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To: Productivity Commission

From: Associate Professor Jenny Buchan, PhD.

Business Set-up, Transfer and Closure

A set of interrelated, unresolved problems in franchise regulation.

For the purpose of this inquiry my specific contributions are:

1. the misleading promise of business format franchising
2. asymmetry
3. due diligence
4. franchisor exit through floating the franchisor, selling to venture capitalist, strategic insolvency.
5. franchisor insolvency
6. regulatory silos

Brief facts about franchising in Australia

- There are 1160 business format franchisors in Australia in 2014. (1180 in 2012).
- There are an estimated 79 000 units operating in business format franchises, reflecting an increase of 8.2 percent since 2012.
- More than 460 000 people are employed directly in franchising.
- Sales turnover of the entire franchising sector was estimated at $144 billion.
- 89 franchise systems ceased operating and a further 48 ceased franchising in the two year period from 2012 to 2014 (Frazer, Weaven, Grace, *Franchising Australia* 2014, Griffith University). Not all 137 failed, but all 137 stopped supporting franchisees and some were insolvent.

1. Misleading promise of franchising

Franchising is promoted as a safer entry point for a new business owner than if they started a business independently. While franchising can deliver on its promise, it doesn't always do so. This may be because:

- the franchisor doesn't adapt the system to changing market conditions
- the inexperience of the franchisor
    - Griffith University found that "One quarter of franchisors (25%) began franchising in the same year that they commenced operating and a further 9 % franchised within one year of commencement" (Franchising Australia 2014, p 27). It takes longer than 12 months to be able to confirm that a business is proven and will be sustainable for the term of a franchise (average 5 years + renewals).
- the original franchisor exits the investment leaving franchisees with a new franchisor that does not understand franchising
- the franchisor's business failing

Bad management can lead to franchisor failure. Because of the multiplier effect, one franchisor failing can affect 60 or more franchisees. I will focus on the consequences of franchisor failure.

Possible solution

Require franchisors to run an independent franchise unit for at least 24 months in Australia before they offer their first franchise for sale.

Legislation affected

Franchising Code of Conduct

2. Asymmetry

This exists throughout franchising and is writ especially large in the context of franchisor failure.

The franchise agreement is, at a single unit level, non-negotiable. It is a standard form contract drafter by the franchisor to protect the franchisor's interests. The government's intention of bringing business contracts under the unfair contracts provisions of the CCA[1] will not help franchisees.

Under the proposed amendment to the *CCA, The Australian Consumer Law 2010* by the deletion of the word consumer and the expansion to small business contracts – franchise agreements would typically fall within the 'protection'. I suggest that the amended s 24 (4) would enable most franchisors to justify all clauses in their already strongly one-sided single unit franchise agreements so the proposed amendment will further entrench asymmetry in franchise arrangements without providing any additional protection from abuse.

ACL s 24 Meaning of *unfair*

(1) A term of a ~~consumer~~ contract is ***unfair*** if:

(a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and

(b) it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and

(c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

(2) In determining whether a term of a ~~consumer~~ contract is unfair under subsection (1), a court may take into account such matters as it thinks relevant, but must take into account the following:

(a) the extent to which the term is transparent;

(b) the contract as a whole.

(3) A term is ***transparent*** if the term is:

(a) expressed in reasonably plain language; and

(b) legible; and

(c) presented clearly; and

(d) readily available to any party affected by the term.

(4) For the purposes of subsection (1)(b), a term of a ~~consumer~~ contract is presumed not to be reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term, unless that party proves otherwise.

[1] See draft bill: http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Extending%20unfair%20contract%20term%20protections%20to%20small%20businesses/Key%20Documents/PDF/Extending_UCTs_ED.ashx

The Franchising Code of Conduct purports to 'address the imbalance between franchisors and franchisees' and 'increase the level of certainty of all participants' (Draft Report, p 22).

Franchisors have the opportunity to 'terminate' franchisees for 7 reasons listed (a) – (g) in clause 29 of the Franchising Code. (below)

Franchisees can not end their relationship with the franchisor if the franchisor does any of the things that would give the franchisor the right to terminate the agreement. These same rights for the franchisor, but not for the franchisee, would typically also be entrenched into the franchise relationship through ipso facto clauses in the franchise agreement.

This is patently unbalanced and inequitable as franchisors have been found to act illegally, become insolvent, abandon the franchise, act fraudulently.

> ***Franchising Code of Conduct* 29 Termination—special circumstances**
> (1) Despite clauses 27 and 28, a franchisor may terminate a franchise agreement without complying with either clause if the agreement gives the franchisor the right to terminate the agreement should the franchisee:
> (a) no longer hold a licence that the franchisee must hold to carry on the franchised business; or
> (b) become bankrupt, insolvent under administration or an externally-administered body corporate; or
> (c) in the case of a franchisee that is a company—become deregistered by the Australian Securities and Investments Commission; or
> (d) voluntarily abandon the franchised business or the franchise relationship; or
> (e) be convicted of a serious offence; or
> (f) operate the franchised business in a way that endangers public health or safety; or
> (g) act fraudulently in connection with the operation of the franchised business.

Possible solution
Extend the rights in clause 29 to franchisees

Legislation affected
Franchising Code of Conduct

Corporations Act (insolvency provisions)

3. Franchisees' Due diligence

The franchisors advisers have great difficulty getting objective information about the franchisor beyond what is contained in the mandatory disclosure. There is no public database of franchise offerings in Australia.

This is what one US based adviser recommends. It is far too simplistic. It assumes franchisees are free to speak, and that what has happened in the system in the past will happen in the future. Both assumptions are flawed. I have added comments in square brackets **in [bold]:**

"**Answering the Million-Dollar Franchise Question** RICK BISIO
HTTP://WWW.ENTREPRENEUR.COM/ARTICLE/247101

July 09, 2015
When it comes to choosing the right franchise, the concept of due diligence is simple: Invest the time and fully understand a prospective franchise system before you buy, and you'll reap the rewards of success down the road.

[This gives the impression that the franchisee should be able to conduct good due diligence – that the information is available. It is usually not on the public record in Australia or where it is, there is not sufficient]

As a franchise coach, I emphasize to prospective franchisees that "due diligence" absolutely must include talking to existing franchisees. Many people underestimate just how important this is to the process.

[Correct. BUT if those franchisees have settled a dispute with the franchisor they are likely to have signed a confidentiality agreement which prevents them talking to anyone about any aspect of the dispute, including its existence. In Australia this source of information is further compromised as there is no public record of franchise mediations.]

But the truth is, you cannot begin to fully understand a franchise system until you put in that time on the phone. Simply phrased: Franchisees are the window through to measure the success of the whole system. So, how do you do this correctly? Here are the six types of franchisees you should speak with to form a complete picture of the system you want to join.

[This implies that the franchisors have nothing to answer beyond the information they have provided in their disclosure. In reality, the franchisor decides the direction of the system and this could include selling it. Their decisions have a profound impact on the franchisees' businesses.]

1. The top 20 percent

A franchise system is like any other group of people. There are the top 20 percent, the middle 60 percent and the bottom 20 percent. Step one is to interview the top 20 percent so you can gain a sense of what success means in a given system. Does what you learn align with your personal view of success? Also assess what type of people these 20 percent are. Are they like you? Can you see yourself building the business they have built?

2. Old and new franchisees

[The ones who have left the system are equally important and may have a very different story.]

3…. 5

6. The franchisee closest to you

Everyone wants to speak with the franchisee who is just down the road. However, you need to approach this situation with significant caution. First of all, this discussion is likely to be biased. That's because most franchisees believe that having a franchisee down the road will either help or hurt their business. So, it may be hard for a franchisee to share honest, unbiased advice when your entry into the market will have a financial effect on his or her business.

More importantly, speaking to the closest franchisee may lead to a loss of opportunity. You might alert them to the impending sale of an adjacent territory. So, speak to the neighboring franchisee at the end of your calls, when you have already gained ample information from at least 10 other franchisees. That will put you in a position to correctly interpret this individual's comments and intentions.

Above all, it's important to remember that these franchisees are not required to speak with you, so you need to be respectful of their time. As it is, a franchisor will only give you access to the franchisees after you have completed the initial steps and been deemed a good candidate. **[By now the prospective franchisee is most likely to be psychologically committed.]** Once you do pass the initial steps and start calling for more information, remember these three vital tips:

- Go beyond yes and no questions. Always follow up to dig deeper and find the truth.

- Listen intently. Pay attention to how the answer is presented as well as the answer itself.
- Be appreciative of the franchisee's time and remember to send a thank you note.

Speaking to a variety of franchisees will give you a clear picture of the good, the bad and the ugly. In the end, have fun with the process, as this should be an enjoyable and encouraging, as well as informative, task."

These are some of the things franchisees should be able to find out before they invest.

Transparency about the source of franchisee's earnings:

Two (2) models exist for money to pass between franchisor and franchisee once the franchisee has entered the business. Many advisers, including financial advisers to franchisees, have not thought through the consequences of Model B for franchisees.

- $ Model A: The model that is commonly assumed to exist in franchising is that the franchisee charges its customers for product/ services, banks the money into its own account and then periodically pays a royalty to the franchisor. The franchisor has access electronically to the franchisee's financial records/ till.
- **$ Model B is the big problem**: The franchisee charges its customers for product/ services, banks all money directly into the franchisor's account and then the franchisor periodically pays a commission to the franchisee. This means that the franchisee is completely dependent on the franchisor paying the commission. This is the franchisee's ONLY source of income. This is the model adhered to by Kleenmaid (insolvent), Beach House Group (insolvent), some services franchises and Allphones.

It is difficult/ impossible ex ante to discover how the money flows between franchisor and franchisee so I believe it is important for franchisor to have to disclose this.

What is the full extent of the franchisor's network and exactly who owns what and who has what role?

Here I refer you to the organization chart on page 293 of the 'Honey Pot' article (see below). Franchisees would have had 'Angus & Robertson P/L' disclosed to them but not the entire network.

Similarly, Kleenmaid operated two parallel corporate groups. Anecdotally, as soon as a franchisee paid its initial franchise fee that money passed immediately to the group that was further removed from the franchisor entity.

When franchisors operate through trusts

'**Legal structure:** More than two thirds of franchisors (70 percent) are organised as private companies. … (14 percent) of franchisors operate as public companies and a further10 percent are organised as trusts'. (Frazer, Weaven, Wright, Franchising Australia 2006)

It is impossible for franchisees to know who is behind a trust. Franchisees are committing significant sunk investments and need to know who they are investing with.

Possible solutions

The disclosure document should be able to be relied upon by professional advisers as a single source of full and accurate information in a context that is not misleading.

Full disclosure of direction of money flow between franchisor and franchisees. Only then can franchisees' advisers provide accurate advice on the level of risk involved in buying the particular franchise.

No personal guarantees to be supplied by franchisees where Model B money flow exists. In that model the franchisor should provide personal guarantees as the franchisee is very vulnerable because all of their income comes from franchisor direct.

Full disclosure of network, all names, all legal entities, all roles, and full disclosure of identify of trustees.

Legislation affected

Franchising Code of Conduct

4. Exit strategies for the franchisor's directors

Two funding models and one failure strategy have emerged as franchisors recognise that they need to have exit strategies. These strategies can also be combined. None requires the franchisor to take account of the franchisees businesses. The duty of good faith that was added to the Franchise Code in 2015 provides no protection to franchisees as the franchisor can rely on sub-clause (6) below.

> (6) To avoid doubt, the obligation to act in good faith does not prevent a party to a franchise agreement, or a person who proposes to become such a party, from acting in his, her or its legitimate commercial interests.

List as a public company

a. A public company will run the franchise network as a division and will, hopefully, understand it and add value.
b. Directors of a public company owe no statutory duties to franchisees.
c. Franchisor does not have to signal its intentions to franchisees, and even if it did, there is nothing they can do other than keep their fingers crossed that the outcome will be good for them.

Sell to a venture capital group

d. A venture capitalist, will typically want to extract value out of the franchise network, then exit with a profit, rather than add value to franchisees' businesses. See the Angus & Robertson REDGroup experience
e. Might buy a failed franchisor as Compass Capital Partners did with the Kleenmaid brand http://compasscapitalpartners.com.au/

Examples of venture capital activity are

REDGroup, as documented in the "Honey Pot" article (pp 292-298). This was assembled by Pacific Equity Partners http://www.pep.com.au/about-us/ that has notably omitted the disastrous (for the franchisor and franchisees) investment in Angus & Robertson, Whitcoulls and Borders from its current website.

Red Rooster and Oporto and Chicken treat owned by Venture Capital fund Archer Capital/ Quick Service Restaurants Holdings Pty Ltd (QSRH) http://www.archercapital.com.au/allmodals/currentinvestments/qsr

http://www.smh.com.au/business/archer-buys-red-rooster-and-oporto-in-450m-deal-20110613-1g0p3.html

The franchisee investigating Oporto, for example, is not informed via Oporto (other than by a media search) that it is owned by QSRH http://www.oporto.com.au/aboutus

Strategic insolvency/ Voluntary Administration

A franchisor overburdened by debt may decide that rather than trade its way out, it can renegotiate debt, shed under-performing franchisees and reinvent itself through strategic insolvency. This is legal but as the franchisor owes no duty of care to franchisees, and in fact no duties other than the few in the franchise agreement and the Franchising Code, it is free to operate its business as it wishes. See paper by Routledge and Morrison (attached).

Possible solutions

Provide franchisees the right to terminate and be paid out by the buyer.

Require franchisors to exercise a duty of care towards franchisees, to have the same duty of good faith towards franchises that they owe their own company as directors.

In the case of strategic insolvency, impose a duty on franchisors directors similar to the duty they currently have towards employees under s 596AB Corporations Act

'There is scope for franchise advice, and franchisor insolvency to become specialisations within the legal, accounting and insolvency professions.

Moneys received by franchisor from franchisees for payment to third parties. All moneys received by franchisors from franchisees for payment to third party suppliers relating to any interest in real property should be held on trust by the franchisor and not placed into a general revenue account

439A Reports: The Code should be amended to require insolvency administrators to provide a copy if the 439A Report to each franchisee. It would also seem reasonable for insolvency practitioner training and best practice guides to recommend that 439A Reports be lodged with ASIC as company disclosures. This is often done in the case of publicly listed companies and could be extended to all franchisors in insolvency.

It would seem logical to require that receivers and liquidators have a disclosure obligation to franchisees in the case of franchisor insolvency to the same extent that they have to unsecured creditors'.[2]

Legislation affected

Corporations Act

Franchising Code of Conduct

[2] These suggestions have been put forward in a paper about Franchisors in Administration by Buchan, Frazer, Qu and Nicholls that is currently being considered for publication in a journal.

5. Franchisor insolvency

I refer you to my article FRANCHISING: A HONEY POT IN A BEAR TRAP in the *Adelaide Law Review* for more detail https://www.adelaide.edu.au/press/journals/law-review/issues/alr-vol-34-2/alr-34-2-ch4.pdf (copy attached)

Specific problems that franchisor failure causes for franchisees:

1. The franchisees do not have the opportunity to 'cut loose' during the franchisor's administration. Until the liquidator disclaims their contracts, and/or the head leases of the premises they occupy, franchisees are trapped like deer in the headlights.
2. The administrator can get an extension of time for filing the final (second) report to creditors. This may take months. For example in the case of Angus & Robertson (see Honey Pot article) where the liquidators required the franchisees to keep trading for several months in order to provide an outlet for the poorly chosen stock that the franchisor had acquired.
3. None of the contracts the franchisee signs to support its business are contingent on the franchisor remaining solvent. (supplier agreements, employment agreements, lease or licence agreements).
4. Some landlords (eg shopping centre) insist on the head lease being held in the franchisor name, the franchisor then sub-leases to franchisee and requires the franchisee's directors to guarantee the performance of the head lease. This can cause problems if the franchisor goes into administration. In a worst case scenario, the rent has been paid by franchisee to franchisor, but not passed on to the landlord, the tenant is thus in breach and the landlord calls on the rental guarantee and terminates the leases. The franchisee loses its business through no fault of its own.
5. Franchisees cannot commence or continue litigation against the franchisor during the period of administration because *Corporations Act* ss 440D, 471(2) imposes a stay on litigation (see Honey Pot article Footnote 97).
6. Some 'sleeper issues'"
    a. If the franchisor decides the franchisor is failing it can pre-empt the failure by deciding to act on a breach and terminating the franchise agreement before the franchisors creditors appoint an administrator. The franchisor can then re-sell the territory. This deprives the franchisee's creditors of the funds that would otherwise be available to satisfy the franchisee's creditors from the sale of this business. I would suggest this is what is known as unjust enrichment.
    b. If the franchisor had had to wait for the franchisee to fail, it would have had to line up with the franchisee's other creditors.

Possible solutions

A commitment to re-examine franchisor failure in all its guises with the intention of providing clear rights for franchisees when their franchisor enters administration and/or is wound up.

Registration procedures: ASIC and the ACCC could work more closely together to bring greater transparency to franchising – ASIC could require a company, on registration, to identify whether it is a franchisor/franchisee. This would make it much easier for advisers and in particular for researchers. This in turn would enable us to do better research to inform policy. We could actually work out the cost of franchisor failure to the economy.

Consequential contracts: ALL contracts that the franchisor requires the franchisee to sign should give the franchisee the right to terminate without penalty if the franchisor enters administration and the administrator does not find a buyer for the chain within a short period of time, say 2 months.

Leases: why not give sub-tenants the right to take over the head lease if the head tenant becomes insolvent. Obviously they would have to satisfy the landlord that their business is viable in the absence of the franchisor but many franchisees could do this. The bond that the franchisee has lost becomes an unsecured debt owing by the insolvent franchisor.

Rental bonds: Franchisors should not be permitted to require the franchisee to put up the franchisor's rental bond if the franchisor takes the head lease.

Ss 21 and 39 of the Ontario, Canada: *Commercial Tenancies Act, R.S.O. 1990*, c. L.7

> 1. "tenant" includes a person who is lessee, occupant, sub-tenant, under-tenant, and the person's assigns and legal representatives. ("locataire") Commercial Tenancies Act, R.S.O. 1990, c. L.7, s. 1; 1994, c. 2, s. 1; 1994, c. 4, s. 1; 1997, c. 24, s. 213 (1, 2); 1999, c. 6, s. 9 (1); 2005, c. 5, s. 10 (1, 2).
>
> Protection of under-lessees, re-entry or forfeiture under superior lease
>
> 21. Where a lessor is proceeding by action or otherwise to enforce a right of re-entry or forfeiture under any covenant, proviso or stipulation in a lease, the court, on motion by any person claiming as under-lessee any estate or interest in the property comprised in the lease or any part thereof, in the lessor's action, if any, or in any action or application in the Superior Court of Justice brought by such person for that purpose, may make an order vesting for the whole term of the lease or any less term the property comprised in the lease, or any part thereof, in any person entitled as under-lessee to any estate or interest in such property upon such conditions as to execution of any deed or other document, payment of rents, costs, expenses, damages, compensation, giving security or otherwise as the court in the circumstances of each case thinks fit; but in no case is any such under-lessee entitled to require a lease to be granted to him, her or it for any longer term than the under-lessee had under the original sub-lease. R.S.O. 1990, c. L.7, s. 21; 2006, c. 19, Sched. C, s. 1 (1).
>
> Section 21 example in operation:
> http://www.canlii.org/en/on/onsc/doc/2007/2007canlii28/2007canlii28.html?searchUrlHash=AAAAAQAvY29tbWVyY2lhbCB0ZW5hbnNpZXMgYWN0LCBmcmFuY2hpc2UsIHNlY3Rpb24gMzkAAAAAAQ&resultIndex=7
>
> 39. (1) The person who is assignee, liquidator or trustee has the further right, at any time before so electing, by notice in writing to the landlord, to surrender possession or disclaim any such lease, and the person's entry into possession of the leased premises and their occupation by the person, while required for the purposes of the trust estate, shall not be deemed to be evidence of an intention on the person's part to elect to retain possession under section 38. R.S.O. 1990, c. L.7, s. 39 (1).
>
> Rights of sub-tenants
>
> (2) Where the assignor, or person or firm against whom a receiving order has been made in bankruptcy, or a winding up order has been made, being a lessee, has, before the making of

the assignment or such order demised any premises by way of under-lease, approved or consented to in writing by the landlord, and the assignee, liquidator or trustee surrenders, disclaims or elects to assign the lease, the under-lessee, if the under-lessee so elects in writing within three months of such assignment or order, stands in the same position with the landlord as though the under-lessee were a direct lessee from the landlord but subject, except as to rental payable, to the same liabilities and obligations as the assignor, bankrupt or insolvent company was subject to under the lease at the date of the assignment or order, but the under-lessee shall in such event be required to covenant to pay to the landlord a rental not less than that payable by the under-lessee to the debtor, and if such last mentioned rental was greater than that payable by the debtor to the said landlord, the under-lessee shall be required to covenant to pay to the landlord the like greater rental. R.S.O. 1990, c. L.7, s. 39 (2).

url http://www.canlii.org/en/on/laws/stat/rso-1990-c-l7/latest/rso-1990-c-l7.html

Legislation affected

Franchising Code of Conduct

Corporations Act

State and Territory leasing legislation

6. Regulatory Silos

As noted at page 221 of the Draft Report, franchising is regulated by the mandatory Franchising Code of Conduct. This is administered by the ACCC. The relevant stakeholders for the ACCC are franchisors and franchisees. Franchisees are regarded as business consumers before they become franchisees.

Insolvency law is regulated under the Corporations Act. This is administered by ASIC. The relevant stakeholders for ASIC are companies, their directors and shareholders. Franchisees are not shareholders and are seldom creditors in the franchisor.

This duality of regulators and legislation does not serve franchising well.