EXPLORING THE LIMITATIONS OF PRE-CONTRACT DISCLOSURE AS A FRANCHISEE-PROTECTION AND EMPOWERMENT MECHANISM IN BUSINESS FORMAT FRANCHISING

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ABSTRACT

Disclosure is an important aspect of the pre-purchase process for numerous business format franchisees in many countries. It may be provided by the franchisor voluntarily, or because legislation requires it. A disclosure document is a snapshot of the current status of the franchise network, focusing primarily on the financial and legal fitness of the franchisor, and on the specific franchise business the franchisee is evaluating.

The policy objective of disclosure is to reduce uncertainty about key aspects of the future relationship between the franchisor and the new franchisee. Knowledge of the information disclosed will, it is thought, enable a franchisee to make a more complete evaluation of the franchise opportunity than it could do without the disclosure document. The intending franchisee will thus be protected from any consequences of making a bad investment decision as it has had the opportunity, ex ante, to address unacceptable risks.

This paper explores the extent to which current disclosure serve its franchisee protection and empowerment when confronted by a franchisor in administration. It identifies some limitations of pre-purchase disclosure in relation to the complex and nuanced legal areas of business failure. In some cases third parties may have an unanticipated detrimental effect on the relationship between franchisor and its franchisee. In other cases the franchisor itself acts in an unpredicted and possibly unpredictable way, to the detriment of its franchisees. Some limitations arise out of the scope and the temporal dimension of the
disclosed material as well as the difficulty of verifying the information supplied by the franchisor. Others are a consequence of matters beyond the immediate parties’ control.

It is concluded that the current style of pre-purchase disclosure in Australia is an inadequate information transmitting or franchisee-empowering mechanism and that more is expected of pre-purchase disclosure than it has the capacity to deliver. Suggested amendments to the current approach are identified.
INTRODUCTION

Franchising is a feature of thousands of businesses in both developed and developing economies. Through franchising an entrepreneur, the franchisor, can expand a branded business very rapidly by creating a distribution channel that harnesses the energy, commitment, access to funding and local knowledge of individual owner operators, the franchisees. Franchises operate in about two-thirds of the approximately 192 countries in the world and make a significant economic contribution.¹ Most people will have dealt with a franchisee in their daily lives; be it to buy travel, a printer cartridge or to have a lawn mown.

Whilst the key players in a franchise network are the franchisor and its franchisees, franchisors operate within a highly inter-connected web of relationships which they do not necessarily control. The model has become increasingly complex. Alan Felstead observed that ‘[o]nly by examining the inter-connections between [those] firms can one fully appreciate that the ability to exercise control over production may stretch beyond a firm’s legal borders’.² By examining the interaction between those firms and the law one can appreciate the far-reaching consequences of adverse events that emanate from the franchisor. The franchisee has very limited options in the face of a detrimental decision by one of the other players in the network.³ A poor business decision by the franchisor, a member of the group of companies it is part of or one of its related entities can damage franchisees.

Policy makers have recognised that franchisees are vulnerable in the franchise relationship and have implemented strategies to address the vulnerability. One widely adopted strategy is to ensure that franchisees enter the contractual relationship with their ‘eyes wide open’. To meet this objective franchisors in Australia must provide a pre-contract disclosure document to franchisees. Ideally this identifies the major commercial, financial and legal risks for the incoming franchisee. It should enable franchisees to know what is


expected of them, to maximise their chance of performing successfully within the franchise and to arrange their own affairs so as to minimise the risk to their personal assets.

The effectiveness of pre-contract disclosure can be stress-tested. One variable to stress-test is the assumed ongoing solvency of the franchisor. This paper evaluates the effectiveness of Australia’s pre-contract disclosure in reducing the vulnerability of franchisees whose franchisor fails. Although it focuses on Australia, the issues it addresses are not unique to Australia.

The paper is structured in the following way. Part I summarises what is franchising? In Part II is a case study of a failed Australian franchisor, Angus & Robertson booksellers. Part III outlines the role and scope of pre-contract disclosure. In Part IV implications of the deficiency of the current disclosure and the inability of pre-contract disclosure to ever provide a solution to franchisor failure are discussed. In the conclusion, some potential solutions are proposed.

I: WHAT IS FRANCHISING

Franchising is a business model where a business operator, the franchisor, grants licences to independent businesses called franchisees to clone a facet of its business. Thirty-five years ago Australia’s Swanson Report stated that the ‘term ‘franchise’ ... describe[s] ... three types of business arrangement:

- a **product franchise** … whereby a distributor acts as an outlet ... for the product(s) of a manufacturer, often on terms that vie the distributor the exclusive right to sell the product(s) within a specific market. Franchises of this nature are common, for example, in retailing motor vehicles and petrol.

- a **system franchise** [now commonly known as a business format franchise] … whereby a franchisor develops a unique of individual manner of doing business and permits the franchisee to use that system, in controlled fashion, in the operation of the franchisee’s independently owned business. ...Sometimes the franchisor provides only the trade name and the pattern or formula of the business. In other cases the franchisee is required to sell foods or services provided by the franchisor.
- a processing or manufacturing franchise … whereby the franchisor provides an essential ingredient or know-how to a processor or manufacturer. Franchises of this nature are common, for example, in the soft-drink industry.4

Business format ‘franchising [can be further explained as] a form of industrial organisation … where the techniques of mass-production are mastered and replicated across time and space by successfully separating conceptual work by a small core of managers and planners [franchisors] from the performance of standardised work tasks by a largely unskilled contingent of easily replicable workers [franchisees]5 who are keen to run a business.

Through business format franchising franchisors can expand branded businesses very rapidly and uniformly by creating a distribution channel that harnesses the commitment, energy, local knowledge, equity and access to debt of individual owner-operators, the franchisees. In addition to funding growth in the usual ways available to a stand-alone business (shareholder equity, or debt) a franchisor is able to finance growth by selling franchises. The business format franchise is marketed as a proven concept. Having been told by the franchisor that they are investing in a proven business, franchisees invest confidently.

Business format franchising has become a significant part of the commercial landscape in both developed (‘[one] out of every 12 businesses [in the USA] is a franchised business’ 6) and developing economies (South Africa enacted the Consumer Protection Act, 2010 which specifically addresses franchisees as consumers) and is the type of franchising that poses particular challenges for policy makers and regulators. The challenges arise out of a combination of three features that uniquely come together in business format franchising. These are firstly the disconnect between the corporate governance of the franchisor and any legal requirement that the franchisor or its administrator or liquidator factor the interests of its franchisees into strategic decisions; secondly, the nature and legal treatment of the franchise agreement; and thirdly, numerous consequential asymmetrical features of the law in general and the franchise contract specifically that enforce ongoing dependence of franchisee on franchisor.

6 Franchise Consultants Inc, 2011.
In regulation of corporations there is an emphasis on controlling the vertical relationship. Mitigating the exploitation of minority shareholders by the majority is a challenge. The law responds for the non-franchised aspects of businesses by imposing a range of checks and balances, such as directors’ duties, shareholder remedies, disclosure, audits, independent directors, securities laws and insolvency procedures. Mitigation of the exploitation of employees is a challenge that is also met by a wide range of laws and by policies such as GEERS in Australia. Denied access to these traditional mitigation mechanisms, franchising poses both vertical and exploitation challenges for policy makers. For example, while insolvency law traditionally accommodates the interests of employees and creditors of the failed entity the franchisees that performed comparable roles to employees and creditors are only accidentally accommodated, if at all.

Policy makers worldwide continue to treat business format franchising as a simple, single contract based franchisor/franchisee relationship. Franchisees enter a contractual relationship with their franchisor. They are both business people. The rhetoric is that franchisees can negotiate terms that will protect them if the franchisor fails. However, there is very limited opportunity for franchisees to negotiate any significant amendments to the single unit franchise agreement. This is widely acknowledged by academics and legal practitioners. The existence of laws about unconscionable conduct between businesses contained in the Australian Consumer Law (Cth) 2010 Schedule 2, Part 2-2, s 22 is legislative acknowledgement in Australia that franchisees can be vulnerable consumers.

Twenty-first century franchisors now operate in ways that rival the complexity of sophisticated multinationals. While checks and balances are imposed on the non-franchised players within a corporation or a corporate group through divisions of enterprise with different functions, clear levels of authority, and a recognisable management structure underpinned by corporate governance principles and legislation, all closely overseen by a regulator, these checks and balances are typically absent in the regulation of the relationship between a franchisor and its franchises.

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8 GEERS is the Australian government’s General Employees Entitlement and Redundancy Scheme http://www.deewr.gov.au/WorkplaceRelations/Programs/EmployeeEntitlements/GEERS/Pages/default.aspx (accessed 25 November 2011)
9 Formerly 51AC Trade Practices Act 1974 (Cth)
The franchise relationship is primarily regulated through the franchise agreement, a contract drafted by the franchisor to preserve and protect the franchisor’s interests. A fundamental aspect of franchising is the separation of ownership (by the franchisees), from control (which remains with the franchisor). This can also be expressed as a separation of risk bearing by the franchisees, and decision functions, which rest with the franchisor.\textsuperscript{10} These contracts expose franchisees to significant risk. The franchise agreement is one of the mechanisms by which the power and risk imbalance is enshrined in the relationship. To get to the point of being allowed to sign the contract the franchisee has told the franchisor every detail of the franchisees finances; but the franchisor is able to withhold information about all aspect of its businesses except that conducted by ‘the franchisor’ entity while still complying with statutory disclosure requirements.

The inability of franchisees to protect themselves as individuals from franchisor-created risks arises through the complexity of the 21st century franchise network. Franchisors are increasingly owned by public companies and venture capitalists. Franchisees typically contract with the franchisor that is a low capitalized member of a sophisticated corporate group. For example ‘the franchisor’ in Appendix 1 of this paper is Angus & Robertson Pty Ltd, a proprietary company that is merely one of 18 companies and trusts in three countries controlled by parent REDgroup Retail Pty Ltd. More of REDgroup later. For a franchisee, signing the franchise agreement after receiving disclosure of the franchisor entity is comparable to getting married before meeting any family or friends of ones spouse – that would be an act of faith.

The franchise model evolved only after long evolving policy and regulation to regulate governance of corporate groups and protect employees, consumers and creditors was well settled. For example, whereas employment and finance law provide statutory rights for employees, and creditors the statute law has not adapted to accommodate franchisees performing similar functions as franchisees. Courts that are often willing to look behind the name of a contract to find its essence accept the franchise agreement on face value.

Asymmetry of risk, information, adviser, reward, regulation and rights that favour franchisors over franchisees’ interests are pronounced. Pre-entry the asymmetry is

pronounced because of barriers to the conduct of effective due diligence, and the non-negotiable nature of franchise agreements wherein the franchisors’ shift risks that would normally be borne by an employer to franchisees. In a negotiated contract risks would normally be measured and costed, then borne knowingly, or rejected, by contracting parties. This level of evaluation is impossible and even if possible, would be prohibitively expensive in franchising. No amount of due diligence would make the franchise agreement negotiable

Franchisor insolvency/ bankruptcy is one key event where governance, contracting and asymmetry conspire to defeat the interests of the franchisees. This will now be demonstrated through a case study of a recent franchisor failure that started in the US and quickly spread to Australia, New Zealand and Singapore.

II: ANGUS & ROBERTSON - CASE STUDY

History of Angus & Robertson booksellers

David Angus and George Robertson started selling books together in Australia in 1886.11 Their business grew and prospered. Thirty four years ago,

‘... the first franchise was opened. ... The next twenty years brought growth as well as ...[six major] ownership changes, including a merger with Bookworld in 1990 and purchases by [New Zealand book retailer] Whitcoulls Group Ltd … in 1993 and Blue Star Group in 1996. In 1995 A&R [opened an] online store. In 2001, WHSmith PLC ... purchased A&R and proceeded to make a significant investment in its continued development and growth. In May 2004 A&R and ... Whitcoulls ... were acquired from WHSmith by the Australian Investment company Pacific Equity Partners12. In 2009 Angus & Robertson, Whitcoulls and the operations of Borders in Australia, New Zealand and Singapore came together under the banner of parent company REDgroup Retail’.13

The REDgroup is a group of 10 Australian companies plus five related companies based in New Zealand and one in Singapore ‘majority owned by Pacific Equity Partners’.14

By early 2011 A & R was able to claim that:

12 PEP is a group of companies and trusts identified in Appendix 2 of this paper.
'Angus & Robertson [is] Australia’s largest bookseller. … [It] has more than doubled the number of stores, currently standing at 185 combined company & franchise. …[W]e have support … and franchise stores right across the country. Borders Bookstores Asia Pacific and Whitcoulls in New Zealand, are both incorporated with Angus & Robertson. This means added benefits to our stores, with system integration, sharing information and, of course, additional buying power’.15

But all was not well in some sections of the book-retailing world. Borders in the US filed for chapter 11 bankruptcy protection in February 2011. Whilst ‘[t]he Australian operation is not financially related to the Borders chain in the United States’16 it met the same fate. Within 24 hours, ‘REDgroup Retail was placed in administration … owing an estimated $170 million’17 and headlines in Australia read ‘Borders Australia and Angus & Robertson chains collapse’.

‘At the time REDgroup was placed into [voluntary] administration by majority [private equity] owners Pacific Equity Partners, it had 260 Borders, Angus & Robertson and Whitcoulls stores in Australia, New Zealand and Singapore’. 18 The administrators closed 36 ‘directly owned A & R stores in early March and a further 12 in late March’.19 As is often the case in administration of a franchised group, the administrators identified the A & R and Whitcoulls franchise agreement as saleable assets. Accordingly, the administrators required the franchisees to continue trading whilst they worked out whether there was a buyer for the businesses or any of their component parts.

The appointment of the administrator

The administration process is regulated under Australia’s Corporations Act 2001 (Cth) (‘CA’). There are several possible paths20 through the insolvency process. The one selected by the secured creditors PEP was voluntary administration. This process enabled PEP as:

18 Chris Zappone, Booksellers’ woes worsen as franchisees seek to defect, Sydney Morning Herald, 5 April 2011.
19 Chris Zappone, Booksellers’ woes worsen as franchisees seek to defect, Sydney Morning Herald, 5 April 2011.
20 These are described at the following link to the regulator, the Australian Securities and investments Commission http://www.asic.gov.au/asic/asic.nsf/byleadline/Resources+-+Insolvency+information+sheets?openDocument
‘… a secured creditor with a charge over most of the company’s assets [to]
appoint an external administrator called a ‘voluntary administrator’. The role
of the voluntary administrator is to investigate the company’s affairs, to report
to creditors and to recommend to creditors whether the company should enter
into a deed of company arrangement, go into liquidation or be returned to the
directors.’

When REDGroup Retail went into administration … the bricks and mortar company
stores were closed and the franchise stores were sold …’22 once a suitable buyer had been
found. The employees of the company owned stores were progressively laid off and the
creditors were invited to lodge their claims. ‘The Administrator has guaranteed all employee
entitlements [for REDgroup employees] will be paid in full’.23 The administrators asked the
court for, and were granted, additional time to hold the second meeting of creditors.24 This is
common and enables administrators to negotiate with parties interested in purchasing parts of
the troubled business. It places the franchisees in limbo for several months.

‘The REDgroup businesses in New Zealand [were] progressively sold down
over the four month administration:
  o On 26 May 2011, the REDgroup New Zealand business was sold to the
    privately owned New Zealand retail business, James Pascoe Group. The sale
    included 57 Whitcoulls stores and five Borders stores.25
  o On 29 April 2011, The REDgroup New Zealand business sold the Bennetts
    chain of eight university-based bookstores to a New Zealand private investor,
    Mr Geoff Spong.
  o On 6 April 2011, the REDgroup New Zealand business sold a portfolio of 10
    Whitcoulls bookstores located in New Zealand’s airports to Australia-based
    travel retail specialist LS Travel Retail Pacific, formerly known as Lagardère
    Services Asia Pacific’. 26

In Australia the administrators worked with two groups of franchisees and at least two
potential buyers. By 17 June 2011, four months after the administrators had been appointed,
they announced a further ‘42 A&R [company-owned] stores [have been closed] this week ….

24 Corporations Regulations 5.6.12 ff the first creditors meeting must be held within 5 business days of the administrator’s
appointment. The second creditors meeting is generally required to be held within 21 days of the appointment of the
administrator but the court has discretion to delay this meeting if the administrators provide compelling reasons.
25 This move away from being owned by PEP elicited a collective sigh of relief from the book industry. An iconic New
Zealand brand was again in the hands of an owner that both understood the book trade and had a track record of restoring
ailing companies to full health.
The closures leave just 19 company-owned stores alongside the 48-strong franchise network.27 ‘A&R franchises are hearing about potential options today’.28

The report to creditors recommended the administration be concluded by a Deed of Company Arrangement29 being executed. Ultimately ‘stock realisations [by the administrators were] sufficient to pay in full all employee entitlements, totalling approximately $11.7 million’.30 Unsecured creditors including franchisees, by implication received nothing.

**The Angus & Robertson franchisees**

When the administrators were appointed to Angus & Robertson there were 61 franchise owned stores. Franchisees starting a new Angus & Robertson store paid between $290,000 and $380,000 total to establish their businesses. As part of their commitment to become franchisees they would have signed franchise agreements and premises leases, invested in stock31 and adhered to the franchisor’s guidelines. They would have hired staff and taken delivery of stock. A & R tells franchisees that ‘[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 and for the subsequent bills that must be paid’.32 Franchisees would have believed they could look forward to building a business over a period of up to 10 years.33

A circular sent by the administrators to franchisees headed ‘Frequently Asked Questions’ stated that the appointment of the administrators did not automatically terminate the franchise and that royalties should continue to be paid by direct debit from franchisees’ banks, as usual. It advised of immediate operational changes such as reducing the value of

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27 Meeting on potential sale of Angus & Robertson underway, Smartcompany, 17 June 2011.
28 Meeting on potential sale of Angus & Robertson underway, Smartcompany, 17 June 2011.
31 Store Set Up Costs. The costs involved in a complete store fit out will depend on many structural details, the size and type of store. As a rough guideline, the cost can be calculated at approximately $ 1100 - $ 1500 per square metre. A typical store would be between 120 - 150 square metres. Stock is your second major cash investment and this can also be calculated on a rough guideline of $ 900 - $ 1000 per square metre, although it will depend on the time of year. [http://www.angusrobertson.com.au/franchise-terms-of-agreement](http://www.angusrobertson.com.au/franchise-terms-of-agreement) (accessed 13 October 2011).
33 Angus & Robertson franchise agreements coordinated the terms with lease term but aimed at providing five years with a further five years renewal.
existing gift cards and ceasing sale of new gift cards, advising franchisees not to replace faulty purchases\(^{34}\) as company owned stores are not accepting refunds. If a franchisee was owed money by the group of entities in administration (including the franchisor) it would be an unsecured creditor for the amount owed and would be entitled to attend creditors meetings. Otherwise franchisees had to continue to meet their contractual obligations but had no rights in the administration process.

Franchisees ‘continue[d] to trade as normal’\(^{35}\) during the administration. By June 17, 2011, 48 of the franchisees were included in the discussions with potential buyers of their franchise agreements.

One franchisee, Mrs Appleby said. “We went to Melbourne and met a few of the groups vying for the franchises and we went to Collins’ conference. … She said she was confident about the future, both of her business and the broader industry. “Collins have innovative thinking and plans for the future. I'll probably do better under the Collins brand than I would have under the A&R brand.\(^{36}\)

Following the appointment of the administrator the A & R franchisees fell into two broad groups. One group of 25 became known by the media as ‘the rebel franchisees’ and the remaining franchisees continued to follow the administrators’ directions and await their fate whilst trading as well as they could. Ultimately most franchisees joined the Collins franchise and the remainder joined an independent buying group (Leading Edge).

**What would make an Angus & Robertson franchisee a creditor?**

Franchisee Mrs Appleby said, “Not many people were aware we were privately-owned and they didn't understand the gift card situation. When 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.”\(^{37}\) This process makes franchisees unsecured creditors for the face value of any unredeemed gift cards.

\(^{34}\) Although this refusal would constitute a breach of the warranties provisions of the *Competition and Consumer Act 2010* (Cth) no one could take action whilst the moratorium permitted under ss 444D and 444E of the *Corporations Act* was effective.


\(^{36}\) Good staff and family support see stores write another chapter Light at end of the tunnel, 13 September 2011, Sunshine Coast Daily, 20.

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Franchisees would also be creditors, probably unsecured, if they had engaged in mediation with the franchisor. Any consequential agreement that the franchisor would pay the franchisee money would make the franchisee a creditor for any outstanding sum. There is no evidence of mediations occurring and no public record of mediation in Australia.

Franchisees would also be creditors if they had purchased stock through the franchisor and items had been returned under warranty. Again, there is no evidence of this. For the bulk of the franchisee’s investment, the franchisee is not a creditor. Most of the franchisee’s investment is in the form of sunk costs and ongoing liabilities to third parties.

**The rebel franchisees**

Franchisees, being parties to a contract, have contract law available as a tool to challenge the administrators. They claim the franchisor has breached or will breach the franchise agreements. During the administration a group of 25 ‘rebel franchise stores’ alleged the franchisor and the administrator had breached the franchise agreement by:

‘changing the terms on which franchisees could honour customers’ gift cards issued up to 2 April, halting all gift card redemptions on 3 April, and, more generally, ‘Angus & Robertson’s failure to provide the services and benefits it is obliged to provide pursuant to the franchise agreement’. 38

The rebels were sued by the administrator. A date was set down for hearing the matter and it was settled before trial. Because the matter was settled it is unclear what specific breach of contract action the A&R franchisees relied on in making their decision to treat their franchise agreements as terminated by the franchisor. Depending on the fact situation some franchisees choose to use an action called ‘anticipatory breach’. It is a form of repudiation of contract that:

‘occurs where a party [here, the franchisor], prior to the time for performance under the contract, evinces an intention no longer to be bound to the contract. A promisee [here, franchisee] may terminate for an anticipatory breach immediately even if the time for performance has not arrived. The only proviso is that the breach must be of a sufficiently serious nature so that if it had occurred at the time for performance the promise would have been entitled to terminate the contract’. 39

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38 Chris Zappone, Booksellers’ woes worsen as franchisees seek to defect, Sydney Morning Herald, 5 April 2011.

The other franchisees

Mr and Mrs Appleby were probably typical A&R franchisees. They bought two franchised bookstores in the Angus & Robertson franchise on Queensland’s Gold Coast in November 2010. This timing enabled them to capitalise on the peak pre-Christmas trading time for booksellers. ‘The book industry … relies heavily on the Christmas trade. This means that 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 and for the subsequent bills that must be paid’. 40 Many customers would have chosen gift vouchers as gifts and would have expected these could be redeemed at any of the 185 Angus & Robertson company-owned or franchisee owned stores in Australia.

Little could Mr and Mrs Appleby guess that at 3pm on 17 February 2011, only two hours after completing their franchisee induction at REDgroup Retail network’s head office in Melbourne, their bank manager would call to tell them their franchisor, Angus & Robertson, a subsidiary of REDgroup Retail Pty Limited had entered administration. 41

The Applebys had two stores. It is not clear whether they established the stores themselves or purchased existing Angus & Robertson outlets. On the basis of costs supplied on the Angus & Robertson website it is reasonable to predict that they had invested over $500,000 on their purchases. Following the appointment of the administrators ‘The Applebys honoured A&R gift cards for as long as they could, despite the fact that as a privately-owned store, they were not legally bound to and despite making a loss on them’. 42

Could franchisees have anticipated the administration?

The front page of the disclosure every franchisee receives before signing a franchise agreement in Australia warns: ‘Franchising is a business and, like any business, the franchise (or franchisor) could fail during the franchise term. [In a masterful understatement it

41 Light at end of the tunnel: Good staff and family support see stores write another chapter, 13 September 2011, Sunshine Coast Daily, 20.
42 Light at end of the tunnel: Good staff and family support see stores write another chapter, 13 September 2011, Sunshine Coast Daily, 20.
continues with the words,] [t]his could have consequences for the franchisee’. A short warning at the point in the relationship when the intending franchisee is psychologically committed to proceeding is unlikely to ring alarm bells. The most it could do is encourage a franchisee to shelter some of its personal assets from the business debts. Its ability to do this would depend on the amount of debt needed to purchase the business and the amount of security other than personal assets that was available as security.

Prior to purchasing Angus & Robertson ‘... strongly encourages [intending franchisees] ... to seek professional legal and financial advice. As part of the decision process, we also suggest you talk with some of our existing Franchise Owners’.44

The Franchising Task Force concluded that ‘...the most vulnerable franchise systems are those that have recently commenced franchising and have less than, say, 12-15 units’ 45 This information would not have caused an aspiring Angus & Robertson franchisee to think twice. A & R began selling books 125 years ago, in 1886, and franchising thirty-four years ago. It had well over 15 units. Many franchisees would have entered the A&R system before PEP became the owner and before A&R became a part of REDgroup. Those that knew of the involvement of the PEP might have been reassured to read that Pacific Equity Partners (PEP) described themselves 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’.46

In this franchise the franchisor ran a large number of the outlets as company-owned stores. The franchisees appear to have held the premises leases in their own names47 and to have dealt directly with the book suppliers48. The administrators were appointed immediately after the busiest trading part of the year, Christmas. If payment for premises rental and stock had normally been made to the franchisor and thence to suppliers the franchisor might have

45 Franchising Task Force Final Report to the Minister for Small Business and Customs, December 1991. 2.7.
47 The administrator was quick to close the company-operated store. If they had been exposed to the ongoing risk of rent for the franchised stores some of these would have been closed too rather than being expected to continue trading. In the end the ability to continue trading enabled some former franchisees to re-brand without having lost their premises.
become a bad credit risk with its suppliers and the franchisees might have then been alerted by changed trading terms. This does not appear to have happened.

In their report to creditors the administrators wrote ‘that it is difficult to maintain an argument that the Group was insolvent for any material period prior to 17 February 2011’.49 No amount of due diligence can anticipate the events that precede some franchisor administrations or insolvencies. REDgroup itself took out a loan with Pacific Equity Partners Fund IV, LP (‘PEP’) for $138 million to complete the acquisition of Borders. At the time the group entered administration ‘the debt due to PEP is cross collateralised across the group. PEP has lodged a Proof of Debt in the Administration of each company for $118,547,419’.50 The franchisees would have had no knowledge of this debt; neither of its existence or the manner in which it was secured. Because of the absence of corporate governance obligations between franchisees and franchisors the franchisees have no role in deciding who owns the franchisor.

At a personal level, 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,” ... “And [Mrs Appleby said] call me naive, but I can't believe that any of the staff in that building on that day knew. Not the day-to-day workers’.51

I would argue that neither the Applebys nor any of the other franchisees could have anticipated the appointment of the administrator.

**Why did the franchisors fail?**

The directors attributed the failure of the REDgroup to several external events, including: ‘[s]ubdued discretionary spending; the legislative framework in relation to the sale of books in Australia which limit[s] the ability of Australian booksellers to compete with overseas retailers due to:


51 Good staff and family support see stores write another chapter Light at end of the tunnel, 13 September 2011, Sunshine Coast Daily, 20.
- No Goods and Services Tax (‘GST’) of 10% being added for Australian online consumers or overseas book purchases – whilst stores operating in Australia must add GST;
- Parallel importation restrictions which allow Australian consumers to buy books directly from overseas whilst Australian retailers have to purchase their books from generally more expensive Australian based publishers;
- The strong Australian dollar which had appreciated against the US dollar and the pound sterling by 20% since September 2009, and further fuelled the growth in Australian consumers purchasing books online from overseas retailers; and
- Deep discounting and increased advertising of front list books by discount department stores’.  

The administrators agreed with the directors and added a further four internal factors that contributed to the failure of the REDgroup, namely ‘management buying decisions did not meet market demands. There was more emphasis on ‘buying’ rather 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 and general lack of consistent business processes with little use and reference to signed off critical paths and event management cycles’.

There is a more fundamental cause of this particular administration that a different perspective reveals. Strategic insolvency is a term recognised by insolvency practitioners who acknowledge that

‘[b]ankruptcy provides a useful business tool for a company to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure. For example, bankruptcy may

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54 D Noakes, ‘Measuring the Impact of Strategic Insolvency on Employees’ (2003) 11(12) Insolvency Law Journal 91, fn 5, quoting Peta Spender ‘strategic insolvency arises when the bankruptcy is invoked due to strategic decision-making rather than being a passive response to market forces.’ Rizwaan Jameel Mokal, ‘The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit’ (2002) 22(4) Oxford Journal of Legal Studies 687, suggests at 698 that ‘because a significant part of the [small firm] shareholder-managers’ wealth is likely to be invested in the [small] firm, as an undiversified investment, far from being ready to liquidate them strategically, shareholder-managers can be expected to fight … single-mindedly to keep them afloat.’ Mokal’s proposition may help explain the franchisees’ response to impending failure, but is inapplicable to franchisors that diversify business risks through their franchisees.
assist a franchisor in addressing the following challenging business issues; overexpansion in the market and the need to eliminate units, an unworkable equity structure, desire to sell or merge with another entity, threat of franchisee litigation, desire to refinance but the lender has expressed concern about financial or other issues.’55

The view from New Zealand commentators was that for PEP:

‘Voluntary administration was seen as a cost-effective way... to exit its ill-fated foray into book retailing. They knew what they were doing and they used the [New Zealand and Australian] 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 A$118 million ($147 million), most of it owed to [secured creditor] Pacific Equity Partners.’56

The likelihood that this was a strategic administration is given weight by the REDgroup the administrators’ conclusion that there was no evidence of ‘trading while insolvent’. The administration was voluntary, triggered by a secured creditor that owned the majority of shares in the REDgroup. This administration can arguably be categorised as part of a considered business strategy. Journalist Patrick Strafford tellingly commented that

‘[d]espite preparing the company for a float or trade sale, last October ... the company unveiled a full-year loss of $43 million for the 2009-10 year. The company, which is owned by private equity group PEP, was also forced to get a waiver from its lenders after breaching some of its financial covenants’.57

Voluntary administration provided an opportunity for the venture capitalist PEP to exit its investment when the financial climate did not permit it to exit by floating the REDgroup.

Against this background the effectiveness of Australia’s pre-contract disclosure requirement in the face of a franchisor’s voluntary administration will now be considered

III: PRE-CONTRACT DISCLOSURE IN FRANCHISING

Policy-makers recognise the imbalance of contracting power between franchisor and franchisees and respond by attempting to mitigate some aspects of asymmetry. One widely

56 Jamie Gray, 4 August 2011, the New Zealand Herald.
adopted mechanism is pre-contract disclosure. This is a regulatory tool that packages much of
the information that a franchisee needs to be aware of before signing a franchise agreement
into one document.

Following a trial period from 1993 the voluntary regime was abandoned in 1998.
Australia then enacted a mandatory franchising code of conduct.\textsuperscript{58} Over time the content has
been amended slightly by regulation.

To comply with the Code all franchisors must maintain a franchise disclosure
document and supply it in prescribed situations. The \textit{franchisor} is required to disclose 250
discrete items of information about itself and the franchise opportunity. Franchisees must
seek legal and financial advice in relation to the material in the disclosure. Part 3 of the Code
contains some limitations on the contents of franchise agreements and mandates a cooling off
opportunity for franchisees. Part 4 addresses dispute resolution by establishing a mediation
regime and making it accessible to parties who are ‘in a dispute arising under a franchise
agreement or this code’.\textsuperscript{59}

The purposes of the Disclosure are stated to be two-fold:

- ‘(a) to give to a prospective franchisee, or a franchisee proposing to enter into,
  renew, extend or extend the scope of a franchise agreement, information from the
  franchisor to help the franchisee to make a reasonably informed decision about the
  franchise; and

- (b) to give a franchisee current information from the franchisor that is material to
  the running of the franchised business’.\textsuperscript{60}

The prescribed format of the disclosure may not be varied. The front of the document
states (underlining added):

\begin{center}
\begin{tabular}{|l|}
\hline
\textbf{DISCLOSURE DOCUMENT FOR FRANCHISEE OR PROSPECTIVE FRANCHISEE;}
\hline
(b) the franchisor’s:
\begin{itemize}
\item[(i)] name; and
\item[(ii)] business address and phone number; and
\end{itemize}
\hline
\end{tabular}
\end{center}

\textsuperscript{58} Trade Practices (Industry Codes — Franchising) Regulations 1998 Statutory Rules 1998 No. 162 as amended made under


\textsuperscript{60} Trade Practices (Industry Codes — Franchising) Regulations 1998 Statutory Rules 1998 No. 162 as amended made under
the Trade Practices Act 1974 (‘the Code’) Section 6A
(iii) ABN, ACN or ARBN (or foreign equivalent if the franchisor is a foreign franchisor); and

(c) the signature of the franchisor, or of a director, officer or authorised agent of the franchisor; and

(d) the preparation date of the disclosure document; and

(e) the following statement:

This disclosure document contains some of the information you need in order to make an informed decision about whether to enter into a franchise agreement. 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.

A franchise agreement is legally binding on you if you sign it. You are entitled to a waiting period of 14 days before you enter into this agreement.

If this is a new franchise agreement (not a renewal, extension, extension of the scope or transfer of an agreement), you will be entitled to a 7 day ‘cooling off’ period after signing the agreement, during which you may terminate the agreement.

If you decide to terminate the agreement during the cooling off period, the franchisor must, within 14 days, return all payments (whether of money or of other valuable consideration) made by you to the franchisor under the agreement. ...

Take your time, read all the documents carefully, talk to other franchisees and assess your own financial resources and capabilities to deal with the requirements of the franchised business.

You should make your own enquiries about the franchise and about the business of the franchise. You should get independent legal, accounting and business advice before signing the franchise agreement.

There is no requirement in Australia for the disclosure document to be registered anywhere, or for the franchisor to be identified as a franchisor in any public register. All details of mediation conducted to satisfy the requirements of the Code remain confidential including the names of the parties. Thus, information about franchisors other than information they supply on their own websites, and breaches of the disclosure regime are difficult to detect unless they lead to litigation.

The effectiveness of Australia’s pre-franchise disclosure

We now explore the effectiveness of the mandatory pre-contract disclosure regime in Australia for the A&R franchisees faced with the administration of their franchisor. A&R’s disclosure in Australia would have disclosed information under the following headings:

2. Franchisor’s details. ‘Franchisor’ and ‘Associate’ 61 mentioned under 2 are defined terms in the regulation.

3. Franchisors’ business experience

4. Litigation

61 See Appendix 3 of this paper for definitions of franchisor and associate.
5. Payments to agents
6. Existing franchises
7. Intellectual property where it would have revealed the existence of six registered trade marks\(^{62}\), owned by Angus & Robertson.
8. Franchise site or territory
9. Supply of goods or services to a franchisee
10. Supply of goods or services by a franchisee
11. Sites or territories
12. Marketing or other cooperative funds
13. Payments
13A. Unforseen significant capital expenditure
13B. Costs of dispute resolution
14. Financing
15. Franchisor’s obligations
16. Franchisee’s obligations
17. Other conditions of agreement
17A. Unilateral variation of franchise agreement
17B. Confidentiality obligations
17C. Arrangements to apply at the end of the franchise agreement
17D. Amendment of franchise agreement on transfer or novation of franchise
18. Obligation to sign related agreements
19. Earnings information
20. Financial details
21. Updates
22. Other relevant disclosure information
23. Receipt

In short, a significant amount of information about the franchisor, its directors, the operational environment the franchisee will become part of, and the financial outlay required of the franchisee is disclosed.

\(^{62}\) TM Numbers 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).
IV: IMPLICATIONS

What is missing is hinted at on the organisation chart that is Appendix 1 to this paper. It shows the position of the franchisor, Angus & Robertson Pty Limited within the corporate REDgroup of companies.63 The ‘franchisor’ makes disclosure as a single legal entity, but the franchisor seldom stands alone. For example, the REDgroup in Appendix 1 operated three franchised brands (A&R, Whitcoulls and Borders) through 18 separate corporations and trusts in three countries (Australia, New Zealand and Singapore). While it is relatively easy and inexpensive to conduct a search of a proprietary (private) company64 conducting meaningful due diligence on more than one company becomes very expensive. Conducting due diligence on a trust is impossible.

The front cover of the disclosure document, as already stated, warns a franchisee that the franchisor might fail. The franchisor is not required to reinforce this caution by identifying the possible consequences of its entering administration or becoming insolvent for the individual franchisee. Those consequences can not readily be foreseen by a franchisee.

Nor is the franchisor obliged to disclose the debt load that it, or its ultimate owner, is carrying unless that debt has triggered litigation that needs to be disclosed under the ‘Litigation’ heading in the disclosure. One of the items under Litigation identifying information to be provided to an incoming franchisee is Item 4.1(a)(iii) contravention of the Corporations Act 2001. Trading while insolvent would be a contravention of the Corporations Act but as we have seen, the franchisor was not thought to have been trading while insolvent in the opinion of the administrator. The nearest the parent appears to have come to trading while insolvent is, as identified by a journalist after the administrator had been appointed, that ‘REDgroup ... was also forced to get a waiver from its lenders after breaching some of its financial covenants’.65 A breach of a contract with a third party may be a warning bell about impending insolvency but it does not need to be disclosed under


64 through www.asic.gov.au

‘Litigation’. In this case the breach was not by the franchisor but by the parent; and thus even more remote and not requiring disclosure.

A further issue devaluing the pre-purchase disclosure as a franchisee protection mechanism is that administrators generally treat the Code as not applying to them. From a policy perspective this seems like an untenable position. As a possible outcome of administration is that the business under administration may be handed back to its directors then there is no valid argument for denying franchisees the right to mediate with the administrator.

Franchise agreements, leases, trade mark licences and other contracts that convey rights to franchisees become assets or liabilities of the insolvent franchisor. Creditors and employees enjoy some statutory protection in insolvency. The franchisees are not creditors in relation to most of their investment. They are seldom employees. Accordingly administrators and liquidators owe statutory duties to the franchisor’s creditors and its employees, but not to franchisees.

The more entities there are, the more expensive and difficult it becomes for franchisees to conduct a robust due diligence.

The disclosure discloses a considerable amount of information about the franchise but the risk is that the franchisor will come from a bad family! In the case of Angus & Robertson the bad family element was not the franchisor that made disclosure. It was the venture capitalist that bought the network and then failed to nurture it.

V: CONCLUSION

Australian legal system currently lets a franchisee down. In civil law countries (for instance Germany), the bankruptcy of one party may constitute a ‘good cause’ to immediately terminate the ongoing contract unless this is not permitted under the applicable insolvency law.

At a policy level it is important to recognise that franchisees are particularly vulnerable as they have no role in the corporate governance of their franchisor. In the case of A&R and the Borders and Whitcoulls franchisees that were part of the same group the

http://www.iuscomp.org/gla/statutes/BGB.htm
owners of the franchisor caused the failure. The way the disclosure requirements are currently written in Australia does not protect franchisees from failure of their franchisors. A solution may lie with changing the disclosure to require disclosure of the entire network and the roles of each player in relation to the franchisee. This would not have informed franchisees that became A&R franchisees before the REDgroup’s involvement.

Ultimately, one way to deal with franchisees rights in the situation A&R experienced is to provide legislative protection that would operate ex ante and ex post the appointment of the administrator. Terms would be implied into all franchise agreements. ‘In proposing that terms be implied into all franchise agreements it must be acknowledged that franchise agreements can be disclaimed as onerous contracts by liquidators. They would, however, apply to the franchisor and the administrator’. 67

For example,

‘When a consumer purchases a product or service in Australia, and the product or service does not meet standards, the person has statute based 68 rights to claim against the supplier or manufacturer. These avenues are currently not available to franchisees that purchase a franchise that turns out to be faulty and to fail – not fit for its purpose. [Australia’s consumer protection legislation] does not provide redress if a manufacturer becomes insolvent, but the Corporations Act classifies consumers of defective products as unsecured creditors. The franchisor failing before the end of the franchise term is arguably analogous to a product or service failing’. 69

Further resolution of the problems caused by franchisor administration and insolvency is that:

‘[t]he franchisor’s breach of the Corporations Act is not a breach of the franchise agreement and does not give the franchisees the right to terminate the franchise agreement and all ancillary commitments.


Where the franchisor is a corporation the franchisor directors’ duties\textsuperscript{70} should be expanded so the directors owe to franchisees the same duties as directors currently have to a company. The rationale behind this is that franchisees provide a significant amount of the operational infrastructure that, absent franchisees, the franchisor would have to supply, and franchisees assume a significant amount of the franchisor’s business risk’.\textsuperscript{71}

**Implied term requiring franchisor to obey all relevant law**

‘The franchisor should have an implied contractual obligation consistent with the franchisees’ current obligation to carry on business activities in compliance with all laws, regulations and Codes of conduct. A statutory obligation should exist to require the franchisor to meet all contractual and statutory obligations between:

- itself and the franchisee
- itself and third parties (for example franchisor obligations in the head lease, and other supplier agreements on which the franchisee and its commercial reputation rely)
- itself and ASIC, the ATO and other levels and arms of government relevant to the franchise network

where a breach would cause harm to the franchisee. A breach of this implied term, depending on its seriousness, could give rise to a right for the franchisee to terminate the franchise agreement and sue for damages for breach of contract.

The term would need to be drafted widely enough to acknowledge that it might not be the franchisor that fails – it might be the parent company or another critical entity in franchisor’s network that fails, taking the franchisor with it.

**Implied term that franchisor will comply with all contractual or statutory obligations towards third-parties**

The franchisor should be required to comply with all collateral contract obligations and all obligations that arise under statute. A breach of any of the third-party or collateral contractual obligations that impacted detrimentally on franchisees would enable the affected franchisees to terminate their agreements and seek damages from the franchisor.

\textsuperscript{70} Directors have statutory duties under *Corporations Act 2001* (Cth) ss 180 (care and diligence), 181 (good faith), 182 (use of position), 183 (use of information), 184 (good faith, use of position and use of information – criminal offences), 190 (responsibility for actions of a delegate), 191 (disclosure of material personal interests) and 588G (insolvent trading).

This term would be used by franchisees whose franchisor did not pay the rent, outgoings or other third-party payments that it had received from the franchisee in a timely way. In failing to do so, the franchisor has put the franchisees’ businesses and reputation at risk.\(^72\)

**Implied term to take effect on appointment of administrator**

‘A term would be implied into all franchise agreements that if an administrator is appointed to the franchisor or to any of the entities in the franchisor’s network that threaten the viability of the franchisee’s business, a 2 step process will be triggered:

Step 1: when an administrator is appointed to their franchisor any franchisee may give notice to the administrator that if a satisfactory resolution (restructuring that takes into account the franchisee’s interests as well as those of the franchisor’s creditors, or sale to appropriate buyer) is not found within x days, it will terminate the agreement,

Step 2: if the administrator does not meet the requirements in x days, the franchisee have the right to terminate the franchise agreement, without this being a deemed breach by the franchisee and without it compromising any other rights the franchisee may pursue. The franchisees may express their losses as unsecured creditors for an amount of their initial investment, adjusted by depreciation and other appropriate considerations, plus any amounts currently owed in the franchisor’s administration/subsequent insolvency.

This approach could be adopted in relation to both franchisor and franchisee failure. This would mean the current asymmetrical provisions in the *Code* and all franchise agreements favouring franchisors in the event of franchisee failure could be removed from franchise agreements, thus making them shorter. It would also eliminate the risk of franchisees being sued by the administrator or liquidator for anticipatory breach’.\(^73\)

The last words belong to the journalist, Robert Stockdill who quipped: ‘Q: How do you start a small business? A: Sell a big business to a private equity company’.\(^74\)

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\(^74\) Robert Stockdill, No one to blame but themselves. 25 February 2011, Inside Retailing.
### Appendix 2

#### National Names Index

Australian Securities & Investments Commission

Index of corporate and business names

8 names found (* indicates former name)

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APPENDIX 3


Section 3(1) franchisor includes the following:

(a) a person who grants a franchise;
(b) a person who otherwise participates in a franchise as a franchisor;
(c) a subfranchisor in its relationship with a subfranchisee;
(d) a master franchisee in a master franchise system;
(e) a master franchisee in its relationship with a franchisee.

Section 3(1) associate, for a franchisor, means 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.