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Edward Elgar
Cheltenham, UK • Northampton, MA, USA

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010925996

ISBN 978 1 84844 866 7

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

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Foreword

Franchising is, in the words of Australia's 1997 *Fair Trading Report*, 'an increasingly popular form of economic organisation providing an alternative means of expanding an existing business or an alternative means of entering an industry'. It is a method of business operation which has revolutionised the distribution of goods and services in most industry sectors and has transformed the business landscape of most countries. As franchising increases its influence internationally the issue of its regulation assumes increasing significance. The regulation of entrepreneurial activity – of which franchising is one of the purest expressions – is never straightforward. The regulatory debate – initially in relation to the need for a dedicated regulatory regime and then as to its shape and content – is sustained and often passionate. Dr Spencer's pioneering book makes a valuable contribution to this debate.

The OECD has pointed out that 'entrepreneurship and business activities are shaped not only by markets, but also by regulatory and administrative environments established by governments'. This is particularly true of franchising. In some cases, such as those of China and Vietnam, the introduction of a regulatory regime recognising franchising as a legitimate and viable method of business operation has been a necessary prerequisite to the development of a viable domestic franchise sector. In most cases however the reason for embracing dedicated franchise regulation is to address what the recent Australian *Opportunity not Opportunism* report described as 'differing expectations about the obligations of each party to the agreement' and an 'asymmetric power dynamic within franchise agreements, with potential to lead to abuse of power'. Dr Spencer is not ambivalent in her belief that monitoring and regulation are necessary to address potential areas of abuse to ensure that the economic and welfare objectives promoted by franchising are not frustrated by inappropriate conduct that can result not only in financial and social cost to franchisees, but also lead to costly market inefficiencies. In this she is not alone.

For many years the US was in splendid isolation in imposing a franchise specific regime on its franchise sector to supplement the underlying commercial laws of general application. California – the cradle of business format franchising – was the first jurisdiction to adopt franchise specific regulation. Its 1971 Franchise Investment Law, based on the securities law model, imposed franchisor disclosure and registration requirements and

was followed at the end of that decade by a federal disclosure law. The international community, although quick to embrace the US franchise model, was not enthusiastic about embracing the US manner of its regulation. By the year 2000 only 17 countries had introduced franchise-specific legislation. There has nevertheless been a significant trend to legislation since then and today over 30 countries have dedicated franchise regulation.

The catalyst for legislative intervention has been the increasing recognition that franchise contracts are, in the language of the Privy Council *in Dymocks Franchise Systems (NSW) Pty Ltd v Todd* [1] 'not ordinary commercial contracts' and that, in the words of Australia's 2008 *Opportunity not Opportunism* report, abuse of the 'inherent and necessary imbalance of power in franchise agreements . . . can lead to opportunistic practices'. While there is increasing recognition of the 'relational' character of franchising, the extra-legal norms which explain relational contracting in the context of contracting equals are less compelling in the context of the typical business format franchise which is characterised by both an information imbalance and a power imbalance. Judicial developments have not progressed to the stage where the general underlying law provides adequate protection for franchisees. Legislative solutions have been increasingly sought. Yet, while the case for remedying the information imbalance by mandatory prior disclosure is widely accepted today – and is indeed the rationale for UNIDROIT's *Model Franchise Disclosure Law* – the power imbalance raises more sensitive issues and remains a difficult, and a controversial, issue.

Dr Spencer argues that franchising must be understood in terms of its risks and that the question is not whether to regulate but how to regulate. This sentiment has increasing support internationally. It may have been regarded as radical at an earlier stage in the development of franchising but today has wide and increasing support as domestic sectors struggle with the challenge of regulating this dynamic and unique business relationship. Commercial risk is an inevitable incident of entrepreneurship and business creation in a free enterprise society. The challenge for franchise regulators is to minimise those risks arising from the unique dynamics of the franchising relationship while leaving the commercial risks to the parties themselves. Although there is increasing international recognition of the need to regulate beyond the scope of the underlying business laws of general application, there is no unanimity among the 30 regulated sectors as to the appropriate regulatory tools let alone the extent of their application. Prior disclosure, registration, controls on conduct or dispute resolution are utilised either individually or in a range of combinations and permutations by

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[1] [2002] 2 All ER (Comm) 849 at 871.

the regulated regimes and there is little consistency in scope or extent even among those jurisdictions adopting the same regulatory strategy.

Dr. Spencer urges governments to embrace regulatory process that is consultative, identifies the harms and potential solutions, implements appropriate tools, monitors outcomes, and adjusts accordingly. Such process, she suggests, will result in 'increased permeability among layers of governance, and so enhance their effectiveness'. Her belief that, through proper process, all layers of governance can interact more effectively together hinges on collaborative process, a process in which the regulator's new role is not to impose rules, but to promote best regulatory process. This, she notes, is not an easy transition, but it is a significant one.

Dr Spencer has performed a valuable service to the international franchising community in writing this book. Its strength is not simply in making the case for franchise regulation which those who practise franchising in a regulated environment such as Australia readily acknowledge has had a strong and positive influence on sector development for the benefit of all stakeholders. Dr Spencer's comprehensive survey of franchise regulation globally and her conceptual analysis of the regulatory tools applied makes a very important contribution to the regulatory debate. Of particular interest is her argument that alternative regulatory approaches, including self-regulatory mechanisms, should be explored and that legislative intervention where necessary and appropriate should draw on the full range of regulatory tools.

I, like the author, believe that the question for domestic franchise sectors is not whether to regulate but how to regulate and her comprehensive survey and analysis of regulatory strategies and tools will be a valuable resource not only for unregulated sectors which are considering regulation but also for regulated sectors as they refine and reshape their regulatory scheme.

Dr Spencer's hope for her book is that it will lead to a better understanding and harmonisation of franchising regulation. Given the massive political, social, economic and commercial diversity of the international franchising community her hope for harmonisation may be too optimistic: even UNIDROIT's *Model Franchise Disclosure Law* has been influential as a beacon rather than as a template. But, Dr Spencer's hope for a better understanding of franchising regulation will undoubtedly be met. This is the strength of her contribution.

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19 August 2010

Acknowledgements

I would like to acknowledge the hard work of my good friend Maria Nicolai, and that of many other research assistants who have been involved in the course of preparing this manuscript. I am grateful for the cooperation of the Franchise Council of Australia in the early days of my research. I would like to thank Bond University Faculty of Law for its support, and the many senior members of the faculty for their continuing patience, guidance, good advice, and for keeping their doors open. I would like to thank Jenny Buchan for her unflagging friendship and support. Andrew Terry, Rupert Barkoff, Andy Selden, and Lorelle Frazer, thank you for your encouragement, your help, and your friendship. I am truly grateful for the loving support of so many wonderful colleagues and friends over these years as I have laboured over this project. I am grateful to my parents and my family for their love and support. Most importantly, I am grateful to my children, Nina and Sam, to whom I dedicate this book.

The law is as stated at 1 January 2010.

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Introduction: The regulation of franchising in the new global economy

> 'In the time of the legendary King Arthur, the quest for the Holy Grail was the highest spiritual pursuit for a knight. Today, franchise reformers search for their own Holy Grail – a convenient formula to deliver balance and equity to the franchise relationship which is commonly characterised by both a power and an information imbalance.' [1]

The concept of business-format franchising originated in the United States of America in the late 1950s and saw rapid expansion there in the 1960s and 1970s. As the phenomenon of business-format franchising has taken hold in many countries around the globe regulation of the sector internationally has increased with a trend toward regulation that has been particularly notable in the years since 1990. The franchise sector was first regulated in the 1970s in the US and Canada. In 1980 only the US and Canada had franchise-specific legislation. By 1990 France and Mexico had joined them. By the year 2000 about thirteen jurisdictions had implemented franchise-specific legislation including Australia, Brazil, the People's Republic of China, Taiwan, Indonesia, Malaysia, Romania, and Spain.

Since the year 2000 another 16 countries have followed suit. Today about 30 countries, or about one-third of the countries where franchised business operates, have enacted regulation directed specifically towards franchising or with the specific intention to capture franchising. These countries include Canada (four of ten provinces: Alberta; Ontario; New Brunswick; Prince Edward Island), the US, Barbados, Brazil, Mexico, Albania, Belarus, Belgium, Estonia, France, Italy, Lithuania, Moldova, Romania, Russia, Spain, Sweden, Ukraine, People's Republic of China, Indonesia, Japan, Kazakhstan, South Korea, Kyrgyzstan, Macau, Malaysia, Vietnam, Taiwan, and Australia. The countries included in this list where regulation is not strictly or solely franchise-specific, but where the intention has been to capture franchising include Albania, Belgium,

[1] Andrew Terry, 'Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?', 23rd Annual International Society of Franchising Conference, San Diego, CA, February 2009.

Belarus, Estonia, France, Georgia, Kyrgyzstan, Lithuania, the People's Republic of China, Taiwan, Russia and Ukraine.[2]

The reasons for the increase in regulation of the sector include an increase in international franchise activity and the recognition of franchising as a unique business model that demands a particularized regulatory scheme. Currently the forms the laws take are not uniform, despite the promulgation in 2002 of the UNIDROIT Model Franchise Disclosure Law. Many countries have responded to problems in the sector with regulatory measures, but some countries, such as England, Germany and the Netherlands, seem to do well with no sector-specific legislation at all. Other countries, such as Sweden, have enacted only minimal regulation. Variation in legislation is to be expected because regulation in each jurisdiction must respond to its own particular circumstances and requirements and because regulation as governance reflects the global diversity of conceptions about the kind of people and societies we are and aspire to be.

At the same time there is also a compelling argument for harmony in regulation internationally to the extent that it is feasible and practicable. Consistency in private law provides a legal framework of private rights as the foundation for social interaction. An international legal regime facilitates transactions, enhances credit facilities and reduces borrowing costs.[3] In order to maximize the benefit of such harmonization, regulation should be understood and applied as consistently as is practicable.

This book is an undertaking that has been motivated principally by two factors. The first is a discernible trend globally to regulate the franchise sector. The second is the lack of consensus on what that regulation should look like. 'The increasing influence of franchising has . . . been accompanied by an increasingly vigorous debate as to the regulatory environment for franchising.'[4] It is hoped that the global survey and analysis of this aspect of the regulation of the franchise sector provided here will lead to better understanding and harmonization of that regulation.

The book is organized in three parts. The first provides introductory material, an overview of the nature of regulatory theory as well as an overview of the nature of the franchise sector. The second part comprises a survey of the regulation of the sector. The survey of regulatory measures

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[2] Venezuela is not included as the legislation directed toward franchising in that country is only for the purposes of exempting franchising from certain competition law requirements.

[3] See http://www.uniformlaw.org/important.php at 14 December 2009.

[4] Andrew Terry, 'A Census of International Franchise Regulation', 21st Annual International Society of Franchising Conference, Las Vegas, Nevada, 24–25 February 2007, 3.

provides an indication of where we are in the progress toward the optimum regulatory program for the sector globally, and an orientation for future plans for regulation. The third part of the book offers a comparative analysis of the current approaches to regulating in light of the concepts for optimum regulation suggested by current regulatory theory.

This book challenges some of the commonly-held myths about both regulation and franchising; first, with the proposition that franchising in fact does have risks and dangers for its participants, and second, with the proposition that appropriate regulation can help to minimize the damaging effects of these risks and so benefit the health and competitiveness of the sector overall. Rather than reinforcing the belief that franchising is low risk, this book argues that franchising must be understood in terms of its risks. This is the logical starting point for regulatory intervention. Rather than reinforcing the belief that regulation is something to be avoided, this book argues that there are multiple levels at which regulation operates, and that it can and should be properly calibrated in order to provide sophisticated, appropriate regulation at each 'layer' of governance.

RECONCEIVING REGULATION

There is a commonly-held belief that regulation is bad for business, and that the heavy hand of government intervention in peoples' private affairs should be avoided at all costs. Such a belief may often be justified; but as often it is not. It is said that judgments are alienated expressions of needs, and certainly there are needs that are not being met by regulation.[5] The widespread mistrust of regulation is the result of years of high costs and intangible benefits of regulation that have eroded public confidence in the efficacy of regulation. In 2001 the US Office of Management and Budget estimated the cost of federal regulations at $380 billion per annum, or about ten percent of the US gross domestic product (GDP) (more than half the output of the US manufacturing sector).[6] Despite the high cost that it is asked to pay for regulation, however, the public does not see its worth. A 2004 report showed that 53 percent of Americans agreed that 'Government regulation of business usually does more harm than good.'[7] Clearly, needs are not being met.

It is true that inefficient regulation can erode confidence, impede growth,

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[5] M. Rosenberg, *Nonviolent Communication: A Language of Life* (2003) 52.

[6] James L. Gattuso, 'Reforming Regulation to Keep America's Small Businesses Competitive' (2004) The Heritage Foundation <http://www.heritage.org/Research/Regulation/tst052104a.cfm#_ftn2#_ftn2> at 14 December 2009.

[7] <http://people-press.org/report/?pageid=756> at 23 December 2009.

and retard needed change. It may limit the expansion of consumer choice, reduce entrepreneurial initiative, and often advantages some unfairly at the expense of others, small business for example.[8] Because many regulatory costs fall disproportionately on small business; if regulation is ineffective, small business feels it first. [9] There are, however, significant benefits to efficient and effective regulation, though they are often harder to quantify than the costs. Appropriate regulation can enhance economic growth and competitiveness, as regulatory regimes support the growth of local economies and global economic development.[10]

As the current global financial crisis continues to unfold, there can be no doubt that there are consequences to regulatory inaction. In place of neo-conservative principles of de-regulation and unbounded faith in markets, there is a renewed appreciation of the potential benefit of effective regulation to enhance competitiveness by ensuring effective and fair commerce. There is in the public discourse an 'increasing sense of anxiety surrounding deregulation' because market processes cannot be relied upon to adequately serve the public interest.[11]

Properly targeted and implemented regulatory measures can reduce costs of unfair practices and failed business, reinvigorate consumer confidence and stimulate investment. An effective regulatory scheme can attract foreign investment and facilitate local expansion overseas. Some experts advise businesses to seek out areas with progressive regulation in terms of concern with social problems, and to set internal goals that meet or exceed regulatory standards because this ultimately leads to advantage as

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[8] Sveinbjörn Blöndal and Dirk Pilät, 'The Economic Benefits of Regulatory Reform' (1997) 1 OECD Economic Studies No. 28 [29] <http://www.oecd.org/dataoecd/22/21/2733617.pdf> at 14 December 2009.

[9] A Crain and Hopkins study found that firms employing fewer than 20 people faced regulatory costs of almost $7,000 per employee, compared to an average of $4,700 for all firms, not including indirect burdens and secondary costs. See W. Mark Crain and Thomas D. Hopkins, 'The Impact of Regulatory Costs on Small Firms: A Report for the Office of Advocacy, US Small Business Administration,' RFP No. SBAHW-00-R-0027.

[10] Sveinbjörn Blöndal and Dirk Pilät, 'The Economic Benefits of Regulatory Reform' (1997) 1 OECD Economic Studies No. 28 [30] <http://www.oecd.org/dataoecd/22/21/2733617.pdf> at 14 December 2009. On the distinction between the regulation of standards and the regulation of competition, see Michael E. Porter, *The Competitive Advantage of Nations* (1990). The topic is also discussed in John Braithwaite, 'Responsive Regulation for Australia' in Peter Grabosky and John Braithwaite (eds), *Business Regulation and Australia's Future* (1993).

[11] Karen Gustafson, 'The New Economy and Internet Regulation: Discourses of Inevitability' (Paper presented at the 57th Annual International Communication Association Conference, San Francisco, CA, 24 May 2007).

other jurisdictions modify their regulations to follow suit.[12] A well-defined legal structure is indispensable for the effective functioning of any business operation and the lack of comprehensive legislation can lead to greater complexity, ambiguities and uncertainty. Commercial interests in any jurisdiction therefore should seek to promote a measured approach toward achieving effective and efficient regulation in order to enhance competitiveness and the effective function of markets and, ultimately, to enhance the quality of life in both economic and social spheres.

Regulation is inevitable. All commerce is underpinned by a legal framework and infrastructure. Not only that, all commerce is regulated privately; specifically at the 'layers' of market and contract the parties use various means to control the nature of their interactions. The question then is not whether to regulate, but how to regulate.

The global financial crisis provided a stark reminder that the economic climate and the regulation of business in economies around the globe can and do impact each other significantly. Regulating business in a post-global-financial-crisis world is likely to involve greater emphasis on the prophylactic benefits of regulation, as a result of a widespread disillusionment with laissez-faire approaches that allow unscrupulous people to profit to the detriment of all. There is less tolerance for 'sharp' business practice and a greater recognition that we all pay for financial opportunism, often on a grand scale, and that we need regulation for the benefits and competitive advantage that good governance can offer.

However, increasing complexity in markets and higher levels of specialization mean it is harder than ever for regulators to comprehend and respond to risks in the marketplace. During the financial instability in the US prior to World War II Franklin D. Roosevelt was able to shut the banks, to take time to analyse and address the particular problems that had caused the most damage to the economy.

Today, it appears to be impossible to unravel the interconnected web of global trade and finance, and the luxury of sufficient time to fully analyse problems and formulate plans seems to be a relic of a bygone era. Further, there seems less consensus than ever on what the role of government can and should be in market intervention:

> Welfare economics supports the concept that failure to satisfy the conditions for perfect competition can justify government intervention in markets . . . but this market failure approach is open to question . . . The difficulty facing regulatory

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[12] Peter Grabosky and John Braithwaite (eds), *Business Regulation and Australia's Future* (1993) 88, citing Michael E. Porter, *The Competitive Advantage of Nations* (1990).

> authorities is how to differentiate between situations requiring intervention and those that do not . . . in general, government intervention is not necessarily the only or even the best solution to instances of market failure . . . also, spillover effects of regulatory actions in one jurisdiction can impact on other jurisdictions and necessitate coordination in a globalised economy.[13]

The answers therefore have to be quicker, with greater reliance on insider/expert knowledge and with awareness of synergies of the ecologies of markets and industries. They must be more self-regulatory, responsive and reflexive, with greater reliance on the expertise and on-the-spot assessments of the participants themselves.

The answers also must be global and broad-based in perspective as the new global economy is more interconnected than ever before. The concept of globalization can mean many things; in this book it is used to refer to, 'a process in which the structures of economic markets, technologies, and communication patterns become progressively more international over time'.[14] The growth of international trade, the expansion of transnational enterprise, and increased interactions of financial markets are components of this process which has significant implications for national economies and global change.[15]

The Malaysian franchise sector's targeted expansion into Middle Eastern markets illustrates the connections among countries and regions such as Southeast Asia and the Middle East and among industry sectors such as tourism and fast food:

> The Malaysians have been particularly successful in the area of introducing new food and fashion brands to the Gulf. Malaysia's current drive, promoting itself as a preferred holiday destination for people from the Gulf, is assisting the drive to export Malaysian brands. Tourists experience the local brands abroad and readily accept them in Saudi when they are introduced. The tourist drive further enhances the concept of brand Malaysia?[16]

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[13] Boon-Cheye Lee, 'Regulation and the New Economy' (Working Paper 02-18, University of Wollongong, NSW, Australia, 2002) 15–16. Available at <http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1063&context=commwkpapers> at19 December 2009.

[14] OECD, 'Environment and Globalisation: Background Report for Ministers' (Report for meeting of the Environment Policy Committee at Ministerial Level, Environment and Global Competitiveness, 28–29 April 2008) < http://www.oecd.org/dataoecd/3/59/40511624.pdf> at 19 December 2009.

[15] Rhys Jenkins, Jonathan Barton, Anthony Bartzokas, Jan Hesselberg and Hege Merete Knutsen, *Environmental Regulation in the New Global Economy: The Impact on Industry and Competitiveness* (2002).

[16] Franchiseek Limited, 'Saudi Arabia Franchise Statistics' (2009) <http://www.franchiseek.com/Saudi_Arabia/Franchise_Saudi_Arabia_Statistics.htm> at 14 December 2009.