
15. Franchisees as externalities of insolvent franchisors: a windfall gain for employees?

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1. THE ROLE OF FRANCHISING IN CORPORATE EXPANSION

A traditional corporation employs its own staff or uses contractors to perform work. It funds growth by reinvesting profits, issuing bonds or shares or borrowing. The directors may rely on investment by family and friends, government grants, or may turn to crowd funding. A corporation may also secure labour and fund growth by appointing franchisees. Franchisees, as independent entrepreneurs, contribute to the growth of the franchisor's brand without the parent, now called a franchisor, needing to increase the number of its own employees.

Franchisors enter contracts with their franchisees, as they do with financiers, advisers, employees, landlords and other suppliers. Financiers, advisers, landlords and other suppliers are likely to have entered negotiated contracts. During the negotiations one of the issues that should have been addressed is the potential insolvency of the franchisor. These parties are likely to have taken security over the franchisor's assets,¹ and/or charged interest at a rate commensurate with the risk they assessed that they were exposed to.

Both franchisors and franchisees are entrepreneurs. They both need to remain solvent to succeed. Franchisees are neither shareholders nor are they cast by a franchisor as its employees. This chapter considers whether their role as workers who would be on the franchisor's payroll in a non-franchised business, means that they are sufficiently integral to the franchisor's business to be entitled to standing under the external administration provisions of Australia's Corporations Act. Are they providing a windfall gain to administrators and the franchisors creditors including the insolvent party's own employees when the franchisor fails? It does not address their potential eligibility as investors, who replace shareholders and other traditional sources of growth capital.

2. BACKGROUND

A franchise is a business conducted by a franchisee under a licence granted by a franchisor or national master franchisee. It permits the franchisee to clone the retail business of the franchisor and operate the clone under the franchisor's brand for the duration of the licence. The terms of this relational contract are standard form, non-negotiable and prescriptive. They impose numerous duties on the franchisee and reserve rights and discretion as to how those rights may be exercised, to the franchisor. A franchised business funds the establishment of

¹ Corporations Act 2001, s 471C, 'Secured creditor's rights not affected. Nothing in section 471A or 471B affects a secured creditor's right to realise or otherwise deal with the security.'

each franchisee-operated unit by using the franchisee's personal equity and its access to borrowed funds. The franchisee's family often provide free labour in the initial stages.

When franchised businesses first appeared in the business world, around the end of World War II, the business structures they inhabited were relatively simple. By the time *Commissioner for Corporate Affairs v Casnot Pty Ltd*² was decided in Western Australia franchises had entered an ambiguous space – were they to be regulated under corporations' law, or not? In that instance the court decided 'yes', but the ensuing uncertainty was clarified through an amendment to corporation's legislation in 1987.

We can only speculate how things would have been in relation to insolvency in franchising if Australia's Franchise Agreements Bill of 1986 had been enacted.³ Franchising would have been regulated by the corporations' regulator. The Bill provided, under section 17(1)(d), for prior disclosure by a franchisor:

In relation to each occasion (if any) where, during the period of 10 years ending on the disclosure date, an officer of the franchisor has become an insolvent under administration – particulars of the circumstances relating to the officer becoming an insolvent under administration on the occasion.

Instead, franchise regulation was affected by path dependency.⁴ From 1987 until 1998 when Australia's mandatory Franchising Code of Conduct⁵ (the Code) was enacted as a regulation under the then Trade Practices Act 1974,⁶ franchised relationships fell beyond the reach of any specific statute. They were regulated primarily through contract law. Compliance with the Code is regulated by the competition and consumer protection regulator, the Australian Competition and Consumer Commission. Contract law, augmented by the Code, has proved unable to get most franchisors to treat their franchisees equitably. This situation is exacerbated by franchisor insolvency, when the franchisee's business is placed at risk.

Franchised operations are no longer simple structures. The franchised part of a business might be one division of a public or private corporate group, a joint venture, a proprietary corporation or an exempt proprietary company.⁷ The franchisor entity itself might be owned by a trust,⁸ a combination of entities or an individual. Country-specific requirements may dictate

² *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) ACLC 33, 122.

³ For details of the proposed Bill and a summary of the amendments see 'Co-operative Companies and Securities Scheme' Second Exposure Draft of the Franchise Agreements Bill 1986, Prepared by the Business Affairs Division of the Commonwealth Attorney-General's Department for and on behalf of the Ministerial Council for Companies and Securities, November 1986.

⁴ Audit relief for proprietary companies. 'RG 115 Audit Relief for Proprietary Companies' (Australian Securities & Investment Commission (ASIC) 30 September 2016) <https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-115-audit-relief-for-proprietary-companies/> accessed 17 January 2020. See also Jennifer L L Gant and Jenny Buchan, 'Moral Hazard, Path Dependency and Failing Franchisors: Mitigating Franchisee Risk Through Participation' (2019) 47(2) *Federal Law Review* 261.

⁵ Australia: now rewritten as Competition and Consumer (Industry Codes—Franchising) Regulation 2014.

⁶ Now rewritten as the Competition and Consumer Act 2010.

⁷ See Exempt Proprietary Company Explanatory Statement <https://www.legislation.gov.au/Details/F2015L01545/Explanatory%20Statement/Text> accessed 17 January 2020.

⁸ Interestingly, the Franchise Agreements Bill of 1987 contained a requirement that a franchisor be a corporation.

ownership requirements. The franchise model itself is capable of infinite variation; some franchises are really commission agencies, others are more traditional where rights cascade down through the network and money cascades up from franchisees to the master franchisee who, in turn, has financial and reporting responsibilities to the franchisor. Some franchisors own real estate, others are thinly capitalised with their assets being their suite of franchise agreements. Some like 7-Eleven, Subway, McDonalds and Hilton Hotels operate in numerous jurisdictions.

Once the structure of a franchise network is established some franchisors franchise all their retail outlets. For Subway, '[t]he driving force behind 100 percent franchisee ownership, in most cases, was the desire to penetrate markets while avoiding the risks of ownership and financing in the local markets'.⁹ Others, for example MacDonal's, retain a proportion of franchisor owned and operated outlets, reasoning:

that we value owning those McD [owned and operated] restaurants [as] they provide the place where we employ a lot of people who end up working in my team in head office. So it becomes [...] a people pipeline and a really successful labour market for us.¹⁰

The nature of franchising means that franchisors divest much risk to their franchisees, including the significant risks and responsibilities associated with being an employer. Franchisees assume those risks as an employee of their own company and as an employer. For example, franchisor Retail Food Group¹¹ (RFG) is a listed public company. In the words of one of its franchisees, Mr Mason:

While RFG hold the head lease, [...] behind the head lease is a signature with an unlimited personal guarantee from each and every franchisee [...] So RFG, on the surface, are responsible for the rent, but then they turn around and countersue people [franchisees] for their losses.¹²

Ultimate responsibility for payment of wages to franchisees' employees may revert to franchisors in Australia where Part 2 of the Fair Work Amendment (Protecting Vulnerable Workers) Act 2017 (Cth) applies. Liability for short-paid wages has extended to franchisors where franchisees had not paid the franchisees' employees correctly. Parliament accepted that where the underpayments were a consequence of compliance with the franchise system being so burdensome that franchisees were incentivised to increase their own profit by underpaying their workers, franchisors should pay.¹³

Not all franchisors succeed. 'According to s 435A of the Corporations Act 2001 (Cth), voluntary administration has the objectives of saving companies or their businesses or, failing

⁹ Donald W Hackett, 'The International Expansion of U.S. Franchise Systems: Status and Strategies' (1976) 7(1) *Journal of International Business Studies* 65, 71.

¹⁰ Andrew Gregory, 'Operation and Effectiveness of the Franchising Code of Conduct', (Oral submission to Parliamentary Joint Committee on Corporations and Financial Services 21 September 2018) 2.

¹¹ Retail Food Group <https://www.rfg.com.au/> accessed 17 January 2020.

¹² Oral submission to Parliamentary Joint Committee on Corporations and Financial Services, Operation and effectiveness of the Franchising Code of Conduct, 16 October 2018, 34.

¹³ See Fair Work Ombudsman (Australian Government) <https://www.fairwork.gov.au/about-us/our-role/enforcing-the-legislation/litigation/accessorial-franchisor-and-holding-company-liability> accessed 17 January 2020.

that, maximizing return to creditors.’¹⁴ An entity trading insolvent passes through several stages before it is wound up. The main ones are the appointment of an administrator (who advises creditors whether the entity is capable of being saved, or is beyond saving), and the transition of the administrator to a liquidator if the administrator determines that the entity should be wound up.

The reality is that franchisors in administration rarely emerge from the administration process as ongoing trading entities. Most are so heavily burdened by debt that they are wound up. The stakeholders in a franchisor administration are the franchisor, its shareholders, employees, suppliers, and franchisees. The interests of each stakeholder at each stage of the insolvency process are very different. While the insolvent franchisor’s employees are ultimately protected by law or social policy, the franchisees risk being positive externalities¹⁵ to an administrator, then having their franchise agreements and agreements with suppliers they depend on, disclaimed by the liquidator.

3. STAKEHOLDERS RIGHTS IN FRANCHISOR INSOLVENCY

Franchisors’ stakeholders derive rights through what was agreed in contracts, overlaid by rights for some like employees that are enshrined in the Corporations Act 2001. Where *ipso facto* clauses are present in contracts The Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017¹⁶ adjusts contractual rights once an administrator is appointed.

‘Certain creditors lack the capacity for self-protection.’¹⁷ Employees have long been identified as vulnerable. They are recognised as preferred creditors in the insolvency provisions of Australian corporations’ law¹⁸ as well as in many other jurisdictions and have some recourse to unmet entitlements via the Commonwealth government-operated Fair Entitlements Guarantee (FEG) scheme once their employer is placed under control of a provisional liquidator or a liquidator.¹⁹ We will return to the impact of the FEG in section 7.

As mentioned, franchisees are in a contract-based relationship with their franchisor. Franchisees are arguably even more vulnerable than employees. They are committed to continue performing their obligations under the non-negotiated franchise agreement while the administrator is in control of the franchisor’s business. Once the liquidator is appointed, they have they lost their job, income and have no grounds to access to FEG, they have lost their sunk investment, the unexpired part of their franchise fee and they may, as Mr Mason of RFG

¹⁴ Helen Anderson, ‘Voluntary Administration and the Protection of Employee Entitlements’ (2012) 20 *Companies and Securities Law Journal* 170.

¹⁵ An externality is a positive or negative consequence of an economic activity experienced by unrelated third parties. (Investopedia) <https://www.investopedia.com/terms/e/externality.asp> accessed 17 January 2020.

¹⁶ See Rob Nicholls and Jenny Buchan, ‘The Law of Unintended Consequences: The Effects of Voiding *Ipsa Facto* Clauses in Business Format Franchise Agreements’ (2017) 45 *Australian Business Law Review* 433.

¹⁷ Helen Anderson, ‘Thinking Outside the Square – Alternative Approaches to the Protection of Employee Entitlements’ (2014) 32 *Companies and Securities Law Journal* 23, 25.

¹⁸ Australia: Corporations Act s 556(1)(e), (g) and (h).

¹⁹ Australia: Fair Entitlements Guarantee Act 2012. See *Commonwealth v Rocklea Spinning Mills Pty Ltd* (2005) 145 FCR 220; [2005] FCA 902 for the reasoning.

pointed out, have guaranteed the performance of the franchisor as principal contractor to third parties. There is no overlay of corporate governance duties owed by franchisors to franchisees. Their contract is entered into on the assumption, by the franchisee and their funders and transactional advisers, that the franchisor knows what it is doing and is marketing a proven concept that it will support for the duration of the licence. Hence franchise agreements rarely make provision for franchisor insolvency. The Code does not make provision for franchisor insolvency either. This leaves franchisees at the mercy of the corporations' law. At the point when the administrator decides to wind up the franchisor, the franchisee, like the Cheshire Cat, fades and ultimately becomes invisible to the legal process. In that context franchisees themselves are treated as externalities.

We now move to explore what makes an employee an employee; and how removing the responsibility for employees to its franchisees advantages a franchisor, and, ultimately, an insolvent franchisor's own employees.

4. WHO IS AN EMPLOYEE?

The Australian Securities and Investments Commission (ASIC) defines an employee for insolvency purposes as follows:

You are likely to be classified as an employee if you are:

[...] engaged by a company under an award, enterprise agreement, agreement based transitional instruments (which are agreements that were in force before the commencement of the Fair Work Act 2009), or a contract of employment, and paid a salary, wages or commission.

If an employee is owed money for unpaid wages, superannuation, annual leave, sick leave, long service leave, retrenchment pay or other benefits, [they] are a creditor of the company. [They] may be entitled to some or all of what [they] are owed in priority to the company's other creditors.²⁰

Franchisors do not intend to create a relationship of employer/employee with their franchisees although, occasionally, courts will decide that the so-called franchisees are, in fact, employees.²¹ Franchise agreements are explicit about the relationship, often going so far as to require the right to approve of key staff appointments by the franchisee. For example, the Aussie Home Loans franchise agreement defines Franchise Manager as 'the person, whether officer (as defined in the Corporations Act) or employee of the Franchisee approved by [the franchisor] in writing from time to time to be the general manager of the Business'.²² This franchisor's control over its franchisees employees is pervasive. The Aussie Home Loans franchise agreement states:

The Franchisee may not engage any Prospective Employee as an Employee if, within 14 Business Days after receipt of the information in clause 12.5 above, [the franchisor] provides the Franchisee with notice that the Prospective Employee is not acceptable to [the franchisor].²³

²⁰ 'Insolvency for Employees' (ASIC) <https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-employees/> accessed 17 January 2020.

²¹ See, e.g., *Awuah v Coverall North America Inc*, 460 Mass 484 (2011).

²² Aussie Home Loans franchise agreement 2017, 8 (on author's file).

²³ Aussie Home Loans franchise agreement 2017, clause 12.6.

Despite this degree of control exerted by the franchisor over the franchisee's hiring practices, the franchisor makes it clear that:

17.1 During the Term the relationship between Aussie and the Franchisee is that of franchisor and franchisee. The parties agree that each are independent contractors.

17.2 The parties are not, and shall not be considered as, joint venturers, partners or agents of each other and no fiduciary relationship shall be deemed to exist between them.

Determining who is 'the employer' in a franchise network should be an easy question to answer – surely it is obvious. But things are not always as they seem in franchising. A franchisor and franchisee might be held to be in a joint employer relationship, or, as we saw in Australia's FWA, the franchisor might become liable for the franchisee's employees' wages.

4.1 Joint Employer Argument

In the US, the National Labor Relations Board (NLRB) has had to address the possibility that a franchisor is a joint employer of its franchisees, or their employees. In 2018 the NLRB overturned the Browning-Ferris joint employer standard and 'reinstated that an entity is not a joint employer unless there is proof that the alleged joint employer exercised "direct and immediate" control over essential employment terms'. As noted in *Hy-Brand*: '[c]hanging the test for identifying the employer, therefore, has dramatic implications for labor relations policy and its effect on the economy'.²⁴ Further:

a finding of joint-employer status shall once again require proof that putative joint employer entities have exercised joint control over essential employment terms (rather than merely having 'reserved' the right to exercise control), the control must be 'direct and immediate' (rather than indirect), and joint-employer status will not result from control that is 'limited and routine'.²⁵

4.2 Employer's Legal Obligations and Statutory Payments to Employees

A franchisee might have tens of employees, including its own directors. For example, consider the value in dollar terms and the reduced liability for providing a safe workplace when a franchisor shifts its workforce to its franchisees. An employer's:

legal obligations to employees [...] [are contained in] a variety of sources: federal, state and territory laws, industrial awards and agreements, tribunal decisions and contracts of employment. [Employers' legal obligations] include paying your employees correct wages, providing employees with pay slips, reimbursing your employees for work-related expenses, ensuring a safe working environment,

²⁴ *Hy-Brand Industrial Contractors, Ltd, et al* 265 NLRB 156, 2.

²⁵ *Hy-Brand Industrial Contractors, Ltd and Brandt Construction Co, as a single employer and/or joint employers and Dakota Upshaw and David Newcomb and Ron Senteras and Austin Hovendon and Nicole Pinnick*. Cases 25-CA-63189, 25-CA-163208, 25-CA-163297, 25-CA-163317, 25-CA-163373, 25-CA-163376, 25-CA-163398, 25-CA-163414, 25-CA-164941, and 25-CA-164945. P5. For a history of labour relations between employer and employees in the US see Thomas J III Walsh, 'Supersizing the Definition of Employer under the National Labor Relations Act – Broadening the Joint-Employer Standard to Include Franchisors and Franchisees' (2016) 47 *U Tol L Rev* 589.

ensuring you have workers compensation insurance for each employee,²⁶ not acting in a way that may seriously damage an employee's reputation or cause mental distress or humiliation, [...] forwarding PAYG tax instalments to the Australian Taxation Office (ATO) and making appropriate payments under the Superannuation Guarantee legislation.²⁷

Once an employee is paid more than \$450 per month before tax the employer is required, by law, to allocate 9.5 per cent of gross pay to the employee's superannuation²⁸ Payroll tax is also payable by employers whose payroll reaches the prescribed threshold. By diversifying its payroll beyond the 'group' of entities envisaged by the legislation franchisors can minimise their payroll tax liability. From 1 July 2018 to 30 June 2019, the payroll tax threshold is \$850,000. From 1 July 2018 the payroll tax rate is 5.45 per cent.²⁹

Cumulatively, the moneys required to be paid to employees to comply with legislation can be significant. Where items like payroll tax are assessed after a threshold is reached, the franchisor will have made a significant revenue saving, which grows as the franchise network grows. 'As a result of their status as priority creditors, the 2012-2013 data from external administrator reports collated by ASIC shows that the majority of employee entitlements are [ultimately] paid.'³⁰

5. OUTSOURCING EMPLOYEE OBLIGATIONS TO FRANCHISEES

As we have seen, the obligations of an employer are significant, both financially and in terms of owing a duty to provide a workplace that is safe in every way. Similarly, in corporate failure, such as that of Roger David menswear stores, where the administrators closed its 57 stores throughout Australia, where '[t]he family owned store employs 200 full time and almost 300 casual[s]'.³¹ Australia's insolvency regime provides, as we will see, safety nets for employees whose employer becomes insolvent. The 500 Roger David staff find they are acknowledged as a category of creditors with distinct rights by the administrator, and then the liquidator.

Where branch offices, and company owned stores are rejected in favour of appointing franchisees the obligations are almost entirely passed through to them when they sign the franchise agreement. 'Craveable Brands employs 540 people directly across Australia. Through our franchise network our brands employ a further 11,900 people across 570 stores in both

²⁶ 'Take out a Workers Insurance Policy' (icare) <https://www.icare.nsw.gov.au/employers/take-out-a-policy/workers-insurance/> accessed 17 January 2020.

²⁷ 'What Employee Records Do You Have to Keep?' (Australian Government Business 11 November 2019) <https://www.business.gov.au/people/managing-and-developing-staff/employees-and-record-keeping/legal-obligations-for-employing-people> accessed 17 January 2020.

²⁸ 'Your Simple Guide to Superannuation Guarantee Contributions' (SuperGuide 1 January 2019) <https://www.superguide.com.au/boost-your-superannuation/superannuation-guarantee-rate> accessed 17 January 2020

²⁹ 'Taxes, Duties, Levies, and Royalties' (NSW Government Revenue) <https://www.revenue.nsw.gov.au/taxes/payroll/factsheet/employer>; <https://www.payrolltax.gov.au/> accessed 17 January 2020.

³⁰ Anderson (n 17) 26.

³¹ Patrick Hatch, 'All Roger David Stores to Shut Down before Christmas: 500 Jobs Gone' (*Sydney Morning Herald* (online) 15 November 2018).

metropolitan and regional locations.³² This means that Craveable Brands franchisees employ an average of 21 employees per franchise. ‘McDonald’s [Australia] has [...] 970 restaurants, with over 260 franchisees, and we employ more than 100,000 people.’³³

Of the McDonald’s restaurants 15 per cent are company owned and operated, the remaining 85 per cent are owned and operated by franchisees like ‘Gavin and Raylee McLeod [who] [...] operate six McDonald’s restaurants in NSW [...], employing 1100 staff’.³⁴ There is no safety net for franchisees or their employees when a franchisor becomes insolvent.

6. FRANCHISOR’S RESPONSIBILITY FOR FRANCHISEES’ EMPLOYEES

Franchise agreements establish the ground rules for relationships that are intended to last many years, between parties whose businesses have a symbiotic relationship. They are necessarily incomplete.

Franchise agreements make one thing clear: the franchisee is not, under any circumstances, their employee. For example, 7-Eleven Inc in the US makes it clear to franchisees that ‘[a]s an independent contractor, you are responsible for the day-to-day operations at your store’.³⁵ The 7-Eleven franchise agreement gives an indication of the degree of control the franchisor exercises over the franchisee, described as an independent contractor.

2. Independent Contractor. You and we agree that this Agreement creates an arm’s length business relationship and does not create any fiduciary, special or other similar relationship. You agree (a) to hold yourself out to the public as an independent contractor; (b) to control the manner and means of the operation of the Store; and (c) to exercise complete control over and responsibility for all labor relations and the conduct of yourself and employees, including the day to day operations of the Store and all Store employees. You and your agents and employees may not: (i) be considered or held out to be our agents or employees or (ii) negotiate or enter any agreement or incur any liability in our name, on our behalf, or purporting to bind us or any of our or your successors in interest. Without in any way limiting the preceding statements, we do not exercise any discretion or control over your employment policies or employment decisions. All employees of the Store are solely your employees and you will control the manner and means of the operation of the Store. No actions you, your agents or employees take will be attributable to us or be considered to be actions obligating us.³⁶

³² Brett Houldin, Craveable Brands, Submission No 24 to Parliamentary Joint Committee on Corporations and Financial Services, Operation and Effectiveness of the Franchising Code of Conduct, 4 May 2018, 1.

³³ Gregory (n 10) 1.

³⁴ Nick Hall, ‘“Just good practice” – Government Moves on Disability Employment’ (Franchise Business Australia 28 February 2019).

³⁵ Item 11(i), page 30 7-Eleven single unit franchise agreement Minnesota. See <https://mn.gov/commerce/industries/securities/franchises/> accessed 9 August 2020.

³⁶ 7-Eleven Inc Store Franchise Agreement, clause 2.

7-Eleven Inc also makes it clear that it:

will have independent access to the information collected on the RIS [retail information system], and there are no contractual limitations on our right to access or use the information and data. We retain sole and exclusive ownership in all information and data collected on the RIS.³⁷

7-Eleven Inc additionally provides itself with the right to terminate the franchise agreement on little or no notice in a range of situations over which the franchisee may have no control, including:

We may terminate on 45 days' notice without providing an opportunity to cure if a provision of the agreement that we consider material is declared invalid by a court of competent jurisdiction.

We may terminate on 30 days' notice without providing an opportunity to cure if you file a petition in bankruptcy or one is filed against you, you make an assignment for the benefit of creditors, or a receiver or trustee is appointed; you attempt to encumber or assign any interest under the franchise agreement in breach of the requirements of the franchise agreement;

We may terminate the franchise agreement upon not less than 30 days' notice if we determine in a normal course of business, to cease the operation of all 7-Eleven stores in the state or metropolitan statistical area in which your store is located. If we sell all of our right in the 7-Eleven stores in your area, or if we decide to close the 7-Eleven stores in your area, you will have the right of first refusal (or of purchase) to acquire our non-proprietary rights in the store, the equipment and real property.³⁸

Franchise agreements may make franchisors responsible for training franchisee employees (at the franchisees' cost), specifying the uniform they wear, and other brand relevant matters they explicitly make all payments to and for franchisee's employees the franchisee's responsibility. For example, the United Petroleum franchise agreement stipulates:

The Franchisee has the sole right to employ and discharge such employees as in the Franchisee's reasonable opinion are necessary and such employees will be employees of the Franchisee. The Franchisee must exercise full and complete control over, and must have full responsibility for, the conduct of the Franchisee's employees and any and all labour relations, including the hiring, firing, supervision, disciplining, compensation (and taxes relating to them) and work schedules of the Franchisee's employees.³⁹

However, in two situations this position can be overridden by the courts. These are if the provisions of the Fair Work Act (FWA) or the tort of negligence apply, or if a workplace incident is attributed to a flaw in the franchisor's operational instructions after the employer-franchisee followed the franchisor's procedures to the letter, but those procedures led to the franchisee's employee becoming injured or dying.

6.2 The Fair Work Act

Section 558A of Australia's FWA, defines franchisee and franchisor entity:

³⁷ Disclosure document for 7-Eleven single unit franchise agreement Minnesota, Item 11(b), 26.

³⁸ 7-Eleven 37.

³⁹ Clause 1.3 (d) United Petroleum single unit Franchise Agreement dated 29 November 2011. There is no public franchise database in Australia. Copy of this agreement is on the author's file.

558A Meaning of franchisee entity and responsible franchisor entity

- (1) A person is a franchisee entity of a franchise if:
 - (a) the person is a franchisee (including a subfranchisee) in relation to the franchise; and
 - (b) the business conducted by the person under the franchise is substantially or materially associated with intellectual property relating to the franchise.
- (2) A person is a responsible franchisor entity for a franchisee entity of a franchise if:
 - (a) the person is a franchisor (including a subfranchisor) in relation to the franchise; and
 - (b) the person has a significant degree of influence or control over the franchisee entity's affairs.

Franchisors can be held responsible if their franchisee does not follow workplace laws about: the National Employment Standards, a modern award, an enterprise agreement, method and frequency of paying wages, deductions from pay and cashback schemes, guarantees of annual earnings, sham contracting, record-keeping requirements, pay slip requirements, an equal remuneration wage order, a workplace determination or a national minimum wage order.

This applies to franchisors:

- who have allowed the franchisee to supply goods or services under their specific brand or trademark;
- whose branding or trademark is major part of the franchisee's business; and
- who have a significant degree of influence or control over the business affairs of the franchisee.

Franchisors can be held responsible for breaches or underpayments if:

- they knew (or could have reasonably known) that a franchisee was not following workplace laws; and
- they did not take reasonable steps to prevent it.⁴⁰

For example, the franchisor and franchisees of Paul Sandler Swimland Pty Ltd,⁴¹ and the master franchisee for Pizza Hut in Australia, Pizza Pan Group Pty Ltd have been found to have franchisees that underpaid workers and have provided enforceable undertakings to the Fair Work Ombudsman. Australian master franchisor for 7-Eleven has also attracted significant scrutiny and been warned to operate its system responsibly.⁴² 7-Eleven franchisees have been prosecuted.⁴³

⁴⁰ 'Franchisors' (Australian Government Fair Work Ombudsman) <https://www.fairwork.gov.au/find-help-for/franchises/franchisors> accessed 17 January 2020.

⁴¹ Enforceable Undertaking Between the Commonwealth of Australia (as represented by the Office of the Fair Work Ombudsman) and Paul Sadler Swimland Pty Ltd and its Franchisees, 22 March 2018.

⁴² 'Statement on 7-Eleven' (Australian Government Fair Work Ombudsman 12 May 2016) <https://www.fairwork.gov.au/about-us/news-and-media-releases/2016-media-releases/may-2016/20160512-statement-on-7-eleven> accessed 17 January 2020.

⁴³ For example, *Fair Work Ombudsman v S & A Enterprises Pty Ltd (QLD) & Anor* [2017] FCCA 3332 and *Fair Work Ombudsman v Xia Jing Qi Pty Ltd & Anor* [2019] FCCA 84.

6.3 Work Health and Safety Legislation, and Tort Liability

While much legislation that businesses need to comply with is Commonwealth based, work health and safety is the purview of the states. In Australia, franchisors have occasionally been held responsible for the death of a franchisee's employees.⁴⁴ In most cases the responsibility for a franchisee's employee's injury would rest with the franchisee⁴⁵ or the employee themselves. US case law, too, records instances in which franchisors have been liable for their own negligence in failing to exercise due care in, for example, 'selecting franchisees, maintaining standards, franchise unit design and security'⁴⁶ or mandating safe product standards.⁴⁷

7. RIGHTS UNDER THE FRANCHISE AGREEMENT IF FRANCHISOR FAILS

Although neither party can anticipate all eventualities that may cause them to turn to the contract for guidance, franchisors can anticipate that one of the parties' businesses may fail. As shown above, franchisors do provide a suite of opportunities for themselves to respond harshly and often pre-emptively to a failing or failed franchisee. They provide no reciprocal opportunity for franchisees.

[...] the effects of franchisor insolvency on the franchise ecosystem translates, upon insolvency, into myriad interests and competing claims among which the franchisee is the least protected. The interests of the franchisees are not protected, and franchisees have no control over the business when the franchisor fails. Franchisees are subject to the decisions of the external controller.⁴⁸

The appointment of an administrator 'gives the company an opportunity to trade out of its difficulties [...] and minimises the chance of worsening the position of creditors'.⁴⁹ 'If a franchisor fails, there are important differences between the effects on the franchisor's employees, suppliers, and independent contractors on the one hand and on franchisees on the other'.⁵⁰ Franchisees, like any party to a contract, enjoy a hypothetical right to sue for breach, antici-

⁴⁴ For example, *WorkCover Authority of New South Wales (Inspector Petar Ankucic) v McDonald's Australia Ltd and Anor* [2000] NSWIRComm 277 and *Workcover Authority of NSW (Inspector Ankucic) v McDonald's Australia Ltd and Anor* [2000] NSWIRComm 1123.

⁴⁵ Such as the employee who fell while descending a ladder after smoking a cigarette on the roof of the McDonalds she worked in and broke her leg. The franchisor's policy required employees to arrive ten minutes before their shift. *Mandep Sarkaria v Workers' Compensation Regulator* [2019] ICQ 1.

⁴⁶ Andrew L Terry and Joseph L Huan, 'Franchisor Liability for Franchisee Conduct' (2013) 39(2) *Monash University Law Review* 388, 392.

⁴⁷ For example the coffee scalding case of *Stella Liebeck v McDonald's Restaurants, PTS Inc and McDonald's International Inc* 1994 Extra LEXIS 23 (Bernalillo County, NM Dist Ct 1994), 1995 WL 360309 (Bernalillo County, NM Dist Ct 1994).

⁴⁸ Wayne Jenvey, 'Rocky Roads and Rollercoasters – Turnaround Strategies for Distressed Franchise Systems' (Legal Symposium at the Franchise Australia Annual Conference, Gold Coast, 24 October 2006) 2.

⁴⁹ Anderson (n 14).

⁵⁰ Jenny Buchan, Lorelle Frazer, Charles Zhen Qu and Rob Nicholls 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22(4) *Journal of Marketing Channels* 311.

tory breach or unjust enrichment. Numerous legal, temporal and operational challenges make each of these options unlikely as solutions.⁵¹ In reality, franchisees have few choices.

The overriding legislative position concerning distribution of funds of an insolvent company are that, 'Except as otherwise provided by this Act, all debts and claims proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they must be paid proportionately.'⁵² The priority creditors are identified in part 5.6 (6)D Corporations Act 2001, sections 556 to 563AAA. Sections 557–561 and 563 concern priority given to payments to employees. These may cover wages, superannuation and other entitlements like retrenchment payments.

There is no mention of franchisees, anywhere. Having been useful and potentially saleable assets during the period of the franchisor's administration, they become invisible, externalities under the liquidator. Their value to an administrator can be, for example, as a sales force for the remaining stock the franchisor has warehoused, as a source of funds in the form of ongoing royalty payments under the franchise agreements and as employers of their own employees for which neither the insolvent administrator nor the FEG has any liability.

When franchisees pay their initial franchise fee, that money was subsumed into consolidated revenue of the franchisor. That fee bought the franchisee the right to trade as a franchisee under the franchisor's brand for a specified number of years. For example, the initial franchise fee for a United Petroleum outlet in 2011 was a total of \$370,000 (plus GST), made up of the franchise fee of \$145,000 and a sum called goodwill of \$225,000. The franchisee is granted a six-year term. That is \$61,667 per annum for each of the six years, paid up front and non-refundable once the statutory cooling off period of seven days has expired. An Aussie Home Loans franchise pays an up-front franchise fee of \$45,000 on signing a licence that is granted for five years. A Michel's Patisserie franchise fee was \$50,000 in 2017. There is no security provided by the franchisor for this money.

Franchisees also contribute to a marketing fund that is then owned and managed by the franchisor. Recommendation 5b of the Review of the Franchising Code of Conduct 2013⁵³ stated that franchisors should be required to hold marketing fees in trust. While all other aspects of the reviewer, Wein's recommendations concerning the marketing funds were adopted, franchisors' interests, again, prevailed over those of their franchisees. This recommendation was not adopted and marketing funds were simply required to be held by franchisors in a separate account. There is typically an initial marketing fee of about \$3,000 payable by each franchisee, plus an ongoing Marketing Levy. In the case of Aussie Farmers Direct this comprised 5 per cent of Gross Delivery Fees plus Goods and Services Tax.

The problems that Wein had identified in his review bore sour fruit in *Re Stay In Bed Milk & Bread Pty Ltd (In Liq)*,⁵⁴ a case concerning the insolvency of a franchisor trading as Aussie Farmers Direct. The liquidator sought directions from the court as to whether it could refund the 91 franchisees the \$789,391 they had paid in marketing levies. Randall AsJ noted that the

⁵¹ See Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer 2013) 140–46.

⁵² Corporations Act 2001 (Cth), s 555.

⁵³ 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. author Alan Wein, 30 April 2013.

⁵⁴ [2019] VSC 181 (SIBMB).

franchise agreement was ‘silent on what happens with the Marketing Fund in the event that SIBMB stops trading’.⁵⁵

The liquidators argued that the marketing fund was held on trust for the franchisees, or, alternatively that a Quistclose trust was formed on the insolvency of the franchisor and that as a consequence the money in the marketing fund should be returned to the franchisees. They did not plead that the FEG would be unjustly enriched. They lost.

The liquidators claim was opposed by the Commonwealth, represented by the Australian Government Department of Jobs and Small Business (‘the Department’). The Department administers the FEG scheme under the *Fair Entitlement Guarantee Act 2012* (Cth). The Commonwealth claimed it should have the money to help make up a shortfall in the amount payable to the franchisor’s 259 employees who were owed \$4,263,654 in outstanding entitlements. The Department argued that no trust had been created and that the money should be an asset of the franchisor and should be available to fund the shortfall of wages and entitlements owing to the employees and payable under the FEG. They won.

This approach to the distribution of franchise marketing funds on a franchisor’s insolvency is a glaring example of the positioning of franchisees as externalities, to the benefit of the franchisor’s former employees.

8. FRANCHISOR FAILURE

8.1 Information about the Franchisor’s Financial Stability Conveyed to the Market

Currently, the franchisor’s financial stability attracts little scrutiny. Franchisees are encouraged to conduct due diligence prior to buying into a system but cannot always plumb the depths of a franchisor’s finances. A franchisor in Australia is required to provide certain financial details in its initial disclosure document to comply with Item 21 of the Code. These include a signed statement that the franchisor was solvent at the end of the last financial year, financial report for the two previous financial years. Similar requirements exist for franchisors that are part of a consolidated entity as defined in the Corporations Act or its foreign equivalent. Exemptions exist where the solvency statement is supported by an independent audit. Alternative solutions exist for franchisors that have not existed for two years, or were insolvent at any time during the previous two years.⁵⁶

Provision of information to comply with Item 21 above should enable the franchisee to proceed confidently with their purchase of a franchise, but some franchisors continue to sell franchises while they are knowingly insolvent.⁵⁷

⁵⁵ SIBMB per Randall AsJ [6].

⁵⁶ Competition and Consumer (Industry Codes—Franchising) Regulation 2014.

⁵⁷ See Jenny Buchan, ‘Franchisor Failure: An Assessment of the Adequacy of Regulatory Response’ (PhD Thesis, Queensland University of Technology 2010).

8.2 Why do Franchisors Fail?

Individual franchisees may blame themselves for their own struggles, not realizing how widespread the problems in their franchise system were, or that it was the franchisor itself who was at the heart of the problems. In a recent example:

Max Brenner Australia, which was started in 1999 [...], appointed voluntary administrators this month [...] An expensive overhaul of the company's head office in Alexandria, in Sydney's inner south, appears to have been a major cause of financial pain – hitting its cash flows so hard it stopped paying staff superannuation for the last six months of 2016.⁵⁸

Max Brenner's employees would probably know their superannuation entitlements had not been paid but this is the type of red flag that does not alert franchisees. Even if it did, there is little they can do to protect their investment *ex post*. a list of 12 possible red flags of impending failure specific to franchisors have been identified, as follows:

- (1) a large proportion of outlets being owned by the franchisor instead of franchisees, indicative of the return of failed franchisees to franchisor;
- (2) a long history of failures on the part of franchisees in the franchise network;
- (3) a breach of a franchisor's obligations to provide advertising support, equipment and inventory;
- (4) evasiveness following franchisor default;
- (5) a landlord's notice of demand;
- (6) a large number of court proceedings against the franchisor;
- (7) restructuring on the part of the franchisor, especially invoices from different companies;
- (8) franchisors not receiving previously favourable trading terms due to impending insolvency, especially where franchisees are 'required' to source stock or other services through their franchisor;
- (9) information in the franchisor's balance sheet, the profit and loss statement, or announcements made to the stock exchange (where the franchisor is listed) pointing to an accumulation of significant debt when the franchise system is not expanding or the writing down of assets, or refinancing activities;
- (10) information from credit reporting services about a franchisor company's financial health;
- (11) a failure on the part of the franchisor to make timely commission payments, where the franchisee is the franchisor's commission agent; and as Canadian insolvency practitioner Craig R Colrairie⁵⁹ suggests,
- (12) '[p]oor financial performance, including the accumulation of significant debt when the franchise system is not expanding, growing operating losses, the writing down of

⁵⁸ Colin Kruger, 'Future of Max Brenner Stores in Doubt after Liquidators Appointed' (*Sydney Morning Herald* (online) 17 October 2018).

⁵⁹ Craig R Colrairie, 'Franchises: Insolvency and Restructuring' (Paper presented at Ontario Bar Association CLE Distribution Law: Catch the Wave, Avoid the Rocks, Toronto, Canada, 26 May 2003) 3.

assets and refinancings'. Colrairie concedes that '[i]dentifying financial problems in non-publicly traded corporations is more difficult'.⁶⁰

Each of these flags can be explained away by franchisors. Some may not be malignant, they may represent a one-off administrative error on the part of the franchisor, but all indicate the level of control franchisors have, and the powerlessness of franchisees. The benefit of franchisees communicating with each other regularly and comparing experiences, and paying attention to the financial press cannot be underestimated.

Retail Food Group has not failed but is an example of decision-making within a franchise that is beyond the control of its franchisees:

Retail Food Group – [listed Australian franchisor of Gloria Jeans, Donut King] Michael's Patisserie, Brumby's, Crust Pizza and Pizza Capers – on Thursday revealed it plunged to a \$111 million net after-tax loss for the six months to December 31 [...] RFG has been in financial trouble since an investigation by The Age and The Sydney Morning Herald revealed many of its brands were struggling and that its sharp business model meant many franchisees were struggling to survive.⁶¹

Franchisees have no opportunity for input into their franchisor's strategic decisions. The actions of the Max Brenner Australian master franchisee and RFG are just two of many examples of a franchisor or national master franchisee making a decision that leads to the system being in significant financial stress. Other examples abound.⁶² '[T]he complete failure of a franchisor entity is likely to have a domino effect on many of its franchisees.'⁶³

9. THE FUTURE

Laws and regulation should create incentives for people to behave in a desirable way. Given the franchisees' vulnerability, what can they do as individuals and how can the law address the need to provide them with some protection if their franchisor becomes insolvent?

9.1 A Separate Franchisee Category with Specified Rights?

An important question is what information the franchisee had about the risks and consequences of franchisor insolvency *before* entering the relationship. This will allow the prospective franchisee to weigh up the risk of that franchise relative to other franchises and investment opportunities available at the time. Ex ante information is, however, not the complete answer as franchisors can.

⁶⁰ Jenny Buchan, 'Franchising: A Honey Pot in a Bear Trap' (2014) 34(2) *Adelaide Law Review* 283, 290–91.

⁶¹ Patrick Hatch, 'Gloria Jeans, Donut King Owner Falls Deeper into Red with \$111m Loss' (*Sydney Morning Herald* 28 February 2019).

⁶² See Buchan et al (n 50) and Buchan (n 60).

⁶³ See Buchan et al (n 50) 317.

9.2 Expand Current Provisions of the Corporations Act

In 2000, the Parliament passed the Corporations Law Amendment (Employee Entitlements) Act 2000 (Cth). The main breach provision is section 596AB(1), which prohibits a person from entering into a transaction with the intention of preventing the recovery of, or significantly reducing the amount of, the entitlements of employees of a company that can be recovered. [...] according to the Explanatory Memorandum the object of s 596AB was 'to deter the misuse of company structures and of other schemes to avoid the payment of amounts to employees that they are entitled to prove for on liquidation of their employer'.⁶⁴

9.3 Disqualify Managers

Under section 86E of the Competition and Consumer Act 2010 the ACCC can apply for an:

Order disqualifying a person from managing corporations

- (1) On application by the Commission, the Court may make an order disqualifying a person from managing corporations for a period that the Court considers appropriate if:
 - (a) the Court is satisfied that the person has contravened, has attempted to contravene or has been involved in a contravention of Part IV; and
 - (b) the Court is satisfied that the disqualification is justified.⁶⁵

This will not help the franchisees who have already been burnt but it may prevent the same people engaging in the same conduct in the future. While Part IV concerns restrictive trade practices, it is conceivable this could be extended to enable the ACCC to seek the disqualification order for persons managing an insolvent franchisor.

9.4 Which Stakeholders Would Cede Priority to Accommodate Franchisees?

Clearly, if the franchisees' rights are enhanced, the rights of some other stakeholders would be diminished. These would most likely be unsecured creditors, the franchisor's employees and its shareholders. In a contest about who is more vulnerable; trade creditors with negotiated contracts, landlords who have lost a tenant but not premises, employees who have the ultimate protection of a priority place in the insolvency law, plus the FEG, or franchisees, it is arguable that it is the franchisees.

⁶⁴ Anderson (n 17) 32.

⁶⁵ Australia: Competition and Consumer Act 2010 (Cth) S86E.

10. CONCLUSION

In franchisor failure, the franchisees' labour, and the unexpired portion of the franchise fee are externalities that the administrator and liquidator are both able to use cost-free.

Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law.⁶⁶

Oliver Hart noted in 1999 that 'bankruptcy reform should not be seen in isolation: it may be necessary to combine it with legal and other reforms, e.g., the training of judges, improvements in corporate governance [...]'.⁶⁷ Insolvency law has stalled when it comes to accommodating franchisees. It has failed to adapt to this business model which has now played a significant role in the Australian market for over half a century.

⁶⁶ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (first published 1776, Encyclopaedia Britannica 1952) vol 5, 403.

⁶⁷ Oliver Hart 'Different Approaches to Bankruptcy' paper delivered at 'Building Effective Insolvency Systems: The Economic Dimensions' conference in Washington DC on 14–15 September 1999.