CORA Cork Open Research Archive
Cartlann Taighde Oscailte Chorcaí

Title	Moral hazard, path dependency, and failing franchisors: mitigating franchisee risk through participation
Authors	Gant, Jennifer L. L.;Buchan, Jenny
Publication date	2019-04-01
Original Citation	Gant, J. L. L. and Buchan, J. (2019)'Moral hazard, path dependency and failing franchisors: Mitigating franchisee risk through participation', Federal Law Review, 47(2), pp.261-287. https://doi.org/10.1177/0067205X19831841
Type of publication	Article (peer-reviewed)
Link to publisher's version	https://journals.sagepub.com/doi/abs/10.1177/0067205X19831841 - 10.1177/0067205X19831841
Rights	© The Author(s) 2019. Published by Sage in Association with The Australian National University. Reprinted by permission of SAGE Publications.
Download date	2026-11-15 17:40:01
Item downloaded from	https://hdl.handle.net/10468/7898

UCC
University College Cork, Ireland
Coláiste na hOllscoile Corcaigh

MORAL HAZARD, PATH DEPENDENCY AND FAILING FRANCHISORS: MITIGATING FRANCHISEE RISK THROUGH PARTICIPATION

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 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 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

[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 had won the right to be provided with a prospectus that complied with the then Companies Act 1981 finding that a 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' *International Journal of Franchising Law* (2014) 12(4) 3, 9 for fuller details.

[4] John W Meyer and Brian Rowan, 'Institutionalised Organisations: Formal Structure as Myth and Ceremony' (1977) 83(2) *American Journal of Sociology* 340, 341.

that: 'Unlike … 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 pay-outs 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 to franchisees' own optimism bias.

Path dependence, 'paths shaped by a nation's political and cultural institutions or chaotic chance events'[6] helps explain how the rejection of the *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) CLC 40-704 interpretation in Australia[7] led to franchising being regulated solely under

[5] Gillian K Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1999) 42 *Stanford Law Review* 927, 991.

[6] Mark J Roe 'Chaos and Evolution in Law and Economics' *Harvard Law Review* (1996) 109(3) 641, 646-647. 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* (2003, Wilberforce, NSW) 187 – 192. '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

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 to franchising being regulated solely under the Competition and Consumer Act 2010 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

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 ttps://www.franchise.org/sites/default/files/uploaded_images/DLAINTLFRANLAWS2016.JPG

[9] Family Law Act 1975 (Cth)

10 Partnership Act 1892 (NSW) Division 4.

[11] Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Clause 29 (1) (b)

[12] Veronica L Taylor, 'Contracts with the Lot: Franchises, Good Faith and Contract Regulation' (1997) *New Zealand Law Review* 459, 467.

[13] Francine Lafontaine, 'Agency Theory and Franchising: Some Empirical Results' (1992) 21 *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.

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 pay-out 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/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 provision for, variously, registration, pre-commitment disclosure, mandatory terms and/or dispute resolution processes. Some address franchisee insolvency/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

[14] For problems newly created by Australia's *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* 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, 444-446.

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 toward 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 is 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

[15] Douglass C North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990).
[16] Jenny Buchan, Lorelle Frazer, Charles Z Qu and Rob Nicholls, 'Franchisor Insolvency in Australia: Profiles, Factors and Impacts' (2015) 22(4) *Journal of Marketing Channels*, 311, 323.
[17] The terms insolvency is used in Australia and the UK for the failure of a corporation. The term bankruptcy is used in the USA.
[18] Uri Benoliel, Jenny Buchan, & Tony Gutentag, 'Revisiting the Rationality Assumption of Disclosure Laws: an Empirical Analysis (2016) 46(2) *Hofstra Law Review* 469.

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

[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, Scott Weaven, Anthony Grace, & Selva Selvanathan, 'Franchising Australia 2016' (Griffith University, 2016).
[22] Don Sniegowski, 'Interview with Aziz Hashim, former Chairman of the International Franchise Association' (Blue Maumau, 28 June 2016) <http://www.bluemaumau.org/15230/ifa_chairman_aziz_hashim_says_franchise_profits_rate_return_are_key#comments> accessed 1 March 2018.

> 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 'Franchising 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 franchisors' 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

[23] Submission 199 to Parliamentary Joint Committee on Corporations and Financial Services, Operation and Effectiveness of the Franchising Code of Conduct, 2018.
[24] Gillian K Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927, 929.
[25] Gillian K Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927, 929.
[26] Jenny Buchan, '*Ex ante* Information and *ex post* Reality for Franchisees: the Case of Franchisor Failure' (2008) 36(6) *Australian Business Law Review* 407.
[27] Gillian K Hadfield ibid, 928.
[28] EXPLANATORY STATEMENT, SELECT LEGISLATIVE INSTRUMENT NO. 168, 2014, Issued by the authority of the Minister for Small Business, Competition and Consumer Act 2010, Competition and Consumer (Industry Codes—Franchising) Regulation 2014, 2.2.
[29] Competition and Consumer (Industry Codes—Franchising) Regulation 2014. Clause 2.

of Conduct 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 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. The UK relies on general commercial law to regulate franchising. Where specific legislation does exist for franchise relationships, it focusses 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 franchisor's 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

[30] Arkansas. Code Ann. ss4-72-201; California Corp. Code s31005; Hawaii Rev. Stat. s482E-2; Connecticut Gen. Stat. s42-133e; 6 Delaware Code Ann. ss2551; Florida Stat. ss817.416; Illinois 815 ILCS 705/1; Indiana Code s23-2-2.5-1; Iowa Code ss523H.1, 537A.10; Maryland Code Ann.s14-201; Michigan MCLS s445.1501; Minnesota Stat. § 80C.01; Mississippi Code Ann. s75-24-51; Missouri Rev. Stat. ss407.400; Nebraska Rev. Stat. ss87-401; New Jersey Stat. Ann. ss56:10-1; New York Gen. Bus. Laws s681(3); North Dakota Cent. Code s ss51-19-01; Oregon Rev. Stat. s650.005(4); Rhode Island Gen. Laws s19-28- 3(c); South Dakota Codified Laws s37-5B-1; Virginia Code Ann. s13.1-559(b); Washington Rev. Code s19.100.010(4); Wisconsin Stat. s553.03(4); see Babette Märzheuser-Wood and Brian Baggott, 'Franchise Law in the United States' (Dentons 2015) <https://www.dentons.com/en/insights/articles/2015/june/12/franchise-law-in-the-united-states>.
[31] Alexander M Meiklejohn (ed.), *Franchising: Cases, Materials and Problems* (American Bar Association 2013) Chapter 9.

of good faith is diluted by Clause 6 (6) of the Franchising Code (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 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-

[32] Stanley Turkel, 'Are Franchisees Agents of Franchisors?' (Blue Maumau 13 August 2013) <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' (2004-2005) 109(1) *Penn State Law Review* 105, and Meiklejohn (n 16) 664-7, 704-6, 726-7.

[33] Alexander M Meiklejohn (ed.), *Franchising: Cases, Materials and Problems* (American Bar Association 2013) 726-727.

[34] See for example 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] FCAFC 131 (Branson, Nicholson and Jacobson JJ). The possibility of the 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'. In Germany, however 'During the initial phase, when a franchisor starts to explain its franchise opportunity, and during contract negotiations a pre-contractual relationship with fiduciary duties emerges which obliges the parities to disclose whatever information is essential for their future relationship'.

[35] See for example the UK Insolvency Act 1986, Schedule 6, Category 5: Remuneration, etc., of employees; Australian Corporations Act 2001, s556; and s507(a)(4) of the US Bankruptcy Code.

[36] See for example 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] L 283, 28/10/1980 P. 0023 - 0027, as implemented among the Member States of the EU and the Australian Air Passenger Ticket Levy (Collection) Act 2001 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 for example 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, 22.3.2001, p. 16–20 and the Australian Fair Work Act 2009 Part 2-8.

offs, redundancy pay;[38] and sometimes, government life-lines.[39] No such life-lines 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 percent 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, 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 are more acute. These asymmetries are

[38] See for example the United States Worker Adjustment and Retraining Notification Act (the WARN Act) 102 Stat. 890, Public Law 100-379 of the 100th Congress, Aug. 4, 1988; the Australian Fair Work Act 2009; 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, 12.8.1998, p. 16–21, as implemented in each Member State.

[39] Ansett Airlines had 15000 employees when it failed in 2002. 4,500 were represented by the Ansett Services union (ASU). The administrators of Ansett negotiated a Federal Government scheme (SEESA – 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, media release 'Ansett administration makes final landing with 96 cents in the $ for employees' 2 September 2011. Similarly, the Federal Government injected up to $22 million as a partial bail-out to keep ABC Learning child care centres open until a buyer was found.

[40] Lorelle Frazer, Scott Weaven, Anthony Grace, & Selva Selvanathan, 'Franchising Australia 2016' (Griffith University 2016) 20.

[41] Jenny Buchan, 'Franchisor Failure: An Assessment of the Adequacy of Regulatory Response' (PhD Dissertation, 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(3) Journal of Law and Economics 503, 507.

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 advisors normally consider the consequences of the franchisor's demise. Naivete 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 write down 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]

---

[43] Robert Cooter and Thomas Ulen, 'Law & Economics' (6th edn, Pearson 2012) 38-41.

[44] Richard A Posner, 'Theories of Market Regulation' (1974) 5(2) Bell Journal of Economics and Management Science 335.

[45] Jenny Buchan, '*Ex ante* Information and *ex post* Reality for Franchisees: the Case of Franchisor Failure' (2008) 36(6) *Australian Business Law Review* 407.

[46] Jason Gherke, 'Sizzler on Life Support as Stores Shut' (Franchise Advisory Centre newsletter) <http://www.news.com.au/finance/business/retail/sizzler-on-life-support-as-stores-shut/news-story/754dfaa661aa32479cbe2396dcd9909c> accessed 26 March 2018.

[47] Don Sniegowski, 'Interview with Aziz Hashim, former Chairman of the International Franchise Association' (Blue Maumau, 28 June 2016) <http://www.bluemaumau.org/15230/ifa_chairman_aziz_hashim_says_franchise_profits_rate_return_are_key#comments> accessed 1 March 2018.

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 sub-tenant of the franchisees' premises, entering administration is a breach of the head lease. The landlord can then terminate the head lease, leaving the sub-tenant 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, down-playing 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, '42 percent of brands began franchising immediately or within the first year of operation.'[50] Finally, it is assumed that franchisees are business people who should conduct proper due diligence, take professional advice, negotiate better contracts

[48] Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Schedule 1 Franchising Code of Conduct, Annexure 2, Information statement for prospective franchisee Information statement for prospective franchisees.
[49] Franchise Council of Australia, 'Buying a Franchise: Guidelines' <http://www.franchise.org.au/buying-a-franchise.html>.
[50] Lorelle Frazer, S Weaven, Anthony Grace, & S Selvanathan, 'Franchising Australia 2016' (Griffith University 2016) 20.

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', as noted in a letter from then franchise lawyer Philip Linacre to [one of the authors] in October 2016. 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.'[55] 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

[51] Jenny Buchan, L Fraser, Scott Weaven, Binh Tran-Nam, and Anthony Grace, 'The Effectiveness of Undertaking Due Diligence Prior to Starting Up or Purchasing a Small Business or Franchise' (Report for CPA Australia).
[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* 21 July 2012.
[53] U Benoliel, Jenny Buchan, and T Gutentag, 'Revisiting the Rationality Assumption of Disclosure Laws: an Empirical Analysis'(2016) 46(2) *Hofstra Law Review* 469.
[54] James R Brown, Robert F Lusch, and Carolyn Y Nicholson, 'Power and Relationship Commitment: their Impact on Marketing Channel Member Performance' (1995) 71(4) *Journal of Retailing* 363.
[55] 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).

parties to be fair towards each other.[56] The Code is non-binding, and there is no clear sanction for a breach.[57] 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.[58] Thus, UK and US franchisees have similar risks to their Australian counterparts.

Franchisors have continued to advertise for franchisees while insolvent,[59] despite, in Australia, issuing the required pre-contract disclosure containing the solvency statement.[60] 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.'[61] 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[62] into its revenue can prove irresistible to a failing franchisor.

---

[56] 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>.

[57] Chris Wormald, 'Franchising in the UK (England and Wales): Overview' (Thompson Reuters Practical Law 2016) <https://uk.practicallaw.thomsonreuters.com> notes that the sanction for non-compliance by a member is exclusion from the BFA.

[58] International Franchising Association Mission Statement/Vision/Code of Ethics <http://www.franchise.org/mission-statementvisioncode-of-ethics>.

[59] 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.

[60] Competition and Consumer (Industry Codes—Franchising) Regulation 2014. Clause 21.1 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.

[61] Jenny Buchan et al, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22(4) *J Marketing Channels* 311, 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.

[62] Lorelle Frazer, Scott Weaven, Anthony Grace, & Selva Selvanathan, 'Franchising Australia 2016' (Griffith University 2016) 37.

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.'[63] 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, sub-leases, 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.'[64] Much of this investment is in sunk costs as shown in Table 1.

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 5 years	$50,000	Franchise agreement between franchisee and franchisor signed	Franchisor in full before commence business	Franchisee 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[65]

[63] Jenny Buchan et al, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22(4) *Journal of Marketing Channels* 311, 318.
[64] Lorelle Frazer, Scott Weaven, Anthony Grace, & Selva Selvanathan, 'Franchising Australia 2016' (Griffith University 2016) 37.
[65] In *Cheque One Pty Ltd v Cheque Exchange (Australia) Pty Ltd (in liquidation)* [2002] FCA 593, 12 applicant franchisees sought leave of the court under s 471B Corporations Act 2001 (Cth) to join proceedings commenced against the franchisor in 2000.

1: Item paid by franchisee	*2: Franchisee's investment*	*3: Relevant contract*	*4: Franchisee paid to …*	*5: Outcome for franchisee in insolvency of franchisor*
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 sub-tenant can negotiate with landlord if head tenant (franchisor) insolvent
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

1: Item paid by franchisee	*2: Franchisee's investment*	*3: Relevant contract*	*4: Franchisee paid to …*	*5: Outcome for franchisee in insolvency of franchisor*
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 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 in Australia

Table 1:[66] Actual costs of an Australian franchisee buying into system in 2016, and outcome for those funds in franchisor's insolvency.

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 retain or terminate during an administration in most jurisdictions. 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.

[66] Table from Jenny Buchan 'Franchisor failure: An Assessment of the Adequacy of Regulatory Response' (PhD dissertation, Queensland University of Technology 2010) 61-64, 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.

Unlike employees, who are entitled to be represented in Committees of Creditors, franchisees may not be creditors of the franchisor; most are debtors.[67] 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.[68] 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.'[69] 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[70] possibly leading to financial ruin.[71] While true that franchisees have a choice and are required to engage in dude diligence, their business experience, or lack thereof, may result in unwise choices influenced by 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.[72]

The bulk of franchisor's assets are intangible,[73] consisting of intellectual property[74] and use licences, head leases[75] 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

[67] Jenny Buchan et al, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22(4) *Journal of Marketing Channels* 311, 324.
[68] Jenny Buchan et al, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22(4) *Journal of Marketing Channels* 311, 322-324.
[69] Jenny Buchan, 'Deconstructing the Franchise as a Legal Entity' (2014) 21(3) *Journal of Marketing Channels* 143, 153.
[70] Jennifer Dolman, Geoffrey Grove, David Sterns, and Stuart Freen, 'Unique Circumstances in Litigating Franchise Class Actions' (Proceedings of Canadian Institute's 12th Annual National Forum on Class Actions Litigation, Toronto, Canada 2011).
[71] Steven H Goldman, 'Tackling Troublesome Insolvency Issues for Franchisees' (2003) <http://www.goldmanhine.com/steven-goldman/>.
[72] Jason Gherke, 'Sizzler on Life Support as Stores Shut' (Franchise Advisory Centre newsletter) <http://www.news.com.au/finance/business/retail/sizzler-on-life-support-as-stores-shut/news-story/754dfaa661aa32479cbe2396dcd9909c> accessed 26 March 2018.
[73] 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.
[74] Jenny Buchan, 'Franchisors' Registered Trademarks – Empirical Surprises' (2009) 21(7) *Australian Intellectual Property Law Bulletin* 154.
[75] 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.

by independent franchisees. … Consequently, the franchise relationships - contractually ratified by the franchise agreements – are usually the most critical assets owned by a franchisor.'[76]

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.'[77]

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.[78] 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.

[76] A M Meiklejohn (ed.), *Franchising: Cases, Materials and Problems* (American Bar Association 2013) 716.
[77] Craig R Colraine, 'Franchises: Insolvency and Restructuring' (Distribution Law: Catch the Wave, Avoid the Rocks, Ontario Bar Association Continuing Legal Education, Toronto, Canada 2003).
[78] Richard A Posner, 'Theories of Market Regulation' (1974) 5(2) Bell Journal of Economics and Management Science 335.

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.'[79] 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.'[80] Because franchise agreements are executory contracts, they cannot be terminated by reason of the filing for bankruptcy.[81]

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.'[82]

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;[83] inability to prosecute as the Corporations Act ('CA') 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.

[79] 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) 21-29.
[80] Sarah B Foster and Carolyn Johnsen, 'The war of the worlds: Bankruptcy versus… (American Bar Association, 28th Annual Forum on Franchising, Florida 2005).
[81] US Code Title 11 Chapter 3 Subchapter IV § 365(e)(1).
[82] Jenny Buchan, 'Franchising: A Honeypot in a Bear Trap' (2014) 34 *Adelaide Law Review* 283, 314.
[83] Jenny Buchan and Rob Nicholls, 'The Law of Unintended Consequences: The Effects of Voiding ipso facto Clauses in Business Format Franchise Agreements' (2017) 45(5) *Australian Business Law Review* 433.

On the insolvency of the franchisor, franchisees may discover that their brand's intellectual property is owned by another company.[84] 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'[85] to administrators to whom a five-day grace period is granted to deal with such leases.[86] An insolvent franchisor will likely default on the head leases of franchisee trading premises, causing its franchisees to forfeit their rental deposits, losing 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. 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, Justice Stone ordered, '[p]ursuant to s439A (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 s439A of the Act [is] extended up to and including 18 September 2011.' [87] 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 timeframe 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.[88] A consequence of time extensions for franchisees who are not consulted, is that they must continue operating their business while dealing with less advantageous

[84] Jenny Buchan, 'Franchisors' Registered Trademarks – Empirical Surprises' (2009) 21(7) *Australian Intellectual Property Law Bulletin* 154.
[85] O M McCoy, 'Administrators and Leases: Obligations and Options' (2012) 24)2_ *Australian Insolvency Law Journal* 24.
[86] Australian Corporations Act 2001 ss433B (2&3).
[87] *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.
[88] Jenny Buchan et al, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impact' (2015) 22(4) J Marketing Channels 311, 322

supplier terms because they are now being supplied direct without the prior benefit of franchisor-negotiated bulk discounts and juggling 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 they can claim in equity against the franchisor or liquidator 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.[89]

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.[90] This puts the Code in conflict with the CA and is an example of the disconnect between consumer protection law and corporate law, and their respective regulators: the ACCC and ASIC in Australia.[91] This right to terminate is not extended to franchisees. This is an example of legislation that purports to level the playing field, tipping it even further in favour of the stronger party.

The United Kingdom/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.[92] Often, franchise agreements will be the franchisor's only valuable asset. An administrator will logically adopt them, intending to sell them to swell the pool of funds for distribution

[89] This is normally not possible because of ss 440D or 471B Corporations Act 2001.
[90] In cl 29 of the Code, which provides for termination in special circumstances. This puts the Code in conflict with the Corporations Act and is an example of the disconnect between consumer protection laws and corporations laws, and their respective regulators the ACCC and ASIC in Australia. See Jenny Buchan and R Nicholls, 'The Law of Unintended Consequences: The Effects of Voiding *ipso facto* Clauses in Business Format Franchise Agreements' (2017) 45(5) ABLR 433.
[91] Jenny Buchan and Rob Nicholls, 'The Law of Unintended Consequences: The Effects of Voiding ipso facto Clauses in Business Format Franchise Agreements' (2017) 45(5) *Australian Business Law Review* 433.
[92] Insolvency Act 1986 Schedule B1.

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 'did not know'; the Netherlands as a franchisee; and Spain as a creditor.[93] Only three of the jurisdictions surveyed Canada, Syria and Vietnam) recognised franchisees as a stakeholder in the franchisor's insolvency.[94] 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, work place, tools, and work performance. An inherent imbalance in employment relationships has historically allowed for the exploitation of employees,[95] and the intentional framing of some employees as franchisees in the US,[96] or as independent contractors in Australia.[97] 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 as yet exists, despite the clear moral hazard present in the business model.

[93] Jenny Buchan, 'Reducing Collateral Damage in Franchisor Insolvency', in Paul Omar (ed) *International Insolvency Law: Themes and Perspectives* (Ashgate 2008) 391.
[94] Jenny Buchan, 'Reducing Collateral Damage in Franchisor Insolvency', in Paul Omar (ed) *International Insolvency Law: Themes and Perspectives* (Ashgate 2008) 392.
[95] Jennifer LL Gant, 'Proletarianisation and the Emergence of Labour Regulation in France and Britain,' Chapter 3 in *Balancing the Protection of Business and Employment in Insolvency: An Anglo-French Perspective* (Eleven International Publishing 2017) 33-78.
[96] *In the Matter of the Claim of Bertrand Baez* (Respondent) v *PD 10276, INC Doing Business a Jan-Pro Cleaning Systems* (Appellant) and *Commissioner of Labor* (Respondent) 2016 NY Slip Op 07061 October 27, 2016.
[97] As described for example by Thomas Faunce, 'Professional Misconduct: *The Case of the Medical Board of Australia v Tausif (Occupational Discipline)*' (2015) 22(3) J Law Med 534 analysing *Medical Board of Australia v Tausif (Occupational Discipline)* [2015] ACAT 4.

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 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.[98] In Australia it has been suggested that 'employees enjoy a priority predominantly because they are involuntary creditors.'[99] 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.[100] While freedom, autonomy, liberty, and individualism are central to the needs of free market capitalism and a growing commercial economy,[101] 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 optimal competitive situation.[102] However, the labour and by extension the franchisee market is 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 as restoring balance to an otherwise potentially exploitative and imbalanced relationship that, without control, would be socially inefficient and unjust due to unilateral reduction employment rights.[103]

---

[98] Donald R Korobkin, 'Employee Interests in Bankruptcy' (1996) 4 *American Bankruptcy Institute Law* Review 5, 6.
[99] Christopher Symes and John Duns, *Australian Insolvency Law* (LexisNexis Butterworths 2009) 310.
[100] Simon Deakin and Frank Wilkinson, 'Rights vs Efficiency? The Economic Case for Transnational Labour Standards' (1994) 23(4) *Industrial Law Journal* 289, 292.
[101] Bruce E Kaufman, 'Labor Law and Employment Regulation: Neoclassical and Institutional Perspectives' in Kenneth G Dau-Schmidt, Seth D Harris, and O Lobel (eds), *Labor and Employment Law and Economics: Volume 2, Encyclopaedia of Law and Economics* (2nd edn, Edward Elgar 2009) 6-9.
[102] Didier Fourage, 'Costs of Non-Social Policy: Towards and Economic Framework of Quality Social Policies – and the Costs of not Having them' (Report for the Employment and Social Affairs DG, European Commission, 3 January 2003).
[103] Bruce E Kaufman, 'Labor Law and Employment Regulation: Neoclassical and Institutional Perspectives' in KG Dau-Schmidt, SD Harris, and Orly Lobel (eds), *Labor and Employment Law and Economics: Volume 2, Encyclopaedia of Law and Economics* (2nd edn, Edward Elgar 2009) 30-41.

Market failures owing to informational problems that cause an inefficient allocation of resources provide a premise for the argument in favour of social policy as a factor for improving that market efficiency.[104] It is only necessary to observe the exploitation of workers that does occur in developing countries to realise that such conditions persist.[105] 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.[106] Further, maintaining a centrally organised company with several units separated geographically can be costly for developing effective means of controlling employees and managers.[107]

Other factors that favour franchising include low initial investment costs and more repeat customers. [108] Finally, the franchise contract itself is habitually drafted in favour of the franchisor with

[104] Didier Fourage, 'Costs of Non-Social Policy: Towards and Economic Framework of Quality Social Policies – and the Costs of not Having them' (Report for the Employment and Social Affairs DG, European Commission, 3 January 2003).
[105] Jennifer LL Gant, 'Conflict and Resolution: Path Dependent Influences on the Evolution of Acquired Rights in Corporate Rescue in the UK and France,' Chapter 6 in *Balancing the Protection of Business and Employment in Insolvency: An Anglo-French Perspective* (Eleven International Publishing 2017) 195-208.
[106] Ying Fan, Kai-Uwe Kühn, and Francine Lafontaine, 'Financial Constraints and Moral Hazard: The Case of Franchising' (2017) 125(6) *Journal of Political Economy* 2082, 2112.
[107] James A Brickley and Frederick H Dark, 'The Choice of Organizational Form: The Case of Franchising' (1987) 18 *Journal of Financial Economics* 401, 403.
[108] J A Brickley and F H Dark, 'The Choice of Organizational Form: The Case of Franchising' (1987) 18 *Journal of Financial Economics* 401, 420.

a view to increasing profit and control,[109] 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 demonstrates this moral hazard.

Decentralisation

Franchisors 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 that 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.[110] 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 pre-commitment 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.[111]

[109] Francine Lafontaine, 'Agency Theory and Franchising: Some Empirical Results' (1992) 21 *RAND Journal of Economics* 263, 279.
[110] Uri Benoliel and Jenny Buchan, 'Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule' 13(3) (2015) *DePaul Business & Commercial Law Journal* 411.
[111] Trevor Sykes, 'The Australian Financial Review Weekend' (9-10 March 2002) 12.

Optimism bias

There is growing evidence that people tends to be stubbornly optimistic, regardless of how well informed they are. Most are overconfident about the future, even when they understand the risks.[112] This is the 'optimism bias' referred to previously and 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 the 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,[113] such as, in franchising, the pervasive mantra of a successful franchisor. 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. Over-optimism is derived from a tendency to reject or downplay information that contradicts more favourable information.[114] Research on franchisees in the US has shown that they are strongly optimistically biased in relation to known potentially damaging risks to their business.[115] 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.[116] 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 franchisors duties beyond the contract, and the likelihood

[112] Jon Hanson, and Douglas A Kysar, 'Taking Behaviouralism Seriously: The Problem of Market Manipulation' (1999) 74 *New York University Law Review* 630.
[113] Christine Jolls, Cass R Sunstein, and Richard Thale, A Behavioural Approach to Law and Economics' (1997-98) 50 *Stanford Law Review* 1471. See also Jenny Buchan, 'Consumer Protection for Franchisees of Failed Franchisors: Is there a Need for Statutory Intervention' (2009) *QUT Law and Justice Journal* 9(2) 232 at 241 – 242 for impediments to prospective franchisees' ability to conduct thorough due diligence.
[114] J Hanson, and Douglas A Kysar, 'Taking Behaviouralism Seriously: The Problem of Market Manipulation' (1999) 74 *New York University Law Review* 630.
[115] Uri Benoliel and Jenny Buchan, 'Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule' 13(3) (2015) *DePaul Business & Commercial Law Journal* 411
[116] J Hanson, and D A Kysar, 'Taking Behaviouralism Seriously: The Problem of Market Manipulation' (1999) 74 *New York University Law Review* 630.

that franchisees are geographically remote from the franchisor, leave them 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 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 macroeconomic argument for providing protection is untested. The 'change in the way employing organisations work'[117] in the 21st century by shifting employees off their payroll and turning some of them into franchisees should not free creditors of these organisations, or policy makers, from allowing franchisees a seat at the table and a clear set of rights if the franchisor becomes insolvent. Franchisees are not nearly as numerous in the entire labour market as employees but do form a sizeable proportion of the work force 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 premises fit-out, 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

[117] Sir Brian Langstaff, 'Changing Times, Changing Relationships at Work…Changing Law?' (2016) 45(2) *Industrial Law Journal* 131.

in the labour market has been well and truly broken by most jurisdictions, it is not too farfetched 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 ('WARN Act'), passed to mitigate social issues surrounding large scale bankruptcies. 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% of the workforce at a single site. Realistically, the US does not provide participative procedures in the event of an employers' insolvency outside what is provided in collective agreements. These vary from employer to employer, and lack consistent application.

In Australia, the Fair Work Act 2014 (Cth) (FWA) provides employee participative procedures. In collective redundancies, employers must consult with employees and their representatives if 15 or more dismissals are proposed for economic, technical, or structural reasons. An employer must notify 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.[118] It has been suggested in Australia that franchisees of franchisors in administration could

[118] Fair Work Act s531.

have the right to put the administrator on notice that if a suitable buyer is not found within a reasonable time, the franchisees should have the right to terminate their contracts.[119] This would impose an obligation on administrators to seek a competent replacement for the franchisor, not just a source of cash for the franchisors' creditors.

In the UK, participative procedures for collective redundancies have developed through the implementation of the EU Collective Redundancy Directive (CRD).[120] 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 provisions present an interesting model for franchising. It requires that employees are consulted when such redundancies are contemplated[121] and that such consultations should include how collective redundancies can be avoided and mitigating their consequences by considering other social measures, including redeployment and retraining.[122] 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.[123] 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

[119] 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) ix.
[120] Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies.
[121] Collective Redundancy Directive (CRD) Art 2(1).
[122] CRD Art 2(2).
[123] CRD Art 2(3).

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, (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 in 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; and
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 equated to the size of their investment.

10. Require franchisors to inform the state and/or private institution governing or regulating franchises,[124] in advance, if a decision may adversely impact the solvency of (a) the franchise network, (b) the individual franchisor, (c) the franchisee, such information to 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.'[125] Observers have noted that the legislative process is skewed in favour of groups with lobbying power, usually special interest groups.[126] 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 the franchisees in all three jurisdictions.

While it has been 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 largest Western economy. The FTC Rule in America requires franchisors to act fairly and seeks to facilitate informed decisions and prevent deception in the sale of franchises by requiring franchisors to provide prospective franchisees with essential information prior to the sale. Thus, there is also a justification for the introduction of some form of participative

[124] For Australia, the Australian Competition and consumer Commission and the Franchise Council of Australia should be informed; for the United States, the Federal Trade Commission and the International Franchise Association; and for the United Kingdom, the British Franchising Association.
[125] George J Stigler, 'Theories of Economic Regulation' 2(1) *Bell Journal of Economics & Management Science* 3, 4.
[126] Robert Baldwin, Martin Cave, Martin Lodge (eds) *The Oxford Handbook of Regulation*, (2010) 5.3.

obligations for franchisees as such already exists 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 appears to be competitive but for numerous asymmetries that favour the franchisor including information failure and, in Australia, legislation that provides rights to franchisors in cases of franchisee failure, but not the reverse. Once the agreement has been executed the franchisee is committed to dealing with the franchisor who arguably becomes a monopolist.[127] The forces of the competitive marketplace have failed franchisees.[128] Without the existence of franchisees, the solvent and failing franchisor would have had to provide a significant amount of the operational infrastructure, hire staff and 'assume significant [additional] business risk.'[129] To more accurately 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.

[127] Maria H Ramjerdi, 'Monopoly by Contract: The Practice of Franchised Fee and Royalty Rate. (2014) 3 *Journal of Reviews on Global Economics* 7.
[128] Jenny Buchan, 'Franchisor Failure: An Assessment of the Adequacy of Regulatory Response' (PhD Thesis, Queensland University of Technology, 2010), 258.
[129] Jenny Buchan, 'Franchisor Failure: An Assessment of the Adequacy of Regulatory Response' (PhD Dissertation, Queensland University of Technology, Brisbane, Australia, 2010), 266.