 47). Where a franchisee does occupy fixed premises there are at least 13 different possible tenancy relationships linking the landlord to the franchisee (Buchan & Butcher, 2009). Where the franchisor is a key link in the chain of title, the franchisee is vulnerable as the franchisee pays the franchisor the rent that is then forwarded to the landlord. In addition it is common in a retail setting for the franchisee to provide the rental guarantee for the premises, regardless of whether the franchisee or the franchisor is the head tenant. Although one would expect it to be common practice for the franchisor to hold this rent in trust, a franchisor experiencing cash-flow problems may receive the rent from the franchisee but not pay it on to the landlord (Buchan, 2013, pp. 32–39).

A tenant wishing to retain premises must, obviously, be an acceptable credit risk for a landlord. The franchisor's failure to pay rent would be an act that enabled the landlord to terminate the lease. Similarly the lease in the name of the franchisor might prove to be a burden that is disclaimed by a liquidator. From the little empirical research on franchisor/landlord/tenant structures we do know that different tenure structures present different risks for franchisees and administrators (cf. Buchan & Butcher, 2009; McCoy, 2012).

Franchise rhetoric may claim that franchisee businesses often survive the failure of their franchisor's business. The fact that three of the administrators surveyed had no knowledge of how the franchisees fared indicates that there is an element of chance involved. The total number of franchisees impacted by each franchisor's administration is also unclear.

Particularly troubling is the finding that any franchisor had continued to sell franchises when they were themselves trading insolvent. Although insolvent trading is not an issue unique to franchisors, this raises concerns from at least two perspectives. First, these franchisors misled the franchisees involved. This is conduct in breach of the consumer protection legislation. But, there is a stay on proceedings under the Corporations Act 2001 (Cth) s 440D during the administration so the franchisees could not commence action against the franchisor. Instead they rely on the insolvency practitioner, who may not know of their existence. They could, however, commence action against any other person (including the franchisor's directors) involved in the conduct (Competition and Consumer Act 2010 s 84; also cf. Wheatley, 2007).

Second, it is common for the same bank to fund both franchisor and franchisee. This arises from franchise processes that recommend the franchisor's bank to a new franchisee. We did not ask about the funding arrangements in this survey, but we do suggest that banks funding franchisors need to re-evaluate the credit worthiness of these franchisor customers before agreeing to fund other customers (i.e., franchisees) into a vulnerable position of financial risk.

As with rental premises, the franchisees' continued access to the franchisor's trademarks, registered designs, and other items of protectable intellectual property may be paramount for the franchisee's continued success. The solvency of the entity that holds the intellectual property assets will mean the assets cannot be grouped together with the assets of the insolvent parties to pay creditors. If the intellectual property-owning entity is solvent, the administrator may decide not to invest resources in negotiating an ongoing license. Clearly the effect of the fate of intellectual property rights—a cornerstone of franchising—on the failure of the franchisor merits further investigation. Seven of the eight administrators said the trademarks were owned by the franchisor. This did not adhere to the more common situation in franchising where the franchisor does not own its intellectual property but shelters it in a separate entity. That entity enters a license agreement with the franchisor for the use of the intellectual property.

In addition to managing risk by owning their intellectual property in a separate entity, franchisors often establish other entities (e.g., companies and trusts) to supply product and services to franchisees. The result may be a large group of companies. The Code does not require disclosure of the entire group. If it did, franchisees' advisors

would be in a much stronger position to conduct prepurchase due diligence for their franchisee clients and to provide better informed advice.

Another troubling issue is the one of *direct insolvency* (i.e., where the franchisor has been wound up or deregistered without the administration process). Clearly, there will be some instances where a franchisor exits in an orderly fashion leading to its winding-up and deregistration. Similarly, there will be some cases where a franchisor will move swiftly from receivership to liquidation in common with other failed firms. However, the impact of franchisor failure on franchisees is likely to be greater than the effect on nonfranchisee unsecured creditors as a result of the issues discussed in this section.

CONCLUSION AND RECOMMENDATIONS

In the expansion of business format franchising, franchisees are key stakeholders in a franchise system. Despite warnings, franchisees invest in what they believe to be the franchisor's proven and solvent business. However, franchisors do sometimes fail. The distinct relationship between franchisors and their franchisees suggests that the positioning of franchisees within the insolvency regime is problematic.

This article has shown how the review of the literature on insolvency in franchising was used to create a survey of administrators of franchisors in Australia. It also presented those results.

In our literature review we confined our search to literature specific to franchising. There exists a large body of research into the field of business failure where franchised businesses undoubtedly formed part of the sample studied but were not specifically identified in the resulting articles. Beyond failure, areas such as corporate governance merit attention through the lens of business failure. To what extent, for instance, does a franchisor or an administrator need to consider franchisees when making decisions that accord with good corporate governance? As noted by Gould and White (1986),

> human behaviour is affected by only that portion of the environment that is actually perceived; our views of the world and the people in it are formed from a highly filtered set of impressions and our images are strongly affected by the information we receive through our filters. (p. 28)

Limitations

The data currently collected are too small in number for us to draw definitive conclusions. The important differences in practice among different administrators and in different franchisor administration situations do, however, confirm our sense that there is no clear path through their franchisor's administration for the franchisees.

Summary of Key Findings

This study found that although the franchisee may have a right to terminate the franchise agreement in the event of the insolvency of the franchisor, the termination may seriously disadvantage the franchisee. In particular, the franchisee may lose access to valuable intellectual property and to the physical premises its franchise operates from.

Franchisees remain captive and financially committed counterparties during insolvency. They impose little burden on the administration but potentially deliver a great financial benefit to the franchisor's creditors. Where franchisees are not creditors they have no statutory right to attend creditors' meetings, potentially depriving them of information and the opportunity to provide input into decisions affecting them. The number of franchisees impacted by each franchisor's administration is unclear.

The administration of franchisors does not take into account the distinct relationship between franchisors and their franchisees. This relationship creates specific issues when a franchisor enters administration including the complex franchisor group structures and the consequent effects on both intellectual and real property rights and on administration. The fact that the Code obligations apply to administrators who ignore them, that the ability of franchisees to access s 439A reports is not guaranteed, and that some franchisors pursue a strategy of direct insolvency (i.e., winding-up without first appointing an administrator) add to the risk of franchisees being marginalized, invisible stakeholders throughout the franchisor's insolvency.

Policy Recommendations

We make five policy recommendations regarding franchisor insolvency practice. The first recommendation aims to address the problem of complex franchisor group structures and the consequent effects on licensing of intellectual property. Our recommendation is that the Code be amended to require that franchisors disclose their complete group and associates structure to franchisees on grant of franchise and as it changes from time to time. In this context, the disclosure document must be able to be relied upon by professional advisors (including insolvency practitioners) as a single source of full and accurate information in a context that is not misleading.

The second recommendation is designed to deal with the fact that Code obligations apply to administrators. We recommend that insolvency practitioner training and best practice guides reflect administrator obligations in respect of franchisors. As a result of the complexity in this area, there is scope for franchise advice and franchisor insolvency to become specializations within the accounting and insolvency professions.

The third recommendation targets the absence of trust structures with respect to monies received by the franchisor from franchisees for payment to third parties. Our recommendation is that all monies received by franchisors from franchisees for payment to third-party suppliers relating to any interest in real property must be held in trust by the franchisor and not placed into a general revenue account.

The fourth recommendation deals with the matter of the s 439A report. We recommend that the Code be amended to require insolvency administrators to provide a copy of the s 439A report to each franchisee. This is the major report to creditors wherein the administrator sets out the progress of the administration, makes recommendations, and seeks the creditors' input on the administrator's proposed strategy for the company. It would also seem reasonable for insolvency practitioner training and best practice guides to recommend that s 439A reports be lodged with ASIC as company disclosures. This is often done in the case of publicly listed companies and could be extended to all franchisors in insolvency.

The final recommendation addresses the dilemma of direct insolvency. Our recommendation is to require that receivers and liquidators have a disclosure obligation to franchisees in the case of franchisor insolvency to the same extent that they have to unsecured creditors.

These recommendations will not reduce the instance of franchisor insolvency. However, they may assist in an orderly administration and, particularly, assist franchisees to survive franchisor insolvency.

Further Research

We conclude that the specific area of franchisor failure, proving to be enduring and important in terms of cost, nationally and internationally, warrants further investigation. Collecting data has also raised some specific issues that we have recommendations about. These are set out next.

We recommend that future research should attempt to source data from both franchisor and franchisee entities. Particular effort should be directed toward the inclusion of franchisor and franchisee representatives, and franchise financiers, who have experience with the administration process within insolvency.

The due diligence process was not central to this study as its traditional focus is on the time prior to the execution of the franchise agreement. However, advisors should note that due diligence should continue after the prospective franchisee becomes an actual franchisee. Ongoing due diligence is clearly a prudent business practice for franchisees.

ACKNOWLEDGMENTS

We thank our research assistants Dr. Ken Billot, Ian Buchan, Anthony Grace, Giridhar Kowtal, and Eddie Wong, as well as the anonymous reviewers, for their assistance.

FUNDING

We gratefully acknowledge the Chartered Accountants Australia and New Zealand for funding this research.

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APPENDIX

Franchisee Failure Literature

References	Field of research	Country
Churchill and Hunt (1973)	Economics	U.S.
Porter and Renforth (1978)	Law	U.S.
Castrogiovanni et al. (1993)	Management	U.S.
Bates (1995)	Labor and urban affairs	U.S.
Beales and Muris (1995)	Finance	U.S.
Lafontaine and Bhattacharyya (1995)	Economics	U.S.
Stanworth (1995)	Enterprise studies	UK
Bates (1998)	Labor and urban affairs	U.S.
Falbe and Welsh (1998)	Entrepreneurship	Mexico, Canada, U.S.
Tractenberg (2000)	Law	U.S.
Frazer (2001)	Marketing	Australia
Kalnins and Mayer (2004)	Management	U.S.
Kalnins and Chung (2006)	Management	U.S.
Pedone and Tractenberg (n.d.)	Law	U.S.
Holmberg and Morgan (2007)	Entrepreneurship	U.S., UK, Europe
Michael and Combs (2008)	Entrepreneurship	U.S.
Tuunanen and Torikka (2008)	Entrepreneurship	Finland
Wadsworth and Cox (2011)	Marketing	U.S.
Welsh et al. (2011)	Entrepreneurship	U.S.
Wyburn (2011)	Law	Australia
Gretchko and Todhunter (2012)	Law	U.S.

Franchisor Failure Literature

References	Field of research	Country
Gilson (1971)	Law	U.S.
Ozanne and Hunt (1971/2011)	Economics	U.S.
Cheng and Kregor (1973)	Accounting	U.S.
Hunt (1977)	Marketing	U.S.
Cross (1994)	Multidisciplinary	U.S.
Price (1996)	Management	UK
Purdy et al. (1996)	Enterprise studies	UK
Shane (1996)	Economics	U.S.
Ingram and Baum (1997)	Management	U.S.
Stanworth et al. (1997)	Enterprise studies	U.S., UK
Taylor (1997)	Law	Australia
Lafontaine and Shaw (1998)	Economics	U.S.
Shane and Spell (1998)	Economics	U.S.
Kirby and Watson (1999)	Management	UK
Shane and Foo (1999)	Economics	U.S.
Azoulay and Shane (2001)	Economics	U.S.
Stanworth et al. (2001)	Management	UK
Colraine (2003)	Law	Canada
Goldman (2003)	Law	Canada
Perrigot and Cliquet (2004)	Management	France
Blair and Lafontaine (2005)	Economics	U.S.
Foster and Johnsen (2005)	Law	U.S.
Buchan (2006a)	Law	Australia
Buchan (2006b)	Law	Australia
Morris (2006)	Law	Australia
Perrigot (2006)	Management	France
Buchan (2008a)	Law	Australia
Abell et al. (2009)	Law	U.S.
Thomson (2009)	Management	Australia
Buchan (2010)	Law	Australia
Bordonaba-Juste et al. (2011)	Marketing	Spain
Buchan et al. (2011)	Law	Australia
de Jong et al. (2011)	Economics	Generic
Einbinder and Dunn (2011)	Law	U.S.
Hughes (2011)	Accounting (insolvency)	Australia
Parsa et al. (2011)	Management	U.S.
Mackie and Owen (2012)	Law	UK
Buchan (2013)	Law	Australia
Buchan (2014a)	Law	Australia
Buchan (2014b)	Law	Australia

Other Franchise Failure Literature

References	Field of research	Country
Fama and Jensen (1983)	Economics	U.S.
Bickerdyke et al. (2000)	Management	Australia
Eljelly and Mansour (2001)	Economics	Sudan
Lee et al. (2011)	Law and entrepreneurship	Multi-country
Routledge and Morrison (2012)	Management	Australia

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

Abstract

In 21st 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

Franchising is a significant aspect of Australian commercial life.[1] 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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1 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.[2] 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'.[3] 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'.[4] 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.[5] 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'[6] agreement. However, regulators in many jurisdictions have nonetheless attempted to impose balance on the relationship.[7] 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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2 Richard Hooley, 'Controlling Contractual Discretion' (2013) 72 *Cambridge Law Journal* 65.

3 Ibid 67.

4 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.

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

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

7 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.[8] 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,[9] and are also evidenced by the conduct of several governmental and parliamentary inquiries at both federal and state level.[10]

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*,[11] the majority of the Australian High Court left open the question of whether administrative law remedies were available against a private entity. Both

8 *CCA* sch 3 s 22 (formerly *TPA* s 51AC).

9 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.

10 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, I*nquiry 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*').

11 216 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 21st 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 21st Century Franchising

The economic reasons for the success of business format franchising are well understood.[12] 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

[12] 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.[13] The long duration of franchise agreements,[14] 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.[15] This may lead to an action under s 18(1) of the *CCA*.[16] 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.[17]

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.'[18] As a consequence, they create 'little in the

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13 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.

14 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.

15 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.

16 Formerly s 52 *TPA*.

17 Hadfield, above n 6, 945-946.

18 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.'[19] 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'.[20] 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*.[21]

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'.[22] 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',[23] 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'.[24]

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[19] Ibid.

[20] Ibid 54.

[21] 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).

[22] Spencer, above n 18, 56.

[23] *Automasters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286 (4 December 2002) [14] ('*Automasters*').

[24] Ibid.

We contend that objective standards of fairness and reasonableness now exist in Australian administrative law[25] — 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.[26] Andrew Terry and Cary Di Lernia observe that 'clear dividing lines between concepts along that continuum are seldom provided'.[27] 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*'.[28] These practices were cast as being 'unfair or deceptive acts or practices'.[29] 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,[30] 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

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

26 Paul D Finn, 'The Fiduciary Principle' in T G Youdan (ed) *Equity, Fiduciaries and Trusts* (Carswell, 1989) 1, 4.

27 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.

28 Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer* Affairs (Australian Government Publishing Service, 1976) *('Swanson Report'*).

29 Ibid 66.

30 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 11th 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.[31]

Whether conduct was unconscionable was to be 'determined by examining all the circumstances of the case'[32] with regard to listed non-exclusive, discretionary, cumulative criteria.[33] 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.[34] 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'[35] 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"'.[36] 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

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

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

33 See *Australian Consumer Law* sch 2 n 22(1)(a)−(k) and sch 2 s 22 (2)(a)−(k).

34 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).

35 Ibid 31.

36 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 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.[37]

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.[38] 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.

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

38 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,[39] and in the context of franchising specifically.[40] The failure to achieve greater symmetry in the franchisor-franchisee relationship has led to calls by some[41] 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. [42] The imposition of an implied term of good faith has been cast as a 'backward step'.[43] In the United States, the content and meaning of the previously settled concept of good faith is being questioned.[44] 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*

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39 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.

40 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*').

41 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.

42 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.

43 Peden, above n 39, 53.

44 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,[45] 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.[46]

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'.[47] 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'.[48] 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'.[49] 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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45 (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.

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

47 Corcoran, above n 39, 8.

48 Ibid 8.

49 Ibid.

by law as a legal incident of a particular class of contract.[50] 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*[51] 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'.[52] 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'.[53] 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'.[54] However, Dixon suggests that wider considerations of policy have also been used to support the implication of contractual terms as a matter of law.[55] 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.[56] In addition, he states that the use of vulnerability as a test 'raises doctrinal issues of …

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50 Bill Dixon, 'Good Faith in Contractual Performance and Enforcement — Australian Doctrinal Hurdles' (2011) 39 *Australian Business Law Review* 227, 233.

51 (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.

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

53 Dixon, above n 50, 234.

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

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

56 Dixon, above n 50, 238.

the interplay between common law and equitable remedies'.[57] 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*[58] 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.[59]

In particular, there appears to have been a '"blurring" between the different standards of reasonableness, unconscionability and good faith'.[60] 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[61] being adopted thus

57 Ibid 241.

58 [2004] NSWCA 15 (20 February 2004).

59 Peden, above n 37, 234 (citations omitted).

60 Ibid 245.

61 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.[62] 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.'[63]

It 'preserves and recognises any developments in the case law on the concept of "good faith"'.[64] 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'.[65] 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.[66] 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.[67]

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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.

62 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.

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

64 Explanatory Statement, Select Legislative Instrument 2010, No 125 (Cth) 5.

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

66 Ibid.

67 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*.[68] Despite concerns over 'good faith', the 2013 reviewer recommended the introduction of an express obligation to act in good faith into the *Code*.[69] 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

[68] *Trade Practices (Industry Codes — Franchising) Regulations 1998* (Cth) (*'Code'*).

[69] *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.[70]

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.[71] Therefore, in the context of insolvency cl 6 is problematic. An administrator is an agent of the insolvent party.[72] 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'[73] 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*[74] 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.[75] 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®.

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

71 Buchan, above n 9, 115–17.

72 *Corporations Act 2001* (Cth) s 437B.

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

74 [2006] VSC 223 (21 June 2006).

75 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'.[76]

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.[77]

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?'[78]

The question has been answered affirmatively in New Zealand[79] and in the United States.[80] 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.[81]

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[76] Hunter, above n 44, 51.

[77] [1979] AC 731, 743.

[78] P S Atiyah, 'Common Law and Statute Law' (1985) 48 *Modern Law Review* 1, 6.

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

[80] *Moragne v States Marine Lines,* 398 US 375 (1970).

[81] 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[82] 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).[83] 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'[84] 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

82 *CCA* sch 2 s 22.

83 *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.

84 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.[85] 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.[86] 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'.[87]

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.[88] 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.[89]

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85 Ibid.

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

87 *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.

88 Buchan, above n 9, 101–9.

89 *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).[90]

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.[91] For administrative lawyers, good faith means more than the 'mere absence of dishonesty'.[92] 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'.[93]

In other words, good faith requires consideration of the 'purposes and criteria that govern the exercise of the power'.[94] 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 …[95]

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

90 *Burger King* (2001) 69 NSWLR 558.

91 *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.

92 French, above n 21, 28.

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

94 French, above n 21, 29.

95 Ibid 24.

being put forward to such an extension.[96] 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.[97]

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.[98]

By contrast, Morgan finds the narrow formulation of *Wednesbury* unreasonableness — a decision so unreasonable that no decision-maker could make it[99] — objectionable 'because it apparently enables the courts to review the substance of a decision, rather than focusing upon the decision-making process'.[100] We agree that application of this standard to the exercise of contractual powers would be 'destructive of party autonomy and commercial certainty'.[101] 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*[102] 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.[103]

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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96 Morgan, above n 38.

97 Named after the decision of *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223 ('*Wednesbury*').

98 Morgan, above n 38, 233.

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

100 Morgan above n 38, 234.

101 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.

102 [2007] EWCA Civ 151.

103 *Code* cl 20(3).

such as one conferring "absolute discretion"',[104] 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'.[105] 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.[106] 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'.[107] 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.[108] 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.[109]

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104 Morgan, above n 38, 241.

105 Ibid 242.

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

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

108 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.

109 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.[110]

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.[111]

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.[112] 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.[113] 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.[114]

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110 Ibid 217–18.

111 French, above n 21, 15, 23.

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

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

114 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.[115]

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.[116] 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.[117] 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.[118] 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*[119] "specifically reserved for future consideration the question of whether a private

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115 For instance to vary the territory or increase royalties and advertising levies.

116 *Code* cl 21(2)(b).

117 Hooley, above n 2.

118 Stewart, above n 114, 283.

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

sector body might be reviewable".'[120] 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'.[121] For example, in *Paragon Finance Plc v Nash*[122] 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'.[123] 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.[124] 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'.[125] Later English cases have cast doubt on the width of the Court's dicta however.[126]

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,[127] and stipulates criteria that may be considered by a franchisor in withholding or giving assent for a franchisee to transfer the franchise. The list[128] contemplates the addition of other criteria in the franchise agreement.

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120 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.

121 Peden, above n 37, 238.

122 [2002] 2 All ER 248.

123 Ibid 261 (Dyson, Astill and Thorpe LLJ).

124 Ibid.

125 Hooley, above n 2, 67.

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

127 *Code* cl 20 (2)–(3).

128 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'.[129] 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[130] 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.[131] 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*,[132] 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,[133] 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

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

130 [2002] WASC 286 (4 December 2002).

131 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.

132 720 P 2d 1148 (Mont, 1986).

133 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.[134] 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*,[135] 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.[136] An example was where a council was found to owe a fiduciary duty to ratepayers as to how rates moneys were spent.[137] 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'.[138] In other words, 'discretionary powers must be exercised according to legal principles'.[139] 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

[134] 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.

[135] (2001) 69 NSWLR 558.

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

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

[138] 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.

[139] 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.[140] 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.[141] 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,[142] 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'.[143]

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*[144] a franchisor's decision not to grant an existing franchisee an additional store licence was found

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140 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.

141 French, above n 21, 23.

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

143 Hadfield, above n 6, 928.

144 [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[145] 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.[146]

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.[147] 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.[148]

Certain procedural steps must be taken before a franchisor can exercise the right to terminate.[149] 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.[150]

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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145 The acronym means Quality, Service and Cleanliness.

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

147 [2000] VSC 310 (18 August 2000) [108].

148 Ibid [70].

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

150 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*,[151] 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.[152] 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.[153] In *Picture Perfect v Camera House Ltd*,[154] 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.[155] 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'.[156] Administrators are placed in an awkward

[151] (Unreported High Court of New Zealand, Master Towle, 10 August 1994).

[152] *Code* cl 17A (inserted by *Trade Practices (Industry Codes-Franchising) Amendment Regulations 2010 (No 1)* (Cth)).

[153] Longdin, above n 139, 129.

[154] [1996] 1 NZLR 310.

[155] *Code* sch 1 cl 9(c), (j).

[156] S Sherman, J Melluish 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,[157] 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'.[158] 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*,[159] 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.[160]

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

158 Conaglen, above n 112, 69 (citations omitted).

159 (2001) 69 NSWLR 558.

160 *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.[161] 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[162] 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.[163] 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.[164] 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.[165] 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.[166] 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.[167] We agree with Hadfield in this regard.

161 Spencer, above n 18, 35.

162 See generally Stephen J Choi and G Mitu Gulati, 'Contract as Statute' (2006) 104 *Michigan Law Review* 1129.

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

164 Hadfield, above n 6.

165 Ibid 980–4.

166 Ibid 983.

167 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.[168]

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'.[169]

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'.[170] 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.[171] 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'.[172] 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

168 French, above n 21, 15.

169 Corcoran, above n 39, 11.

170 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.

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

172 Corcoran, above n 39, 11.

discretion was for 'legitimate commercial interests.[173] 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.[174]

This indeed is the same process that occurs when a court reviews a decision made by an administrator in a public law context.[175]

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*:[176]

> [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 was [sic] of saying the same thing.[177]

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.[178] 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.

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

174 (2006) 230 ALR 437, 499.

175 See generally Weeks, above n, 83.

176 (1973) 130 CLR 575, 587.

177 (1998) 44 NSWLR 349, 368.

178 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 contacts. 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'.[179] 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.

179 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.

REVISITING THE RATIONALITY ASSUMPTION OF DISCLOSURE LAWS: AN EMPIRICAL ANALYSIS

Uri Benoliel, Jenny Buchan, and Tony Gutentag*

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ABSTRACT

Disclosure laws are based on one central assumption: that disclosees are, by their very nature, rational actors. This article questions the validity of this theoretical assumption. The article empirically shows that franchisees, who are considered sophisticated disclosees, are unrealistically optimistic about disclosed risks.

In this empirical study, franchisees (N = 205) completed an online research questionnaire, in which they compared their own chances of experiencing disclosed risks with the chances of their colleagues. It was found that franchisees were optimistically biased. Franchisees believed that the chances that their franchisor might opportunistically terminate their franchise are significantly lower than that of an average franchisee in their chain and state.

The theoretical and practical implications of overconfidence in the franchise business are discussed.

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Electronic copy available at: http://ssrn.com/abstract=2805844

INTRODUCTION

Disclosure laws are one of the most common types of regulation in American law.[1] These laws normally require the "discloser" to give the "disclosee" a pre-contractual "disclosure" which includes information about, *inter alia*, the potential risks associated with a product or service provided by the discloser.[2] Disclosure laws cover a wide range of products and services such as mortgages, houses, mutual funds, health, and franchises.[3]

Given the broad coverage of disclosure laws, it is not surprising that they have sparked years of ongoing and intense debate and controversy.[4] Proponents of disclosure laws

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1 Omri Ben-Shahar & Carl E. Schneider, *The Futility of Cost-Benefit Analysis in Financial Disclosure Regulation*, 43 J. LEGAL STUD. 253, 253 (2014) ("Mandated disclosure is one of the most common regulatory techniques in American law"); Daniel E. Ho, *Fudging the Nudge: Information Disclosure and Restaurant Grading*, 122 YALE L.J. 574, 577 (2012) ("disclosure is a mainstay of the regulatory toolkit"); Matthew A. Edwards, *The Virtue of Mandatory Disclosure,* 28 NOTRE DAME J.L. ETHICS & PUB. POL'Y 47, 47 (2014) ("During the past fifty years mandatory disclosure has emerged as a dominant method of legal regulation in the United States"). S*ee* also, Paula J. Dalley, *The Use and Misuse of Disclosures as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1092 (2007) ("There are dozens, possibly hundreds, of regulatory schemes that use disclosure in whole or in part to accomplish their purposes"); Erin Bernstein, *The Upside of Abortion Disclosure Laws*, 24 STAN. L. & POL'Y REV. 171, 190 (2013) ("Indeed, disclosure laws are commonplace").

2 Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 649 (2011).

3 *See infra* Part I.

4 *See e.g.*, OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014); ARCHON FUNG ET AL., FULL DISCLOSURE: THE PERILS AND PROMISE OF TRANSPARENCY (2007); Ben-Shahar & Schneider, *supra* note 1, at 253; Ben-Shahar & Schneider, *supra* note at 2, at 681; Oren Bar-Gill, *Seduction by Contract: Law, Economics, and Psychology in Consumer Markets* 105-111 (2012); Ho, *supra* note 1, at 577; Allen Ferrell, *Measuring the Effects of Mandated Disclosure*, 1 BERKELEY BUS. L.J. 369 (2004); Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. LEGAL STUD. 213 (2007); Michael J. Fishman & Kathleen M. Hagerty, *Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers*, 19 J.L. ECON. & ORG. 45 (2003); Robert A. Hillman, *Online Boilerplate: Would Mandatory Website Disclosure of E-Standard Terms Backfire?*, 104 MICH. L. REV. 837 (2006); Paul G. Mahoney, *Mandatory*

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believe that these laws allow disclosees to be well-informed and consider the contractual risks before purchasing a product or service.[5] By considering the disclosed risks, disclosees can choose safer goods and services.[6] This support for disclosure laws is backed by one central implicit theoretical assumption that underlines these laws: that disclosees are, by their very nature, *rational* actors who are likely to read and analyze the risks disclosed before making a decision which involves risks.[7]

This dominant assumption that underlines disclosure laws, namely that disclosees are rational actors, has already been questioned by opponents of disclosure laws. In particular, those opposed to disclosure laws theoretically argued that disclosees suffer from one serious cognitive constraint: bounded rationality.[8] More specifically, a typical

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Disclosure as a Solution to Agency Problems, 62 U. CHI. L. REV. 1047 (1995); Florencia Marotta-Wurgler, *Does Contract Disclosure Matter?*, 168 J. INSTITUTIONAL & THEORETICAL ECON. 94 (2012); Florencia Marotta-Wurgler, *Will Increased Disclosure Help? Evaluating the Recommendations of the ALI's "Principles of the Law of Software Contracts,"* 78 U. CHI. L. REV. 165 (2011); Alan D. Mathios, *The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market*, 43 J.L. & ECON. 651 (2000); William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 COLUM. L. REV. 1701 (1999); Oren Bar-Gill, *Defending (Smart) Disclosure: A Comment on More Than You Wanted to Know*, 11 JERUSALEM REV. LEG. STUD. 75 (2015).

[5] Y. Angela Lam, *The Gift That Keeps on Taking: How Federal Banking Laws Prevent States from Enforcing Gift Card Laws*, 93 MINN. L. REV. 311, 336-337 (2008) ("Consumer advocates have long argued for more disclosure, based on the idea that a well-informed consumer will be better able to consider the risks […] before purchasing a product"). For other potential benefits of disclosure laws *see e.g.*, THOMAS A. DURKIN & GREGORY ELLIEHAUSEN, TRUTH IN LENDING: THEORY, HISTORY, AND A WAY FORWARD 173-174 (2011); Bernstein, *supra* 1, at 199 ("the theory underlying the regulatory technique of mandatory disclosures presupposes that people make better decisions for themselves when well-informed than anyone can make for them"); Ben-Shahar & Schneider, *supra* note 2, at 681 ("[Mandated disclosure] supposes that people make better decisions for themselves than anyone can make for them and that people are entitled to freedom in making decisions.").

[6] ARCHON FUNG ET AL., *supra* note 4, at 6.

[7] *See infra* Part I.

[8] Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309, 1321 (2015) ("Scholars and regulators have generally attributed discloser's failures to bounded consumer rationality…); Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 508 (2007) ("A related criticism of

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disclosee is boundedly rational,[9] and is therefore cognitively incapable of reading and analyzing disclosures, which are normally too complex and ubiquitous.[10]

In the same vein as existing theoretical behavioral criticism on disclosure laws, this article empirically shows, for the first time, that disclosees may suffer from another serious cognitive limitation apart from bounded rationality: *unrealistic optimism about disclosed risks*. Focusing as a case study on franchisees, who are often perceived as sophisticated and rational disclosees,[11] this article empirically shows that franchisees

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expansive disclosure regulations is that users of information (including regulators as well as investors) are constrained -- boundedly rational -- in their ability to know what information is useful to them and how to use the information they receive to make optimal decisions"); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 187 (2006) ("No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality"). Bounded rationality refers to the fact that human cognitive abilities are limited. Specifically, "people have limited computational skills and seriously flawed memories". *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998).

9 Bounded rationality refers to the fact that human cognitive abilities are limited. Specifically, "people have limited computational skills and seriously flawed memories". *See* Christine Jolls et al., *supra* note 8, at 1477 (1998).

10 Ben-Shahar & Schneider, *supra* note 1, at 258 ("Disclosers pile so much information on readers that they cannot possibly cope with the burden of understanding and analyzing what they have read. These problems are intensified by the fact that people are often not literate enough, or schooled enough in the complexities of quite specialized decisions, to use the information profitably").

11 Christopher R. Drahozal, *"Unfair" Arbitration Clauses*, 2001 U. ILL. L. REV. 695, 766 (2001) ("franchisees are much closer to the sophisticated, well-informed individual […] than are consumers or employees); Christopher R. Drahozal & Quentin R. Wittrock, *Is There a Flight from Arbitration?*, 37 HOFSTRA L. REV. 71, 87 (2008) ("Franchisees are business people, and at least some franchisees are very sophisticated business people…"); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 257 (1993) (in franchise contracts "the price is set in each case by negotiations among sophisticated and knowledgeable parties"); Mary deLeo, *Emasculating Goliath: Did Postal Instant Press v. Sealy Strike an Unfair Blow at the Franchising Industry?* 25 W. ST. U.L. REV. 117, 171 (1997) ("Today's franchisees are more savvy, more educated, more likely to come from a business background and therefore more likely to be experienced in assessing risks and making informed decisions accordingly."); Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992) ("The Sigels

are, by their very nature, irrational. More concretely, this paper shows that franchisees are unrealistically optimistic about the major risks disclosed under the federal franchise disclosure rule that governs the significant franchise industry.[12]

The broad potential implications of our empirical results are twofold: first, the assumption that disclosees are rational is dubious. Second, disclosees, being unrealistically optimistic about disclosed risks, may discount risk-related information disclosed under disclosure laws. Our results hence cast significant doubts over the effectiveness of disclosure laws in protecting disclosees from prospective hazards.

This article will proceed as follows: Part I will provide context by reviewing the underlining major implicit assumption of disclosure laws, namely that disclosees are rational actors. Part II will present data and discuss the methodology for empirically testing our hypothesis whereby franchisees, the focus of our empirical case study, are unrealistically optimistic about disclosed risks. Part III discusses the normative implications of the empirical results.

I. DISCLOSURE LAWS RATIONALITY ASSUMPTION

One central goal of disclosure laws is to allow disclosees to assess the expected risks of a decision before making one.[13] For example, the purpose of the Know Before You

are not vulnerable consumers or helpless workers. They are business people who bought a franchise . . . ."); Broussard v. Mieneke Discount Muffler Shops, Inc., 155 F.3d 331, 348 (4th Cir. 1998) ("By all lights, Meineke franchisees are independent, sophisticated, if sometimes small, businessmen who dealt with Meineke at arms' length and pursued their own business interests."); Doctor's Assocs., Inc. v. Jabush, 89 F.3d 109, 113 (2d Cir. 1996) ("As purchasers of a Subway sandwich franchise, the Spearses '[were] not vulnerable consumers or helpless workers. They [were] business people who bought a franchise.'").

12 *See infra* Part II.

13 See, for example, Consumer Financial Protection Bureau, *Know Before You Owe: New Mortgage Disclosures, New Rule* (Oct. 5, 2015), *available at* http://www.consumerfinance.gov/blog/know-before-you-owe-new-mortgage-disclosures-new-rule/ ("This rule is a part of our Bureau-wide Know Before You Owe mortgage initiative. We are working to make the […] risks of financial products and services clearer, so you can make better, more informed decisions"); Department of Housing and Urban Development (HUD) and the Environmental Protection Agency (EPA), Lead;

Owe mortgage disclosure rule is, *inter alia*, to help consumers understand the key risks of the mortgage loan for which they are applying.[14] For that purpose, lenders must disclose the loan's key risks, such as payment penalties or increases to the mortgage loan balance.[15] Likewise, the purpose of the Lead Disclosure Rule is, *inter alia*, to ensure that home purchasers are aware of the risks of exposure to lead-based paint before buying an apartment.[16] Accordingly, the Rule requires sellers to provide purchasers with a federally approved lead hazard information pamphlet.[17] Likewise, the purpose of the Securities and Exchange Commission's (SEC) Mutual Fund Disclosure policy is, *inter alia*, to help mutual fund investors more easily obtain key information about mutual fund risks.[18] Accordingly, each fund must disclose the principal risks of investing in the fund, including the risks to which the fund's portfolio as a whole is subject and the circumstances reasonably likely to adversely affect the fund's net asset

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Proposed Requirements for Disclosure of Information Concerning Lead-Based Paint in Housing, 59 Fed. Reg. (Nov. 2, 1994), *available at* https://www.gpo.gov/fdsys/pkg/FR-1994-11-02/html/94-27097.htm ("The purpose of this proposed rule is to ensure that families are aware of […] the hazards of exposure to lead-based paint"); Securities and Exchange Commission, *SEC Improves Disclosure for Mutual Fund Investors*, *available at* https://www.sec.gov/news/press/2008/2008-275.htm (""Today's action will help mutual fund investors more easily obtain the key information they need — such as the description of the fund's investment […] risks," said SEC Chairman Christopher Cox").

14 Consumer Financial Protection Bureau, *supra* note 13.

15 Consumer Financial Protection Bureau, *What is a Loan Estimate?*, *available at* http://www.consumerfinance.gov/askcfpb/1995/what-is-a-loan-estimate.html ("The lender must provide you a Loan Estimate within three business days of receiving your application...the form indicates if the loan has special features that you will want to be aware of, like penalties for paying off the loan early (a prepayment penalty) or increases to the mortgage loan balance even if payments are made on time (negative amortization)").

16 Department of Housing and Urban Development (HUD) and the Environmental Protection Agency (EPA), *supra* note 13.

17 24 C.F.R. § 35.88(a)(1) ("The seller or lessor shall provide the purchaser or lessee with an EPA-approved lead hazard information pamphlet").

18 Securities and Exchange Commission, *supra* note 13; Securities and Exchange Commission, *Statement by SEC Chairman: Enhanced Disclosure for Mutual Fund Investors*, *available at* https://www.sec.gov/news/speech/2008/spch111908cc.htm.

value, yield, and total return.[19] Similarly, pre-abortion disclosure laws require physicians to inform women of the health risks associated with abortion and childbirth before performing an abortion, in order to allow women to assess these risks.[20]

Another major example of a disclosure law that aims to allow disclosees to assess the expected risks of their decision, and on which this paper is focused, is the Federal Franchise Rule.[21] One of the Rule's goals is to allow prospective franchisees to assess the risk that their potential franchisor will terminate their franchise contract opportunistically. The risk of opportunistic termination can take one of two central forms: (1) franchisors may terminate the contract of an efficient franchisee, who fully complies with the contract, solely for the purpose of selling the latter's profitable unit to a new franchisee for higher franchise fees;[22] (2) a franchisor may terminate the contract of an efficient franchisee simply to manage the successful unit himself.[23] In order to allow the potential franchisee to assess the prospective risk of opportunistic

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[19] Securities and Exchange Commission, *Final Rule: Registration Form Used by Open-End Management Investment Companies: Sample Form and Instructions*, *available at* https://www.sec.gov/rules/final/33-7512f.htm; *See* also Securities and Exchange Commission, *Form N-1A, item 9(c)*, available at https://www.sec.gov/about/forms/formn-1a.pdf.

[20] *See e.g.*, GUTTMACHER INTS., STATE POLICIES IN BRIEF, COUNSELING AND WAITING PERIODS FOR ABORTION 1 (March 1, 2016), *available at* https://www.guttmacher.org/sites/default/files/pdfs/spibs/spib_MWPA.pdf (25 states require information about the risks of abortion. In addition, 27 states require information about risky developments during pregnancy).

[21] *See* 16 C.F.R. §§ 436.

[22] *See* ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 271 (2005); Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., 462 A.2d 595, 601 (N.J. Super. Ct. App. Div. 1983).

[23] *See* BLAIR & LAFONTAINE, *supra* note 22, at 271; Michael J. Lockerby, *Franchise Termination Restrictions: A Guide for Practitioners and Policy Makers*, 30 ANTITRUST BULL. 791, 834 (1985); Tracey A. Nicastro, *How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement*, 28 VAL. U. L. REV. 785, 801 (1994); Boyd Allan Byers, Note, *Making a Case for Federal Regulation of Franchise Terminations—A Return-of-Equity Approach*, 19 J. CORP. L. 607, 621 (1994); David Hess, Note, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333, 334 (1995); Mark Pruitt, *Disclosure and Good Cause Legislation: "Where's the Beef" in Franchise Regulation?*, 90 COM. L.J. 563, 565 (1985).

termination by their franchisor, the Franchise Rule requires each franchisor to disclose the following information through a pre-contractual disclosure document entitled "Franchise Disclosure Document" (FDD). First, the franchisor must summarize the conditions under which it may terminate the franchise contract.[24] Specifically, if the franchisor has a right to terminate the contract at-will, it must disclose this right in a specified tabular format.[25] Second, the franchisor must disclose the history of civil litigations within the franchise system.[26] This information is intended to alert potential franchisees that a franchise system has been plagued by lawsuits of opportunistic termination practices.[27] Third, the FDD must disclose the annual number of franchisees previously terminated by their franchisor without compensation.[28] Fourth, the franchisor must disclose the contact information of former franchisees terminated by the franchisor.[29] This information is intended to allow prospective franchisees to investigate the causes of previous franchisee terminations, and use it to assess the prospective risks of future opportunistic termination by the franchisor.[30]

A seminal implicit assumption that underlines disclosure laws – which aim to allow disclosees to assess the expected risks of their decision – is that disclosees are inherently

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24 § 436.5(q) & Item 17 Table.

25 *Id*.

26 § 436.5(c).

27 Charles S. Hale, II, *Market Impact in the Information Age: Protecting Hotel Owners from Hotel Management Companies*, 108 W. VA. L. REV. 573, 581 (2005) ("The most effective part of the disclosure laws are the requirements that franchisors disclose information regarding the history of criminal and civil litigation within the franchise system, alerting potential franchisees that a franchise system has been plagued with complaints of abusive practices").

28 § 436.5(t) & Item 20, Table No. 3.

29 § 436.5(t)(5).

30 Mario Herman, *Don't Be a Victim of Franchise Fraud, aka, Churning – Understanding Item 20 Part 2*, *available at* http://www.franchiseknowhow.com/legal-corner/churning2.htm (last visited May 15, 2015) ("[A] careful review of Item 20 [of the Franchise Rule] can disclose some red flags which might help to prevent you from falling victim to franchise ... churning. Is there a high turnover rate? What are the reasons for the turnover rate?"); see Cal. Dep't Corps, *Look before You Leap: A Guide to Buying a Franchise* 5 (Jan. 2007), *available at* http://www.dbo.ca.gov/Licensees/franchise investment law/pdflLookBeforeYouLeapENG.pdf ("Questions to ask a former franchisee: If there was a termination or non-renewal, did the franchisor explain why…?").

rational.[31] More specifically, disclosure laws assume that disclosees, as rational actors, are likely to read the risk-related information disclosed, systematically assess the disclosed risks, and freely choose whether to take these risks based on their internal risk preferences.[32] For example, in the context of the franchise disclosure rule, the FTC explains, that the franchise disclosure rule is based on the theory that an informed franchisee "***can determine*** whether a franchise deal is in his or her best interest".[33] Moreover, the Bureau of Consumer Protection at the FTC explains that the franchise disclosure rule is "a cost-effective way to provide material information to prospective franchisees so they ***can assess*** the […] potential financial risks involved in entering into a franchise relationship".[34] Given the assumption that franchisees can rationally assess the franchise risks, the FTC's long-held conclusion is that "informed [franchisee] choice is the best regulator of the market".[35]

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31 *See*, for example, Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 712 (2006) ("Current federal law governing home lending requires that borrowers be given an avalanche of disclosures […]. The law is premised on a largely unbounded rational actor model of borrower decisionmaking…).

32 Steven W. Bender, *Consumer Protection for Latinos: Overcoming Language Fraud and English-Only in the Marketplace*, 45 AM. U. L. REV. 1027, 1075 (1996) ("Disclosure laws assume that consumers will read the information disclosed…"); Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 MICH. J. INT'L L. 207, 210 (1999) ("The theory of disclosure assumes that if the business and financial condition of an enterprise are adequately and accurately disclosed in a publicly available document, then an investor can make an informed determination regarding whether to engage in the prospective transaction"); Ben-Shahar & Schneider, *supra* note 2, at 727 ("Mandated disclosure assumes that people want to make decisions themselves and want to do so by gathering and evaluating information about their choices"); Willis, *supra* note 31, at 712 ("Current federal law governing home lending requires that borrowers be given an avalanche of disclosures […]. The law […] assumes that borrowers will take the disclosures and freely choose a loan available in the market according to the borrower's own internal price and risk preferences").

33 Federal Trade Commission, supra note שגיאה! הסימניה אינה מוגדרת., at 57294.

34 Bureau of Consumer Protection, *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule* (16 CFR Part 436), FTC 6 (2004), *available at* http://www.ftc.gov/sites/default/files/documents/reports/staff-report-bureau-consumer-protection-federal-trade-commission-and-proposed-revised-trade/0408franchiserulerpt.pdf.

35 Bureau of Consumer Protection, supra note 34, at *11.

II. THE EMPIRICAL TEST: ARE FRANCHISEES RATIONAL

A. THE FRANCHISE INDUSTRY – A BRIEF OVERVIEW

The franchise industry plays a vital role in the U.S. economy. It incorporates around 796,000 establishments.[36] These establishments, in turn, provide approximately 9.1 million jobs.[37] Furthermore, they produce goods and services worth about $944 billion annually, and contribute approximately $552 billion to the GDP.[38] Franchise businesses cross more than 300 business lines.[39] These lines can be categorized into 10 major areas: Automotive, Business Services, Commercial & Residential Services, Lodging, Personal Services, Quick Service Restaurants, Real Estate, Retail Food, Retail Products & Services and Table/Full Service Restaurants.[40]

The franchise industry is governed by a federal disclosure law known as the Franchise Rule.[41] The Rule was enacted by the Federal Trade Commission (FTC),[42] an agency that aims to enhance informed consumer choice.[43] The Rule requires each franchisor to provide potential franchisees with a Franchise Disclosure Document ("FDD")

36 HIS Economics, FRANCHISE BUSINESS ECONOMIC OUTLOOK FOR 2016, 2 (2016) *available at* http://emarket.franchise.org/FranchiseOutlookJan2016.pdf [hereinafter OUTLOOK FOR 2016). An establishment is a "single physical location at which business is conducted or services or industrial operations are performed. An establishment may be owned by the franchisor or the franchisee". *Id.* at 5 n.2.

37 *Id.* at 2.

38 *Id.*

39 International Franchise Association, *Franchises Business to Continue Growth Trend in 2016, Outpacing Economy-Wide Pace*, *available at* http://www.franchise.org/franchise-businesses-to-continue-growth-trend-in-2016-outpacing-economy-wide-pace.

40 *Id.*

41 *See* 16 C.F.R. §§ 436.

42 The Rule went into effect on 1979 and amended in 2007. *See*, Federal Trade Commission, *Franchise Rule Compliance Guide*, i (2008), *available at* https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.

43 Federal Trade Commission, *About the FTC*, *available at* https://www.ftc.gov/about-ftc.

containing information about the offered franchise, its officers, and its franchisees.[44] The FDD is intended, *inter alia*, to allow potential franchisees to assess the expected risks of the offered franchise before making a purchasing decision. [45]

B. THE THEORETICAL HYPOTHESIS

Our hypothesis is that the rationality assumption that underlines the federal franchise disclosure rule is false. Particularly, we predict that franchisees are in their nature unrealistically optimistic about the specific risks that are disclosed in the FDD, as required by the FTC Franchise Rule. Our hypothesis is based on existing empirical studies that show that people, in various aspects of life, are unrealistically optimistic about general future risks.[46] *Unrealistic optimism* is broadly defined as the tendency of an individual to think that misfortunes will happen to the other, not to oneself[47]. The concept of unrealistic optimism was first introduced in 1980[48], and has since been documented in over one thousand studies[49].

For example, smokers are unrealistically optimistic about their risk of lung cancer, heart disease, and emphysema.[50] Individuals are unrealistically optimistic regarding their likelihood of contracting HIV.[51] Individuals are unrealistically optimistic about their

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[44] Federal Trade Commission, *Franchise Rule*, *available at* https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/franchise-rule.

[45] *Id.*

[46] "Unrealistic optimism" is broadly defined as the tendency of an individual to think that misfortunes will happen to the other, not to oneself. Neil D. Weinstein, *Unrealistic Optimism about Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 806 (1980).

[47] Weinstein, *supra* note 46, at 806.

[48] *Id.*

[49] James A. Shepperd et al., *A Primer on Unrealistic Optimism*, 24, CURRENT DIRECTIONS IN PSYCHOLOGICAL SCIENCE 232, 232 (2015).

[50] Tracy Williams & Valerie A. Clarke, *Optimistic Bias in Beliefs About Smoking*, 49 AUSTL. J. PSYCHOLOGY 106, 110 (1997); *see also* N. D. Weinstein et al., *Smokers' Unrealistic Optimism About Their Risk*, 14 TOBACCO CONTROL 55, 58 (2005).

[51] *See, e.g.*, Meg Gerrard, *Antecedents of Pregnancy and Pregnancy Attrition in First Term Women Marines*, OFFICE OF NAVAL RESEARCH 55-56 (Nov. 1, 1989), *available at* www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA216868; R. S. Gold & H. M. Aucote, *'I'm Less at Risk than Most Guys':*

chances of suffering health problems, such as heart attacks or arthritis.[52] Women are unrealistically optimistic about their risk of getting breast cancer.[53] Men are unrealistically optimistic about their risk of getting prostate cancer.[54] Drivers are unrealistically optimistic about their driving risks.[55] College students are unrealistically optimistic about their risk of being involved in a traffic accident.[56] Motorcyclists are unrealistically optimistic about their risk of being involved in a serious road accident.[57] College students are optimistically biased about positive life events, such as liking their post-graduation job or owning their own home.[58] College students are also unrealistically optimistic about negative life events, such as having a drinking problem or being fired from a job.[59] Individuals are unrealistically optimistic about their risk of committing suicide or becoming addicted to drugs.[60] Individuals who had recently applied for a marriage license are unrealistically optimistic about the longevity of their

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Gay Men's Unrealistic Optimism About Becoming Infected with HIV, 14 INT'L. J. STD AIDS 18, 21-22 (2003); Shelley E. Taylor et al., *Optimism, Coping, Psychological Distress, and High-Risk Sexual Behavior Among Men at Risk of Acquired Immunodeficiency Syndrome (AIDS)*, 63 J. PERS. SOC. PSYCHOLOGY 460, 469 (1992); J. van der Pligt et al., *Perceived Risk of AIDS: Unrealistic Optimism and Self-Protective Action*, *in* THE SOCIAL PSYCHOLOGY OF HIV INFECTION 39, 54 (J. B. Pryor & G. D. Reeder, eds. 1993).

52 *See* Christopher Peterson & Mechele E. De Avila, *Optimistic Explanatory Style and the Perception of Health Problems*, 51 J. CLINICAL PSYCHOLOGY 128, 131 (1995); *see also* Vera Hoorens & Bram P. Buunk, *Social Comparison of Health Risks: Locus of Control, the Person-Positivity, and Unrealistic Optimism*, 23 J. APPLIED SOC. PSYCHOLOGY 291, 298 (1993).

53 Valerie A. Clarke et al., *Unrealistic Optimism and the Health Belief Model*, 23 J. BEHAV. MED. 367, 371-72 (2000).

54 *Id*. at 371-74.

55 *See* Dominique Gosselin et al., *Comparative Optimism Among Drivers: An Intergenerational Portrait,* 42 ACCIDENT ANALYSIS & PREVENTION 734, 738 (2010); *see also* Ola Svenson et al., *Perceived Driving Safety and Seatbelt Usage*, 17 ACCIDENT ANALYSIS & PREVENTION 119, 126 (1985).

56 David M. Dejoy, *The Optimism Bias and Traffic Accident Risk Perception*, 21 ACCIDENT ANALYSIS & PREVENTION 333, 338 (1989).

57 D. R. Rutter et al., *Perceptions of Risk in Motorcyclists: Unrealistic Optimism, Relative Realism and Predictions of Behaviour* 89 BRITISH J. PSYCHOLOGY 681, 691-692 (1998).

58 Weinstein, *supra* note 46, at 810-811 & 813.

59 *Id*.

60 Neil D. Weinstein, *Unrealistic Optimism About Susceptibility to Health Problems: Conclusions from a Community-Wide Sample*, 10 J. BEHAV. MED. 481, 486 & 488 (1987).

marriage.[61] Students who experienced an earthquake are unrealistically optimistic, a couple of months after the earthquake, about their risk of being hurt in a natural disaster.[62] Novice bungee jumpers are unrealistically optimistic about their risk of injury.[63]

Equally, empirical studies consistently show that business people, although being often perceived as more sophisticated than non-business people,[64] are unrealistically optimistic as well. Entrepreneurs are unrealistically optimistic about their own odds for business success.[65] Similarly, entrepreneurs are unrealistically optimistic about the probability of their business surviving.[66]

Within the field of franchising, the focus of our empirical test, empirical studies show that franchisees are also unrealistically optimistic. For example, franchisees may be unrealistically optimistic about their potential profits, and the level of training and support provided by the franchisor.[67] Similarly, franchisees are unrealistically

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[61] Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW AND HUM. BEHAV. 439, 440 & 446 (1993).

[62] Jerry M. Burger & Michele L. Palmer, *Changes in and Generalization of Unrealistic Optimism Following Experiences with Stressful Events: Reactions to the 1989 California Earthquake*, 18 PERS. SOC. PSYCHOLOGY BULL. 39, 42 (1992).

[63] Wendy Middleton et al., *Give 'Em Enough Rope: Perception of Health and Safety Risks in Bungee Jumpers*, 15 J. SOC. CLININCAL PSYCHOLOGY 68, 76 (1996).

[64] For example, in the legal context, business people are often perceived as more sophisticated than members of the general population, such as consumers. *See, e.g.*, Doctor's Assocs., Inc. v. Jabush, 89 F.3d 109, 113 (2d Cir. 1996); Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992); Susan Saab Fortney, *Seeking Shelter in The Minefield of Unintended Consequences - The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 752 n.158 (1997); Harry G. Prince, *Unconscionability in California: A Need for Restraint and Consistency*, 46 HASTINGS L.J. 459, 460 (1995).

[65] Arnold C. Cooper et al., *Entrepreneurs' Perceived Chances for Success*, 3 J. BUS. VENTURING 97, 103 (1988).

[66] John F. Pinfold, *The Expectations of New Business Founders: The New Zealand Case*, 39 J. SMALL BUS. MGMT. 279, 280 & 281 tbl. 1 (2001).

[67] *See* Markus Blut et al., *What to Expect After the Honeymoon: Testing a Lifecycle Theory of Franchise Relationships*, 87 J. RETAILING 306, 309-10 (2011); See also Marko Grünhagen &

optimistic about the number of units they will develop in their territory within a certain time period.[68] Likewise, franchisees are unrealistically optimistic about their business capabilities to uncover and implement their own novel business alternatives which compete with the ones provided by their experienced and knowledgeable franchisor.[69] Correspondingly, franchisees are optimistically biased about their sales volume.[70]

Given the empirical evidence that people, including franchisees, are generally optimistic about the future, we predict that franchisees are specifically optimistic about major risks disclosed under the federal franchise disclosure law.

C. METHODOLOGY

1. General

In order to assess whether franchisees are rational or unrealistically optimistic about risks disclosed under the Franchise Rule, we apply the "*direct method*" of analysis,[71] developed mainly by Professor Neil Weinstein.[72] This method is the most popular empirical method for assessing unrealistic optimism and was applied in hundreds of

Michael J. Dorsch, *Does the Franchisor Provide Value to Franchisees? Past, Current, and Future Value Assessments of Two Franchisee Types*, 41 J. SMALL BUS. MGMT. 366, 376 (2003).

68 Arturs Kalnins, *Overestimation and Venture Survival: An Empirical Analysis of Development Commitments in International Master Franchising Ventures*, 14 J. ECON. MGMT. STRAT. 933, 951 (2005).

69 *See* Sidney G. Winter et al., *Reproducing Knowledge: Inaccurate Replication and Failure in Franchise Organizations*, 23 ORGAN. SCI. 672, 676 & 681 (2012)

70 Bernadette H. Schell & Sheila McGillis, *How Type A Franchisees Cope with Failed Business: An Analysis of Micro- and Macro-System Factors*, 12 J. SMALL BUS. ENTRE. 27, 35-36 (1995).

71 Adam J. L. Harris & Ulrike Hahn, *Unrealistic Optimism About Future Life Events: A Cautionary Note* 118 PSYCHOL. REV. 135, 137 (2010); James A. Shepperd et al., *Taking Stock of Unrealistic Optimism*, 8 PERSPECTIVES ON PSYCHOLOGICAL SCIENCE 395, 399 (2013).

72 Harris & Hahn, *supra* note 71, at 137; Professor Neil Weinstein is a Distinguished Professor Emeritus at the Rutgers School of Environmental and Biological Sciences. His classic papers on unrealistic optimism include *Unrealistic Optimism about Future Life Events*, 39, JOURNAL OF PERSONALITY AND SOCIAL PSYCHOLOGY 806 (1980); *Unrealistic Optimism about Susceptibility to Health Problems* 5 JOURNAL OF BEHAVIORAL MEDICINE 441 (1982); *Unrealistic Optimism About Susceptibility to Health Problems: Conclusions from a Community-Wide Sample* 10 JOURNAL OF BEHAVIORAL MEDICINE 481 (1987).

studies.[73] Under this method, representative individuals from a group are required to provide a comparative, quantitative response indicating the degree to which they are more or less likely to experience a certain risk than the "average" person in their group.[74] If the individuals, as a whole, are rational, their overall mean of comparative risk judgments combined should equal the "average".[75] In other words, the average of all individual levels of risk indicated by the participants should be equal to the average risk in the group. Specifically, individuals who say they have a risk that is above the group average should balance others who say their risk is below that average. Conversely, a significant tendency for the individuals' overall mean to be lower than "average" indicates unrealistic optimism on the part of the individuals, as a whole, because the mean risk of the group should be, by definition, "average".[76] The lower the mean, compared to the average, the greater the level of unrealistic optimism.[77] To illustrate, if *all* individuals claim that their chances of experiencing a problem are *well below* average, they clearly demonstrate, as a whole, unrealistic optimism.[78]

2. Participants

The federal Franchise Rule obligates every franchise chain to disclose the contact information of its current franchisees in its Franchise Disclosure Document (FDD).[79] Since we decided, for logistical reasons, to conduct an email survey, rather than a phone survey, we located all the franchise chains, in the representative Entrepreneur Magazine's dataset,[80] that disclose their franchisees' email

[73] Harris & Hahn, *supra* note 71, at 137 (The direct method is "the most popular measure for assessing unrealistic optimism"); Shepperd et al., *supra* note 71, at 399 ("Most unrealistic optimism studies – hundreds of them – have examined unrealistic comparative optimism using the direct approach").

[74] Harris & Hahn, *supra* note 71, at 137 (The direct method is "the most popular measure for assessing unrealistic optimism"); Shepperd et al., *supra* note 71, at 399.

[75] Weinstein, *supra* note 60, at 488; Harris & Hahn, *supra* note 71, at 137.

[76] Weinstein, *supra* note 60, at 488.

[77] Weinstein, *supra* note 60, at 488.

[78] Weinstein, *supra* note 60, at 442.

[79] *See* 16 C.F.R. §§ 436.5(t)(4).

[80] Previous studies have estimated that Entrepreneur Magazine's dataset is representative of the population of franchisors operating in the United States. Scott Shane & Maw-Der Foo, *New Firm*

addresses in their FDD, as opposed to their phone numbers. This process led to a sample of 1,741 franchisees from 26 different franchise chains.[81] These chains are from heterogeneous business lines such as real estate, business services, health care, maintenance, education, vending, fitness, shipping, children's products and services, and fast food.

Out of 1,741 email addresses, 118 were invalid. Of the emails sent to valid addresses, 878 were read by the franchisees. We predict that unread emails sent to valid addresses were suspected as spam and therefore not opened. Of the 878 emails that were read, 205 franchisees (23.3%) filled out the research questionnaire. Franchisees who chose to participate in the study did so voluntarily, without any monetary or other compensation.

The age of franchisees ranged between 20 to 61 years and above: 2% of the franchisees in the sample were 20 to 30 years of age, 12.3% were 31 to 40, 23.0% were 41 to 50, 34.8% were 51 to 60, and 27.9% were 61 and over. The majority of the sample, 85.8%, were over 41 years of age. The franchisees' experience in the franchise industry ranged between less than one year to 16 years and above: 29.1% had 0 to 2 years of experience, 32.5% had 3 to 5 years, 18.9% had 6 to 10 years, 10.2% had 11 to 15 years, and 9.2% had 16 years of experience or more. More than half of the sample, 61.7%, had up to 5 years of experience.

The number of franchise units owned by each franchisee ranged from one unit to five units or more: 79.1% had only one franchise unit, 15.0% had two units, 1.5% had three

Survival: Institutional Explanations for New Franchisor Mortality, 45 MGMT. SCIENCE 142, 146 (1999); *See also* Scott Shane et al., *The Effects of New Franchisor Partnering Strategies on Franchise System Size*, 52 MGMT. SCIENCE 773, 778 (2006).

81 The sample chains were Amazing Athletes, American Poolplayers Association, Bevintel, Bricks 4 Kidz, Dryer Vent Wizard, East Coast Wings, Happy & Healthy Products, HomeVestors, HUMAN Healthy Vending, InXpress, KidzArt, Massage Heights, Menchie's, Molly Maid, Mr. Handyman, National Property Inspections, PostNet, Pro Martial Arts, Right at Home, SpeedPro, Steamatic, TGA Premier Youth Tennis, The Alternative Board, The Woodhouse Day Spa, Tippi Toes Dance, Wild Bird Unlimited, and Zoom Room.

units, 1.0% had four units, and 3.4% had five units or above. The vast majority of franchisees had only one franchise unit.

3. Instruments

A questionnaire comprising five items was developed specifically for this study. Two items were used to assess unrealistic optimism by asking the franchisees to assess two potential risks addressed in the Franchise Disclosure Document, as provided to each franchisee under the federal Franchise Rule. More specifically, franchisees were asked to assess the likelihood that their franchisor might terminate a franchise unit that they own in order to resell it to someone else, and the likelihood that their franchisor might terminate a franchise unit that they own in order to operate it directly. Franchisees were asked to respond using a 7-point Likert scale: much below average, below average, a little below average, average for a franchisee in my chain and state, a little above average, above average, and much above average. When analyzing the data, the seven possible responses were assigned numerical values ranging from (-3) to + 3 ("much below average" to "much above average", respectively). This response scale is typically used in studies that empirically investigate the incidence of unrealistic optimism.[82]

The remaining three items in the questionnaire were demographic questions: franchisees were asked to report their age ("How old are you?"), years of experience in the franchise industry ("How many years in total have you been a franchisee?"), and number of units owned ("How many franchise units do you own? ").

4. Procedure

Franchisees were sent an email asking them to volunteer to participate in a study concerning franchisees' perceptions of specific business risks. The email contained a hyperlink navigating participants to an online version of the research questionnaire.

[82] Harris & Hahn, *supra* note 71, at 138 ("The response rate typically used in this paradigm is a 7-point scale from -3 (chances much less than the average person's) to +3 (chances much greater than the average person's)").

Franchisees who did not complete the questionnaire received a reminder to participate in the study 6 days later.

D. Data

Table 1 presents the distribution of franchisee responses in percentages, as well as the mean and standard deviation, regarding their franchisor's intentions to resell the franchisee's unit or operate the unit directly. As evident from the data concerning both potential risks, most of the franchisees believe that the likelihood of either scenario is well below average or below average.

Table 1. Franchisee assessment of franchisor's intentions

	Franchisee assessment of franchisor's intentions to:	
	Resell the unit (%)	Operate the unit directly (%)
Much below average	63.4	78.9
Below average	16.6	10.8
A little below average	2.4	2.5
Average	7.3	4.4
A little above average	3.4	2.4
Above average	2.4	0.0
Much above average	4.4	1.0
Mean	-2.04	-2.55
SD	1.66	1.07

E. Results

1. Evidence of Unrealistic Optimism

The unrealistic optimism hypothesis was tested, namely, whether franchisees exhibit overconfidence in their judgments. If the comparative risk judgments in franchise businesses are unbiased, then the mean judgment will be zero for each risk. A mean less than zero indicates an optimistic bias, that is, a tendency to claim that one's risk is

less than the risk of others (i.e., the average risk). Thus, the mean comparative risk judgment is a measure of unrealistic optimism: the more negative the mean, the greater the bias.

A one sample t-test of the hypothesis that the mean is different from zero revealed a significant unrealistic optimism bias, in each of the two risks: (a) The likelihood attributed by franchisees to the risk that their franchisor might terminate a franchise unit they own in order to resell it to someone else was significantly lower than zero, i.e. the average (t [204] = -17.62, $p < .001$, $d = 1.23$; $M = -2.04$, $SD = -1.66$); with a large effect size. (b) In addition, the likelihood attributed by franchisees to the risk that their franchisor might terminate a franchise unit they own in order to operate the unit directly was significantly lower than zero, i.e. the average, as well (t [203] = -33.95, $p < .001$, $d = -2.38$; $M = -2.55$, $SD = 1.07$); with a large effect size. It is apparent that franchisees display a significant optimistic bias with respect to the two risks included in this study.

2. Unrealistic Optimism and Demographics

The franchisees' assessment of their franchisors' intentions to resell their unit was found to be uncorrelated with age ($r = -.03$, $p = .635$), or years of experience ($r = -.04$, $p = .581$). However, it was found to be correlated with the number of franchises owned ($r = .16$, $p = .019$); with a small effect size. That is, the more franchises a franchisee owns, the greater their assessment that their franchisor intends to resell a franchise unit that they own.

The franchisees' assessment of their franchisors' intentions to operate the unit directly was found to be uncorrelated with years of experience ($r = -.08$, $p = .284$) or number of franchises owned ($r = -.01$, $p = .959$). However, it was found to be correlated with age ($r = -.14$, $p = .044$); with a small effect size. That is, the younger the franchisee, the greater their assessment that their franchisor intends to operate the unit directly.

The franchisees' assessments of their franchisors' intentions to either resell the unit or operate the unit directly were found to be correlated with one another ($r = .63$, $p < .001$); with a large effect size. That is, the less a franchisee believes that their franchisor

intends to resell their unit, the less they believe that their franchisor intends to operate the unit directly.

Age was correlated to years of experience ($r = .40, p < .001$); with a medium effect size. That is, the older a franchisee, the more years of experience they have. The number of franchises owned was uncorrelated to age ($r = -.05, p = .490$) or years of experience ($r = .04, p = .553$).

3. Two Risk Comparison

Although, as reported earlier, the relationship between the two items assessing overconfidence – the franchisees' assessment that their franchisor intends to resell their unit or operate the unit directly – was found to be significant with a large effect size ($r = .63, p < .001$), we wanted to compare the two items to see if franchisees showed greater optimism bias with respect to one risk over the other. To this end, we applied a paired sample t-test. We found that the franchisees' assessment that their franchisor intends to operate the unit directly ($M = -2.55, SD = 1.07$) was significantly lower than their assessment that the franchisor intends to resell the unit ($M = -2.04, SD = 1.66; t [202] = 5.45, p < .001$). That is, optimism bias was greater for franchisor intentions to resell the unit than for franchisor intentions to operate the unit directly.

III. Discussion and Normative Implications

Our empirical study reveals that franchisees, often perceived as sophisticated and rational disclosees,[83] are inherently irrational about disclosed risks. This discovery casts significant doubts over the underlining implicit assumption of disclosure laws, namely that disclosees are rational actors.[84]

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83 *See supra* note 11.

84 *See supra* part I.

In addition, our results, which show that disclosees are irrational despite being perceived as sophisticated, question the effectiveness of disclosure laws.[85] More specifically, disclosees, being overly optimistic about disclosed risks, may simply avoid risk-related disclosure information that might contradict their optimistic beliefs.[86] If disclosees perceive that particular negative events are less likely to happen to them then it is possible that they will pay less attention to risk-related disclosure information.[87] Disclosees who are unrealistically optimistic about their own abilities may not pay much attention to disclosure risk information, which they may feel is mainly directed at other less careful or less skillful individuals than themselves.[88]

Indeed, empirical studies systematically show that people who are optimistically biased about their risks are less likely to seek information about those risks. For example, an empirical study by Anh, Park and Haley examined the relationship between consumers' optimism bias and their inclination to read mandated legal disclosures.[89] By analyzing the survey data of 404 consumers, the study reveals that unrealistically optimistic consumers are less likely to pay attention to the mandated legal disclosure on the health risks of drugs, which is required by the Food and Drug Administration (FDA).[90] The study further shows that unrealistically optimistic consumers are less likely to seek

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[85] PETER H. HUANG, *Regulating Irrational Exuberance and Anxiety in Securities Markets*, in THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR 501, 523 (Francesco Parisi & Vernon L. Smith ed., 2005) ("Mandatory disclosure might be at best, an impotent, and at worst, a socially harmful regulatory policy if the majority of investors experience cognitive biases and utilize heuristics in the processing of information and/or feel irrational exuberance and anxiety before and during their investing process").

[86] Deborah J. Wiebe & David Black, *Illusional Beliefs in the Context of Risky Sexual Behaviors*, 27 J. APPL. SOC. PSYCHOL. 1727, 1728 (1997).

[87] Frank P. McKenna, *It won't Happen to Me: Unrealistic Optimism or Illusion of Control?*, 84 BRITISH J. PSYCHOL. 39, 44 (1993).

[88] Marleen Decruyenare et al., *Adolescents' Opinions about Genetic Risk Information, Prenatal Diagnosis, and Pregnancy Termination*, 32 J. MED. GENET. 799, 804 (1995); Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 260-61 (2006); Ripken, *supra* note 8, at 167.

[89] Ho-Young (Anthony) Ahn et al., *Consumers' Optimism Bias and Responses to Risk Disclosures in Direct-to-Consumer (DTC) Prescription Drug Advertising: The Moderating Role of Subjective Health Literacy*, 48 J. CONSUM. AFF. 175 (2014).

[90] *Id*. at 182 & 185.

additional information about a drug's health risks through alternative sources.[91] In the same vein, an empirical study by Park, Ju and Kim reveals that as consumers are more optimistically biased about the future risk of depression, they are less likely to seek information about this health problem.[92]

Likewise, in an experimental study conducted by Fowler and Geers, undergraduate students who were unrealistically optimistic about their health conditions were less likely than other subjects to seek health information by attending informative seminars.[93] In the same vein, in an empirical study conducted by Radcliffe and Klein, subjects were given an opportunity to read about one heart-attack risk factor out of six: alcohol consumption, fat consumption, nutrition, smoking, exercise and stress.[94] The study shows that subjects who were unrealistically optimistic about their risk of heart attack chose to read about a risk factor towards which they believed they possessed a favorable standing, and they chose not to read about risk factors towards which they possessed a less favorable standing.[95]

Likewise, according to an empirical study conducted by Lu, Dzwo, Hou and Andrews,[96] subjects who were optimistically biased about the risks of eating food cooked by arsenic-contaminated oil were less intent on seeking information regarding those

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91 *Id.* at 185.

92 Jin Seong Park et al., *Direct-to-Consumer Antidepressant Advertising and Consumers' Optimistic Bias about the Future Risk of Depression: The Moderating Role of Advertising Skepticism*, 29 HEALTH COMMUN. 586, 589 & 592 (2014).

93 Stephanie L. Fowler & Andrew L. Geers, *Dispositional and Comparative Optimism Interact to Predict Avoidance of a Looming Health Threat*, 30 PSYCHOLOGY HEALTH 456, 461-462 & 465 (2014).

94 Nathan M. Radcliffe & William M. P. Klein, *Dispositional, Unrealistic, and Comparative Optimism: Differential Relations With the Knowledge and Processing of Risk Information and Beliefs About Personal Risk*, 28 PERS. SOC. PSYCHOLOGY BULL. 836, 839 (2002).

95 *Cf. id.* at 844.

96 Hung-Yi Lu et al., *Factors Influencing Information-Seeking Intentions and Support for Restrictions: A Study on an Aresnic-Contaminated Frying Oil Event*, 113 BRIT. FOOD J. 1439 (2011).

risks.[97] Similarly, in an experimental study conducted by Wiebe and Black,[98] subjects received an informative pamphlet containing information about contraception, as well as about the specific advantages and disadvantages of several contraceptives.[99] Prior to reading the pamphlet, the optimistically-biased subjects reported lower interest in the pamphlet than did the more realistic subjects.[100]

CONCLUSION

A seminal assumption that underlines current disclosure laws is that disclosees are intrinsically rational. As such, disclosees are presumed to be able to rationally assess the risks involved in contracts and avoid those risks. Based on this rationality assumption, current disclosure laws are predominantly based on rules which aim to provide disclosees with information regarding future risks. Equipped with this information, disclosees, as rational actors, are assumed to be capable of protecting themselves against future contractual risks. This article questions the validity of the assumption that disclosees are rational actors. As this empirical study shows, franchisees, despite being business people who make large investments in the franchise, suffer from an inherent cognitive constraint known as unrealistic optimism. Due to them being overly optimistic about the future, it is expected that franchisees would systematically discount risk-related information disclosed under disclosure laws.

The broad potential implications of our empirical results are that other disclosees, less sophisticated than franchisees, are also likely to be unrealistically optimistic about disclosed risks. Our results hence cast significant doubts over the effectiveness of disclosure laws in protecting disclosees from prospective hazards.

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[97] *Id.* at 1442 & 1446.

[98] Deborah J. Wiebe & David Black, *Illusional Beliefs in the Context of Risky Sexual Behaviors*, 27 J. APPLIED SOC. PSYCHOLOGY 1727 (1997).

[99] *Id.* at 1733.

[100] *Id.* at 1744.