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# Balance of power, certainty and discretion in the franchise relationship: An analysis of contractual terms

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**Balance of Power, Certainty and Discretion in the Franchise  
Relationship:**

**An Analysis of Contractual Terms**

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## Executive Summary

Balance of power is a factor in considerations of fairness in the formation of contracts and in Australia is an express factor in determining unconscionability in contract formation and performance. Certainty is essential to business confidence that underpins planning and investment. Certainty is also a factor in evaluating what parties have agreed to in making the contract. Discretion, if it is too wide, may no longer represent the true intentions of the parties, but may instead be an indication of other forces, including asymmetries in the power relationship. These issues are of particular significance in franchising; redressing imbalance of power and ensuring certainty among the parties are among the stated goals of the regulation of the franchise sector in Australia.

Previous analysis has demonstrated that the market interaction between franchisor and franchisee sets up a relationship that is characterized by imbalance of power and uncertainty for a franchisee. Further, it has been demonstrated that, in theory, the standard form and relational qualities of the franchise contract synergistically reinforce these conditions. This paper tests that theory by evaluating balance of power and uncertainty in the terms of franchise contracts. A sample of ten contractual terms from nineteen franchise contracts is analysed as follows: first, the purpose of each contract term is outlined and the interests of both a franchisor and a franchisee are explained with respect to each term; second, the results of the sample are discussed.

The results show that contract terms indicate that greater power resides with a franchisor, while higher levels of uncertainty are experienced by franchisees. This section also discusses the allocation of discretion in franchise contracts. Discretion accorded to parties in contracting relationships can be both a measure of balance of power and certainty as well as a factor that reinforces these conditions. The results presented here also indicate that franchise contracts confer high levels of discretion upon a franchisor. Complacency about the ability of the sector to regulate itself through market and contractual mechanisms therefore should be guarded against.

Note: A companion paper discusses direct intervention, with a particular focus on the potential for disclosure to function effectively as a principal means of regulating the sector. (Please refer to 'Effective Disclosure in the Regulation of Franchising'.)

**Keywords:** contract, regulation, discretion, balance of power, standard form

## INTRODUCTION

Debate continues in academic, practitioners, and government circles over the question of the nature of the franchise relationship and how it should be regarded in the law. Approaches to interpreting the relationship between franchisor and franchisee (the franchise relationship) typically involve analogies to other legal relationships, such as employment, licensing, distributorship, and investment. . Is the franchisee a business partner or a joint venturer? Or is its role closer to that of an employee, an investor, or a consumer? Through the use of such analogies it is possible to make certain inferences about the nature of the franchise relationship, in particular, which party exercises control, whether the parties are acting on behalf of the other and so on. This research acknowledges the importance of these analogies, but takes a different approach as it looks to contract for direct evidence of such factors as control, power, certainty and discretion in the relationship.

In this paper the franchise relationship will be approached from the point of view of the contractual obligations of the parties. In her seminal paper on franchise relationships Gillian Hadfield wrote, '[T]he heart of franchising's legal structure is still contract.'<sup>1</sup> Former CEO of the Franchising Council of Australia, Richard Evans, more recently reiterated this view, 'It is a contract relationship, and needs to be understood as such.'<sup>2</sup> The contract informs the structure of franchising as organizational form, as a form of governance of the franchise organization, and as an alternative to planning, promise and competition.<sup>3</sup> The contract as governance outlines a matrix of overlapping roles of franchisor and franchisee, serving both as a means for parties to organize themselves and as a guide to public entities (courts and regulators) on how to interpret the relationship. The contract puts in place the regulatory mechanisms for a franchisor to monitor a franchisee, to provide performance incentives, to allocate risk, manage externalities,

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<sup>1</sup> Gillian Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927, 939.

<sup>2</sup> Richard Evans, CEO of the Franchising Council of Australia, quoted in 'Follow the Winning Plan', *The Australian* (Sydney), 30 June 2006, 12.

<sup>3</sup> See Oliver Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22(2) *Journal of Law and Economics* 233.

information asymmetry, and facilitate information search, entrepreneurship and interdependence.

Much of the nature of the relationship is codified through the contract. Anyone with an interest in the relationship must look to the contract for clarification of what is expected. As Blair and Lafontaine observe, a franchisee should,

‘recognize his contract for what it is....it makes sense to think of a franchise contract as a rental contract over an intangible asset, namely the brand, with the terms of the franchise contract clearly defining the relationship.’<sup>4</sup>

The words, ‘*with the terms of the franchise contract clearly defining the relationship*’, emphasize that an accurate understanding of the nature of the contractual agreement is critical to understanding the relationship.

With this in mind, this paper explores the nature of the franchise relationship, in particular, the allocations of power, uncertainty and discretion, in order to inform a better understanding of how this relationship should properly be regarded in the law. The paper summarizes an analysis of ten contract terms from nineteen contracts sampled. This analysis is used to assess whether contract terms reflect imbalance of power and uncertainty in the relationship and tests the theoretical analysis of contract as a private layer of governance that, because of its standard form and relational qualities, reinforces these conditions.

The paper is organized in two sections. There is first a brief introductory section that outlines the significance of balance of power, certainty and discretion in contract generally. In the second section the results of the analysis are discussed. The purpose of each contract term is explained and the interests of both a franchisor and a franchisee are outlined with respect to each term, so that it is possible to evaluate the balance of these competing interests as they are manifest in the sample. The results are that contract terms provide evidence of the power imbalance in favour of the franchisor, and that, largely through the allocation of discretion, that there are high levels of uncertainty for franchisees.

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<sup>4</sup> Roger Blair and Francine Lafontaine, *The Economics of Franchising* (2005) 221.

## **PART ONE: BALANCE OF POWER, CERTAINTY AND DISCRETION IN CONTRACT**

Power is defined as, ‘Strength in arranging the terms of one's dealing with other firms or people.’<sup>5</sup> Imbalance is defined as ‘lack of proportion or relation between corresponding things.’<sup>6</sup> Imbalance of power is, then, a lack of proportion or relation between parties’ strength in arranging the terms of dealing.<sup>7</sup> In a contract that is both standard form and relational power and certainty are linked; the link is discretion. Discretion is defined as ‘the power or right to decide or act according to one's own judgment; freedom of judgment or choice.’<sup>8</sup> Hawkins writes that ‘discretion is power, with all its corrupting implications’.<sup>9</sup>

A franchisor’s discretion to act equates to a ‘right of action’.<sup>10</sup> The disadvantages of discretion are that it facilitates action on improper considerations and permits the substitution of subjective, personal standards for accepted or agreed-upon ones. The party that has discretion has the power and the certainty that it can make choices to benefit itself. The party that gives discretion, a franchisee, bears the uncertainty and increased risk. The following economic definition of uncertainty underscores the link between risk and uncertainty:

‘A consciousness of lack of knowledge about present facts or future possibilities. ...Some writers distinguish between risk and uncertainty...Many authors, however, simply use risk and uncertainty interchangeably.’<sup>11</sup>

Another definition of uncertainty states that it,

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<sup>5</sup> John Black, *A Dictionary of Economics*. (2002). *Oxford Reference Online*. Oxford University Press, <<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t19.e2399>> 20 November 2006.

<sup>6</sup> *The Oxford Dictionary of English* (2<sup>nd</sup> ed, 2005).

<sup>7</sup> John Black, *A Dictionary of Economics*. Oxford University Press, 2002. *Oxford Reference Online*. Oxford University Press. Bond University. 20 November 2006 <<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t19.e185>>.

<sup>8</sup> *Random House Unabridged Dictionary*, (2006).

<sup>9</sup> K. Hawkins, *The Uses of Discretion* (1992) 4.

<sup>10</sup> William L. Killion, ‘Putting Critical Decision-Making Where It Belongs: Scouring the Franchise Agreement for the “D” Word’ (2005) 24 *Franchise Law Journal* 228.

<sup>11</sup> John Black, *Dictionary of Economics*. Oxford University Press, 2002. *Oxford Reference Online*. Oxford University Press. Bond University. 20 November 2006 <<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t19.e3223>>.

‘arises when decisions have to be made about the future where it is not possible to assign probabilities to the various outcomes. Often used as a synonym for risk.’ (sic) Risk is defined as ‘the possibility of large price or rate movements in assets or liabilities, usually computed using probabilities. Most commentators and market practitioners associate risk with adverse, or the downside, effects of price or rate movements’<sup>12</sup>

Uncertainty will be used in this paper to refer to the inability of a franchisee to predict. Because franchise contracts employ flexible, open-ended terms and discretion to accommodate the longer term and relational nature of the relationship, uncertainty is closely related to flexibility in the contract, grants of discretion to a franchisor, and concomitantly high levels of risk to a franchisee.

The regulatory program for franchising acknowledges these conditions. Among the several stated goals listed in the regulatory impact statement for the Franchising Code of Conduct (the Code) are reducing risk and generate growth in the sector by increasing the level of certainty for all participants/providing an environment of certainty, and addressing the imbalance of power between franchisors and franchisees.<sup>13</sup> In this paper contract terms are assessed as they provide an indication of the extent to which regulation is achieving its goals, i.e. whether the regulation is ‘effective’, in the sense of ‘successful in producing a desired or intended result’. If the current regulatory regime is meeting its stated goals, the contract should reflect 1) a balance of power and 2) certainty for both parties.

Balance of power will be measured by considering the proportionality of rights and obligations of the parties, levels of flexibility and discretion and other safeguards or measures, if any, as these are manifest in the contract. Balance of power is indicated by a contract that reflects the interests of both parties, an equal proportion of rights, reciprocity of obligation, and the reciprocity of flexibility and discretion.<sup>14</sup>

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<sup>12</sup> *The Handbook of International Financial Terms*. Peter Moles and Nicholas Terry. Oxford University Press 1997. *Oxford Reference Online*. Oxford University Press. Bond University. 20 November 2006 <<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t181.e8049>>

<sup>13</sup> Explanatory Statement - *Trade Practices (Industry Codes - Franchising) Regulations 1998* (Cth) No. 162 <<http://www.comlaw.gov.au/ComLawwithLegislation/LegislativeInstrument1.nsf/framelodgmentattachment/s/77630AD9222B25BCCA256F73000E7654>> at 9 December 2006.

<sup>14</sup> This lack of proportion ‘depends on the losses failure to agree is likely to cause to the various parties to a negotiation. In the absence of agreement, each party has a fall-back position: the less uncomfortable this is,

Contract can be used also to measure certainty by comparing specificity versus flexibility and discretion in the contract terms and by the levels of discretion in contractual terms. Specific and precise contract terms provide greater certainty than contractual terms characterized by high levels of flexibility and discretion. Uncertainty refers to the inability of a franchisee to predict, and so it is closely related to flexibility in the contract, grants of discretion to a franchisor, and risk to a franchisee. A party to a contract may gain a measure of certainty by controlling dispute resolution procedures and through the exercise of discretion. Either party can do this by ensuring its ability to fill the gaps in contract, by ensuring it has the power to decide matters left unspecified in the contract. This analysis measures the reciprocity of that discretion. A low level of reciprocal discretion in the contract indicates more certainty for the party that enjoys higher discretion, less for the party conferring the discretion.

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and the longer any party can afford to stay in it, the stronger is their bargaining power. A party with a very uncomfortable fall-back position and an urgent need for an agreement has very little bargaining power. Bargaining power is increased by unity, financial reserves, and a reputation for toughness, and is decreased by division, shaky finances, and a reputation for being willing to compromise.’ Many other factors affect balance of power such as proportionality; availability of meaningful alternatives and relative fall-back positions; need for an agreement; unity as opposed to division; financial reserves; and reputation for toughness as opposed to reputation for being willing to compromise; necessity; the nature of the good or service; ability to negotiate terms; wealth; business sophistication; education or knowledge; race; gender; "size" of the parties; monopoly power; and consumer status. See definitions section for quotations relating to these qualities of bargaining power discussed in John Black, *A Dictionary of Economics* (2002) accessed via *Oxford Reference Online*, <<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t19.e185> at 20 November 2006; and Daniel D. Barnhizer, ‘Inequality of Bargaining Power’ (2005) 76 *University of Colorado Law Review* 139, 199-201.



## **PART TWO: RESULTS OF CONTRACT TERMS ANALYSIS**

In the following sections eight contract terms are individually evaluated for the extent to which they reflect these stated goals of regulation of the sector. The following contract terms are analysed for the extent to which they reflect balance of power and certainty in the franchise relationship. These terms offer a representative view of different stages of the relationship:<sup>15</sup>

- Terms relating to the roles of the parties and the scope and duration of the agreement:
  - Scope of grant
  - Contract term (duration) and right of renewal
- Terms relating to performance:
  - Franchisor obligations regarding advertising
  - Supply to franchisee
  - Franchisee minimum performance and reporting requirements
- Terms relating to exit:
  - Transfer
  - Termination
- Term relating to adjustments to the contract and contractual restraints:
  - Restraint of trade

Two other terms, the clause relating to ‘franchisee independence’ and the ‘collective agreement’ clause are also discussed, but in less detail, at the beginning and end of this section respectively.<sup>16</sup>

### **Contract Term: Franchisee Independence**

A franchise is a transfer of a right, a type of license.<sup>17</sup> Often it represents the most effective means for an owner of a trademark and other intellectual property relating to a business system to obtain revenue from that intellectual property, while at the same time maintaining the requisite control to preserve and enhance the value of the intellectual

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<sup>15</sup> Two terms from the original sample (i.e. lease and ownership of intellectual property and goodwill) have been omitted from this discussion because of the length and complexity a discussion of these terms would require and because neither term is governed primarily by the Code.

<sup>16</sup> A complete sample franchise agreement can be found in *Franchising Law and Practice*, <<http://www.lexisnexis.com.ezproxy.bond.edu.au/au/legal/results/pubTreeViewDoc.do?nodeId=TAAKAA&pubTreeViewWidth=23%25>> at 2 March 2007.

<sup>17</sup> The Federal Court in *Australian Competition & Consumer Commission v Ewing* [2004] FCA 5 considered the distinction between a license and a franchise. Some commentators have touched upon it, but there is no clear legal distinction. Some distinctions that are noted are that franchising is a license for the entire system, and that there is greater participation and control by the franchisor than would be the case in a non-franchising licensing arrangement.

property. Despite efforts to define it, a cogent, consistent legal definition of franchising has so far proved elusive. Legal approaches to franchising are rarely straightforward. The franchise relationship has been compared to a joint venture, employment, investment, distributorship, marriage, and sharecropping to name a few.

Indeed, the franchise relationship takes many forms and within each of these forms a franchisor and franchisee play various roles. These multiple roles add to the confusion over the legal nature of franchising. The role of a franchisee is often explicitly stated in the contract. More precisely, the contract explicitly states what a franchisee is not. A typical clause might read, 'Nothing in this agreement will be construed so as to create a partnership or any other relationship between the parties'.<sup>18</sup> Most contracts sampled expressly provide that a franchisee is not an agent, subsidiary, representative, legal representative, legal representative, employee, nor in a fiduciary relationship, partnership or joint venture. A contract may include additional language that further negates an agency relationship such as, '[n]either party has the power to obligate or bind any other party except as authorised by this Agreement.'<sup>19</sup>

That this contract term is often labelled, 'franchisee independence' offers an insight into the drafter's capacity for irony; in actual practice a franchisee is not independent of a franchisor in its operation. Despite these contractual disclaimers, the contract and the relationship in many ways suggest that a franchisee is like an employee, a distributor, an agent, and/or a joint venturer. There are also many similarities in the role of a franchisee to the role of an investor and also to the role of a consumer of goods and/or services. Evidence to the contrary notwithstanding, a franchisor wants to avoid the legal burdens of such relationships, and includes an express term that says the relation is none of these things. A franchisor has control, and it uses that control to draft terms like this one to avoid obligations and liabilities and to ensure favourable outcomes when subject to judicial interpretation or legislation.<sup>20</sup> The balance of power favours the franchisor, with

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<sup>18</sup> Often in a clause under the heading 'Franchisee Independence'. The particular clause cited here is from the System F19 contract.

<sup>19</sup> System F7.

<sup>20</sup> There is no regulation in the form of disclosure or any other regulatory tool with respect to this contract term. It may be appropriate for a court (or a regulator) to find that one or more of these relationships does

high levels of uncertainty for a franchisee, as the benefit and safeguards of the contract accrue largely to the benefit of the franchisor.

### **Contract Term: Scope of Grant**

A franchise is a license to operate the franchise unit at a specified location or geographic area, and to use the intellectual property, operations manual, and images to the extent permitted by the scope of the grant. The Scope of Grant clause defines the scope of the license a franchisor grants to a franchisee to use intellectual property rights and sets the limits on that use.<sup>21</sup> Details of the grant may be found also in ancillary documents that specifically define the scope of the grant or license specific rights to use intellectual property such as trademark.

This term, like all franchise contract terms, reflects the balance of competing interests struck by the parties. A franchisee wants to maximize the extent of the rights it is buying from a franchisor. A franchisee prefers an exclusive right to use the intellectual property as extensively as possible in order to ensure 1) that it will benefit from his own efforts to develop its business at a particular location and 2) that its investment is secure from franchisor encroachment.<sup>22</sup> A franchisor, on the other hand, wants to protect its flexibility and its options to expand and develop the system and brand awareness, to limit what it grants to a franchisee and retain, as far as possible, its own rights to use and sell the rights to the intellectual property to others.

Encroachment is a frequent concern among franchisees. Encroachment by a franchisor can take a variety of forms, such as franchisor development of alternative distribution channels through supermarkets; kiosks; convenience stores; independent retailers; and non-traditional or seasonal locations. A franchisor may initiate a mail order operation or provide services from outside a franchisee's area into his market through the use of the

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exist, even in the face of an express term that states all the relationships that franchising is not. The challenge in interpretation is to comprehend the multiple roles played by the franchisee in the franchise relationship, to consider not only the clause that neatly proclaims the franchisee to be an independent contractor, but to look at all the contract terms, and beyond the contract to consider the entire relationship.

<sup>21</sup> For a general overview of grants clauses in intellectual property see Donald M. Cameron, *The Grant Clause* (1997) JurisDiction <<http://www.jurisdiction.com/grant.htm>> at 15 March 2006.

<sup>22</sup> Encroachment is defined as 'the act of entering 'gradually or stealthily into the possessions or rights of another' *Merriam-Webster's Dictionary of Law*, Dictionary.com <<http://dictionary.reference.com/browse/encroach>> at 29 Jul. 2007.

Internet (known as 'virtual encroachment'). Increasingly, encroachment occurs when a franchisor acquires a competing brand and shares information with franchisees from the other brand.<sup>23</sup> A 2003 survey carried out in the US showed that 24 percent of franchisees had been 'threatened, encroached upon or coerced into unwanted expansion by their franchisor.'<sup>24</sup>

Perhaps the most common form of encroachment involves a franchisor placing a competing unit close to an existing unit. Franchisors are 'obsessed' with selling franchise units<sup>25</sup> because initial entry fees are a critical source of franchisor income, and because each new unit adds to brand awareness, which in principle enhances the value of the franchise system. Franchisees, however, do not always share the franchisor's enthusiasm for opening new stores. The following hypothetical illustrates the conflict of interest between franchisor and franchisee:

A franchisee operates a unit that grosses \$10,000/week. A franchisor decides to open another store five hundred metres away. Within a few months the new unit grosses \$7,000/week. Perhaps \$3000 of that is pulling from the first store's business. For a franchisor, two stores each making \$7000/week is preferable because a franchisor receives royalties on \$14,000 rather than \$10,000. But to the extent that the second unit does pull \$3000 in business from the first, unless sales increases outpace the losses to encroachment, franchisees' profit margins decline.<sup>26</sup> The first franchisee loses business, and the second franchisee may never be as profitable as it might have been if the area development had been more carefully planned.

The foregoing discussion explains why a franchisor can be expected to draft this contract term to protect its right to encroach and limit a franchisee's exclusive rights.

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<sup>23</sup> Co-branding involves a franchisor owning multiple franchise systems and brands, or franchisors agreeing to market together. Co-branding increases royalty revenue for the franchisor, but, like other forms of encroachment, can dilute the value of the brand to the franchisee. *Concise Legal Dictionary*, (3<sup>rd</sup> ed, 2004).

<sup>24</sup> Tina Perazzini of Subway stated her employer's policy on encroachment during the 1990's: "We put them up any f\*\*\*ing place we could.", Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004) 109 *Penn State Law Review* 105, 185.

<sup>25</sup> Lorelle Frazer, Professor of Marketing, Griffith University, 'Are Franchisees Potential Competitors? A Study of Franchisees Who Exit the System but Continue Operating', (Paper presented at the 18<sup>th</sup> International Society of Franchising Conference, Las Vegas, 2004), <[http://www.huizenga.nova.edu/business/abstracts/abstracts2004/Paper%2014\\_2004\\_Frazer\\_Abstract.doc](http://www.huizenga.nova.edu/business/abstracts/abstracts2004/Paper%2014_2004_Frazer_Abstract.doc)> at 30 December 2005.

<sup>26</sup> Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004) 109 *Penn State Law Review* 105, 310. This is particularly of concern to franchisees in low margin industries such as quick-serve restaurants.

Over half of the contracts in the sample explicitly state that the grant to a franchisee is non-exclusive. Franchisors may refuse to make grants to franchisees of exclusive territory, citing the need for flexibility in responding to market conditions. Where franchisors do grant exclusive territories to franchisees, the contract provision often covers only the unit premises; the franchise contracts in the sample indicate that the prevailing practice is to limit the license to a franchisee's premises. Several contracts in the sample (Systems F1, F2, F4, and F5) granted an exclusive license to the use the intellectual property, limited to the territory or the shop premises. Even this right may be subject to franchisor oversight; one contract provides that the franchisee has no property rights over premises; the franchisor keeps keys, and has unlimited access to the premises.<sup>27</sup>

Most of the contracts sampled provide very limited, if any, restraints on a franchisor's use or further grant of the intellectual property beyond a franchisee's premises. Some expressly ensure a franchisor's discretion, e.g. franchise contracts that contain language reserving a franchisor's rights provide a substantial legal basis to uphold a franchisor's right to encroach (Systems F1, F2, F4, F7, and F8). One contract sampled further specifically protects a franchisor's right to do business on the Internet.<sup>28</sup>

The grant of an 'exclusive' right at the premises or similar language may give the illusion of greater protection of its rights than a franchisee actually enjoys. A franchisee with an 'exclusive' license at its premises, for example, does not in reality gain real assurance against franchisor encroachment. A franchisor is still free to open a new unit a block or two away, creating uncertainty for a franchisee. Some contracts, however, do include limits on a franchisor's licensing of the intellectual property in the franchisee's territory,<sup>29</sup> and one of the contracts in the sample imposes a duty on a franchisor to protect a franchisee's territory.<sup>30</sup>

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<sup>27</sup> System F14.

<sup>28</sup> System F7.

<sup>29</sup> System F16.

<sup>30</sup> System F2.

Three of the contracts contained a franchisee right of first refusal, so that if a franchisor wishes to open a new unit near a franchisee, the franchisee has the first option to buy and operate that unit.<sup>31</sup> In some cases a right of first refusal is a benefit to franchisee but it can be double-edged sword because it creates added risk for the franchisee, while giving the appearance of offering franchisee protection.

Keeping a franchisor's options open is a justifiable discretion to the extent that it benefits the system and all franchisees; it may be less justifiable where it adversely affects the rights of individual franchisees to conduct business. To the extent that a franchisor retains the right to use and sell the intellectual property, notwithstanding any rights sold to a particular franchisee, then that franchisee is receiving correspondingly less value for its investment in the right.

The sample indicates that this contract term reinforces a franchisor's interest in maximum discretion and flexibility to exploit the intellectual property freely outside a franchisee's premises, and so reflects an imbalance of power between the parties and a high level of uncertainty for a franchisee.

Without contractual protection a franchisee that is faced with franchisor encroachment is forced to rely on a vague standard such as the principle of unconscionable conduct, though its application in franchising cases generally has been unhelpful to franchisees.<sup>32</sup> A franchisee might have some hope of prevailing on a claim of lack of good faith by a franchisor in the exercise of its discretion, or on a claim of misleading or deceptive conduct.<sup>33</sup>

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<sup>31</sup> Systems F6, F15, F17.

<sup>32</sup> Jenny Buchan, 'Who is the franchisee contracting with and does it matter anyway?' (Paper presented at the 51st ICSB World Conference, 2006, Melbourne, Australia). There are few cases in franchising where a court has held in favour of a franchisee on a claim of unconscionable conduct.

<sup>33</sup> For example, in *Neilson Investments (Qld) P/L and Ors v Spud Mulligan's P/L and Ors* [2002] QSC 258) a franchisee purchased a franchise that failed. Meanwhile, the franchisor had built a competing store within three kilometres of the franchisee's store. The franchisee claimed to have relied on representations by franchisor that had induced him into entering franchise agreement. The court held for the franchisee; the franchisor was found to have breached the Trade Practices Act (the TPA) section 52. In *Bamco Villa Pty Ltd v Montedeen Pty Ltd* [2001] VSC 192 a franchisee prevailed on a claim that the franchisor had breached a contractual term. The court held that the franchisee's breach of the contract 'was not a breach which the franchisor, acting in good faith and reasonably, ought to have relied upon as a ground for exercising the power to terminate the franchise agreement.' The franchisor was in breach of the express

## **Contract Term: Duration and Right of Renewal**

The duration of the contract and right of renewal, if one is provided for, are commonly included together in the early sections of the franchise contract. The length of the contract, any ensuing renewal period, and the conditions placed upon it, are important considerations for both franchisor and franchisee, but once again their interests conflict. A franchisee prefers an initial contract duration long enough to allow it to recoup its investment and to achieve a reasonable return on its original capital investment.<sup>34</sup> Franchisee fees allow a franchisor to recover the costs of its investment in the development of the unit.<sup>35</sup> A franchisor typically prefers relatively short contract duration with a conditional option to renew.<sup>36</sup> Shorter contract duration gives a franchisor the opportunity to collect further fees at transfer or renewal or upon sale of the franchise to a new franchisee. The conditions of renewal give franchisors the opportunity to impose additional operating requirements, to require franchisees to upgrade premises and/or to undertake additional obligations.<sup>37</sup>

Established systems, larger territories, and master franchise arrangements often involve longer contract durations, probably because of larger investments by franchisees and longer time frames required for franchisees to achieve reasonable returns. Another

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term, and its conduct was held to be unconscionable in breach of section 51AC of the TPA. (No contract in the sample contains a term similar to the express term that was found to have been breached by the franchisor in the case.) In *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 McDonald's opened a new restaurant near an existing franchisee, but had not offered the franchise to that franchisee. The franchisee had no territorial rights nor any express contractual right to be offered this franchise, but it alleged that McDonald's forced it out of the system and breached the implied duty of good faith. Though there was insufficient evidence to prove McDonald's lack of good faith, the case is significant because the court held that there was an implied duty of good faith, 'there is to be implied into a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose'. With respect to virtual encroachment, in *Dymocks Holdings Pty Ltd v Top Ryde Booksellers Pty Ltd & Ors* [2000] NSWSC 795 the court held that the franchisor's website was in direct competition to the franchisees.

<sup>34</sup> Jeff Elgin, *Ready to Commit? About to buy a franchise but intimidated by the license agreement? We explain what to look for before you sign on the dotted line* (2005) Entrepreneur.com <<http://www.entrepreneur.com/article/0,4621,321573,00.html>> at 10 August 2005.

<sup>35</sup> The share parameter or royalty, on the other hand, is set so as to compensate the franchisee and the franchisor for the costs of their ongoing efforts.

<sup>36</sup> Jeff Elgin, *Ready to Commit? About to buy a franchise but intimidated by the license agreement? We explain what to look for before you sign on the dotted line* (2005) Entrepreneur.com <<http://www.entrepreneur.com/article/0,4621,321573,00.html>> at 10 August 2005.

<sup>37</sup> Ibid.

reason for longer terms is that more experienced franchisor systems and franchisee operators are involved. It is common that McDonald's contracts run for twenty years and typically do not offer a right of renewal. Longer duration contracts are less likely to carry with them automatic rights of renewal due to higher risk exposure if franchisees do not perform, or relations break down. Because the initial contract duration for a McDonald's franchise is around twenty years, there is ample opportunity for a franchisee to recoup his considerable initial investment. It is therefore reasonable to expect that a franchisor will be unwilling to commit to right of renewal at the end of the twenty year contract duration. This is a good example of the need for different approaches depending upon the stage of maturity and development of the franchise system.

Franchisors are perennially concerned with the pool of qualified potential franchisees. Currently much of what a franchisor does is geared to make a franchisee as 'substitutable' as possible.<sup>38</sup> Franchisees are often surprised to find that their share at transfer or termination does not meet expectations.<sup>39</sup> A franchisee wants a term long enough to recoup its investment, to have something to sell upon exiting the arrangement, and not to be subject to franchisor hold-up. The term 'right of renewal' is a misnomer to the extent that the term does not spell out a right of a franchisee as much as it outlines conditions and ensures franchisor discretion not to grant renewal.

The initial contract duration in the sample varied from five to ten years; no contract in this sample was of duration longer than ten years. Most contracts sampled did contain a right of renewal. The most commonly-used formula in the contracts sampled is the five-year initial contract duration with an option to renew for a further five years.<sup>40</sup> All contracts sampled offered an option to renew for one term of the same length as the initial term; none offered a further option to renew. Some provisions were made for month-to-month operation after the expiration of the initial term. Variations among these

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<sup>38</sup> The author is not aware of any economic analysis that has been conducted on the economic benefit to franchisor or franchisee longevity compared to high franchisee turnover.

<sup>39</sup> Telephone interview with Richard Evans, Franchising Council of Australia, late 2004.

<sup>40</sup> In Europe most franchisee agreements run for a period of between five and ten years but 'Pan EU agreements are usually longer between 10 and 25 years', in order for the franchisee to obtain a decent return on its investment.



terms related principally to the notice period for renewal, renewal fees and other conditions for renewal.

To address franchisor concern that the 'right of renewal' might create a property right in a franchisee, most of the terms in this sample include extensive conditions that can be imposed by a franchisor to prevent a franchisee from acquiring a property right or other right that is onerous to a franchisor.<sup>41</sup> These conditions allow a franchisor to refuse to grant renewal where a franchisor may have an interest in limiting the power and influence of existing franchisees, for example, in major or geographically extensive markets, or where, for these and other reasons, there is a potentially strong franchisee that may no longer comply sufficiently or may threaten a franchisor's control.<sup>42</sup>

Only one contract in the sample, F19, provides for an automatic renewal that can be declined by either party with three months' notice. If the contract were to reflect a balance of power between the parties, contract duration terms could be expected to be calibrated to protect and allow recovery of a franchisee's specific investment while safeguarding a franchisor from franchisee free-riding.<sup>43</sup> It is not clear whether the five-year initial term with five-year right of renewal does create such a balance but shorter contract terms do tend to favour a franchisor, and most of the contracts in the sample provide for short contract terms. The sample therefore indicates that the contract reflects an imbalance of power between the parties.

Most case law that is available regarding right of renewal in franchising in Australia involves petrol stations.<sup>44</sup> Several of these cases suggest that the terms of contracts are

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<sup>41</sup> Because a contractual relationship of limited duration becomes property right – 'statutes that limit the franchisor's right not to renew...impinge upon the substantive economic rights of the parties'. See Rupert M. Barkoff, *Government Regulation of the Franchise Relationship in the United States* (2003) Kilpatrick Stockton LLP <<http://www.kilpatrickstockton.com/publications/pubs.aspx>> at 15 August 2003.

<sup>42</sup> *The Franchise Agreement* (2005) European Franchising Network <<http://www.europeanfranchising.com/introtofranchising/14franchiseagreement.aspx>> at 30 December 2005.

<sup>43</sup> Janet Bercovitz, 'An Analysis of the Contract Provisions in Business Format Franchise Agreements' (1999) International Society for New Institutional Economics <<http://www.isnie.org/ISNIE00/Papers/Bercovitz.pdf>> at 8 December 2004.

<sup>44</sup> These cases include *Ampol Ltd v Calaby Pty Ltd* (1991) 110 ALR 343, *Sagittarian Enterprises Pty Ltd and Others v Ampol* (1986) 69 ALR 551, *Anjac Pty Ltd v Caltex Oil Australia Pty Ltd* (1985) 69 ALR 733,

often constructed so that a franchisor does not have to renew, as the court found that there was not a right of renewal enjoyed by the franchisee.<sup>45</sup>

The scope for franchisor discretion in determining conditions for renewal is difficult for a prospective franchisee to assess but can have a significant impact on a franchisee's return on its investment. Long-term contracts are in theory associated with uncertainty, but shorter contract duration in the long-term contract also creates uncertainty for a franchisee. Not only is a franchisee in this situation giving discretion to a franchisor over the period of the initial term, but also a franchisee is subject to franchisor's conditions, often exercised with a franchisor's discretion, at the expiration of the initial term. For example, a common renewal condition is to require a franchisee to sign the "then current" form of the franchise contract, which is likely to include higher fees as well as new restrictions on the operation of the business. A franchisee may be required to update the physical plant of the business to the current basis for new units opening in the system, a potentially major investment.<sup>46</sup> As franchisees approach the expiration of their term they may be subject to franchisor pressure to conform in a variety of ways as a condition of renewal.<sup>47</sup>

### **Contract Term: Franchisor Obligation to Advertise**

Maintenance of brand and trademark is a critical aspect of the success of any franchise system. Franchisor promotional obligations build and reinforce brand and trademark. They also can help to curb franchisee free-riding by centralising brand maintenance for the system, while a franchisee may undertake local promotions on behalf of the unit. Franchisee participation in promotional funding is mandatory. Promotions are paid for

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*Mobil Oil Australia Ltd v Brian Brindle* (1983) 62 ALR 89, *Dinyarrak Investments Pty Ltd v Amoco Australia Ltd* (1982) 45 ALR 214.

<sup>45</sup> See the *Petroleum Retail Marketing Franchise Act 1980* (Cth). Because these cases are governed by the separate code, they are not discussed further here.

<sup>46</sup> Jeff Elgin, 'Ready to Commit? About to buy a franchise but intimidated by the license agreement? We explain what to look for before you sign on the dotted line' (2005) Entrepreneur.com <<http://www.entrepreneur.com/article/0,4621,321573,00.html>> at August 2005. See also; 'The Problems Franchisees Face' (2003) American Franchise Association <<http://www.franchisee.org/problem>> at 30 December 2005.

<sup>47</sup> Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004) 109 *Penn State Law Review* 105, 116.

with funds a franchisor collects from franchisees. A franchisor may allocate funds at its discretion for advertising and promotions.<sup>48</sup>

Advertising is one of the few explicit contractual obligations of a franchisor, but it is an obligation undertaken at a franchisor's discretion; a franchisor

‘shall oversee all System and Product advertising, with sole discretion to approve or disapprove the creative concepts, materials and media used in such advertising, and the placement and allocation thereof.’<sup>49</sup>

This situation where one party that provides an asset that is vulnerable to the actions of the other party exercising control over the asset presents a classic case of opportunistic risk. A franchisee is vulnerable to several forms of franchisor opportunism in promotional activities. There is, for example, no contractual provision to restrict spending on promotions that increases the revenues of franchisors, but not those of franchisees. Contracts are often drafted so that a franchisor is not required to spend advertising dollars in the market where franchisees have contributed to the funds. A franchisor can use the funds to advertise heavily in areas served by company stores or those served by favoured franchisees.

Franchisees need some assurance that franchisors will fulfil this crucial obligation to its franchisees. The following hypothetical illustrates a problem that arises with respect to franchisor control over promotions:

A franchisor in the exercise of this discretion offers 35 percent off all products in a state-wide promotion. Volume will increase but profit margins may be reduced. A franchisor gains because its royalties are based on volume. Franchisees, whose remuneration is based on profits (which can be calibrated by a franchisor to run at the narrowest of margins) may lose money. A franchisor in such a situation may assure concerned franchisees that the decline in profit margins will be made up in volume, but franchisees report that in reality this is often not the case, and that

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<sup>48</sup> Rupert M. Barkoff and Andrew C. Selden (eds), *Fundamentals of Franchising* (1997) 60; note that franchisees must beware to avoid price-fixing and related anti-competition regulations, but see *Leegin Creative Leather Products Inc. v. PSKS Inc.* (2007), The Oyez Project, Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. \_\_\_\_ (2007), available at: <[http://www.oyez.org/cases/2000-2009/2006/2006\\_06\\_480/](http://www.oyez.org/cases/2000-2009/2006/2006_06_480/)> Tuesday, September 4, 2007. Note also that in addition to funding franchisor's promotions for the brand, a franchisee has an obligation to promote locally.

<sup>49</sup> System F1.

those paying high royalties are particularly burdened.<sup>50</sup> There is nothing franchisees can do, however, because marketing expenditures are expressly left to a franchisor's discretion.

Most contracts state that a franchisee has an obligation to pay into a marketing fund to be administered by a franchisor. The schedules for these amounts are often contained in other documents, but the F9 contract states that in addition to the amounts a franchisee must pay for local advertising; it must pay a percentage into the national fund along with a 15% administration fee to the franchisor.

Eight of the contracts sampled, F2, F4, F7, F11, F15, F17, F18, and F19, list franchisor obligations regarding promotion by stating that the franchisor 'shall', 'will' or 'must' engage in some promotions or brand maintenance but every one of these contracts qualifies this obligation, according discretion to a franchisor with permissive language to the effect that a franchisor may engage in advertising and promotion as it determines to be 'reasonably necessary' (F2), 'as it deems appropriate' (F11), or it will apply reasonable endeavours or efforts (F7, F19). F8, and F12 state that the franchisor may advertise, as it considers reasonably necessary (F12).

F4, F15 and F17 state that the franchisor will set up or administer a marketing fund. F10 states that the franchisor will apply the franchisees' advertising fees to promotions. F2, F9 and F13 state that the franchisor will advise or assist franchisees with promotions, but qualified with language such as 'if and when available' (F9). F2 states that it will be entitled to reimbursement and may delegate this function and require a franchisee to pay all costs.

Franchisor obligation in this contract term is stated in vague terms and/or is subject to a franchisor's discretion, '...the manner and style of advertising and promotion together with their frequency will be determined in the absolute discretion of the Franchisor.'<sup>51</sup> A

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<sup>50</sup> This scenario was reported to have occurred in a major US eyewear franchise system. See Laura M. Holson, *Have We Got a Deal For You: The Hidden Truth About Franchising* (1996) Zarco Einhorn Salkowski & Brito P. A. <<http://www.zarcolaw.com/CM/News/news46.asp>> at 30 December 2005.

<sup>51</sup> System F2.

franchisor's discretion may include the ability to delegate the function; a franchisor may administer the program directly or set up trust or corporation to administer.<sup>52</sup>

Also, this clause does not ensure adequate investment by a franchisor in brand maintenance, as the following two excerpts illustrate: '... the Franchisor may determine in its discretion how the Marketing Fund is spent'<sup>53</sup> and '...the Franchisor operates that account for the purposes of and to pay for the costs of developing, publishing, operating and administering, advertising, public relations and promotional material and programmes in such manner as the Franchisor in its sole discretion deems appropriate for the benefit of the Franchise System, the Franchisee and all other franchisees.'<sup>54</sup>

If a franchisor's circumstances are such that promoting the brand becomes a lower priority, either for a franchisee's territory or for the entire franchise system, a franchisee has little recourse. If a franchisor is rapidly expanding, for example, or if a franchisor is in a cost-cutting phase, a franchisee may lose franchisor brand support.<sup>55</sup>

This clause could be presented to a prospective franchisee as offering protection against franchisor opportunism, such as inadequate investment by a franchisor in promotion, but given the level of discretion with which such clauses are qualified, the practical effect is that they offer maximum latitude to franchisors with little protection or assurance to franchisees. In fact, several contracts (See F15 and F17) expressly provide that a franchisor has no obligation to spend the funds, and the franchisee nevertheless has no claim to these funds.

Case law provides few clues in interpreting these issues.<sup>56</sup> On balance these clauses delegate to a franchisor maximum latitude with minimum obligation. Some discretion is

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<sup>52</sup> System F2's contract expressly allows a franchisor to delegate advertising responsibilities.

<sup>53</sup> System F7.

<sup>54</sup> System F2.

<sup>55</sup> Telephone interview with Nick Heys, National Manager, Franchising and Small Business, Australian Competition and Consumer Commission (2004).

<sup>56</sup> In *Mark Clifford and Ors v Eagle Boys Dial-A-Pizza Australia Pty Ltd*, [2000] NSWIRComm 30 the franchisee claimed that the amounts expended by the franchisor and the nature of the expenditures were inadequate, rendering the agreement unfair.<sup>56</sup> The court held that the franchisee did establish unfairness. In *Sunice v Wendy's Supa Sundaes and Anor*[1998] QSC 223 a franchisee who was dissatisfied with the franchisor's promotional proposals sought summons for all advertising money paid to the franchisor. The

necessary because at the time the contract is signed, no one knows what sorts of promotions will be required. Because a franchisor's interests are not coterminous with those of its franchisees, however, franchisees' total lack of control in this function can reinforce franchisee uncertainty and compound franchisee vulnerability to franchisor opportunism.

### **Contract Term: Supply**

Supply requirements allow a franchisor to control franchisees' use of sub-standard products and free-riding on the quality of product in other units, as well as to provide for approved suppliers, and to maintain levels of stock. In the name of uniformity and brand maintenance, a franchisor exercises control over supply and can impose changes unilaterally. A franchisee must follow a franchisor's requirements.

Supply requirements vary with the type of franchise business. Franchises that involve sales of products often involve supply and product-tying requirements where any variation by a franchisee is subject to franchisor approval.<sup>57</sup> A franchisor may be a supplier or one of several approved suppliers, and will negotiate supply and distribution contracts to which it may require franchisees to commit to certain levels of purchases, regardless of whether local conditions warrant such levels.<sup>58</sup>

Here again a franchisor's legitimate need to preserve uniformity creates risks to a franchisee. A franchisor can require a franchisee to supply from a franchisor, which sets prices and controls quality so that a franchisor's product purchase requirements can erode franchisee profit margins. Tying franchisees to vendors reduces franchisee flexibility in supply, threatens competition and can cause franchisees to have to pay higher prices, thus reducing franchisee profit margins. Thus, if franchisees must purchase products solely

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court ordered mediation, as the most recent franchise agreement provided for dispute resolution, but because the results of mediation are confidential, the disposition of this case is not known.

<sup>57</sup> Antony W. Dnes, 'A Case-Study Analysis of Franchise Contracts' (1993) 22 *Journal of Legal Studies* 367, 393.

<sup>58</sup> <<http://www.tfsa.info/consider.htm> at 15 February 2005.

from a franchisor, or from suppliers designated by a franchisor, the determination of a franchisee's gross margin lies in the hands of a franchisor.<sup>59</sup>

Supply requirements also pose a risk where there may be secret rebates to franchisors. Kickbacks, promotional fees and commissions paid to franchisor reduce franchisee profit margins.<sup>60</sup> A franchisor has discretion to require a franchisee to purchase from a supplier whose products are more expensive, but who pays a franchisor a commission. Some franchise contracts expressly protect a franchisor's right to make deals with franchisee suppliers.

Most contracts in the sample restrict a franchisee's liberty to supply through the conditions, specifications and/or standards of supply set by a franchisor. Systems F1 through and including F9 as well as F13, F15 and F17 all require a franchisee to supply only what meets franchisor's standards and specifications, terms and conditions, or similar language.

Some supply clauses refer to franchisor's specifications with respect to quantity (F5 and F6). F2, F6, F7, F9 and F13 also require that franchisees can only supply from the franchisor or approved suppliers. Some systems (F2, F5, and F17) stipulate that a franchisee can only source approved products rather than from approved suppliers. F8 stipulates both approved products and approved suppliers.

F6 allows a franchisor to set quantities as well as to require its franchisees to purchase from the franchisor or approved suppliers. Thus, the franchisor can say that its franchisee can only buy from the franchisor, in the quantities the franchisor dictates, regardless of the franchisee's requirements.<sup>61</sup>

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<sup>59</sup> E-mail from David Newton, 10 Feb 2003. The particular concerns here involve quality, price or delivery time of goods.

<sup>60</sup> *The Problems Franchisees Face* (2003) American Franchise Association  
<<http://www.franchisee.org/Buying%20a%20Franchise.htm#problem>> at 9 December 2006.

<sup>61</sup> This is what happened in the *Simply No-Knead* case. See *ACCC v Simply No-Knead (Franchising) Pty Ltd* [2000] Australian Competition & Consumer Commission v *Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365.

F15 specifically authorizes payments to a franchisor by suppliers of a franchisee, ‘the Franchisor shall be entitled to negotiate and receive a fee from suppliers used by Franchisees’.

There appears to be a difference in the importance placed upon supply across different types of franchise systems. In the case of restaurants there was greater attention in the contract to the issue of supply (F1, F4, F6, and F7). In the case of retail a franchisor may be less concerned about its role as supplier. In coaching/training, manuals are a revenue source for a franchisor, but not a principal source. In services supply appears less important, but there will still be standards and requirements (F10, F11, F16 and F18).

### **Contract Term: Minimum Performance and Reporting Requirements**

Minimum performance clauses and reporting requirements are used by a franchisor to address franchisee free-riding on the performance of others, inaccurate reporting by franchisees, and the lack of available high-quality franchisees. Minimum performance clauses help curb franchisee free-riding by ensuring the performance levels of each individual franchisee. A franchisor takes measures to ensure franchisee performance through accounting procedures; minimum performance clauses; specific benchmarks; reservation of right of inspection,<sup>62</sup> and restrictive covenants that may require a franchisee to devote its effort exclusively to the operation of the franchise or set minimum hours or impose restrictions on passive ownership. The costs of these measures are generally passed on to a franchisee

A franchisor is vulnerable to a franchisee’s information advantage about the operation of the local franchise unit. A franchisee may be tempted not to provide a franchisor with accurate accounts, as this information affects the amount of royalty a franchisee must pay, and the attainment of performance targets. Here again, a franchisor and a franchisee’s interests diverge. A franchisor will focus on volume as the most important indicator of the franchise unit performance, while a franchisee may be more concerned with profit and may be tempted to inflate costs (or a franchisee may for some reason lack

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<sup>62</sup> American Bar Association Forum on Franchising, Rupert M. Barkoff and Andrew C. Selden (eds), *Fundamentals of Franchising* (1997) 61-62.



incentive to control costs).<sup>63</sup> To counter its risk due to asymmetric knowledge, a franchisor includes contract provisions to help ensure its right to information through reporting requirements, periodic reporting/reviews, verification methods, and verification procedures. Franchisor access to a franchisee's business premises and computer systems may also be expressly guaranteed in the contract. Some contracts may allow a franchisor access to all franchisee computers and business records, with no qualification that they be related to the franchise operation. Such terms raise concerns over invasion of privacy because they provide an unnecessarily broad license for a franchisor to intrude on a franchisee's operation.

Franchisors also rely on these clauses to mitigate problems stemming from poor quality of franchisees where there is an inadequate supply of qualified franchisees. A franchisor shifts the risk that a franchisee will fail to each franchisee through its ability to terminate if a franchisee does not meet the performance standards. For example, if there is an exclusive grant (the territory is usually limited to the premises), minimum performance requirements facilitate franchisor's taking back the franchise due to under-performance and so help ensure that a franchisor can maximize revenues from the territory. Such provisions should be considered carefully by the prospective franchisee, as they may permit a franchisor to terminate the franchise on the basis of unilaterally imposed performance requirements that are vague or unfair.

In *Auto Masters Australia Pty Ltd v Bruness Pty Ltd*,<sup>64</sup> where a franchisee was experiencing difficulties in accurately processing invoices using software and hardware supplied by franchisor, the franchisor alleged franchisee breach in failing to comply with invoicing and reporting requirements. The franchisor served breach notices over a four month period and commenced legal proceedings to terminate the agreement on same day that the franchisee served a notice of dispute. The contract contained an express term to act in good faith. The court held that the franchisor had breached its obligation to act in

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<sup>63</sup> Antony W. Dnes, 'A Case-Study Analysis of Franchise Contracts' (1993) 22 *Journal of Legal Studies* 367.

<sup>64</sup> *Auto Masters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286.

good faith and that the franchisor had acted unconscionably in contravention of section 51AC of the Trade Practices Act 1074 (Cth).<sup>65</sup>

Franchisors impose various types and levels of reporting requirements. Some contracts have 'best efforts' or 'all reasonable efforts' (F1, F2) while others refer to minimum performance criteria or sales targets (F7, F13). These criteria or target figures are usually unilaterally determined by a franchisor; a franchisor may impose performance requirements with little or no consultation with a franchisee.

A recent situation involved a system that required master franchisees to open a certain number of new stores. None of the master franchisees was able to meet the target number, leading to complaints of franchisor lack of due care in analysis.

The F3 contract requires a franchisee to produce two business plans, a one-year and a three-year. No such requirements are imposed on a franchisor. Other requirements in these terms may include a full-time manager, minimum hours, and specified reporting periods.

Contracts also provide for franchisor access to a franchisee's computer systems and premises. The F14 contract provides that the franchisor can enter a franchisee's premises at any time, 'We may retain keys to the Business Premises and have unlimited access to the premises for the purposes of this Agreement or the Manual.'

### **Contract Term: Transfer by Franchisee**

The Chairman of the Franchising Council of Australia has stated that a franchise is 'like a marriage, when it's over it's over – you do not bring in a substitute'.<sup>66</sup> Transfer describes the arrangement in which the franchise is transferred or sold by a franchisee. A franchisor usually has unlimited capacity to sell the system or any part of its interest in it at any time without consulting its franchisees. After several years of operation a franchisee may wish to transfer its operation, but a franchisee has less latitude than a

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<sup>65</sup> The court adopted the passage from *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 that, 'there is to be implied into a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose.'

<sup>66</sup> 2004 ACCC Franchise Consultative Committee meeting. Stephen Giles provides information about the meeting, though not of this particular statement, at *Franchising Focus* (2005) Deacons <[http://www.deacons.com.au/franchisingfocus/ff\\_12\\_04.htm](http://www.deacons.com.au/franchisingfocus/ff_12_04.htm)> at 3 October 2005

franchisor to sell its interests relating to the franchise system. Franchisors derive little benefit from franchisee transfer of the franchise, and so, there is, perhaps not surprisingly, no 'right' of a franchisee to transfer the franchise.

Many contracts include a franchisor right of first refusal. When a franchisee applies to a franchisor for approval of a transfer, a franchisor may choose to exercise this right and buy the unit.

As the sample indicates, this contract term consists primarily of franchisor constraints on franchisee transfer. Franchisors use constraints on a franchisee's right to transfer to protect a franchisor's interest in brand maintenance and to ensure the level of quality in system franchisees.<sup>67</sup> They also draft the term with an eye to deterring franchisee hold-up, such as post-contractual revision of fee schedule.

A franchisee cannot transfer his franchise unit without the prior written consent of a franchisor. A franchisee can only transfer if it complies with a franchisor's conditions,

'In addition to meeting the then-current (franchisor) franchisee qualification requirements of Sub-Franchisor, approval of a transfer to an heir, legatee or other proposed transferee may also be subject to one or more of the following conditions in the sole discretion of (franchisor) or Sub-Franchisor.'<sup>68</sup>

While this term is similar across systems, there is some variation in conditions for franchisor approval of transfer. Most systems demand a payment of a transfer fee. For example, F1 sets the fee at \$5000, F3 at 10 percent of purchase price, while F6 sets the fee at the greater of 10 percent or \$10,000. In addition to payment of the transfer fee there is usually a lengthy list of conditions can provide a franchisor with justification to refuse transfer.<sup>69</sup> Franchisor approval of franchisee transfer cannot be unreasonably withheld, however,

'The Franchisor must not unreasonably withhold its consent to an assignment... The Franchisor's consent to a sale, assignment or transfer to a proposed transferee may

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<sup>67</sup> Note also that a franchisor is concerned with the nature of franchisee organization (individual, partnership, corporation, trust), in order to ensure that all individuals signing the agreement will be personally liable.

<sup>68</sup> System F1.

<sup>69</sup> See typical transfer clause in this section. For more information, see Rupert M. Barkoff and Andrew C. Selden (eds), *Fundamentals of Franchising* (1997) 65.

be withheld absolutely or granted upon such conditions as the Franchisor in its discretion considers reasonably appropriate.’<sup>70</sup>

Finally, there is the related issue of ownership of goodwill. In contrast to the convention in the US where local goodwill belongs to a franchisee, in Australia, contracts typically provide that goodwill belongs to a franchisor. No exception is made for local goodwill.<sup>71</sup> Franchisors argue that this is necessary to ensure that it retains control over the use of the elements that make up the goodwill, so that these elements retain their distinctiveness to preserve the goodwill of the business for both the franchisor and the franchisees. The following is an example of a clause which appears in a similar form in most contracts sampled:

Goodwill and Intellectual Property Rights to vest in Franchisor: The Franchisee assigns to the Franchisor all existing and future goodwill arising out of the use of the System by the Franchisee; Intellectual Property Rights in improvements to the System developed by the Franchisee; and Intellectual Property Rights in any plans, specifications or advertising materials prepared by or for the Franchisee in relation to the Franchise Business... all existing goodwill and existing Intellectual Property Rights ...vest in the Franchisor and all future goodwill and future Intellectual Property Rights, on their creation, will vest in the Franchisor; and [franchisee] must do, at its own cost, all things reasonably requested by the Franchisor to enable the Franchisor to assure further its title to the goodwill and the Intellectual Property Rights...<sup>72</sup>

This limitation on a franchisee’s rights regarding the goodwill of the business is often not understood by franchisees. It is also not clear, given the many other ways in which a franchisor exercises control over a franchisee’s activities, why control over goodwill to protect the brand must necessarily require that a franchisee has no property interest in the goodwill.

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<sup>70</sup> System F2.

<sup>71</sup> Though some assert that it is understood in the sector that a franchisor may at its discretion allow a franchisee to sell part of the goodwill, there is no such contractual provision. Even if there were such a provision, the discretion of a franchisor remains. While a franchisor may permit a franchisee to sell goodwill, such a decision is made at the discretion of the franchisor; for any individual franchisee, the situation is far from certain.

<sup>72</sup> System F3.

A franchise is a wasting asset.<sup>73</sup> As Blair and Lafontaine point out, a franchisee who contracts for a license to use a franchisor's intellectual property needs to understand that it is purchasing something that it can never sell. There may be a significant difference in net sales proceeds from a franchise as opposed to an independent operation.

The Code was put in place in 1998; in 2008 the first franchisees will near the end of their renewal periods. Some will find that after ten years of nurturing a business, they have less to sell than they expected. In addition, a franchisee may not have control over the property or lease, the conditions of which may make the franchise more difficult to sell.<sup>74</sup> For these reasons accountants advise franchisees that the best time to sell is in about year seven of a ten-year term, when a franchisee will have had a return on its investment, but still an interest to sell in the remaining duration of the license.

Seven of the nineteen contracts contained a franchisor right of first refusal. A franchisor right of first refusal is sometimes described to a franchisee as insurance that a franchisor will buy the unit if a franchisee needs to sell. This is generally not the case. A franchisor right of first refusal is a right and not an obligation of a franchisor. It does not create any rights in a franchisee. Anecdotal evidence suggests that franchisors may buy back units from distressed franchisees, but often at distress-sale prices. Some contracts include asset valuation clauses with a pre-set formula for franchisor purchase of the franchise. Dnes speculates that these clauses may provide some certainty to a franchisee.<sup>75</sup> However, since a franchisor has the discretion to exercise its right of refusal, the set formula is more likely to benefit a franchisor. None of the contracts in the sample contained or referred to an asset valuation with respect to a franchisor right of first refusal.

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<sup>73</sup> Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004) 109 *Penn State Law Review* 105, 116.

<sup>74</sup> Significant problems for franchise systems stem from the high rents and onerous requirements of shopping center leases.

<sup>75</sup> See Antony W. Dnes, 'A Case-Study Analysis of Franchise Contracts' (1993) 22 *Journal of Legal Studies* 367, 392. Article has a significant section on termination and valuation of assets to protect franchisees.

A franchisor may require as a condition of completing the sale that the selling franchisee sign a termination and release form which says the outgoing franchisee gives a franchisor a general release of claims.<sup>76</sup> Two contracts in the sample contained this condition.<sup>77</sup>

### **Contract Term: Termination by Franchisor**

Termination rights enable a franchisor to deal with under-performing franchisees, franchisee free-riding and franchisee hold-up. While a franchisor's right to terminate is important to a franchisor in maintaining uniformity and the quality of the brand, inefficient termination in which a franchisee loses more than a franchisor gains, should be discouraged. Efficiency in the termination of a franchise agreement is difficult to measure, however, especially when trying to take into account impact on a franchisor's brand. Perhaps this is why, 'Courts have traditionally applied the rule of termination at will to exclusive agency and distributorship agreements.'<sup>78</sup> This tradition has carried over into the franchise relationship, franchisors defend the right to terminate if a franchisee performs poorly or breaches contract as a crucial aspect of maintaining brand. A franchisee, however, has a considerable investment in the relationship and deserves some protection, more than an agent or distributor that has a less significant investment in the relationship.

While there are cases that have been decided in favour of franchisees who object to a franchisor's exercise of its rights to terminate,<sup>79</sup> a franchisor still has wide latitude to exercise its rights to terminate. In *Dymock's (NSW) Pty Ltd v Todd*,<sup>80</sup> the judge held that, under the law of New South Wales, a power to terminate had to be exercised reasonably.

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<sup>76</sup> *The Problems Franchisees Face* (2003) American Franchise Association  
<<http://www.franchisee.org/Buying%20a%20Franchise.htm#problem>> at 9 December 2006.

<sup>77</sup> Systems F2 and F17.

<sup>78</sup> George Dent, 'Lawyers and Trust in Business Alliances' (2002) 58 *The Business Lawyer* 45, n247.

<sup>79</sup> In *Burger King Corp v Hungry Jack's Pty Ltd*, (*Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (see also *Hungry Jack's v. Burger King* [1999] NSWSC 112). Burger King sought to terminate the Hungry Jack's franchise for failure to develop four restaurants per year. The court held that Burger King had breached an implied duty of good faith through its conduct in preventing Hungry Jack's from meeting the quota. The notice of termination was therefore invalid. *Aura Enterprises Pty Ltd v Frontline Retail Pty Ltd* (*Aura Enterprises Pty Ltd v Frontline Retail Pty Ltd* [2006] NSWSC 902) the defendant franchisor notified the plaintiff franchisee of its intention to terminate. The court held for the franchisee because the notice of termination did not identify obligation breached.

<sup>80</sup> *Dymock's (NSW) Pty Ltd v Todd* [2002] UKPC 50, [2004] 1 NZLR 289.

In *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd*<sup>81</sup> six franchisees alleged that the franchisor had threatened the removal of certain products in order to compel them to surrender their franchises under value, enabling the franchisor to provide these products at its wholly-owned outlets instead. The court held for the franchisor, which it found to have acted with the legitimate purpose of promoting its commercial interests. The court did not determine if there was an obligation of good faith, as it found that the franchisee had failed to establish breach of any applicable obligation of good faith. The court also held that the franchisees failed to establish their claims of misleading and deceptive conduct and unconscionable conduct.

Franchisors argue that courts should demand only good faith and reasonable notice for termination.<sup>82</sup> They support this argument not only with their need to protect the brand, but also with the claim that they are unlikely to terminate profitable franchisees. There are reasons, however, that a franchisor might wish to terminate, even when a franchisee is profitable. For example, a franchisor may feel that the power of a franchisee is too great, or a franchisee is too independent, or there might be conflicts over leases or financing.

From a franchisee's point of view this right of a franchisor to terminate without regard to a franchisee's investment in specialized assets leaves a franchisee vulnerable to 'hold-up' by a franchisor. A franchisee's other related contracts and rights with respect to dispute resolution may also be compromised.<sup>83</sup>

In Australia most termination clauses in contracts mirror the Code provisions.<sup>84</sup> Under Clause 21, termination in case of franchisee breach, the Code requires the franchisor to give to a franchisee reasonable notice that the franchisor proposes to terminate the franchise agreement because of the breach; to tell a franchisee what the franchisor

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<sup>81</sup> *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 223 (21 June 2006)

<sup>82</sup> *Id.*, 252.

<sup>83</sup> Paul Steinberg and Gerald Lescatre, 'Beguiling Heresy: Regulating the Franchise Relationship' (2004) 109 *Penn State Law Review* 105, 124-125: 'As added risk to the franchisees, default of one franchise agreement may result not only in termination of the franchise at issue, but - due to cross-default clauses - result in declaration that the franchisee is in default of all the franchisee's agreements.'

<sup>84</sup> There is a similar pattern in the US where termination clauses in contracts mirror FCC termination regulations. See Rupert M. Barkoff, and Andrew C. Selden, (eds), *Fundamentals of Franchising* (1997).

requires to be done to remedy the breach; and to allow a franchisee a reasonable time to remedy the breach (but a franchisor does not have to allow more than 30 days). Clause 22 addresses termination where there is no breach by franchisee; this clause also requires reasonable notice to a franchisee and ensures applicability of Part 4. Clause 23 provides the circumstances where a franchisor is not required to comply with Clauses 21 or 22.

If you or the specified person fails to attend or successfully complete the initial training sessions to our reasonable satisfaction then we may, at our discretion either: by notice to you terminate this agreement; or insist on additional training at your cost.<sup>85</sup>

There is little reciprocity with respect to termination in franchise contracts. Termination by a franchisee is not addressed at all in most contracts, but some franchise contracts give a franchisor 30, 60, or 90 days to cure any alleged defaults.

### **Contract Term: Restraint of Trade**

Restrictive covenants protect franchisor's intellectual property, information and brand identity against franchisee free-riding. Restrictive covenants are used to address information asymmetry where control over a resource (including a system or process) is separate from control over information relevant to efficient use of the resource;<sup>86</sup> such problems are addressed through signalling regarding commitment to perform.<sup>87</sup> This signalling function, along with its poor bargaining position generally, helps explain franchisee willingness to accept restraint of trade clauses. It also explains why there is no reciprocity of franchisor obligation here, for example, in the form of limitations on a franchisor's right to encroach.

In the US and other jurisdictions where a franchisee owns the goodwill of the franchise unit, restrictive covenants maintain the value of the penalty for franchisee failure over life of the contract. This is due to the fact that the value of local goodwill increases over

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<sup>85</sup> System F5.

<sup>86</sup> David Goddard, 'Long-Term Contracts: A Law and Economics Perspective' [1997] *New Zealand Law Review* 423, 438.

<sup>87</sup> Other forms of signalling include bearing greater risk, accepting a smaller sum, and making greater up-front commitments.



time, while physical asset value may decline.<sup>88</sup> In Australia, this is perhaps not necessary because a franchisee is not technically the owner of the goodwill (though a franchisor may permit a franchisee to include the value of goodwill in the value of the franchise at transfer).

Some franchisees argue that they should be allowed to engage in a similar business provided that they discontinue the use of a franchisor's trademarks and trade secrets and return all confidential operating materials to a franchisor.<sup>89</sup> It is not often likely that there will be an issue about brand awareness at the location because in many cases a franchisor exercises some form of control over the premises so that a franchisee exiting the system cannot remain in the same location.<sup>90</sup>

Franchisees argue that their position is more analogous to that of employees than business owners in the interpretation of such restraints. Once a franchisee learns to run a computer repair business or a cake shop, effectively these clauses prohibit a franchisee from continuing to ply its trade after the expiration of the franchise licence. The only way a franchisee can continue in its occupation is to participate in the franchise system.

It has been pointed out that, due to a franchisor's retention of ownership of goodwill, there may be less need for restrictive covenants in Australia. Nevertheless, every contract sampled contained restrictive covenants. This could be explained by the fact that Australian franchisors, in practice, do typically allow a franchisee to include local goodwill in the transfer of a franchise unit.

Some clauses are quite abbreviated while others (in the sample, restaurants in particular) contained lengthy restraint of trade clauses. Very often these clauses are stepped to ensure a franchisor the maximum protection that the common law as applied in that jurisdiction will allow.

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<sup>88</sup> Antony W. Dnes, 'A Case-Study Analysis of Franchise Contracts' (1993) 22 *Journal of Legal Studies* 367, 388.

<sup>89</sup> See for example, *The Problems Franchisees Face* (2003) American Franchise Association <<http://www.franchisee.org/Buying%20a%20Franchise.htm#problem>> at 30 December 2005.

<sup>90</sup> Jenny Buchan, 'Who is the franchisee contracting with and does it matter anyway?' (Paper presented at the 51st ICSB World Conference, 2006, Melbourne, Australia).

The restraint of trade doctrine is traditionally concerned with protecting personal liberty, rather than competition generally in the market. At common law, any restraint of trade is prima facie contrary to public policy and void unless the restraint is reasonably necessary to protect legitimate interests. Whether a restraint of trade is reasonable depends on a number of factors. Courts consider geographical area, the scope of the activities restrained and the period of the restraint, the degree to which the restraint is necessary to protect goodwill and confidential information, customs and practices within the particular industry; and whether the restraint applies only during the term of the contract or covers a post-termination period. A different test for reasonableness of restraint applies depending upon jurisdiction.<sup>91</sup>

Franchisors have successfully argued that restraints of trade contained in franchising agreements, such as the grant of an exclusive territory to a franchisee, are actually pro-competitive, and accordingly fall outside the purview of the doctrine against restraints of trade. Case law is indicative of the difficulties faced by a franchisee that wishes to challenge these clauses.<sup>92</sup>

### **Contract Term: Collective Agreement**

To provide further assurance of franchisor discretion, some franchise contracts include a collective agreement clause (also known as an ‘agree to agree’ or ‘come along’ clause) that binds a franchisee to cooperate with any decisions of the majority, whether or not it

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<sup>91</sup> In *KA and C Smith Pty Ltd (trading as Uticolor Australia) v Ward and Ors* [1999] NSWSC 138 there was a conflict between jurisdiction where CL applies and jurisdiction where legislation addresses defects in CL.

<sup>92</sup> For example in both *Stained Glass Overlay Australasia Pty Ltd and Ors v Kevin James Rea and Anor* [1998] WASC 325 and *Sureslim Australia v Mansell* [2002] NSWSC 945 courts upheld restraint of trade clauses in the franchise agreements. However in *KA and C Smith Pty Ltd (trading as Uticolor Australia) v Ward and Ors* [1999] NSWSC 138 the court considered the whether the restraint of trade clause was too broad given the need to balance the interests of the parties. It considered the interests of the franchisor, ‘the franchisor has an interest at stake which is analogous to the purchaser’s goodwill. It has an interest in protecting the patronage built up through the operation of the franchise, which may be lost if the franchisee is permitted to compete without restriction. The franchisor also has an interest in preserving the confidentiality of confidential information provided to the franchisee, which could be used by the franchisee to compete with the franchisor if there were no restraint.’ The court also considered the interests of the franchisee, ‘the franchisee has an interest in protecting the goodwill of its business. The customers are customers of the franchisee’s business, though the franchisor also has an ‘interest’ in the customers since they are attracted to the business as a franchise business.’ The holding pursuant to NSW Statute was that there was an unreasonable restraint of trade which was void at common law, but because the Section 4(1) of the Restraints of Trade Act 1976 (NSW) applied, the restraint was held to be valid.

agrees. Contracts may also include terms that provide for a franchisor to unilaterally change certain aspects of the agreement.<sup>93</sup> The following is a sample of the language used in a collective agreement clause:

‘Come along: You will abide by any decision of the majority even if you are not one of the majority.’<sup>94</sup>

The same contract also contains the following provision:

**IMPROVEMENT TO THE SYSTEM:** You must incorporate into the franchise business all changes to the system stipulated by us from time to time. Any development or improvement to the system created by you or on your behalf must be specified and notified to us. You agree that we own the rights to any improvement or development to the system made by us or by you (or on your behalf) from time to time.<sup>95</sup>

A franchisor in most cases can make changes unilaterally. Franchisees must comply even if they do not agree. A franchisor can also change operations manual, computer systems, and sometimes control over franchisee premises.

### **General conditions of asymmetry of obligation and discretion in franchise contracts**

This section gives examples of asymmetry of discretion and of asymmetry of obligation in franchise contracts. First there is asymmetry of obligation. Most franchise contracts contain fewer obligations for a franchisor than for a franchisee. A franchisor’s contractual obligation usually involves some commitment to maintain and promote the brand and to provide training, but these obligations are almost always to be carried out at a franchisor’s discretion. One of the contracts in the sample is arranged with an ‘Our Obligations’ section for a franchisor and a ‘Your Obligations’ section for a franchisee, and so provides a neatly pre-packaged example of the ratios of franchisor to franchisee obligations. The franchisor’s ‘Our Obligations’ section is two pages in length and consists of fourteen items, many of which can be performed according to franchisor discretion, while the franchisee’s ‘Your Obligations’ section covers four pages and

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<sup>93</sup> There was some discussion of regulating against the unilateral revision of contracts at a 2004 ACCC Franchise Consultative Committee meeting. Stephen Giles, who attended the ACCC Consultative Committee meeting, provides information at: *Franchising Focus* (2005) Deacons <[http://www.deacons.com.au/franchisingfocus/ff\\_12\\_04.htm](http://www.deacons.com.au/franchisingfocus/ff_12_04.htm)> at 3 October 2005.

<sup>94</sup> System F3.

<sup>95</sup> System F3.

consists of 58 items, many of which are highly specific and/or are also subject to franchisor discretion.

Second, there is asymmetry of discretion. The following two excerpts from contracts in the sample provide for franchisor discretion with respect to general conditions and terms and changes thereto (*italics added*):

- ‘Franchisee further acknowledges and agrees that (franchisor) shall have sole control and discretion over the development of the System and the designation of the Products and services to be offered in the Store, and that Franchisee will comply with franchisor’s requirements in that regard.’<sup>96</sup>
- ‘Standard franchise agreement means the standard terms and conditions pertaining to the grant of a franchise by us as amended by us from time to time in our *absolute discretion*.’<sup>97</sup>

Another contract in the sample contains several provisions that ensure franchisor discretion to exercise control in various aspects of performance (*italics added*):

- ‘The Franchisee must not sell the Products from a removable site or vehicle, whether within or outside the Territory, without the express prior written consent of the Franchisor. The consent of the Franchisor may be granted or withheld at the Franchisor’s *absolute discretion* and on such conditions as the Franchisor shall determine.’
- ‘The Franchisee may not establish or operate another business similar to the Business, whether inside or outside the Territory, without the prior written consent of the Franchisor. The consent of the Franchisor may be granted or withheld at the Franchisor’s *absolute discretion and on such conditions as the Franchisor shall determine*.’
- ‘...the Franchisor has reserved its rights to decide in its *absolute discretion* how Commercial Customers will be serviced;’
- ‘...the Franchisor has reserved its rights to decide in its *absolute discretion* how special events will be serviced.’<sup>98</sup>

In the contracts sampled there are no procedural standards connected with the terms granting discretion to a franchisor, for example in franchisor training, support or

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<sup>96</sup> System F1.

<sup>97</sup> System F5.

<sup>98</sup> All four provisions taken from System F2.

promotional activities. Franchisee obligations, on the other hand, are typically subject to strict standards, schedules, and targets, often to be set and/or changed at the sole discretion of a franchisor. Not all franchisee obligations, however, are strictly specified at the outset. It is not uncommon that franchise contracts impose requirements on a franchisee that fail to clearly specify the nature of the contractual obligation. Minimum performance is one example where the contractual term allows a franchisor to unilaterally impose and vary exact requirements through other schedules and documents such as the operations manual. With respect to certainty of contractual obligations, those assumed by a franchisee are often highly specific, but at the same time are subject to change by a franchisor through the operations manual, technical and training manuals and other documents, as well as by relying on the collective agreement clause, or on provisions in the contract that accord to a franchisor broad discretion. Even the flexible, open-ended requirements of franchisee must be performed subject to a franchisor's discretion and approval.

The contracts sampled could not be said to contain reciprocal commitments.<sup>99</sup> The lack of reciprocity is evidenced by the lack of performance standards for a franchisor. Franchisor obligations are generally not specific; they tend to be open-ended, to be performed at a franchisor's discretion, with no assurance of performance, or, in some cases, vague reasonableness or procedural standards.<sup>100</sup>

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<sup>99</sup> Recommended by Goddard as a desirable feature of the longer duration contract. See David Goddard 'Long-Term Contracts: A Law and Economics Perspective' [1997] *New Zealand Law Review* 423.

<sup>100</sup> An express reasonableness requirement is common in franchise contracts. The content analysis of the contracts sampled showed a high frequency of a 'reasonable' standard. Franchisor legal advisers find any such requirement unacceptable. They argue that discretion offers insufficient protection for a franchisor, 'there is general agreement among the courts about one thing—the (implied covenant of good faith) requires that parties exercise discretion "reasonably."' In order to avoid even the requirement to act reasonably a franchisor is counselled to, 'go hunting for the "D" [discretion] word replacing it with 'the (franchisor's)"right"... Better yet, make clear somewhere in the agreement that whenever the franchisor is reserving a right, it has the uncontrolled or unfettered right...Almost all courts agree that the covenant of good faith and fair dealing does not trump an express right.' See William L. Killion, 'Putting Critical Decision-Making Where It Belongs: Scouring the Franchise Agreement for the "D" Word' (2005) 24 *Franchise Law Journal* 228, 229-230.

## CONCLUSION

While it is difficult to make generalizations about diverse contract terms, some patterns emerge. Imbalance of power and uncertainty for a franchisee are reflected in the terms of the contract. High levels of discretion to one contracting party indicate an imbalance of power in the contracting relationship. This analysis shows that the terms of franchise contracts consist largely of lengthy and detailed obligations for a franchisee, as well as high levels of discretion to a franchisor, not only in the performance of the contract, but also at transfer or termination, even though these events are subject to some procedural substantive regulation. With respect to certainty, where contractual obligations are vague, flexibility and discretion accrues to franchisor. In both the case of franchisee and franchisor obligation the sample shows that uncertainty is subject to a franchisor's judgment or discretion, never that of a franchisee. The discretion accorded to a franchisor therefore not only indicates an imbalance of power, but also uncertainty for and risk to a franchisee.

Case law provides little guidance in the interpretation of franchise contracts; this is because Code-mandated mediation means relatively few cases are litigated and because of the complex and idiosyncratic nature of the issues in the cases that are litigated.

The results presented in this paper are consistent with the theoretical analysis that the standard form and relational contract exacerbates the conditions of imbalance of power and uncertainty in the franchise relationship. The contract terms reflect an imbalance of power and high levels of uncertainty for a franchisee. There are high levels of discretion to a franchisor while franchisees are subject to high levels of uncertainty concomitant with the exercise of discretion by a franchisor. As the standard form and relational nature of the contract would suggest, throughout the terms analysis, a franchisor has control. Franchisor interests are protected and franchisor risks are minimized. This is accomplished largely by shifting risk to franchisees that enter the relationship with less power and for a variety of reasons can be persuaded to grant high levels of discretion to franchisors.

The franchise contract binds a franchisee over a period of years. A franchisee's extensive obligations are specified in detail and can be strictly enforced. If a franchisee

fails to meet any of them, a franchisor can terminate for breach of contract. A franchisor, on the other hand, is subject to a minimum number of requirements, as a franchisor requires flexibility and discretion in operating the system. Because neither a franchisee nor a franchisor can predict future circumstances, a franchisee has to trust its franchisor, and hope that a franchisor will act in a franchisee's best interests. Unfortunately, given the many conflicts of interest in the relationship, this is not always the case.

The parties' self-regulation cannot be relied upon to achieve the goals of regulation, because private regulation through market and contract creates and reinforces imbalance of power and uncertainty. There is therefore a need for direct intervention to address private law failure in franchising.