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FRANCHISING: A HONEY POT IN A BEAR TRAP

Abstract

A franchisee's business is like a honey pot inside a loaded bear trap. This article explores the laws that purport to protect the interests of franchisees (namely contract law, the *Competition and Consumer Act 2010* (Cth) and the Franchising Code of Conduct) and identifies why those laws are doomed to failure if the franchisor becomes insolvent. The example of failed franchisor Angus & Robertson is used to explain the franchisees' predicament in the face of the responsibilities imposed on insolvency practitioners by the *Corporations Act 2001* (Cth). The article concludes that piecemeal reform of consumer protection legislation can never result in fair franchising. An approach that includes amendments to insolvency policy and regulation is required.

I Introduction

Business format franchising has been described as 'a form of "honey trap" into which inexperienced franchisees [are] lured by promises of success'.[1] On investigating a franchise the franchisees and their advisors test the honey, but seldom notice, examine or understand the power of the bear trap that surrounds it. That bear trap is franchisor insolvency. The power to trip this bear trap sits with the franchisor and the franchisor's creditors. Once tripped, all franchisees are caught within its teeth. Most are unable to escape until the franchisor's administrator or liquidator frees them. Notwithstanding this flaw, franchising remains an important part of Australia's economy.[2] In 2011, the Parliament of South Australia heard that

> approximately $180 billion nationally is devoted to franchise expenditure … the numbers are actually amazing. There are 1270 different franchise operations existing in Australia, and 670 of those operate in South Australia alone. Nationally, franchising employs 775 000 people.[3]

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1 Economic and Finance Committee, Parliament of South Australia, *Franchises* (2008) 18.

2 Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer, 2013) 16–17.

3 South Australia, *Parliamentary Debates*, House of Assembly, 13 September 2011, 4878 (Steven Griffiths). Based on South Australia having 7.2 per cent of Australia's population franchising would provide work for 55 800 South Australians.

The law is playing a catch-up game with this evolving and nuanced business model. As South Australia considers enacting an industry code[4] for the franchise sector[5] it is timely to reach into the honey pot in an effort to determine the size and power of the bear trap it inhabits. How strong are its jaws? Do they need to be weakened? If so, how might this be achieved?

This article explores the fraught pathway of a franchisor's insolvency through the experiences of franchisees, primarily those connected with failed franchisor Angus & Robertson ('A & R'). It also suggests how franchisees can respond to the failure of their counterparty within the boundaries of the current law. Concluding that the current situation is unsatisfactory, it suggests where solutions lie. Part II introduces the concept of franchisor failure: how often do franchisors fail, and why? Part III then identifies indicators of a company's insolvency, using this as a background to investigate the failure of A & R in Part IV. Part V examines the precarious position of franchisees in circumstances of franchisor failure, in light of the current legal structure. Part VI outlines ex ante and ex post courses of action available to franchisees to anticipate and mitigate their losses within the current law. Part VII identifies potential solutions, and Part VIII concludes.

II Failure in Franchising

This article is concerned with the failure of franchisor insolvency, including administration and liquidation. The law does not provide a predictable path through franchisor failure for franchisees. The South Australian Franchise Review ('SA Review') accepted that

> many franchisees entering franchises are not in a position to anticipate the difficulties they may face as a result of the failure of their franchisor. … The provision of … information [about consequences of franchisor failure on a generic level is] insufficient to address the current regulatory gap.[6]

The specific structure of the franchisor's network, its level of debt, the availability of suitable buyers for the failing franchisor, and each individual franchisee's personal and financial resilience and negotiating ability influence how individual franchisees emerge from their franchisor's failure. 'Some can draw from a deep well of prior experience … and a strong personal support network; some [should] only attribute the survival of their business to luck or its demise to bad luck'.[7] But, is franchisor failure a big enough issue to merit concern about its consequences?

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4 Evidence to Estimates Committee A, Parliament of South Australia, Adelaide, 22 June 2012, 195 (Tom Koutsantonis).

5 Pursuant to powers granted under the *Small Business Commissioner Act 2011* (SA) s 14.

6 Economic and Finance Committee, above n 1, 37–8.

7 Jennifer Mary Buchan, *Franchisor Failure; An Assessment of the Adequacy of Regulatory Response* (PhD Thesis, Queensland University of Technology, 2010).

A *How Often Do Franchises Fail?*

Before considering the consequences of franchisor failure it is useful to understand the magnitude of the issue. As long as 35 years ago researchers in the United States ('US') observed that many franchises were failing, identifying '54 entire restaurant franchise systems that turned "belly up" over a two-year period'.[8] Other American researchers noted that out of an estimated population of 2177 franchisors in 1986: '[a] total of 104 franchisors operating 5423 outlets failed [the following year] … The annual volume of sales represented by those failed firms was [US]$1.7 billion, of which the franchisee-owned portion was [US]$1.5 billion'.[9] More recently, Rozenn Perrigot and Gérard Cliquet studied 952 French franchising networks, and found that during the 10 year period from 1992–2002, nearly 58 per cent of franchisors failed.[10]

Australian franchisors fail too. 'The 1999 Australian Franchising Yearbook and Directory listed 347 franchisors. Of these, 251 (72 per cent) were no longer franchising'[11] by 2011. There were 1100 franchisors trading in Australia in 2008 and by 2010 a total of '56 franchise systems had ceased operating and a further 88 ceased franchising'.[12] This was 13 per cent in two years — more than one franchisor in five over two years. By 2012 a further 48 franchisors had stopped franchising in Australia.[13] The Australian numbers include franchisors that ceased franchising but possibly remained in business, and others that failed, like Kleenmaid (15 franchisees),[14] Kleins Jewellery

8 Shelby D Hunt, 'Franchising: Promises, Problems, Prospects' (1977) 53(3) *Journal of Retailing* 71, 75, citing Select Committee on Small Business, United States Senate, *The Economic Effects of Franchising* (1971) 93.

9 Roger D Blair and Francine Lafontaine, *The Economics of Franchising* (Cambridge University Press, 2005) 272; see also Andrew Kostecka, *Franchising in the Economy* (United States Department of Commerce, 1988) 12.

10 Rozenn Perrigot and Gérard Cliquet, 'Survival of Franchising Networks in France from 1992 to 2002' (Paper presented at the 18th Annual International Society of Franchising Conference, Las Vegas, Nevada, 6–7 March 2004).

11 Jenny Buchan, Charles Qu and Lorelle Frazer, 'Protecting Franchisees from their Franchisor's Impending Failure: A Way Forward for Consumer Protection Regulators Using Indicators?' (Paper presented at The First International Conference on Comparative Law and Global Common Law: Exchange and Integration of the Contemporary Legal Systems, College of Comparative Law, China University of Political Science and Law, Beijing, 24–25 September 2011); Blair and Lafontaine, above n 9, 44, 272; Francine Lafontaine and K L Shaw, 'Franchising Growth and Franchisor Entry and Exit in the US Market: Myth and Reality' (1998) 13(2) *Journal of Business Venturing* 95, in Frank Hoy and John Stanworth (eds), *Franchising: An International Perspective* (Routledge, 2003) 163–4; Perrigot and Cliquet, above n 10.

12 Buchan, Qu and Frazer, above n 11.

13 Lorelle Frazer, Scott Weaven and Kelli Bodey, *Franchising Australia 2012* (Griffith University, 2012).

14 The Kleenmaid franchisees paid initial fees of $60 000 to $120 000 each plus setup costs. They subleased premises from the franchisor's associate, Kleenmaid Property: Deloitte, 'The Kleenmaid Group (Administrators Appointed) Administrators' Report to Creditors Pursuant to s 439A *Corporations Act 2001* (Cth)' (Administrators' Report, 14 May 2009) 12.

(134 franchisees),[15] Traveland (270 franchisees), Beach House Group (22 franchisees), Healthzone Limited (80 franchisees), Refund Home Loans (320 franchisees), Tyrecorp (33 franchisees), Darrell Lea (69 company-owned and franchised stores), Master Education Services (well known for its test case)[16] and A & R (48 franchisees). A franchisee that is receiving negligible assistance from a franchisor is likely to quit the system before the franchisor fails. The fate of each franchisee that is still in the system when the franchisor fails will depend on many variables: some also fail, others rebrand as a franchisee of another system, and yet others become independent businesses.

Each franchisor has between one and thousands of franchisees. 'The proportion of franchisors to franchisees [averages] 1:60 in Australia'.[17] This ratio lends weight to the proposition that one franchisor failing has a far greater economic impact than one franchisee failing, and indeed, it suggests that the issue is serious enough to investigate its consequences. In economic terms franchising is a classic example of market failure. Franchisors pass risk and the consequences of franchisor failure on to franchisees. The externalities[18] that manifest themselves when franchisors fail are not costed into the franchise model.

Urban myth is responsible for the claim that franchisees cause their franchisor's failure. It is thus important to probe the myth. Maybe franchisees get what they deserve?

B *Why Do Franchisors Fail?*

In 1991, when business format franchising was not yet regulated in this country, Australia's Franchising Task Force attributed franchisor failure to a combination of: under-capitalization of the franchisor, too-rapid expansion of the franchise system, poor product or service, poor franchisee selection, franchisor greed, external factors, devaluation of the Australian dollar, an increase in import duties, the withdrawal of an important source of products, an aggressive and cheaper competitor, and severe downturn in the economy.[19] In the US, Cross saw '[f]ailure as a result of "franchising-related" factors as falling into five key categories: business fraud, intra-system competition, involving franchise outlets being located too close,

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15 James Thomson, *Kleins Collapse Turns Nasty* (30 November 2012) Smart Company <http://www.smartcompany.com.au/growth/economy/973-kleins-collapse-turns-nasty.html>; see also Birkett Long Solicitors, *What Happens if a Franchisor Fails?* (28 September 2009) <http://www.birkettlong.co.uk/site/library/legalnews/what_happens_if_a_franchisor_fails.html>.

16 *Master Education Services Pty Limited v Ketchell* (2008) 236 CLR 101; *Ketchell v Master of Education Services Pty Ltd* (2007) 226 FLR 169.

17 Buchan, *Franchisees as Consumers*, above n 2, 16.

18 Externalities have been described as 'items missing a price tag': Ian Fletcher, 'The Theory That's Killing America's Economy — And Why It's Wrong', *Huffington Post* (online), 4 July 2011 <http://www.huffingtonpost.com/ian-fletcher/the-theory-thats-killing-_b_846452.html>.

19 Franchising Task Force, *Franchising Task Force Final Report: Report to the Minister for Small Business and Customs The Hon David Beddall MP* (The Task Force, 1991).

insufficient support of franchisees, poor franchisee screening, [and] persistent franchisor-franchisee conflict'.[20] These are in addition to the traditional causes for small and medium-sized-enterprise ('SME') failure identified by Cross as being 'generic' causes which should be ameliorated by franchising: undercapitalization, absence of economies of scale, lack of business acumen and inability to survive intense competition in sectors where barriers to entry are low.[21]

The complexity of today's franchise environment suggests that additional threats to the security of franchisees' interests are emerging. Particularly problematic are: the failure of the franchisor's parent company, franchisor ownership by venture capitalists, the absence of governance duties being owed by franchisors to franchisees,[22] the awkward accommodation of franchisees under Australia's insolvency law, and strategic insolvency. For Traveland, for example, failure of its parent company Ansett in 2001 was the beginning of the end. At the time it was concluded that 'Air New Zealand['s] … decision to buy Ansett … destroyed both'.[23] For today's financially troubled business, insolvency may be part of a considered business strategy. Craig Tractenberg identifies that '[f]ranchisors file for bankruptcy to escape or postpone the consequences of mass franchisee litigation, shareholder litigation, and lender enforcement activities'.[24] Other franchisor advisers concur with Tractenberg, acknowledging that voluntary administration can enable a franchisor

> to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure. [It] may assist a franchisor in addressing … overexpansion in the market and the need to eliminate units, an unworkable equity structure, desire to sell or merge with another entity, threat of franchisee litigation, [or a] desire to refinance [being hampered because] the lender has expressed concern about financial or other issues.[25]

A franchisor's strategic insolvency[26] suggests a lack of fairness and good faith towards franchisees. It is an example of "capricious termination" that was identified

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20 John Stanworth, David Purdy and Stuart Price, 'Franchise Growth and Failure in the USA and the UK: A Troubled Dreamworld Revisited' (1997) 2(2) *Franchising Research: An International Journal* 75, 78–9.

21 James Cross, 'Franchising Failures: Definitional and Measurement Issues' (Paper presented at the International Society of Franchising Conference, Las Vegas, Nevada, 13–14 February 1994) 2–4.

22 Buchan, *Franchisees as Consumers*, above n 2, chs 7–8.

23 Stathi Paxinos, 'Ansett from A to T', *The Sunday Age* (Sydney), 17 February 2002, 9.

24 Craig R Tractenberg, 'What the Franchise Lawyer Needs to Know About Bankruptcy' (2000–01) 3(20) *Franchise Law Journal* 3.

25 Sarah B Foster and Carolyn Johnsen, 'The War of the Worlds: Bankruptcy Versus …' (Paper presented at the American Bar Association, 28th Annual Forum on Franchising, Florida, 19–21 October 2005).

26 David Noakes, 'Measuring the Impact of Strategic Insolvency on Employees' (2003) 11(12) *Insolvency Law Journal* 91, 92, quoting Peta Spender, 'Scenes from a Wharf: Containing the Morality of the Corporate Law' (Paper presented at the 9th Annual Corporate Law Teachers Association Conference, Monash University, February 1999) 21–9.

by Harold F Brown in 1973 as [the] Achilles heel of the entire franchising industry'.[27] The disconnect between consumer protection of franchisees under the *Competition and Consumer Act 2010* (Cth) ('*CCA*') and the insolvency regime under the *Corporations Act 2001* (Cth) ('*CA*') is demonstrated in Figure 1 and will be explored later in this article.

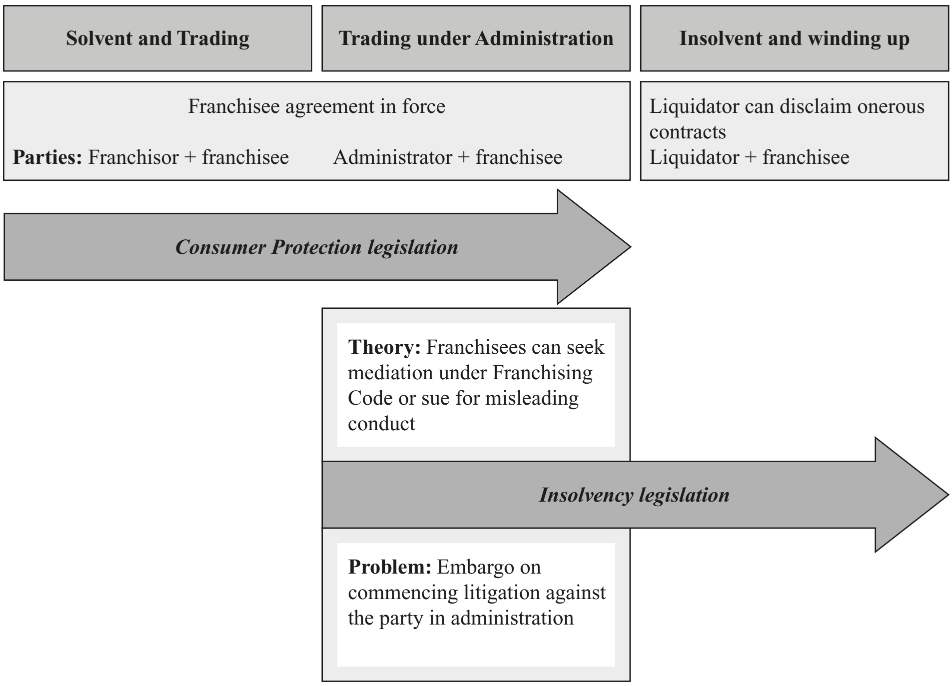

Figure 1: Insolvency legislation trumps contract, and consumer protection legislation[28]

Australian franchise law still addresses the late 20th century franchise environment, but the reality of the franchising business model has progressed. As will be demonstrated by the A & R scenario, there are many stakeholders including public company and venture capitalist franchisor owners — and their shareholders and suppliers — whose conduct and legal rights may impact on the solvency of the franchise network and ultimately on the franchisee. Most are not factored into the *Trade Practices (Industry Codes — Franchising) Regulations 1998* ('*Code*'). This is acknowledged in the following comment:

27 Harold Brown, *Franchising: Realities and Remedies* (Law Journal Press, 1973) 40, cited in Hunt, above n 8, 77, cited in Buchan, *Franchisees as Consumers*, above n 2, 123.

28 Adapted from Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer, 2013) 151.

> we've been talking about two parties in a relationship, the franchisor and franchisee, but we have really been talking about that in something of a vacuum. The reality for many of these operators is that there is a third player in the game — the Westfield or someone else — who has a relationship with one of those two, probably the franchisor. … there is a risk-passing exercise which starts with the shopping centre owner, who then imposes a whole lot of costs on to the lessee of the premises, … the franchisor. They then shove that down the line to the next person [the franchisee].[29]

As well as risk-passing, financial problems such as cash flow or refinancing difficulties can be hidden elsewhere in the network of the corporate group, where they may incubate until they destroy the franchisor. In light of the above, an argument that the franchisees cause the failure of their franchisors is not sustainable. Accepting that franchisors can and do fail, it is useful to set out the recognised general and franchisor-specific indicators of insolvency.

III Generic and Franchisor-Specific Indicators of A Company's Insolvency

The cash flow test of solvency is adopted in the *CA* at s 95A. Under the cash flow test a debtor is insolvent when it cannot discharge all its debts when they fall due. Whether a debt has become due is not always determined by the time fixed in the contract; the date may depend also on industry practice.[30] The notion of 'become due' is a legal one and a debt is not rendered 'not due' just because the creditor has, to date, forborne from pursuing recovery.[31] Before pursuing the A & R example, let us look at the indicators of both generic and franchisor-specific failure.

Australian courts have developed a generic checklist of indicators of corporate[32] insolvency. In *ASIC v Plymin*,[33] a 'checklist of insolvency indicators was put in evidence'.[34] Justice Mandie used this checklist to determine whether the directors had breached the insolvent trading provisions of the *CA*.[35] The general indicators were: (1) continuing losses; (2) the liquidity ratio of the company being below 1; (3) overdue Commonwealth and State taxes; (4) poor relationship with banks, including inability to borrow further funds; (5) the company does not have access

29 Economic and Finance Committee, above n 1, 80.

30 *Re New World Alliance Pty Ltd (rec & mgr apptd); Sycotex Pty Ltd v Baseler [No 2]* (1994) 51 FCR 425, 434 (Gummow J).

31 *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187, 198–9.

32 In Australia 70 per cent of 'franchisor' entities are proprietary corporations, 14 per cent are public corporations and 10 per cent are trusts. Lorelle Frazer, Scott Weaven, Owen Wright, *Franchising Australia 2006* (Griffith University, 2006) 34.

33 (2003) 175 FLR 124.

34 Michael Murray and Jason Harris, *Keay's Insolvency Personal and Corporate Law and Practice* (Lawbook, 7th ed, 2011) 475.

35 *Corporations Act 2001* (Cth) s 588G.

to alternative finance; (6) inability on the part of the company to raise further equity capital; (7) suppliers insisting on Cash on Delivery terms, or otherwise demanding special payments before resuming supply; (8) creditors being paid outside trading terms; (9) issuing of post-dated cheques; (10) the company has dishonoured some of the cheques paid to creditors; (11) special compromise arrangements made by the company with selected creditors; (12) solicitors' letters (of demands), summons(es), judgments or warrants issued against the company; (13) payments on the part of the company to creditors of rounded sums not reconcilable to specific invoices; and (14) inability to produce timely and accurate financial accounts to display the company's trading performance and financial position, and to make reliable forecasts.[36]

While there is currently insufficient empirical data on the financial and risk profiles of failed (and successful) franchisors to provide a definitive list of indicators specific to franchising, 12 possible indicators of a franchisor's impending failure have been identified: (1) a large proportion of outlets being owned by the franchisor instead of franchisees, indicative of the return of failed franchisees to franchisor;[37] (2) a long history of failures on the part of franchisees in the franchise network;[38] (3) a breach of a franchisor's obligations to provide advertising support, equipment and inventory;[39] (4) evasiveness following franchisor default;[40] (5) a landlord's notice of demand;[41] (6) a large number of court proceedings against the franchisor;[42] (7) restructuring on the part of the franchisor, especially invoices from different

36 (2003) 175 FLR 124, 213–14.

37 Although Taylor and Hughes note that 'sometimes this is not apparent, as stores can be held by directors outside of the franchise structure': Fiona Taylor and Richard Hughes, *Five Lessons for Franchisees from the Kleenmaid Case* (6 October 2011) Griffith University <http://www.franchise.edu.au/articles/five-lessons-for-franchisees-from-the-kleenmaid-case.html? &utm_content=3846129>.

38 Ray Borradale, *Why Some Franchisors Fail* (19 January 2009) Blue Maumau <www.bluemaumau.org/why_some_franchisors_fail>.

39 Craig R Colraine, *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; Borradale, above n 38.

40 Emily Maltby, 'Dragged into a Bankruptcy That Isn't Yours', *CNN Money* (online), 17July2009<http://money.cnn.com/2009/07/17/smallbusiness/franchise_bankruptcy.smb>.

41 This may come direct to the franchisor as head tenant, and may not be passed on to the franchisee sub-tenant that is not in breach as it has paid rent to the franchisor.

42 'Warning Signs of Failure', *The Australian Financial Review* (Sydney), 2 May 2006, 50. The significance of litigation as an early indicator of failure was identified in a Dun & Bradstreet Corporate Health Watch survey. It was concluded from the survey results that '[c]ompanies that have had legal action taken against them are nearly eight times more likely to fail than those that haven't'. Further, specific research would reveal whether the threat of franchisee litigation caused the franchisor to consider pre-emptive or strategic bankruptcy or whether the litigation caused the subsequent failure of the franchisor.

companies;[43] (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;[44] (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;[45] (10) information from credit reporting services about a franchisor company's financial health;[46] (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 Colraine 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 assets and re-financings'. Colraine concedes that '[i]dentifying financial problems in non-publicly traded corporations[47] is more difficult'.[48] It can readily be deduced from the lists of general and franchise-specific indicators that many of the 26 are not apparent to franchisees.

Four factors differentiate franchisors from the corporations and corporate groups traditionally regulated under the *CA*. First, franchisors are able to raise additional equity capital through selling more franchises, and are thus able to hide their impending insolvency from franchisees for longer than they could hide it from a traditional finance source or from a supplier. Second, Abe de Jong, Tao Jiang and Patrick Wirwijmeren have found:

> the maximum debt [to equity] ratio allowed [for franchisees in a system] depends on the size of the outlets, on the age of the franchise firm, on arrangements between the franchisor and the franchisee (such as cooperative advertising), and on the type of industry [and] that as the franchisor sets a higher requirement for the franchisee's equity component than expected, the franchisor is [itself] able to raise more debt. … the strategic use of the franchisee's capital structure affects the franchisor's decision of financing.[49]

Third, there is an absence of direct scrutiny and accountability between franchisees and their franchisor because their respective governance structures are independent

43 Taylor and Hughes, above n 37.

44 Buchan, *Franchisor Failure*, above n 7, 48.

45 Colraine, above n 39, 3.

46 For example, the Credit Reference Association of Australia, or Dunn and Bradstreet Inc. These sources should also be used with awareness that some of the information recorded will have been supplied by the franchisor itself.

47 Best estimates indicate that in 2012 there were 40 franchisors owned by or trading as public companies in Australia with the remaining 1140 being proprietary companies, trusts, partnerships and sole traders, or combinations of these.

48 Colraine, above n 39, 3.

49 Abe de Jong, Tao Jiang and Patrick Virwijmeren, 'Strategic Debt in Vertical Relations: Evidence from Franchising' (2011) 87(3) *Journal of Retailing* 381–92.

of each other. Finally, franchisors owe no statutory duty of care and no fiduciary duty to their franchisees. Theirs is purely a contractual relationship. As a consequence of these differentiating factors, whilst any of the general indicators may be relevant in the case of a franchisor, they may not be apparent to its franchisees. For example, general indicator (10) was present in REDgroup, the ultimate owner of A & R, which ‘delayed payments to its suppliers and landlords by up to 30 days’.[50] Figure 3 identifies that in August 2010 REDgroup also breached financial covenants (concerning interest cover ratio and gearing ratio) and received a waiver from its lenders.[51] A & R franchisees could not have learned of these breaches. Any of the 12 franchisor-specific indicators may have a benign explanation so should be treated cautiously.

The scarcity of highly reliable indicators available to franchisees is in direct contrast to the plethora of indicators of a franchisee’s impending insolvency that are available to a franchisor. The franchisor provides for itself a contractual right to receive numerous periodic payments from franchisees on time, to access franchisees’ figures and to conduct audits on all aspects of the franchisee’s business.

We will now turn to the demise of A & R.

IV Angus & Robertson

The failure of franchisor A & R serves to illustrate the experience of franchisees whose failed franchisor becomes embedded in a complex corporate group. A & R’s franchisees were attracted to the honey pot and became firmly ensnared in the bear trap. A & R knew the business of buying and selling books.[52] The company traded successfully as an Australian buyer and seller of books for 91 years before starting franchising, and over 100 years before its first merger in 1990. This longevity does not distinguish A & R from other failed franchisors.[53] As is demonstrated in Figure 3, A & R had several owners before 2004 when it was sold to a venture capitalist called Pacific Equity Partners (‘PEP’). The business structure within which franchising is conducted is often complex.[54] Through its involvement with PEP, for example,

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50 Ferrier Hodgson, ‘REDgroup Retail Pty Limited and Associated Companies (Administrators Appointed) Report by Administrators Pursuant to Section 439A(4)(a) of the *Corporations Act 2001* (Cth)’ (Administrators’ Report, 25 July 2011) 9.

51 Ibid.

52 Anne Wright, ‘Hundreds Sacked at Angus & Robertson’, *Herald Sun* (online), 16 June 2011 <http://www.news.com.au/business/hundreds-sacked-at-angus-and-robertson/story-e6frfm1i-1226076157825>.

53 For example, Darrell Lea was placed in administration after trading for 85 years, Speeds Shoes after 94 years, Traveland after 43 years and Kleins Jewellery after 26 years.

54 Similarly, failed franchisors Kleenmaid comprised two groups of companies with the franchisor entity nested on the periphery, and Traveland was one of over 40 entities under the Ansett umbrella.

Angus & Robertson Pty Ltd became one of a group of 22 companies and trusts, including two franchisors and one master franchisee, operating in three countries as shown in Figure 2.

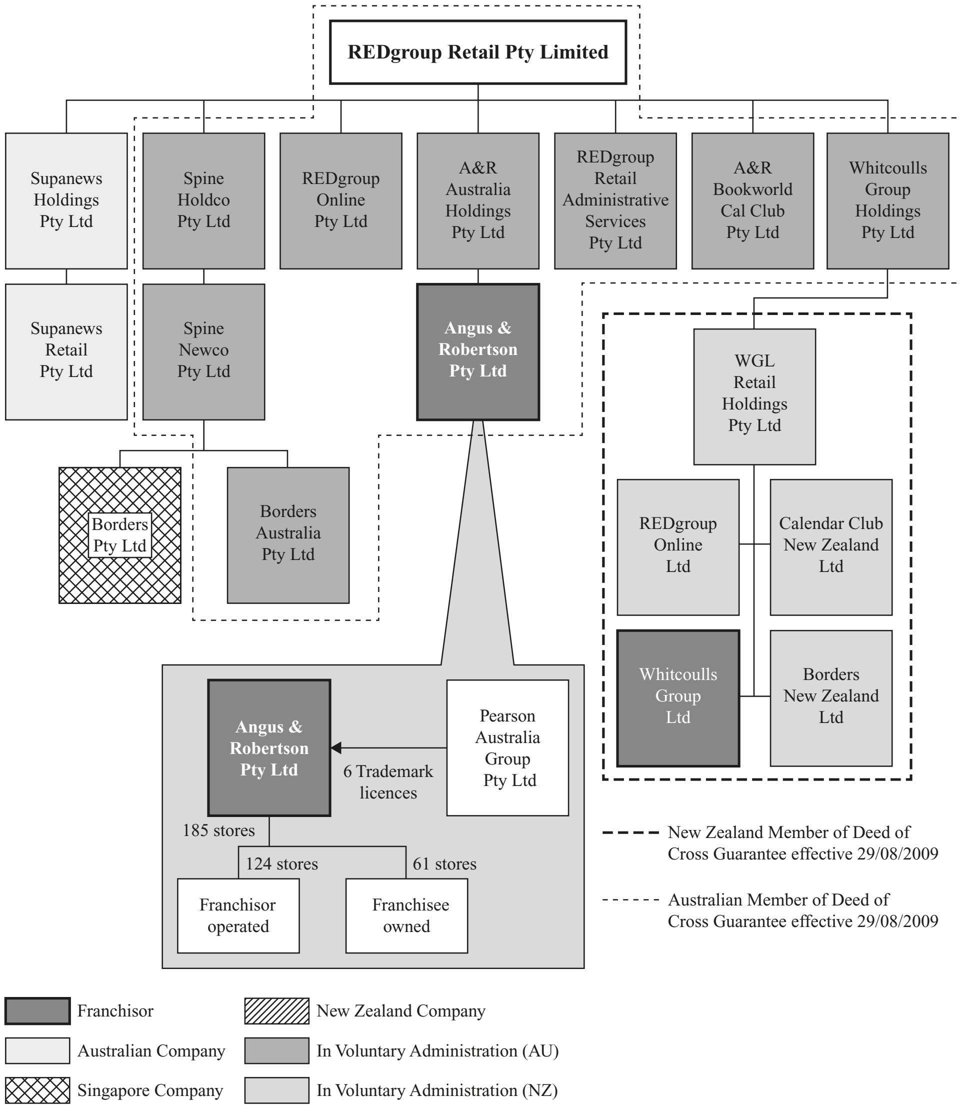

Figure 2: REDgroup organisation chart[55]

Franchisees paid up to $380 000 to establish an A & R store. This sum becomes 'sunk' costs. Franchisees also signed franchise agreements and premises leases.

55 Adapted from Ferrier Hodgson, above n 50, app C (Group Structure), published in Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer, 2013) 122.

A & R franchise agreements provide a five-year term with a five-year renewal. Mr and Mrs Appleby purchased two A & R franchised bookstores in Queensland in November 2010. Stock is the franchisee's second major cash investment and costs $900–1000 per square metre.[56] The Applebys' timing meant they were able to start strongly as

> [t]he book industry … relies heavily on the Christmas trade. [A] large percentage of our sales, and our positive cash flow comes from the Christmas season. Franchisees must be prepared for the increase in stock required to meet Christmas demand.[57]

This example demonstrates how

> [t]he risks associated with entering the franchise arrangement from the franchisee's point of view are predominantly financial. The initial step of setting up a franchise requires substantial up-front investment that usually covers the franchise fee, equipment costs, set-up fees and other expenses.[58]

Moving now to the A & R insolvency: on 17 February 2011, within three months of buying their stores, and only two hours after completing their franchisee induction at REDgroup Retail network's head office in Melbourne, the Applebys received a call from their bank manager that their franchisor had appointed an administrator.[59] As new franchisees, the Applebys 'had done a tour of the office [the same day the administrator was appointed], [the REDgroup] had welcomed us, the CEO had been in to talk to us the day before. Mrs Appleby said "call me naive, but I can't believe that any of the staff in that building on that day knew"'.[60] Their experience highlights an important aspect of insolvency: it brews slowly and then happens fast. The franchisees can be the 'last to find out about a franchisor's financial problems'.[61]

A *Why did A & R Fail?*

Figure 3 shows the stages of growth and ultimate decline of A & R.

During 2010 it became clear to those in the sector that the environment for retailing books was becoming difficult. The well-known US-based book retail franchisor, Borders, filed for Ch 11 bankruptcy protection in the US in February 2011. Within

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56 A & R, *Terms of Agreement and Financial Commitment* <http://www.angusrobertson.com.au/franchise-terms-of-agreement>.

57 A & R, *Being a Franchise Owner* <http://www.angusrobertson.com.au/franchise-partners>.

58 Economic and Finance Committee, above n 1, 15.

59 'Light at End of the Tunnel: Good Staff and Family Support See Stores Write Another Chapter', *Sunshine Coast Daily* (Maroochydore), 13 September 2011, 20.

60 Ibid.

61 Frank Zumbo, Submission to Parliament of South Australia, House of Assembly, Economic and Finance Committee, *Inquiry Into Franchises*, February 2007, 9.

24 hours, 'REDgroup Retail [(the Australian master franchisee of Borders)] was placed in administration … owing an estimated $AUD170 million'.[62]

REDgroup had taken out a loan from PEP Fund IV, LP for $138 million to complete the acquisition of Borders. 'The debt due to PEP was cross-collateralized across the group. REDgroup's secured creditors, … PEP lodged a Proof of Debt in the Administration of each company for $118 547 419'.[63] This enabled PEP as a secured creditor to appoint voluntary administrators. It should be noted that 'some franchisees would have entered the A & R system before PEP became the owner or before PEP created the REDgroup. Those that knew of the involvement of PEP might have been reassured to read that PEP described'[64] itself as 'a leading Australasian private equity firm focusing on buyouts and late stage expansion capital in Australia and New Zealand' that assists businesses move closer to their 'full potential'.[65] There were eight PEP entities.[66] Even if it had been aware of PEP's involvement it is beyond the resources of individual prospective franchisees to conduct due diligence on a set of complex entities. Additionally, the administrator's conclusion that there was no evidence of the REDgroup having traded whilst insolvent suggests that even the most diligent A & R franchisee would have found nothing to cause alarm.

REDgroup's directors attributed the failure to external events: consumer spending patterns, the GST and parallel importation laws giving online sellers an unfair benefit, and the strong Australian dollar 'which had appreciated against the US dollar and the pound sterling by 20% since September 2009'[67] and given Australians strong overseas buying power. The administrators added internal factors that contributed to the failure of the REDgroup and its franchise subsidiaries. These were

> more emphasis on 'buying' than 'selecting' stock resulting in overstocking with aged, poor stock; failure to recognize and promptly address loss making stores; under-utilisation of space in stores and poor organisation with no logical grouping

62 Jenny Buchan, 'The Failure of Pre-Purchase Disclosure to Protect Franchisees of a Franchisor in Administration' in Thomas Ehrmann et al (eds), *Network Governance: Alliances, Cooperatives and Franchise Chains* (Springer-Verlag, 2013) 313, 317.

63 Ferrier Hodgson, above n 50, 7.

64 Buchan, 'The Failure of Pre-Purchase Disclosure', above n 62, 325.

65 Pacific Equity Partners, *About Us* <https://investor.pep.com.au/pages/content.asp?pid=1>; cf Pacific Equity Partners, *About Us* < http://www.pep.com.au/about-us/>.

66 Pacific Equity Partners Fund 1 Pty Limited ACN 083 026 822, Pacific Equity Partners Pty Limited ACN 082 283 949, Pacific Equity Partners Fund III (Australasia) Pty Limited ACN 117 565 410, Pacific Equity Partners Fund II (Australasia) Pty Limited ACN106 318 370, Pacific Equity Partners Fund 111 GP (Jersey) Limited 126745686, Pacific Equity Partners Fund III SPV Pty Limited ACN 119 059 040, Pacific Equity Partners Fund IV (Australasia) Pty Limited ACN 124 839 989 and Pacific Equity Partners Fund IV LP 150258165.

67 Ferrier Hodgson, above n 50, 13–14.

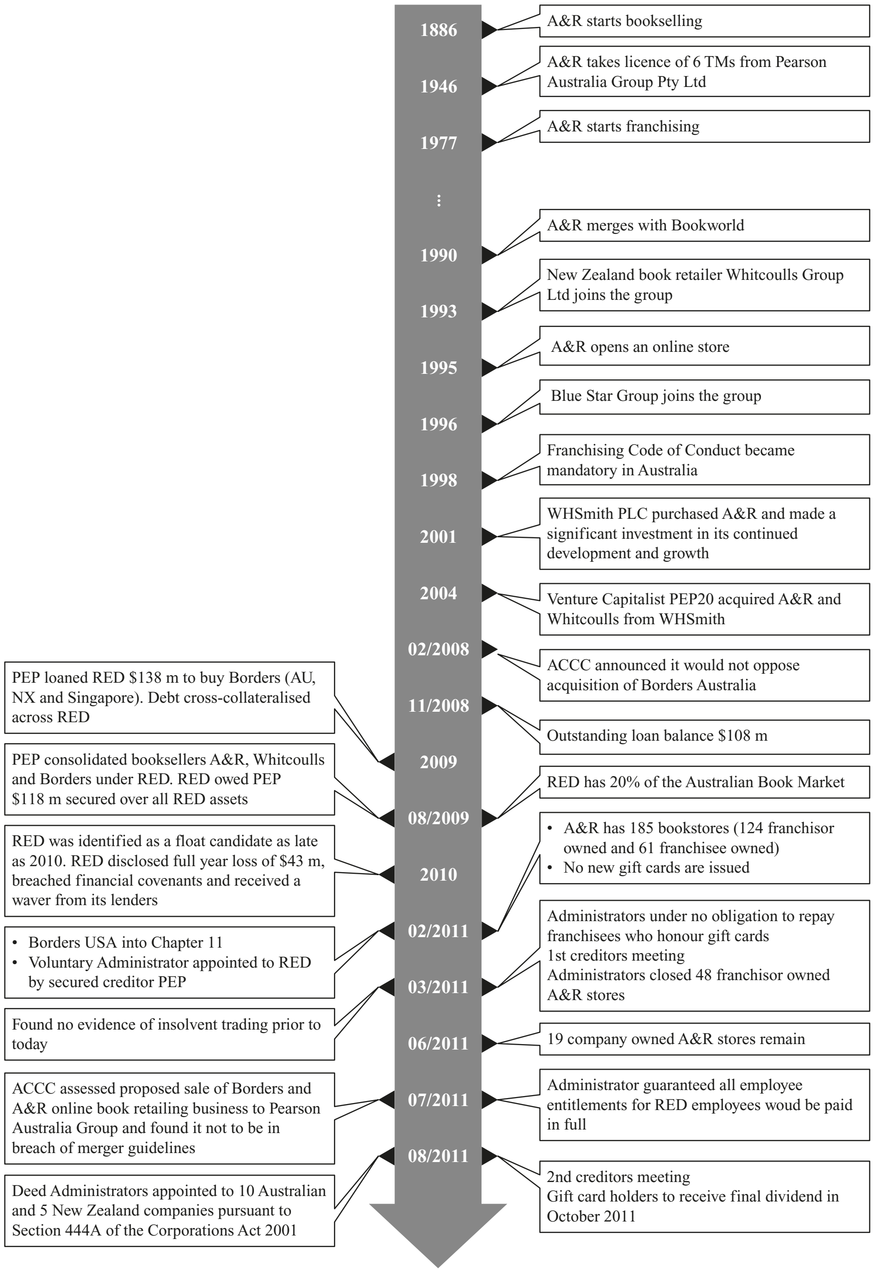

Figure 3: Rise and fall of Angus and Robertson[68]

68 From Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer, 2013) 126. The references in the timeline in Figure 3 are from the following sources: references dated 1886, 1977, 1990, 1993, 1995, 1996, 2001, 2004: A & R, *About* <http://www.angusrobertson.com.au/company-information>; 1946: see trade mark registrations numbered 299489 (Class 16), 343650 (Class 16), 637633 (Class 42), 861016 (Class 16, 35, 41), 1025323 (Class 16, 35, 41) and 1073382

> and general lack of consistent business processes with little use and reference to signed off critical paths and event management cycles.[69]

As already mentioned, insolvency may be a strategic business decision. A New Zealand journalist, commenting on the impact of REDgroup's failure on the Whitcoulls franchise, suggested that PEP, upon realising that the planned exit strategy of floating had become unviable, saw voluntary administration:

> as a cost-effective way … to exit its ill-fated foray into book retailing. They … used the law to the maximum possible extent to extract everything they could out of it. … Effectively this was a staged exit. … REDgroup's total secured debt was $A118 million ($NZ147 million), most of it owed to [secured creditor] Pacific Equity Partners.[70]

Voluntary administration meant REDgroup could walk away from the franchisees without having to buy businesses back or risk being sued. The likelihood that this voluntary administration was a strategic move is given weight by the REDgroup administrators' conclusion that there was no evidence of trading while insolvent. The

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(Class 16, 35, 41); 02/2008: Australian Competition & Consumer Commission, 'A&R Whitcoulls Group Holdings Pty Ltd (ARW) — Proposed Acquisition of Borders Australia Pty Limited' (Public Competition Assessment, 27 February 2008) 1; 11/2008, 2009: adapted from Ferrier Hodgson, above n 49, 6; 08/2009: Ferrier Hodgson, above n 49, 7; 08/2009: Chris Zappone, 'Borders, A&R Call Time on Book Vouchers', *The Sydney Morning Herald* (Sydney), 23 March 2011; 2010: Ferrier Hodgson, above n 49, 9; 02/2010: Patrick Stafford, 'Borders Australia and Angus & Robertson Chains Collapse', *Smartcompany* (online), 17 February 2011 <http://www.smartcompany.com.au/growth/economy/18695-20110217-borders-australia-and-angus-robertson-chains-collapse.html>; 02/2011: Ferrier Hodgson, 'A&R Has 185 Bookstores', 'No New Gift Cards Are Issued', *Frequently Asked Questions: Franchisees* (17 February 2001); 03/2011: Ferrier Hodgson, 'Second Meeting of REDgroup Creditors' (Press Release, 27 July 2011); 03/2011: Ferrier Hodgson, 'Administrators Under No Obligation to Repay', '1st creditors meeting', 'Administrators Closed 48 Franchisor Operated A&R Stores', *Frequently Asked Questions: Franchisees* (17 February 2001); Chris Zappone, 'Booksellers' Woes Worsen as Franchisees Seek to Defect', *The Sydney Morning Herald* (Sydney), 5 April 2011; 06/2011: Chris Zappone, 'Pearson Buys Borders, A&R Websites', *The Sydney Morning Herald* (Sydney), 5 July 2011; 07/2011: ACCC, *Mergers Register: Pearson Australia Group Pty Ltd — Completed Acquisition of Certain Assets of REDGroup Retail Pty Ltd (Administrators Appointed)* (August 2011) <http://www.accc.gov.au/content/index.phtml/itemId/1002218/fromItemId/751043>; 07/2011: Ferrier Hodgson, above n 49, 19; 08/2011: see DOCA dated 4 August 2011 between REDgroup Retail Pty Limited (Administrators Appointed) and the companies listed in Part A of Schedule 3 and Steven John Sherman, John Melluish and John Lindholm of Ferrier Hodgson; 08/2011: Ferrier Hodgson, 'Angus & Robertson Pty Limited and Borders Australia Pty Limited (Subject to Deed of Company Arrangement) ('the Companies'), Gift Cards', *Frequently Asked Questions 2*; Ferrier Hodgson, above n 49, 29.

69 Ibid.

70 Jamie Gray, 'REDgroup Creditors Set To Vote On Slim Payout', *The New Zealand Herald* (Auckland), 4 August 2011.

administration was voluntary, triggered by a secured creditor PEP that owned the majority of shares in the REDgroup. The consequential A & R administration can arguably be categorised as part of a considered business strategy. Voluntary administration provided an opportunity for the venture capitalist PEP to exit its investment at relatively low cost. This failure could not be attributed to the franchisees' conduct. Faced with a failing franchisor, what can franchisees do to protect their businesses?

V What Happens When a Franchisor Fails?

On failure of the franchisor, the group arrangements where economies of scale can be achieved cease. The cost of doing business will accordingly increase for franchisees that become standalone operators. The services previously provided by franchisors will have to be taken in-house.[71] In some cases relationships will have to be forged with new suppliers who may be reluctant to supply to an unproven operator. What role does the law play?

A *Contracts*

The franchise agreement is the primary regulatory source of the franchise relationship.[72] The franchisees also assume, wrongly, that there will be statutory protection through the *Code* and the *CA*. Each source of regulation is now examined.

A franchisor is 'connected' to its franchisees by contracts, including a franchise agreement. The party (franchisor) drafting a standard form commercial contract acts in its own interests. The franchisee of a single unit is offered the opportunity to buy into the franchise on a 'take it or leave it' basis. A franchisor's contractual duties are typically expressed as discretions and the franchisees' duties are expressed as obligations with clear consequences for breach. The franchise agreement is only one of many contracts franchisees enter into in order to operate their business. The absence of balance in the initial contract is symptomatic of deep asymmetry that permeates franchise relationships.[73] Franchisees also sign leases, sub-leases or premises licenses, supplier agreements, licences granting them the right to use intellectual property and employment contracts with their own staff. These consequential contracts where, again, the franchisee is typically not the party drafting the contract, seldom if ever identify franchisor failure as a trigger that would enable the franchisees to terminate without penalty. Franchisees must continue to perform all contracts even if the lynch pin, the franchisor, has failed and is unable to support them. For example, as illustrated by this comment by a former franchisee:

71 Birkett Long Solicitors, above n 15.

72 Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010) 76–115.

73 Jenny Buchan 'Ex Ante Information and Ex Post Reality for Franchisees: The Case of Franchisor Failure' (2008) 36(6) *Australian Business Law Review*, 407–31 explores contract, process, information, regulatory and risk asymmetry in franchising.

> [w]e had just signed renewals of our franchise agreements with Traveland (this franchisee had multiple agencies) for another 5 years when Ansett became insolvent. … There was no way we could get out of our franchise agreements or premises leases.[74]

Contracts, including the franchise agreement, are not terminated by the appointment of an administrator. Their position under leases is very important for affected franchisees. There are numerous models through which a franchisor secures retail premises and then provides tenure to franchisees. These include the franchisor owning the premises or taking the head lease; the franchisee taking the head lease, a sub-lease or a licence; or the franchisee owning the premises.[75] In some situations the franchisee guarantees the performance of the franchisor under the head lease.[76] Leases 'present [an] area of recurring uncertainty'[77] to administrators, to whom

> [s]ection 443B(2) of the CA[78] [provides] a grace period of five business days before [the administrator] incurs personal liability for rent under pre-appointment leases. During [that time] the administrator can give the lessor a notice that the company does not propose to exercise rights in respect of the property (s 443B(3) CA).[79]

A notice served on a landlord under s 443B(3) 'does not terminate the lease'.[80] A further complication for franchisees is that where the franchisee sub-tenant has guaranteed the performance of its franchisor under a head lease, and the franchisor has not paid the landlord, the franchisor's default makes the franchisee guarantor liable. This can mean the franchisee pays the same rent twice: once to the franchisor, and again as guarantor. Regardless of how the administrator treats the lease, payments due by the franchisee to the franchisor continue to be payable, as do payments by the franchisee to third parties. If the franchisor is wound up, the liquidator has the power to disclaim[81] a lease as an onerous contract. This leaves the franchisee without tenure.

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74 Jenny Buchan and Lorelle Frazer, 'The Domino Effect: How Ansett Airlines' Failure Impacted on Traveland Franchisees', (Paper presented at the Academy of World Marketing Management and Development Conference, Paris, 10–13 July 2006) 1907.

75 See 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, 170 for a discussion of the combinations and some consequences.

76 See, eg, *Neldue Pty Ltd v Moran* [2004] WASC 100 (8 April 2004); *Miller v Loyal [No 6]* (2001) 187 ALR 766.

77 Orla M McCoy, 'Administrators and Leases: Obligations and Options' (2012) 24(2) *Australian Insolvency Journal* 24.

78 *CA* div 9: Administrator's liability and indemnity for debts of administration.

79 McCoy, above n 77, 25.

80 *Silvia v Fea Carbon Pty Ltd (admin apptd) (recs and mgrs apptd)* (2010) 185 FCR 301.

81 *CA* s 568; see *Willmott Growers Group Inc v Willmott Forests Ltd* (in liq) (recs and mgrs apptd) [2013] HCA 51 (4 December 2013.

Franchisees may also be affected by retention of title arrangements. Often franchisees believe they have title to stock on site, and have included it in calculations of assets available as security to their financiers. However, franchise agreements may stipulate that stock is not transferred to the franchisee until it is paid for.

B *The* Code

In singling out franchisees for protection from exploitation by franchisors policy makers have recognised that unlike suppliers that are able to negotiate their terms of trade, or employees who have extensive statutory protections, or consumers who can return a faulty product, franchises are uniquely vulnerable.[82] Having signed a franchise agreement, a franchisee submits to its franchisor's significant power and discretion. The *Code* purports to protect franchisees in key risk areas, both ex ante and ex post signing a franchise agreement.

Compliance with the *Code* requires a franchisor to attempt to resolve disputes via mediation, and to provide a prospective franchisee with pre-contract disclosure. Requests by franchisees for mediation during the administration are not well received by administrators.[83] The *Code* enables a franchisor to instantly terminate the franchise agreement if a franchisee becomes bankrupt, insolvent under administration or an externally administered body corporate,[84] but the converse does not apply. This lopsided statutory right entrenches the asymmetrical nature of the relationship. Only rarely is a counterbalancing *ipso facto* clause found in a franchise agreement to provide the franchisee with the right to terminate if its franchisor exhibits signs of financial ill health.[85]

The *Code*-prescribed disclosure is current information, predominantly addressing the financial and legal fitness of the entity identified as 'the franchisor'. It is difficult for a franchisee to objectively verify at a reasonable cost much of the information disclosed by the franchisor, so franchisees rely heavily on the information supplied in the disclosure document. To return to A & R, its disclosure would have provided franchisees with a plethora of information under 23 major headings. Since 2010 the front cover of the disclosure made by franchisors warns:

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82 See above nn 39–66; Buchan, *Franchisees as Consumers*, above n 2; Jenny Buchan, 'Square Pegs in Round Holes: Franchisees of Insolvent Franchisors' (2008) 2(9) *Business Law International* 114, 121–2.

83 Their reasons and the opposing arguments are outlined in Buchan, *Franchisor Failure*, above n 7, 207–8.

84 A franchisor does not have to comply with cl 21 or 22 [ie provide notice of intention to terminate] if the franchisee: … (b) becomes bankrupt, insolvent under administration or an externally administered body corporate': *Code* cl 23 (Termination — special circumstances).

85 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, 170. From a sample of 70 franchise agreements on USA database Free Franchise Docs <http://www.freefranchisedocs.com/index.html> as at 5 June 2008, 76 per cent permitted the franchisor to terminate the franchise agreement, usually with no notice and no right to cure, if the franchisee became bankrupt.

> Entering into a franchise agreement is a serious undertaking. Franchising is a business and, like any business, the franchise (or franchisor) could fail during the franchise term. This could have consequences for the franchisee.[86]

This is unlikely to promote caution in franchisees buying into a long-established franchisor. The specific disclosure items with the potential to reveal information about the franchisor, its plans and its attitude to risk are Items 2 (franchisor's details), 3 (franchisors' business experience), 4 (litigation), 7 (intellectual property) and 18 (obligation to sign related agreements).

'Franchisor' and 'Associate' are defined terms under Item 2. The Appleby's franchisor was A & R. Under the heading of associate the franchisor must disclose a person

> (a) who:
>
> (i) is a director or related body corporate, or a director of a related body corporate, of the franchisor; or
>
> (ii) for a franchisor that is a proprietary company — directly or indirectly owns, controls, or holds with power to vote, at least 15% of the issued voting shares in the franchisor; or
>
> (iii) is a partner of the franchisor; and
>
> (b) whose relationship with the franchisor is relevant to the franchise system, including supplying goods, real property or services to a franchisee.[87]

Without access to the A & R disclosure document it is not clear whether the existence of controlling shareholder PEP would have been disclosed. PEP would not have been supplying goods, real property or services to the franchisees. It can be seen from Red Group's organisational chart (Figure 2) that PEP was probably too distant to be disclosed. It had a role superficially unrelated to supporting the franchisees. The franchisees could have had no knowledge of the $AUD138 million debt, or the manner in which it was secured. If all franchise agreements were included in this security then this diminishes their value as security for loans taken out by franchisees to purchase their businesses. Even if they had known of the debt to PEP, franchisees would not have the ability or the resources to evaluate its significance. Any disclosure provided before 2009 would have preceded the existence of the REDgroup. Due diligence is further discussed under the heading 'Franchisees' Ex ante and Ex post Responses to Franchisor Insolvency'.

Item 3 requires the franchisor to outline its business experience. As previously noted, A & R was long established. It has already been franchising for 33 years when the Applebys signed franchise agreements. The parent, REDgroup, had the appearance of being a very well organised, well-capitalised, geographically diversified player in the retail bookselling world.

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86 *Code* Annexure 2 item 1.1(e).

87 Ibid cl 3(1).

Item 4 addresses litigation. It would not have revealed any current litigation against the franchisor or its associates. The *Code* directs franchisors and franchisees to attempt to resolve disputes through mediation. As disputes resolved by mediation are confidential, and mediation is not litigation, their existence is not disclosed.[88] A breach of a contract with a third party[89] may be a 'red flag' about impending insolvency, but it does not need to be disclosed unless it is currently being litigated. Item 4 would not give rise to disclosure of a franchisor's debt unless that debt has triggered litigation. For A & R franchisees, therefore, Item 4 would not have drawn attention to REDgroup's breaches of financial covenants, or its receipt of a waiver from its lenders in 2010. These events approached general insolvency indicator (4), but remained hidden from franchisees.

Item 4.1(a)(iii) requires any franchisor contravention of the *CA* to be disclosed. Trading while insolvent is a contravention of the *CA* but A & R was not thought by the administrator to have been trading while insolvent.

Under Item 7 (intellectual property), A & R would have revealed the existence of six registered trademarks[90] protecting the names 'Angus & Robertson' and 'Angus & Robertson where books come to life', all owned by a company called Pearson Australia Group Pty Ltd ('Pearson') and licensed to A & R. The appointment of the administrators to the licensee is likely to have been an event allowing Pearson to terminate the trademark licenses. Pearson ultimately bought the REDgroup's online retailing business from the administrators after gaining mergers approval from the Australian Competition and Consumer Commission ('ACCC').[91]

The '[o]bligation to sign related agreements' identified in Item 18 would direct the franchisees' attention to its premises lease. In some franchise systems the franchisor might also require franchisees to lease fit out or to sign loan agreements and personal guarantees.

Item 2 of the *Code* provides for a pre-purchase statement about the financial details that have been supplied to the franchisee. A director of the franchisor is required

88 For a discussion of mediation and the problems the confidentiality of the process creates see Jenny Buchan, Jennifer Harris and Gehan Gunasekara, 'Franchise Mediation: Confidentiality or Disclosure: A Consumer Protection Conundrum' (Paper presented at the 25th Annual International Society of Franchising Conference, Boston, USA, June 2011).

89 See Patrick Stafford, 'Borders Australia and Angus & Robertson Chains Collapse' (17 February 2011) Smart Company <http://www.smartcompany.com.au/growth/economy/18695-20110217-borders-australia-and-angus-robertson-chains-collapse.html>.

90 Numbered 299489 (Class 16), 343650 (Class 16), 637633 (Class 42), 861016 (Class 16, 35, 41), 1025323 (Class 16, 35, 41) and 1073382 (Class 16, 35, 41).

91 ACCC, *Mergers Register: Pearson Australia Group Pty Ltd — Completed Acquisition of Certain Assets of REDGroup Retail Pty Ltd (Administrators Appointed)* (August 2011) <http://www.accc.gov.au/content/index.phtml/itemId/1002218/fromItemId/751043>.

to sign the statement that in the director's opinion the franchisor is solvent. From franchisors that are not trading strongly this may be of limited value. Usually, only public corporations in Australia must be audited. Even if the auditor has identified a situation that casts doubt on an entity's 'going concern' status, the directors may have been able to satisfy the auditor that there are mitigating circumstances and that 'all will be well'. Such mitigating circumstances, for instance new franchisees committed to investing, may or may not eventuate. Thus, a *Code*-compliant audit may present an inaccurate and ultimately misleading picture of the franchisor's solvency.

The *Code*, with its emphasis on 'the franchisor' remains a response to franchising as it was modeled in the 20th century. Figure 2 demonstrates how nuanced the franchising model has become.

C *Corporations Act*

A transition from consumer protection under contract law and the *Code* to insolvency administration and thence to winding up under the *CA* signal a shift in focus, and in statutory duties. Importantly for franchisee advisers, whilst administrators are bound by the *Code*, and the terms of the franchise agreement,[92] they are regulated by the *CA*. The liquidators' duties and liabilities are found only in the *CA*.[93]

The *CA* provides three possible paths through the insolvency process.[94] The most common corporate insolvency procedure is voluntary administration resulting in a deed of company arrangement ('DOCA') or liquidation. Voluntary administration is an external administration where the directors of a financially troubled company or a secured creditor with a charge over most of the company's assets appoint an external administrator, a 'voluntary administrator'. The voluntary administrator must investigate the company's affairs, and report to creditors, recommending whether the company should enter into a DOCA, go into liquidation or be returned to the directors.

A voluntary administrator is usually appointed by a company's directors after they decide that the company is insolvent or likely to become insolvent. Less commonly, a voluntary administrator may be appointed by a liquidator, provisional liquidator, or a secured creditor. Once the administrator has been appointed, factors that impact on how individual franchisees fare include the financial climate at the time of the failure, the proximity of competitors, the type of product or service the franchisee's business sells, whether the franchisor's business is sold to one buyer or the assets are

92 See *Schering Pty Ltd v Forrest Pharmaceutical Co Pty Ltd* [1982] 1 NSWLR 286, where the court granted an ex parte injunction restraining a proposed breach of a franchise agreement by a franchisor in receivership. See also Steve McAuley, 'Squeezing the Lemon Dry' (2010) 48(3) *Law Society Journal* 61.

93 See Michelle Power, Nick Anson and David Dickens 'Liquidators of Landlords Can Disclaim Tenants' Leasehold Interests' (2012) 50(10) *Law Society Journal* 60, 60–3.

94 See Australian Securities & Investments Commission, *Resources* <http://www.asic.gov.au/asic/asic.nsf/byheadline/Resources>.

sold to several unrelated buyers, and the expertise of the buyer of the franchisor. As one insolvency practitioner remarked:

> [s]ale of the [franchisor's] business may subject the franchisee to the control of a company unfamiliar in the area and incapable of running the business profitably. The dramatic demise of Traveland [franchise subsidiary of Australia's former Ansett Airlines] demonstrates the implications of a buying entity that has little experience in the franchisor's core business area and has insufficient expertise or resources to support the business.[95]

The DOCA is the most common outcome of administration. A DOCA is a binding arrangement between a company and its creditors, governing how the company's affairs will be dealt with. It aims to maximise the chances of the company — or as much as possible of its business — continuing, or to provide a better return for creditors than an immediate winding up of the company, or both.[96]

If an administrator recommends that a business cannot be saved and should be wound up, control of the company passes to the liquidators. Liquidation is the orderly winding up of a company's affairs. The liquidator sells the company's assets, ceases or sells its operations, distributes the proceeds among the creditors and distributes any surplus to the shareholders.

Regardless of the specific path the insolvency follows, s 471B of the *CA* applies to deny any right to continue or initiate court action, except by the administrator or with the consent of the court.[97] The duties on the administrator or liquidator thus effectively trump the consumer protection regime (the *CCA*, *Code* and any industry code enacted under the *Small Business Commissioner Act 2011* (SA)). During the administration (see Figure 1) the administrator, standing in the shoes of the franchisor, theoretically should engage with the franchisees, but the rigorous statutory time limits that apply in the insolvency arena, the provisions of the *CA* that focus on creditors' rights, the fact that franchisees are often spread far and wide geographically, and the absence of funds weigh in favour of the insolvency regime taking priority over consultation in practice.

Franchisees have difficulty achieving standing in their franchisor's insolvency through the *CA* because of their limited creditor status. Whilst the *pari passu* principle states

95 Wayne Jenvey, 'Rocky Roads and Rollercoasters — Turnaround Strategies for Distressed Franchise Systems' (Paper presented at the Legal Symposium at the Franchise Australia Annual Conference, Gold Coast, 24 October 2006) 9.

96 Australian Securities & Investments Commission, *Resources*, above n 94. See also Australian Securities & Investments Commission, *Insolvency Information Sheets* <http://www.asic.gov.au/asic/asic.nsf/byheadline/Resources++Insolvency+information+sheets>.

97 The relevant legislation is the *CA* ss 440D, 471(2). See *Ibbco Trading Pty Ltd v HIH Casualty & General Insurance Ltd (in prov liq)* (2001) 19 ACLC 1093. See also Christopher Symes and John Dunns, *Australian Insolvency Law* (LexisNexis Butterworths, 2009) 295.

'creditors should share equally in the bankrupt estate',[98] the bulk of the franchisee's investment is in the sunk costs of establishing its business. For these sums the franchisee is not a creditor. Only creditors have standing in a creditors' meeting. The approach some administrators take to franchisees is that, if in doubt, put each franchisee in as a creditor for $1. While this secures franchisees the right to attend creditors' meetings, it pays scant recognition to their investment and potential loss.

Putting aside their initial investment, franchisees may manifest disparate claims as creditors or debtors. The Kleins franchise agreement, for example, contained a guarantee that if annual turnover did not reach a certain level, the franchisor would pay the franchisee an agreed sum. Anecdotally, many franchisees received or were entitled to receive these payments. For this sum they were a creditor. The franchisor and franchisee might have concluded a mediation agreement that resulted in the franchisee being owed money, or, similarly, moneys may be owed under a judgment debt. Some of the Traveland franchisees were owed money by the franchisor in connection with airline ticket refunds. A franchisee may also be a creditor in relation to any rent payments that the franchisor received from the franchisee but did not pass on to the landlord, arguably held by the franchisor on trust.

Widespread media attention to a failure can damage franchisees whose businesses may still be viable. News of the failure or impending failure of a franchisor will affect the franchisees' relationship with their customers. The extent of the impact will depend on variables such as the length of time between the usual purchase and delivery of the product or service sold by franchisees, the way the customer finds out about the failure and the extent of franchisees' rights to continue operating in reliance on their contracts with third parties. A franchisee selling white goods or travel[99] that will be paid for now and delivered in the future, for instance, will struggle to retain their customers' confidence, whereas the franchisees selling cups of coffee that are consumed immediately should be able to continue trading so long as their suppliers continue supplying coffee beans. In the worst-case scenario, a franchisee's customers will only discover the franchisor has failed when the franchisor's head lease is disclaimed by the liquidator with the result that the franchisee is evicted from its premises and the customers are met by a locked roller door.

Under s 568(1) of the *CA*, liquidators (but not administrators) have the power to disclaim onerous contracts.[100] This enables them to disclaim head leases, trademark licences, franchise agreements, obligations to pay commissions and any other contracts that are seen as unsaleable or a drain on resources. Decisions the administrator or liquidator takes in relation to disclaiming onerous contracts will impact significantly

98 See ibid 150–67 for an explanation of the pari passu principle and its exceptions.

99 Buchan and Frazer, above n 74, 1908.

100 It should be noted that the options in relation to leases and other onerous contracts available to administrators and liquidators differ. Administrators operate under pt 5.3A of the *CA* s 443A (B) and do not have a power that liquidators have under s 568 to disclaim onerous contracts. For a detailed discussion of this point see McCoy, above n 77, 24–9.

on the options available to franchisees. If the liquidator disclaims the head lease, the sub-lessee franchisee will lose the value of the sunk costs unless it is able to negotiate a new lease. Even then, the franchisee may find that the lack of the power of the brand or the loss of group bargaining power may render its business unviable.

If the administrator decides to wind up the franchisor's business, there is nothing to stop a liquidator selling the franchisor's business to a direct competitor[101] of the franchisor. It is unlikely that an acquisition would meet the threshold test of, 'having the effect, or be likely to have the effect of substantially lessening competition in a market',[102] that would lead to close examination of a proposed merger of two franchise networks by the ACCC. That direct competitor may elect not to buy the franchise agreements but, instead, to simply buy the brand cheaply and shelve it.

D *The A & R Franchisees*

A & R franchisees expected to be able to amortise their investment over a 10 year term but discovered '[t]he majority of those costs cannot be fully recovered in the case of the franchise's failure'.[103] Franchisees reported experiencing 'serious falls in sales after the collapse'.[104]

A & R's administrators sent franchisees a circular early in the administration period stating that the appointment of the administrators did not automatically terminate the franchise agreements and royalties should continue to be paid by direct debit from franchisees' banks, as usual. The absence of strict duties on the franchisor enables administrators to require the ongoing performance of franchise agreements by franchisees so long as the franchisor is not in breach of a head lease or other essential supply line contract. From the administrators' perspective, franchisees 'continue[d] to trade as normal'[105] during the administration.

Where franchisees are selling instant use items like books, the administrator can be assured of a steady stream of revenue by requiring franchisees to keep trading. This was the situation in A & R's case. Before it was placed into voluntary administration the REDgroup network had over 2500 employees.[106] Despite the lack of ongoing support by the franchisor, post-administration royalties and marketing

101 *CCA* s 50 prohibits acquisitions that would result in a lessening of competition but the tests are relaxed where the entity being acquired is insolvent.

102 *CCA* s 50(1).

103 Economic and Finance Committee, above n 1, 15.

104 Madeleine Heffernan, '25 Angus & Robertson Franchisees To Go Independent After Collapse' (5 April 2011) Smart Company <http://www.smartcompany.com.au/growth/franchising/19414-20110405-25-angus-robertson-franchisees-to-go-independent-after-collapse.html>.

105 Ferrier Hodgson, 'Negotiations Underway for Sale of Angus & Robertson Bookstores' (Press Release, 15 June 2011).

106 'Troubled Bookstores Face Closure This Week', *ABC Melbourne* (online), 1 March 2011 <http://www.abc.net.au/news/stories/2011/03/01/3151898.htm>.

contributions paid by franchisees contributed $226 518 to the administrators' pool of funds. Ultimately 'stock realisations [being commissions on post-administration sales paid by franchisees were] sufficient to pay in full all employee entitlements, totaling approximately $11.7 million'.[107]

Within a month of their appointment the administrators closed '48 franchisor-owned A & R stores'.[108] They identified the A & R franchise agreements as saleable assets. The franchisees were required to continue trading whilst the administrators sought a buyer for the businesses or any of their component parts. A & R's Terms of Agreement and Financial Commitment for franchisees state that '[p]ayment of stock and all other expenses is managed by the Franchise Owner'.[109] A & R franchisees appear to have held the premises leases in their own names and to have dealt directly with the book suppliers. Thus the franchisor's failure would not result in franchisees losing the right to trade from their shops.

By 17 June 2011, the administrators had closed a further '42 [franchisor-owned] stores [leaving only] 19 company-owned stores alongside the 48-strong franchise network'.[110] The franchisees were included in the discussions with two potential buyers of their franchise agreements. Options were presented to the A & R franchisees on 17 June. Most decided to join the Collins bookseller group[111] and the remainder joined an independent buying group called Leading Edge. Ongoing personal liability for their premises rental, independent of the success of their franchisor, would bear heavily on each franchisee's decision. The Applebys had every incentive to protect their very new investment.

Two features of the administration specific to A & R — gift cards and consumer warranties on merchandise purchased before the administration and normally returnable if faulty — serve to illustrate other considerations the franchisees needed to weigh up.

The February timing of the A & R administration meant that a high proportion of gift cards issued prior to Christmas and redeemable at any of the then 185 company-owned or franchisee-owned stores would not yet have been redeemed. Prior to the administration, Mrs Appleby pointed out that '[w]hen we sold a gift card, A & R took that money off us straight away. We didn't get that money back until someone used that gift card and then we had to claim it back'.[112] Once the franchisor was in administration, holders of

107 Ferrier Hodgson, 'Second Meeting of REDgroup Creditors' (Press Release, 27 July 2011).

108 Chris Zappone, 'Booksellers' Woes Worsen as Franchisees Seek to Defect', *The Sydney Morning Herald* (Sydney), 5 April 2011.

109 Angus & Robertson, above n 56.

110 Smart Company, 'Meeting on Potential Sale of Angus & Robertson Underway' (17 June 2011) <http://www.smartcompany.com.au/growth/economy/20478-20110617>.

111 Collins itself had been formed as a buyers' group after the Collins Booksellers franchisor failed in 2005 after selling books since 1929.

112 'Good Staff and Family Support See Stores Write Another Chapter', above n 59.

gift cards became unsecured creditors. The administrators advised as part of a series of updates about the progress of the administration that '[a]cceptance of gift cards is at the franchisee's discretion but the Administrators are under no obligation to repay you for any gift cards redeemed'.[113] This operational change placed franchisees in an unenviable position. Whilst they became unsecured creditors for the face value of any unredeemed gift cards they also wanted to retain their customers. The Applebys 'honoured A & R gift cards for as long as they could, despite the fact that they were not legally bound to and despite making a loss on them'.[114] The dilemma is illustrated in Figure 4.

The administrators' advice to franchisees not to replace faulty items or provide refunds to customers[115] raised issues of warranties for faulty goods. Although this refusal would constitute a breach of the statutory warranties that provide consumer protection under the *CCA*, sch 2, *Australian Consumer Law*, ('*ACL*') ch 9, no claimant could

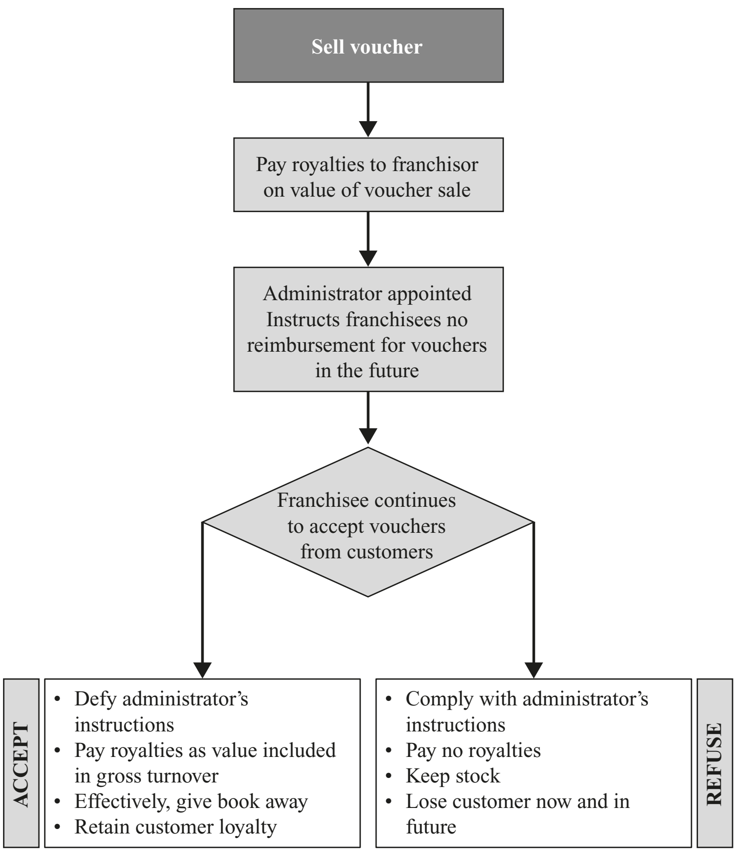

Figure 4: Gift card dilemma

[113] Ferrier Hodgson, 'Frequently Asked Questions: Franchisees' (Circular, 17 February 2011) 2.

[114] 'Good Staff and Family Support See Stores Write Another Chapter', above n 59.

[115] Ferrier Hodgson, 'Frequently Asked Questions: Franchisees', above n 113, 2.

take action whilst the moratorium against creditors initiating or pursuing litigation was effective. In this regard the administrators' powers under the *CA* effectively 'trump' the consumer's rights under the *ACL*. Problems for franchisees go further than deciding how to manage customer loyalty. The provisions of the *CA* — including time limits and order of priority of payments — must be adhered to strictly by administrators. This includes a requirement that a second creditors' meeting must be held within 21 days of the appointment of the administrator. The court has discretion to consent to this meeting being held later if the administrators provide compelling reasons. In the REDgroup case (and similarly with Kleenmaid and Kleins), the administrators who had been appointed on 17 February 2011 were granted additional time to hold the second meeting of creditors. On 14 March 2011, Stone J ordered:

> [p]ursuant to s 439A(6) of the *Corporations Act 2001* (Cth) (Act), … the period within which the Administrators of the second plaintiffs must convene meetings of creditors of REDGroup Retail Pty Ltd and each other company names in the Schedule under s 439A of the Act [is] extended up to and including 18 September 2011.[116]

This enabled them to identify and negotiate with parties possibly interested in purchasing parts of the troubled business. The extended time frame placed the franchisees in limbo for 213 days from appointment of the administrator to the second creditors' meeting, 192 days (nearly 28 weeks) longer than the usual statutory period. This extended timeframe underscores the complexity of a franchisor administration and emphasises the franchisees' vulnerability.

We have seen through the A & R experience how franchisees move from being key stakeholders to being an incidental player if their franchisor becomes insolvent. Their investments are largely unprotected by the contracts, laws and the *Code* that helped inform their decision to enter the deal. We now turn to examine what franchisees may be able to do to protect their investment from the consequences of franchisor failure.

VI Franchisees' Ex ante and Ex post Responses to Franchisor Insolvency

In general terms:

> 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.[117]

116 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).

117 Jenvey, above n 95, 2.

How, then, might franchisees insulate themselves ex ante and respond ex post to the announcement of its franchisors insolvency?

A *Ex ante*

Under the law of contract, prospective franchisees can 'attempt to structure his or her affairs to ensure minimum personal liability and [maximum] flexibility in keeping or restructuring the business in the event the franchise business fails or alternatively the franchisor becomes insolvent'.[118] Their ability to do so depends on the franchisor's willingness to negotiate, the franchisor's policies regarding matters such as whose name the premises lease is in, and how keen the franchisor is to make the sale. Franchisees would then be well advised to attempt to negotiate *ipso facto* clauses into all agreements they sign that depend on them continuing as a franchisee. Such clauses would be designed to provide franchisees with the right, but not the obligation, to terminate the agreement on the appointment of the franchisor's administrator. It has also been suggested that a liquidated damages clause could be incorporated into contracts to avoid the franchisee being exposed to protracted litigation if they decide to terminate following the franchisor's failure.

In the same way as indicators of a franchisee's pending insolvency are easier for a franchisor to identify than the converse, franchisee failure is also easier for franchisors to pre-empt and navigate. A franchisor noticing its franchisee trading precariously may terminate the grant in reliance of a breach before the administrator is appointed. The franchisor does this in order to avoid dealing with the administrator. The franchisor will then be able to re-sell the former franchisee's business and may avoid the risk of having it clawed back into the insolvency as a voidable preference. US franchise lawyer Craig Tractenberg recommends that '[i]f the franchise agreement is terminated before bankruptcy is filed, it is not protected by the automatic stay and the franchise is not property of the estate'.[119] Failing this, the franchisor could negotiate to buy back the business from the franchisee's administrator if the franchisor wants the site.

When conducting pre-purchase due diligence, a franchisee should take heed of the wording on the disclosure document '[t]his disclosure document contains *some of* the information you need in order to make an informed decision about whether to enter into a franchise agreement'[120] and think beyond it. Due diligence might include pursuing a range of lines of inquiry including: the direction of cash flow between franchisor and franchisees, market, risk of franchisor insolvency, and franchisor exit strategies.

It should not be assumed that the franchise is structured so the cash (eg royalties) flows from franchisee to franchisor. In some networks the franchisor receives the

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118 Steven H Goldman, *Tackling Troublesome Insolvency Issues for Franchisees* (Unpublished, 2003) 3–6. Goldman's paper outlines 10 specific strategies franchisees may attempt to put in place.

119 Tractenberg, above n 24, 7, citing *Moody v Amoco Oil Company*, 734 F 2d 1200 (7th Cir, 1984).

120 *Code* Annexure 1, item 1.1 (e).

proceeds of each sale the franchisee makes direct from the franchisee's customer. The franchisor then remunerates its franchisee by paying commissions. In this situation the franchisee may be dependent on the franchisor for all of its cash flow. The intending franchisee should calculate how long its business could function if the franchisor did not pay in a timely way. With this risk clearly identified the franchisees should protect its own investment by seeking personal guarantees from the franchisor, and a right of setoff.

As mentioned previously, the *Code* prescribes mediation. Franchisees could seek security for moneys they become owed as a result of mediation. This would elevate them above unsecured creditors in the insolvency. It would also be prudent for franchisees entering mediation settlement agreements to require personal guarantees from the franchisor's directors if the agreement involved the franchisor paying money to the franchisees. This is because of the stay of proceedings[121] the appointment of the administrator triggers vis-à-vis the franchisor.

Useful pre-commitment due diligence can be performed to determine whether the sector is viable in the medium term, or whether it is already saturated. US practitioner Cheryl Mullin suggests prospective franchisees

> [g]oogle the franchisor with the key words 'earnings' and/or 'financial' and 'competitors' [and recommends that] 'earnings' and 'financial' often turns up statements that a principal or representation has made to the press. 'Competitors' will turn up articles addressing the competition. Often a franchise concept that is new to me is just one of many following a new craze or fad.[122] If the barrier to entry is low, the concern is that even if the franchisee has a protected territory, it will soon be occupied by the competition. If there are competitors … look at their [Franchise Disclosure Documents][123] to compare fees, initial investment, and financial performance representations.[124]

In addition to the disclosure requirements in the *Code*, franchisees are expected to seek advice from lawyers, accountants and business advisers. In correspondence to the Committee, the Franchise Council of Australia identified the main causes of franchisee failure to undertake effective due diligence as being:

> (1) aversion to incurring the costs of professional advice;
>
> (2) lack of understanding as to the value of professional advice or reluctance to seek advice;

121 *CA* ss 440D, 471(2).

122 For example the successful Boost Juice franchise in Australia was unsuccessfully mimicked by Pulp Juice Bars (owned by failed Signature Brands), and Nrgize (owned by failed Nrgize Australia Pty Ltd).

123 Known as FDDs in the United States, this avenue is not available in Australia as there is no requirement that a franchisor's disclosure document be placed on a public data repository.

124 Cheryl L Mullin (Mullin Law, Texas) Post on American Bar Association, *Forum on Franchising* (Wednesday 21 November 2012, 10.37 am) (access restricted).

(3) a belief that they do not need assistance; and/or

(4) ignorance of the *Code* requirement.[125]

Due diligence has limitations. Part of the disclosure document may not be accurate. Some franchisors sign a statement of solvency when their business is insolvent. For example, franchisor Beach House Group ('BHG') was still accepting franchise fees from new franchisees in the third quarter of 2006. BHG's liquidator concluded that 'in my opinion the company became insolvent in 2005 and [knowingly remained] insolvent from that time'.[126] He also reported having

> discovered an email prepared by one of the company directors dated 7 May 2007 admitting the company was insolvent and that the company should be wound up. There is no evidence to show the relevant director took any steps to prevent the company from incurring further debts.[127]

Retail jewellery franchisor Kleins sold franchises while it was 'in [financial] trouble'.[128] Similarly, white goods franchisor Kleenmaid was described as being 'hopelessly insolvent'.[129] The liquidators were appointed on 15 May 2009 and reported 'each of the companies traded whilst insolvent prior to our appointment as Administrators. We are of the opinion that each of the companies in the group has been insolvent since March 2008'.[130] No franchisee could have uncovered damning financial information buried within the group accounts of franchisor-related insolvent Kleenmaid entities in time to avoid investing.

Franchisees must remember that franchisors also need exit strategies. Many are now at an age when they want to retire[131] so the franchisor's succession planning is relevant. If possible the franchisees should make themselves aware of the franchisor's succession plan and should devote some thought to how the identified strategy might impact on the franchisees' business.[132]

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125 Economic and Finance Committee, above n 1, 25.

126 Cor Cordis, 'The Beach House Group Liquidators' Report to Creditors Pursuant to the *Corporations Act 2001* (Cth) s 508' (Liquidators' Report, 19 October 2009) 13.

127 Ibid.

128 Thomson, above n 15; see also Birkett Long Solicitors, above n 15.

129 Richard Hughes (Liquidator, Deloitte), Comment by Member of Panel, Griffith University Franchise Forum, 2009.

130 Deloitte, 'The Kleenmaid Group Liquidators' Report to Creditors Pursuant to the *Corporations Act 2001* (Cth) s 508' (Liquidators' Report, 25 August 2010).

131 In L Frazer, S Weaven and K Bodey, *Franchising Australia 2010* (Griffith University, 2010) 112, only 50 per cent of the franchisors surveyed were the founder of the original business.

132 For a preliminary discussion of this issue see Buchan, *Franchisees as Consumers*, above n 2, ch 7.

A final consideration is the power given to the ACCC under section 219 of the *CCA* to require advertisers (including franchisors seeking franchisees) to substantiate their claims.[133] If franchisees perceived that the general or franchisor-specific insolvency indicators mentioned earlier were present they could request that the ACCC use this power to require their franchisor to substantiate the claim that it is solvent. By exposing a franchisor's financial vulnerability through steps such as issuing of substantiation notice followed by an infringement notice or a public warning notice the ACCC could prompt a franchisor's proactive restructuring rather than allowing it to continue to fund itself through selling franchises, without which it would be insolvent.

B *Ex post*

The franchisees' ability to actively respond, ex post learning of the franchisor's insolvency, is limited. As noted earlier, the franchisor's insolvency does not constitute a breach of the franchise agreement. Under contract law the franchisee may argue that the franchisor's administration is an anticipatory breach that justifies the franchisee's termination. This places the franchisee at risk of a counterclaim by the administrator, but it is a strategy that some franchisees working under the commission agency model have used successfully.

Is it misleading and deceptive in breach of sch 2, s 18 of the *CCA* to continue to sell franchises when a franchisor suspects or knows it is insolvent, or is considering strategic insolvency? This possible action has never been litigated in the context of franchising, but in an analogous case concerning an employee *Moss v Lowe Hunt & Partners Pty Ltd*,[134] Katzmann J held that it was misleading or deceptive (under s 52 of the *Trade Practices Act 1974* (Cth), now sch 2, s 18 of the *CCA*) to describe a business as 'successful' when, without the continued support of its parent company (which itself had difficulties), it would be insolvent.

Bearing in mind the stay of proceedings mentioned previously, franchisees may turn their attention to solvent parties that facilitated their investment in the flawed franchisor. Some franchisors secure priority access to banks for prospective franchisees on the strength of the bank approving the franchise system. If the bank were to advance money to prospective franchisees on the strength of the franchise's credit approval ranking, is it misleading and deceptive of the financier if the franchisor was, in fact, the subject of a credit watch at the same bank at the time? It is arguable that this level of complicity could found an action for misleading and deceptive conduct under s 18 and/or unconscionable conduct under sch 2, s 20 of the *CCA* against the lender.

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133 See Stephen G Corones, *The Australian Consumer Law* (Lawbook, 2011) 495–7.

134 [2010] FCA 1181.

VII Potential Solutions

The *CA* identifies the stakeholders whose interests merit special consideration. Franchise agreements and leases may be assets or liabilities to be dealt with accordingly, but franchisees, to the extent that they are not creditors, are excluded. Administrators thus have discretion as to how they treat franchisees. In the US some franchisor's administrators convene committees of franchisees. This creates a two-way information conduit and enables the administrators to gauge whether, for example, a group of franchisees is interested in buying the franchisor's business. It is a practice that should be adopted universally in Australian franchisor failures.

In relation to the franchise fee and money paid by franchisees to secure options to take up future franchises, the franchisor could be required to hold these on trust for the franchisee rather than shifting these amounts directly into a general revenue account. The franchisor would have the right to access amounts pro rata as the term of the grant passed milestones. The weight currently attributed to the value of franchisees' initial investment is not an appropriate reflection of their role within the franchise network, or of the risk they take. A more equitable solution than 'putting them in for $1' would be to attribute to each franchisee a creditor weighting based on the written down value of their business at the time of the appointment, the residual value of their initial franchise fee (if, say the term was for 5 years and the franchisor failed after 1, then four fifths of the initial fee would be notionally owing by the franchisor as the franchisor has arguably been unjustly enriched by this amount), and any other amounts currently recognised as owing. Franchisees as a voting block at creditors' meetings could then, with the combined value of their investments, have an effective voice in the process.

The current order of insolvency priorities would thus need to be amended to accommodate the interests of franchisees. Because this would reduce the value of other creditors' claims, further research would be needed to ensure the *CA* priorities were equitably recalibrated.

VIII Conclusion

Franchisees invest debt-funded and equity capital in the franchisor. Traditional suppliers of debt finance such as banks have the opportunity to take security, and to price their loans accordingly. Traditional suppliers of equity finance, shareholders, have taken the risk of the entity becoming insolvent knowingly and on the basis of information supplied in a prospectus that has met rigorous statutory standards. Creditors, shareholders and employees enjoy clear rights in insolvency under the *CA*. Neither the law of contract nor the consumer protection regime offer effective relief to franchisees.

Any franchising industry code drafted under the *Small Business Commissioner Act 2011* (SA) should address today's highly sophisticated franchise networks. The simple model of a franchisor plus franchisees is rapidly becoming a thing of the past. The SA Review concluded that '[r]egulation … cannot remove the possibility of failure or guarantee success. Ultimately, a prospective franchisee's best protection against failure is educated, informed and conscientious due diligence'.[135] This must be read in the context of the amount of information that is inaccessible to franchisees (or accessible only at great cost) and of the accuracy of the amount disclosed by the franchisor. It must also be remembered that a franchisor may change the way it does business. It may decide to become insolvent after the franchisee has entered the system.

The franchise model contains fixable flaws, but legal solutions that focus on the time before the contract was formed cannot solve the conundrum of the franchisees' correct legal positioning in their franchisor's insolvency. It is also unrealistic to expect small business commissioners and consumer protection regulators to address the consequences of franchisor failure in isolation; teamwork is required. We must 'look beyond the boundaries of the legislative silos [to resolve] problems that cross boundaries'.[136] The team must include state and territory regulators of property rights, as well as insolvency policymakers and the corporations' regulator. The honey pot remains a source of sweet riches but the bear trap is becoming increasingly exposed. Its teeth are sharp.

135 Economic and Finance Committee, above n 1, 25.

136 Jenny Buchan *Franchisees as Consumers*, above n 2, 182 citing United Nations Commission on International Trade Law, *Legislative Guide on Insolvency Law* (2005) 19.