

Chapter 2

The Franchisor

Abstract The role, identity, qualifications and characteristics of franchisors is discussed in this chapter. The impact of franchising on the economy of a nation is identified by reference to Australia, France, New Zealand, the United Kingdom and the United States. Franchisors are compared to SMEs and franchisees. Their roles as suppliers operate at two levels: supplier of the franchise system and also of stock and plant. In the second supplier role franchisors' ability to create monopolies is explored. Possible approaches franchisors adopt to managing risk are also identified.

Franchisors 'hold substantial power in the franchising relationship'.¹ To emulate Ray Croc of McDonald's 'in achieving manufacturing uniformity without stifling the individual creativity of its operators through excessive regimentation'² is an enduring test for franchisors and requires wise use of that substantial power. Typically, the franchisor controls the franchise's strategy, its look and feel, and sources and negotiates with suppliers to the system, and sets and enforces standards in exchange for franchisees making payments, signing contracts and creating and operating a near clone of the franchisor's prototype. Franchisors choose which functions they themselves will perform, which functions will be performed by franchisees and which functions will be performed by third parties.

After identifying a business opportunity, ideally operating a pilot business to refine the concept, and then fine-tuning the business, the franchisor drafts a franchise agreement, and where required it prepares a disclosure document.³ The content of this disclosure document varies with jurisdictional requirements. The franchisor also documents all operational aspects of the franchised business, then recruits and appoints franchisees. Advertisements to attract franchisees appear under headings like 'your guide to living the dream'.⁴ Franchisors acknowledge the

¹ Do the numbers stack up? Lesley Parker, November 2, 2011, Sydney Morning Herald quoting ACCC Chairperson, Rod Sims. <http://www.smh.com.au/small-business/franchising/do-the-numbers-stack-up-20111102-1muio.html#ixzz1fqKnikkU>

² John F Love *McDonald's: Behind the Arches*, (Bantam Books, 1986) 115

³ According to Spencer, 20 of the 30 countries with franchise-specific legislation have regulated by means of disclosure requirements. Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010) 218

⁴ Daily Telegraph, 16 March 2012

hard work that goes into building any business and promise that through choosing to put in the hard work via franchising a franchisee will be well supported. For example, Australian bookseller franchisor, Dymocks, says owning a business ‘can be a bit like walking a high wire, but with Dymocks you know you have a safety net below you’.⁵ Over time the franchisor refines the franchise system and updates the operations manuals. The franchisors require franchisees to respond to the commercial environment and comply with the evolving system.

The franchisor establishes a business that performs many functions. It is possible for the franchisor entity itself to conduct all functions that support the franchisees. The only role that is not open to a franchisor is ‘franchisee’. However, many franchisors conduct a retail-level outlet along the same lines as a franchisee-owned outlet. This provides an opportunity for franchisors to market-test products, new technology or ideas, to benchmark expectations about stock levels and other ratios and test operational instructions before placing instructions into franchisee-bound operating manuals.

As demonstrated in Table 2.1, franchising is a business model to which each franchisor brings its own nuanced interpretation. There are notable differences between established and new franchisors. Policy makers should not see either franchisors or franchisees as all being small to medium enterprises (‘SMEs’). Regardless of the level of maturity of the franchise, the franchisor is the point of connection between the franchise network and the franchise system. Table 2.1 that follows identifies some points of difference between what is recognised as a typical SME and franchisors and franchisees.

An examination of Table 2.1 reveals that numerous differences exist between franchisors and franchisees. Whilst either may be categorised as an SME, some franchisors and even some master franchisees and franchisees are large corporations, while others are travelling along the same learning curve as any newly formed independent business.

In terms of impact on the economy, there are few datasets that permit comparison of the numbers of franchisors, franchisees and their impact. Australia, France⁶ and the United Kingdom⁷ generate current longitudinal data and New Zealand has now conducted its second survey of its franchisors. We know there were ‘828,138 franchised business establishments in the United States in 2007’⁸ but not the number of franchisors. In New Zealand, an estimated 423 franchisors were operating in 2010 with 23,600 franchised units trading under their brands. The best available comparative longitudinal figures for the franchise sectors are drawn from Australia and France and shown in Figs. 2.1, 2.2 and 2.3 below.

⁵ Advertisement on <http://www.franchisebusiness.com.au/c/Dymocks>

⁶ France’s Banque Populaire collaborates with the French Franchise Federation to produce annual surveys of franchising in France. The survey is now in its eighth year and can be accessed at <http://franchise-fff.com/presse/les-communiqués-de-presse-de-la-fff/240-enquete-annuelle-sur-la-franchise.html>

⁷ The NatWest bank combines with British Franchise Association to conduct an annual survey of franchising in the UK. Highlights are available online at <http://www.natwest.com/business/services/market-expertise/franchising/natwest-bfa-survey.ashx#1>

⁸ This was a figure calculated before the Global Financial Crisis bit deep. It includes product and business format franchises and franchisor-owned and franchisee-owned outlets. Of these, xxx were business format franchises and 14% of those were owned by the franchisor, 86% by franchisees. <http://www.buildingopportunity.com/impact/overview.aspx> Accessed 10 April 2012

Table 2.1 Competitive dynamics: typical characteristic of SMEs, established franchisors and franchisees (Adapted from table in Schaper, MT 2010, ‘Competition Law, Enforcement and the Australian Small Business Sector’ Small Enterprise Research 17(1) pp. 7–18)

SME	Typical established franchisor	Typical new franchisor	Typical franchisee
Geographically constrained	Not geographically constrained. Wide footprint, including multi-jurisdictional	One franchisor-owned pilot, plus franchisees in close geographical proximity	One or two outlets, but some own dozens of outlets in several brands
Limited product and service range	Product and service range may include selling franchises in one or more franchise systems, importing/manufacturing stock to sell to franchisees, owning/leasing franchisees’ premises, training franchisees, managing system’s marketing fund, managing system’s superannuation company	Product or service range is limited, focussing on one franchise brand	Dictated by franchisor and further limited by terms of premises lease
Limited market share	Compete vigorously to attract franchisees May have sizeable share of product or service market Create a monopoly through supply arrangements with franchisees	Compete vigorously to attract franchisees Limited market share	Dependent on franchisor Potential for abuse of this power by franchisor -May be dependent on one supplier, the franchisor One level of customer: Customers buying products or services from franchisee
One or two key customers	Two types of customer: franchisees buying franchises; customers buying products or services from franchisor-owned outlets or direct from franchisor, either face to face or online	Two types of customer: franchisees buying franchises; customers buying products or services from franchisor-owned outlets or direct from franchisor	
High levels of business failure	Limited inconclusive data Business failure levels cannot be dismissed	No evidence to suggest that younger or more established franchisor fail at a higher rate	In theory, the franchisees should be less susceptible to failure than a stand-alone small business
Greater compliance costs	The bigger the franchise network becomes, the proportionally lower the compliance cost – franchisor has improved economies of scale Some compliance burden is shifted to franchisees	Proportionately high because have not yet achieved economies of scale	High; compliance with franchisors rules, landlord’s requirements and ongoing statutory compliance

(continued)

Table 2.1 (continued)

SME	Typical established franchisor	Typical new franchisor	Typical franchisee
Imperfect information and information asymmetry	Sophisticated operator: Can access information easily, controls information dissemination to franchisees, has full information about its franchisees	Limited; ad hoc Information asymmetry in relation to the market, but has full information about its franchisees	Limited; ad hoc Severe information asymmetry re-franchisor and ability to pay for advisers to match franchisor's advisers but can access information on public databases and blogs
Less access to established suppliers	Easy, sophisticated, sought out by established suppliers, significant purchasing power	Better than franchisees but limited power until established	Being a franchisee opens doors to established suppliers BUT unable to freely negotiate
Usually unincorporated	Public corporations, groups of entities comprising public and proprietary corporations, trusts, few stand-alone proprietary corporations, partnerships or sole traders. Some owned by venture capitalists	Proprietary corporations, trusts, few partnerships or sole traders	
Limited financial resources	Directors' assets sheltered Significant ability to access finance, including thorough public listing	Directors' assets sheltered Often limited finances. Ability to access equity finance through appointing franchisees	Uses most of financial resources and borrowing capacity to buy franchise, thereafter limited financial resources until strongly established
Limited access to skilled advice	Established franchisors are advised by multi-jurisdictional law and accountings firms and have in-house advisers	May use large firms or small or brokers to help set up	Seek advice (if at all) from small firms. Once established, they use advisers only when they are in trouble. Mirror typical SMEs

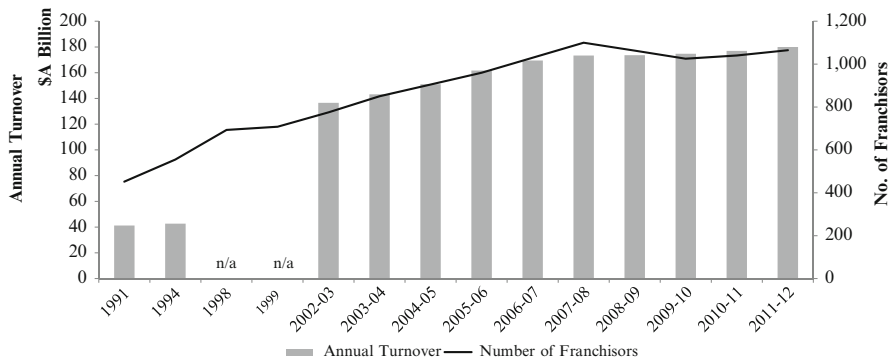


Fig. 2.1 Number of franchisors and annual turnover of Australian franchise sector

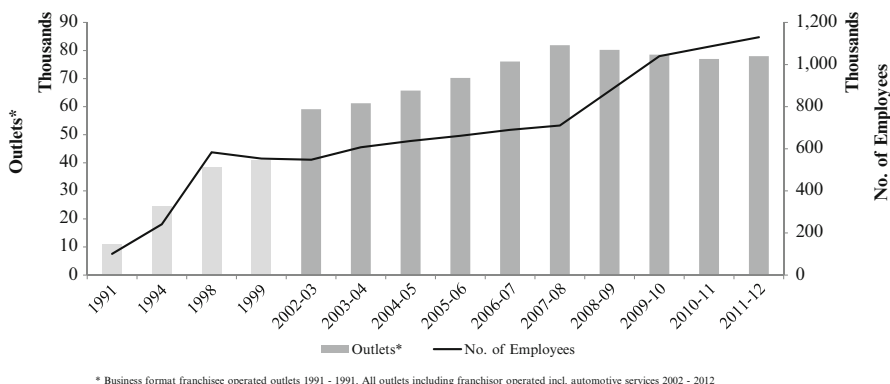


Fig. 2.2 Numbers of franchisor- and franchisee-run outlets and employees in Australia. (Sources of data: 1991, Franchising Task Force Final Report (Beddall report), R Fitzgerald; Department of Industry, Science and Technology Franchising Sector Survey results 1994, Australian Bureau of Statistics; 1998 and 1999; Lorelle Frazer and Scott Weaven, Franchising Australia 2002, Commonwealth Bank Franchising Survey, Griffith University; Lorelle Frazer and Scott Weaven, Franchising Australia 2004, Griffith University; for data 2002–2012, IBISworld Report X0002 Franchising in Australia May 2012)

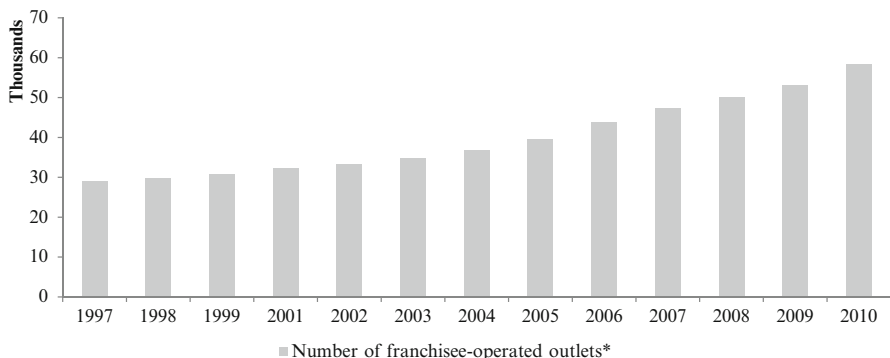


Fig. 2.3 Numbers of franchisee-run outlets in France (*These figures represent the number of franchise outlets, not the number of franchisees)

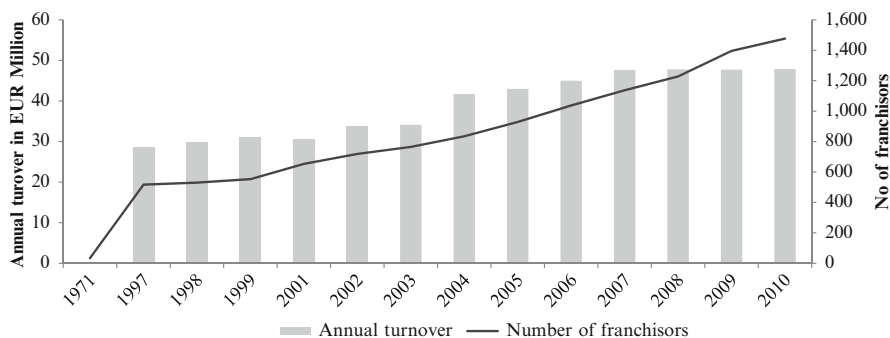


Fig. 2.4 Number of franchisors and annual turnover of French franchise sector

By 2009, franchising provided work for 690,000 employees, and the franchise sector turned over approximately \$60 billion in Australia. The 2010 figures for France are equally compelling with franchising providing work for 335,000 employees and the franchise sector turning over more than 47,89 billion euros (or nearly \$60 billion Australian dollars)* (Fig. 2.4).

Each franchisor has between one and thousands of franchisees. The proportion of franchisors to franchisees is about 1:60 in Australia,⁹ 1:39 in France¹⁰ and 1:55 in New Zealand.¹¹ These ratios assume that one franchisee operates one outlet. It is however common for franchisees to own and operate numerous franchised units and to be known as a multiunit operator.¹² Less often, one franchisee also operates more than one brand, an approach known as co-branding which helps a franchisee diversify risk and maximise the use of its management team. An extreme example of a 'franchisee with the lot' is multiunit, co-branding operator Sun Holdings LLC, a US company founded in 1997 by Mr Perales. Sun Holdings has created a network of companies that 'operate 167 Burger King® restaurants, 72 Popeye's franchises, 33 Golden Corral, 46 CiCi's, 4 del Taco and 5 Denny's restaurants'.¹³

Becoming a franchisor or a franchisee is to accept the responsibility of running a business. Despite the level of managerial experience required to fulfil either role well, there are no specific pre-entry education requirements for franchisors. Both the formally educated and those with little formal education become franchisors. In Australia, 69% of franchisors had prior business start-up experience before entering

⁹ Lorelle Frazer, Scott Weaven and Kelli Bodey *Franchising Australia 2010*, Asia Pacific Centre for Franchising Excellence, Griffith University

¹⁰ Enquête Annuelle sur la Franchise, Résultats, 2010

¹¹ Susan Flint-Hartle, Lorelle Frazer, and Scott Weaven *Franchising New Zealand 2010*, Massey University and Griffith University

¹² See, for example, Marko Grünhagen and Robert Mittelstaedt *Entrepreneurs or Investors: Do Multi-unit Franchisees Have Different Philosophical Orientations?* (2005) 43(3) *Journal of Small Business Management* 207–225

¹³ April 16, 2012, Business Wire, 'Burger King® Franchisee Guillermo Perales Acquires 96 Restaurants in Central Florida: Becomes Largest Minority Franchisee in the US' <http://business-wire.com/news/home/20120416006453>

their current business.¹⁴ This means almost a third of Australian franchisors had no prior experience starting a business before they started their franchise. Their first franchisees are, in effect, their ‘guinea pigs’. Of the franchisors operating in Australia in 2010, ‘30 per cent [had] completed secondary education [i.e. high school], 30 per cent [had] attained a technical or trade qualification and 26 per cent’¹⁵ had a university degree. To put these figures in context, of the whole population of business owners in Australia, 49% list their highest academic qualification as completing secondary school, 46% complete a trade qualification and 23% possess an undergraduate university degree.¹⁶ These statistics suggest that an entrepreneurial flair rather than a formal education is the foundation from which many franchise businesses begin.

Some franchisors operate the franchise through corporations, others through trusts and some through a combination of corporations and trusts. Australian data categorises 70% of ‘franchisor’ entities in Australia as proprietary corporations, 14% public corporations and 10% trusts.¹⁷ Where a franchisor is owned by a public corporation, the company’s published reports may or may not contain meaningful discrete information about the franchise division. Franchisees need to conduct pre-purchase due diligence. If the franchisor is set up as a trust, it is impossible for a third party, including a franchisee, to obtain information about the true identity of the franchisor from the public record. For example, in *Australian Competition and Consumer Commission v. Chaste Corporation Pty Ltd*,¹⁸ Lander J observed:

Chaste was entirely controlled by the fourth respondent, Mr Foster and the second respondent, Mr Webb, and those two gentlemen, through the [trusts] which they controlled,... would receive respectively 75per cent and 25 per cent of the profits. As far as a bystander [including a franchisee] was concerned, Chaste was entirely controlled by Mr Webb. No bystander could have known that there were agreements in place...which gave control of Chaste to Mr Foster.¹⁹

Having looked at the franchisor in general terms, let us now delve into its role as a supplier and the opportunities this affords.

¹⁴ Frazer, Weaven, Bodey, *Franchising Australia 2010*, 118

¹⁵ Frazer, Weaven, Bodey, *Franchising Australia 2010*, 116–117

¹⁶ Frazer, Weaven, Bodey, *Franchising Australia 2010*, p. 116–117 figures drawn from Australian Bureau of Statistics ‘Counts of Australian Business Operators 2006–7’ Catalogue number 8175.0

¹⁷ Lorelle Frazer, Scott Weaven, Owen Wright, *Franchising Australia 2006* (Griffith University, 2006), 34

¹⁸ *Australian Competition and Consumer Commission v. Chaste Corporation Pty Ltd (In Liquidation)* (ACN 089 837 329), Braddon Ralph Webb, Orlawood Pty Ltd (ACN 059 294 334), Peter Clarence Foster, Sean Petrie Allen Cousins, Kevin Anthony McMullan, Alan Kenneth Cooper, Stephen D’alton, Qud 252 of 2001

¹⁹ *Australian Competition and Consumer Commission v. Chaste Corporation Pty Ltd (In Liquidation)* (ACN 089 837 329), Braddon Ralph Webb, Orlawood Pty Ltd (ACN 059 294 334), Peter Clarence Foster, Sean Petrie Allen Cousins, Kevin Anthony McMullan, Alan Kenneth Cooper, Stephen D’alton, Qud 252 of 2001 [22], [24]. For a discussion with conman Peter Foster see <http://www.abc.net.au/sundayprofile/stories/2578118.htm>.

Franchisor as Supplier

One of the franchisor's roles is to establish a network of reliable suppliers who will supply everything a franchisee needs to establish and run its business.²⁰ A well-established franchisor has significant negotiating power with suppliers, from landlords through to suppliers of stock. This is very valuable for novice franchisees. The franchisor's 'weight' can open doors and secure deals that a stand-alone new business entrant could not achieve.

Whereas open market monopolies are closely regulated to protect consumers from the impact of anti-competitive conduct, this level of scrutiny does not occur in franchising. A franchisor creates, through the franchise network, a monopoly where the franchisee-consumers are contract bound to deal with the monopolist, the franchisor supplier, on terms set by the franchisor. So long as the law identifies 'the market' in traditional ways, the franchisor will not be seen as a monopolist and will escape rigorous regulatory scrutiny in anti-trust matters. This is particularly the case in relation to anti-competitive conduct whose legitimacy is measured by reference to impact on the ultimate consumer. Observations by Lisa Bruttel and Simeon Schudy that '[w]hen evaluating the competitiveness of a market, cartel authorities assume that subsidiary companies with the same parent do not compete with each other or their parent...antitrust law in the European Union presumes that firms belonging to the same owner always act in the owner's interest'²¹ are equally valid in Australia. It could be asserted with confidence that a presumption to this effect exists when cartel authorities are evaluating the anti-competitive potential of otherwise prohibited conduct within franchise systems. On a closer look, the franchisees may be operating within a monopoly in relation to all supplies the franchisor controls. They do not have a choice to deal with other suppliers even if they could secure more favourable terms elsewhere.

There is thus little to prevent franchisors from using their pivotal role in the supply chain to operate like monopolists vis-à-vis their franchisees. Stephen Corones notes that through their supplier arrangements '[f]ranchise agreements may fall within the ambit of [competition/anti-trust legislation] if they involve horizontal or vertical anti-competitive conduct'.²² This is the prohibited anti-competitive conduct that competition/anti-trust regulators are familiar with. In Australia, franchisors may secure the consent of the regulator, the Australian Competition and Consumer Commission (ACCC), to engage in conduct that if it were not shown to be in the

²⁰ It should be noted that where a franchisee needs supplies of highly perishable stock like fruit to make fresh squeezed juice with the franchisees may be required to source their own local suppliers of this item

²¹ Lisa Bruttel and Simeon Schudy 'Competition within Firms' (2012) 8 *Journal of Competition Law and Economics*, 167

²² Stephen G Corones, *Competition Law in Australia* (5th ed, Thomson Reuters, 2010), 618

public interest would otherwise be in breach of the competition legislation. Andrew Selden observes that ‘many [franchise] agreements carefully establish the franchisor’s role as the greatest competitive threat to its own franchisees by reserving plenary authority to the franchisor to establish additional locations in close proximity to the franchised unit and to distribute same-branded goods and services through other channels of distribution’.²³

An example which elucidates some of these issues is that of the bread-baking franchise network Bakers Delight Holdings Ltd (‘BDH’). Franchisees are required to order products from entities unrelated to BDH as is described in the notification to the ACCC.²⁴ Despite several franchisees making submissions in opposition, the ACCC accepted the franchisor’s submissions that ‘the public benefits likely to arise out of the proposed arrangements between [the franchisor] and its franchisees would outweigh any public detriment’.²⁵ For example, one franchisee submitted that BDH

have been known to use their relationship with the supplier to terminate franchise agreements, breach privacy and call in debts normally at the detriment of the franchisee. Doing so can prevent the small business operator from obtaining another supplier and continue trading. The public receives no benefit from the franchisee being forced to purchase from Bakers Delights nominated suppliers, however Bakers Delight Holdings gains a lot, including commissions.²⁶

Consequently, BDH can legally require its franchisees to deal with specific suppliers. In making its decisions, the ACCC provides franchisees and other stakeholders with the opportunity to object on a confidential basis to the proposed legitimisation of the anti-competitive conduct. The process is public to the extent that notification applications and objections to the proposed consent are posed on the ACCC’s website. In the absence of a confidential process enabling franchisees to express legitimate tying or other anti-competitive conduct to the competition regulator, franchisors would always have the upper hand. They could find ways to punish franchisees who object to product supply arrangements that may be anticompetitive. For example,

approved suppliers of ingredients, packaging and equipment contribute 2% of their sales to Bakers Delight franchisees to the Conference and Development Fund which is administered and controlled by the Franchisor....BDH use these funds for conferences where the approved suppliers attend to market their excellent service to us but non approved suppliers are locked out. Therefore we are not given the opportunity to assess other potential suppliers during these conferences. The Conference and Development fund is also used in a punitive

²³ Andrew C Selden ‘Beyond the Law and Contracts: Strategies for Effective Franchise Relationship Self-Management’ in Elizabeth C Spencer (ed) *Relational Rights and Responsibilities: perspectives on Contractual Arrangements in Franchising*, (Bond University Press, 2011) 161

²⁴ Notification N92536 under s 47 Trade Practices Act 1974 (Cth) < <http://www.accc.gov.au/content/index.phtml/itemId/750777/fromItemId/729985>> Accessed 17 June 2010

²⁵ Letter Deacons to Australian Competition and Consumer Commission 23 June 2006. At <http://www.accc.gov.au/content/index.phtml/itemId/750777/fromItemId/729985/display/notification>

²⁶ Letter 21 April 2007 Narelle Walter to ACCC re Third line forcing notification N92536 lodged by Bakers Delight Holdings Ltd <http://www.accc.gov.au/content/index.phtml/itemId/750777/fromItemId/729985/display/submission>

manner...in October 2006 BDH invoiced Franchisees that source ingredients outside the approved suppliers to pay for their cost of attending the conference to the value of lost revenue to the Conference and Development Fund relative to the 2% not paid by the suppliers....Those Franchisees who had advised BDH of their intent not to attend were threatened with a breach of their Franchise Agreement.²⁷

Doug Frazey accepts the ‘captive market’ role of franchisees as a ‘structural inevitability of franchising [where] the franchisee may depend on the franchisor not only for materials essential to the business, which the franchisee can often only purchase through the franchisor, but also for premises and finance’.²⁸ This structural inevitability is also structural inequality and it provides scope for abuse.

Franchisor’s Approaches to Managing Risk

A franchisor/franchisee relationship can be expressed as separating decision functions, which rest with the franchisor, from risk-bearing borne by franchisees.²⁹ Franchisors structure the franchise network to protect core assets like intellectual property and limit their personal exposure to loss. Within the franchise network, the separation is achieved through the franchise agreement and the segregation of functions among numerous independent franchisor-related and franchisee entities.

The agreement is the primary regulatory mechanism for the franchise relationship. It defines, preserves and protects the franchisor’s interests and embeds power and risk imbalance in the relationship. These contracts expose franchisees to significant risk. For instance, before being allowed to sign the contract, franchisees are usually required to disclose every detail of their personal finances to the franchisor. This is to reassure the franchisor that the franchisee is able to afford the business. Conversely, the franchisor is able to withhold information about all aspects of its businesses except what has to be disclosed to meet statutory requirements. Through this asymmetry of financial information, for example, the franchisee takes on the risk that the franchisor may be insolvent. It relies on the franchisors’ word.³⁰

²⁷ Letter 25 April 2007 Paul Costanzo to ACCC re Third line forcing notification N92536 lodged by Bakers Delight Holdings Ltd. <http://www.accc.gov.au/content/index.phtml/itemId/750777/fromItemId/729985/display/submission>. Costanzo’s company, franchisee PAKAMALA PTY LTD, was registered on 6 August 2004 and commenced trading as Bakers Delight Ulladulla in September 2004. It is now (2012) in external administration

²⁸ Doug Frazey, ‘Case Note: When ‘Good Cause’ Goes Bad: Minnesota Restricts Protection for Dealers under HUMEDA – River Valley Truck Ctr., Inc V. Interstate Cos’ (2006–2007) 33(2) *William Mitchell Law Review* 711, 728 quoting ABA Antitrust Section: Monograph No 17, Franchise Protection: Laws Against Termination and the Establishment of Additional Franchises 19 (1990). We see the extent to which the franchisee may rely on the franchisor for access to premises in Chap. 2

²⁹ See EF Fama and MC Jensen, ‘Separation of Ownership and Control’ (1983) XXVI(2) *Journal of Law and Economics* 301, 304 who do not include franchise networks in the spectrum of organizations discussed

³⁰ Franchisors are not always solvent when they sign franchise agreements. Franchisors’ insolvency is discussed in detail in Chap. 8

Appropriately, franchisors give themselves the right to maintain the reputation of the franchised brand via the agreement. McDonald's is reported to have a 'morals' clause in its franchise agreements, granting itself the discretion to terminate the contract if 'a franchisee engages in conduct reflecting poorly on McDonald's or brings McDonald's into disrepute'.³¹

Business owners are aware of the opportunity to divest legal and financial responsibility that accompanies a move into franchising. Take, for example, public company telecommunication services provider, Commander Communications Limited, for which 'the effect of franchising will be an increase in sales, movement of costs from fixed to variable and a reduction in direct labour costs with an increase in commissions'.³² All did not go to plan for Commander Communications. Having had an annual turnover of \$A1billion in revenue and 1,200 employees,³³ by August 2008, the franchisor Commander Communications Limited and its 46 related entities were under external administration.³⁴ Commander Communications' motivation to franchise is consistent with the motivation of franchisors that responded to the question 'why did you choose a franchise model?'³⁵ in the 2010 Franchising Australia Survey. Perhaps not unexpectedly as this survey was conducted as the Global Financial Crisis impacted the availability of credit, the most commonly stated response was that 'franchisees provided capital for expansion'.³⁶

The logic employed by Commander Communications is not lost on US-based franchisors. For example, in commenting on the potential impact of the *Californian Fair Franchising Bill*, Canadian lawyer Michael Webster noted that global franchisor United Parcel Service Company (UPS) creates franchisees who are effectively employees who pay for the right to work by buying a franchise. The company's revenue is generated from shipping packages. Traditionally UPS 'had a series of depots and unmanned drop-off boxes to process returns...[but] some packages must be returned from where they were shipped to'.³⁷ This left UPS with the choice of employing more staff and creating more UPS-operated depots or appointing franchisees. It resolved the problem by acquiring

³¹ *Shelley Lynn v. Keith Handley, Ivernia, Inc., McDonald's USA, LLC*, Does 1–10 Complaint and Demand for Jury Trial, CV12-02140 Filed Central District of California, March 14, 2012, para 103

³² Jacqui Walker, Small Business Does it Tough ... Hardie Trio Quit ... Economists Tip Wages to Firm ... Gloria Jean's Tax Trouble ... Domino's Setback ... Small Biz Stats ... Commander to Franchise ... Economic Roundup' (2007) Smartcompany <<http://www.smartcompany.com.au/retail/small-business-does-it-tough-hardie-trio-quit-economists-tip-wages-to-firm-gloria-jean-s-tax-trouble-domino-s-setback-small-biz-stats-commander-to-franchise-economic-roundup.html>> Accessed 17 September 2009

³³ Tony Boyd, 'Employees from collapsed telco Commander Communications hit out at receivers' Smartcompany.com.au 25 March 2009

³⁴ Ferrier Hodgson, Administrators appointed

³⁵ Frazer, Weaven and Bodey *Franchising Australia 2010*, 123

³⁶ *Franchising Australia 2010*, Griffith University. 47% of franchisors, closely followed by 45% who chose franchising to achieve rapid market penetration

³⁷ Michael Webster, 'Fair Franchising Bill Will Create Jobs for California' on Bluemaumau.org.au (17 April 2012) http://www.bluemaumau.org/fair_franchising_bill_will_create_jobs_california

an existing franchise system, [MBE] out of bankruptcy. [UPS] changed the franchise agreement, giving the franchisor more control, ... put their signage in front and the public now believes that they are dealing with UPS employees. UPS achieved its business goals: they effectively turned these [former MBE] franchisees into employees who will not be a payroll expense.³⁸

Clearly, from the UPS example and that of the Australian bakery franchisor Pie Face, franchisors are aware of fiscal benefits of replacing staff with franchisees. For Pie Face, a deciding factor in favour of franchising is

the cost of employing staff in Australia. Having a company-owned network of stores is just so expensive, and too expensive to own all our stores with payroll tax, and so on. That's obviously part of the reason we've moved to a franchise system.³⁹

In addition to controlling their exposure to payroll tax and staff superannuation liabilities by replacing employees with franchisees, franchisors can choose how the money will flow between themselves and their franchisees. The traditional pathway is for a franchisee's customers to buy the product or service from the franchisee and to pay the franchisee. The franchisee then banks the money into its own account and pays a royalty, marketing contribution and possibly premises rental and stock invoices to the franchisor. In some cases, however, franchisors choose to route the money flow in the opposite direction; from the franchisee's customers to franchisor, with the franchisor having a contractual obligation to pay its franchisees a commission. For example, the commission system was adopted by former gym franchisor Beach House Group that required its franchisees to agree to use the services of the franchisor's related entity, Skinsama Debt Collections Pty Ltd, to manage and collect the franchisees' customers 'membership payments by way of direct debit'.⁴⁰ This reverse money flow provides a franchisor with first call on 100% of the franchisees' earnings but increases the vulnerability of franchisees that then depend on their franchisor for their income. The consequences of this are pursued in Chap. 8.

Franchisors also shed or manage risk through the legal relationships created with the owners of intellectual property. The franchisor is typically not the owner of the trademarks that it licences franchisees to use. Retail leases and trademarks are expanded on in Chaps. 3 and 8.

A franchisor's ability to manage risk is again demonstrated when the franchisor wishes to exit its role. In Australia, only 50% of the franchisors surveyed replied that they were the founder of the original business.⁴¹ In New Zealand,⁴² fewer than

³⁸ Michael Webster, 'Fair Franchising Bill Will Create Jobs for California' on Bluemaumau.org.au (17 April 2012) http://www.bluemaumau.org/fair_franchising_bill_will_create_jobs_california

³⁹ Patrick Stafford quoting Homschek in A Bigger Slice of the Pie (2009) SmartCompany <<http://www.smartcompany.com.au/food-and-beverages/20090821-a-bigger-slice-of-the-pie.html>> on 22 September 2009

⁴⁰ Letter Mills Oakley to ACCC re Exclusive dealing Notification N92650 dated 20 September 2006 filed on the Australian Competition and Consumer Commission website

⁴¹ Frazer, Weaven and Bodey *Franchising Australia 2010*, 112

⁴² Susan Flint-Hartle, Lorelle Frazer and Scott Weaven *Franchising New Zealand 2010*, 108

45% of franchisors were the founder of their system. Although in France,⁴³ by way of contrast, 84% of franchise networks are still owned by the original directors, this still means at least 236 French franchise systems had a new franchisor by 2010. Just as the only certainties in life are birth, death and taxes, so for franchisors an event that needs to be addressed sooner or later is 'how do I get out of this thing?' Formulating and executing an exit strategy is an aspect of corporate governance explored in Chap. 7.

The question then needs to be asked whether and how the interests of the franchisees should be taken into account. Before examining this, I will place the franchisor and franchisee into the context of the franchise network.

⁴³ Enquête Annuelle sur la franchise, Résultats, 2010, 1. 'des réseaux matures (l'enseigne a 20 ans, le réseau 11 en moyenne); de grosses PME très majoritairement détenues par leurs dirigeants d'origine, qui ont choisi la franchise pour accélérer leur développement, mais aussi parce qu'ils ont confiance en les qualités intrinsèques de la franchise : effet réseau, services aux franchises'.

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Buchan, J.

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