FRANCHISING SCHEMES IN SINGAPORE — LEGAL ASPECTS OF PUBLIC OFFERS

INTRODUCTION

FRANCHISING is an expanding commercial activity in Singapore. The legal nature of this increasingly popular mode of business enterprise is essentially one of contract, entered into betwween the franchisor and the franchisee. There is no cause for public concern if the franchise agreement is entered into privately between two companies in their respective capacities as franchisor and franchisee. This is because the corporate franchisee can adequately safeguard its own interests when dealing with the franchisor. However, the above assumption must be discarded if a franchisor chooses not to offer the franchises privately but instead offers them indiscriminately to members of the public. This public offer is easily effected by way of an advertisement in the press in a manner not unlike a public offer of securities by public companies. Given the gullibility of investors this raises the question whether some form of statutory regulation is needed to protect the investors who may be easily overwhelmed by the exaggerated profit projections in such an advertisement. In view of the fact that public offers of franchises are on the increase in Singapore,[1] it is timely that an attempt be made to examine the nature of franchising in order to determine whether or not the public offers of franchises fall within the scope of Part IV, Division 5 of the Singapore Companies Act[2] and are therefore to be regulated by the regulatory regime imposed thereunder. It is hoped that in the course of enquiry the other outstanding problems inherent in franchising can also be highlighted.

WHAT IS FRANCHISING

A commentator has written that "a franchise is essentially a permission that allows the franchisee to take on the appearance of being closely associated with the franchisor's organisation and to represent that the products he is selling or the services he is providing are those of the franchisor."[3] This can be done, if the franchisor grants to the franchisee the right to use the franchisor's trademark or trade name so that the franchisee can sell a product or service under that name or mark. The appearance of a close association is also achieved by allowing the franchisee to set up and decorate his business premises in identical fashion to the business premises operated by the franchisor.

The right to use the franchisor's trademark or business name is valuable if the trademark or business name is well-established and

[1] See *e.g.,* the classified advertisements in Straits Times' Business Opportunities Column dated 2 June, 1984; 25 June, 1984; 6 September, 1984 and 17 September, 1984.

[2] Cap. 185, Statutes Of Singapore, 1970 Rev. Ed.

[3] David Shannon, *Franchising in Australia* (1982), p. 15.

identifies exclusively for customers the nature and the high quality of the goods sold or services rendered by all retailing outlets under that trademark or business name.[4]

From the franchisee's point of view, franchising permits an inexperienced businessman to gain access to an established brand name, practise well-developed marketing techniques, and enjoy the benefits of nation-wide advertising. In addition, he usually receives supervision and guidance from the franchisor in all aspects of his business operations.[5] Franchising is, therefore, an immensely attractive business venture to the man in the street and in the words of an American commentator:[6]

> The package is enticing to the man of moderate capital who wants to go into business for himself. Instead of venturing into uncharted seas, he can join a large organization and sell a standardized, trademarked, well-established, and widely-advertised product or service.

From the franchisor's point of view, franchising is a profitable activity by itself. Franchise fees that are received for the grant of a franchise often constitute an important source of income for the franchisor. In a typical franchise arrangement, each franchisee is often required to bear the full costs of establishing the new franchise outlet. Thus, the arrangement operates as a cost-free way for the franchisor to expand his distribution channels. The franchise arrangement is also convenient to the franchisor because he usually wields discretionary control over all aspects of a franchisee's business. In practical terms, this means that the degree of control enjoyed by the franchisor over the franchised distribution chain is akin to that of a vertically integrated distribution chain. It is also interesting to note that this is achieved without the problems of ownership inherent in such chain.

THE TYPES OF FRANCHISING SCHEMES IN SINGAPORE

It is important in the Singapore context to distinguish between conventional and unconventional franchises, the reason being that unconventional franchises such as pyramid sales are prohibited in Singapore.[7]

a. *Unconventional Franchises*

A conventional franchise allows the franchisee to use the franchisor's trademarks and trade names and also requires him to invest in real estate, fixtures, equipment and inventory in order to set up his own franchise outlet.[8] The unconventional franchise, on the order hand, generally requires a negligible capital investment beyond the franchise fee.[9] A typical example of an unconventional franchise is a pyramid

[4] Donald P. Hortwitz, "Regulating the Franchise Relationship" (1980) 54 St. John's L. Rev. 221, 227.
[5] Harold Brown, "Franchising — A Fiduciary Relationship" (1971) 49 Tex. L. Rev. 650, 661.
[6] Harold Brown, *Franchising Realities and Remedies,* (2nd ed., 1978), pp. 4-21.
[7] See Multi-Level Marketing and Pyramid Selling (Prohibition) Act, Act No. 50 of 1973.
[8] Michael G. Moore, "Franchising: Probable Impact of the New Federal Trade Commission Rule" (1979) 40 Ohio St. L.J. 387, 388.
[9] *Ibid.*

sales plan. As noted by a writer, a pyramid sales plan operates in this way:

> Under the plan, a company would sell an exclusive territorial right to a franchisee to sell a product or provide a service who in turn has the right to sell the right to any sub-franchisees who choose to operate under him. The procedure may be repeated in turn at several descending levels, so the base continually broadens from the pointed peak and is almost bottomless.[10]

As noted by another writer, what is inherently wrong in a pyramid sale plan is that:

> … the totality of opportunities to make money offered by the plan is primarily contingent upon the sale of dealership or distributionship in a chain letter manner rather than the successful sale of an acceptable product to consumers. The plan is also objectionable because "pyramid" investors are mathematically doomed to fail because the sale of the "dealership" or "distributorship" in a chain-letter manner naturally requires involvement in the plan of more individuals than are likely to be interested in any given product or service within a restricted geographical locality.[11]

Therefore, it should come as no surprise to know that the Multi-level Marketing and Pyramid Selling (Prohibition) Act[12] absolutely prohibits pyramid selling in Singapore.

b. *Conventional Franchises*

Although the list of business activities capable of being franchised is infinite, conventional franchise schemes may be categorised in the following manner:

(i) *A Product Franchise Scheme*

Shannon defines a product franchise as:

> … an arrangement whereby a distributor acts as an outlet, whether wholesale, retail or otherwise, for the product(s) of a manufacturer, often on terms that give the distributor the exclusive right to sell the product(s) within a specific market.[13]

In Singapore, franchises of this nature are common in the retailing of petrol.

(ii) *A Processing or Manufacturing Franchise Scheme*

This is defined by Shannon as:

> … an arrangement whereby the franchisor provides an essential ingredient or "know-how" to a processor or manufacturer. Franchises of this nature are common, for example, in the soft-drink industry.[14]

[10] Charles L. Vaugh, *Franchising* (1979), p. 34.
[11] See Howard N. Solodky, "Prohibiting Pyramid Sales Schemes: County, State And Federal Approaches To A Persistent Problem" (1975) 24 Buffalo L. Rev. 877, 880.
[12] *Supra,* note 7.
[13] Shannon, *supra,* note 3, at p. 5.
[14] *Ibid.*

In Singapore, noteworthy examples of such franchises are the Coca Cola, Seven-Up and Fanta franchises granted to Fraser and Neave Limited.

(iii) *Group Trading Franchise Scheme*

Shannon describes this scheme as follows:

> this is an arrangement whereby a number of independent stores operate a voluntary chain for buying and promotional purposes. They may take on a common name and appearance to benefit from co-operative advertising economies. Often such groups are centered on an independent wholesaling organization. Group trading is often found in grocery and hardware distribution.[15]

In Singapore, group trading activities are prevalent in the grocery trade. The common names of such grocery chain stores include "Econ Minimart", "7-Eleven", "Our Home", "Myshop", and "One Plus". These grocery chain stores are mushrooming at such a fast pace that they have attracted the attention of the Domestic Trade Section of the Ministry of Trade and Industry. A survey conducted by the Ministry has shown that with the exception of "Econ Minimart" most of the franchises originated from overseas.[16] For example, the "Myshop" grocery chain store is Japanese in origin while "Our Home" grocery chain store is of American origin. The preliminary results of the survey have also shown that in order to operate a franchise grocery store, franchisees are required to pay an initial franchise fee of $100,000 to $200,000 and subsequent payments of royalties based on total sales at each franchisee's outlet. In return, the franchisees can expect to receive staff training and enjoy the benefits of nation-wide advertising, proven marketing techniques and centralised purchasing facilities. In view of the fact that most of the franchise grocery chain stores here have overseas franchisors, it is interesting to note that the Straits Times recently reported the closure of two poorly located "Myshop" outlets because the Japanese consultants had selected the sites on the erroneous assumption that the Singaporeans like the Japanese would not mind walking or driving an extra distance to get to a convenient store.[17]

(iv) *Business Format Franchising*

Business format franchising is the most typical form of franchising. This is also the area that is most promising in terms of growth potential. A business format franchise can only be offered by a franchisor who has allegedly developed a unique and successful manner of doing business under a trademark or trade name. He is therefore able to offer a business format package that usually includes the right to use the franchisor's trademarks, and to benefit from his marketing strategy and plan, operating manuals and standards, quality control measures and a communication system.[18] Under this arrangement, the franchisee independently owns and operates the franchise outlet under the strict control and supervision of the franchisor.

15 *Ibid.*, p. 6.

16 At the time of the author's enquiry the results of the survey were still being compiled.

17 See "Timesdollar" page, Straits Times, August 22, 1984.

18 Richard F. Davis, "Franchising In the United States" (1980-1981) 5 Can. Bus. L.J. 346, 347.

The common names of business format franchising in Singapore are:

Big Rooster, Burger King, Dunkin Donuts, Hardees, Holiday Inn, Kentucky Fried Chicken, Kis, Long John Silver, MacDonald, MacDota, Pizza Hut, Orange Julius, Wendy, and others...

(v) *Business Opportunity Franchising*

This form of franchising is particularly suited to a franchisor who has only one product to sell and therefore requires widespread distribution in order to achieve high volume sales. Examples of such products are soft-drinks dispensed from a drink dispenser and potato chips fried by an automatic machine. In order to defray the capital costs of purchasing and installing such machines at the numerous outlets, franchises are offered to the public so that prospective franchisees will pay, apart from the franchise fee, the full costs of purchasing and installing the required machines at outlets allocated to each franchisee. An outstanding feature of this scheme is that the franchisee does not participate in the active management of the scheme. He is required, however, to pay management fees to the franchisor who would then secure outlets or accounts for the franchisee and maintain the stock level of such outlets.[19] It is obvious that under such a scheme the franchisee bears considerable risks because as a sleeping partner he is required to provide the full capital and operating costs of the outlets.

In Singapore, "Jumbo Orange Juice" and "Mr French Fries" are names that suggest the presence of business opportunity franchising.

At this juncture, it is useful to take stock of the common features of franchising in order to distinguish the arrangement from the other similar contractual arrangements like licensing, management and sole agency agreements. As noted by one writer, franchising possesses the following features:

1. There is a contract between franchisor and franchisee;
2. The franchisor grants a right or licence to the franchisee to use, in connection with a business of the franchisee, a trademark, name or other commercial symbol of the franchisor;
3. That trademark, name or symbol is used in such a way by the franchisee as to substantially identify that business carried on by him;
4. The franchisor is entitled to exercise continuing control over significant aspects of the manner in which the franchised business is conducted;
5. The franchisor offers or is obliged to provide assistance to the franchisee in aspects of the franchised business (such as in training staff, merchandising, marketing or production methods, know-how etc.) and
6. The franchisee pays money (which includes royalties) to the franchisor.[20]

[19] John M. Tifford, "The Federal Trade Commission Trade Regulation Rule on Franchises and Business Opportunity Ventures" (1981) 36 Bus. Law. 1051, 1054.

[20] Geoffrey Taperell, "Franchising: An Important and Intricate Growth Area", (1983), Law Soc. J., 500.

THE PROBLEMS IN FRANCHISING

The merits of franchising as a dynamic marketing tool are beyond doubt. Also the extent to which franchising can contribute to a country's economy cannot be ignored. In Britain, total sale of goods and services through the franchise marketing method presently accounts for about 15% of all retail sales.[21] It was also recently reported in Britain that more than 8,000 companies have been created in recent years by the franchise system, and almost 60,000 people have been given employment as a result.[22] In the United States, according to the 1983 figures released by the Commerce Department, total sale of goods and services through franchising represented a third of American retail sales and constituted 15 per cent of the country's gross national product. Is has also created 5 million new jobs in the process.[23]

The Singapore consumer market is increasingly dominated by "brand names" rendering it extremely difficult for small businessmen to enter such a market. With franchising the small businessman can associate himself with an owner of a nationally known trademark thus overcoming the invisible entry barrier. It follows that franchising has a strong growth potential in Singapore and may rightly be hailed as the last stand against creeping economic concentration in the retail sector. However, franchising activities are plagued by serious problems that merit not just academic discussion but judicial and legislative intervention.

a. *The Problems of a Franchise Offer*

When a franchise is offered to a prospective buyer it is implicit in the offer that the franchisor is the innovator of a unique and successful marketing system and, as a result, the franchisor now owns a trademark or trade name that enjoys substantial goodwill. For instance, in a local franchise advertisement the franchisor made the following express representations:

> ABC Ltd is the region's largest, most dynamic, fastest-growing franchising consortium. The organization is international in scope and has pioneered and perfected its successful marketing system in Malaysia and Singapore. The system is so effective that of all the franchising companies in the region, only ABC Ltd guarantees its success for you, or your money back.

In another advertisement, the franchisor advertised the attractiveness of his franchise in these words:

> Looking for a fast start in Business? Instant Identification? On-going marketing support? That's Franchising! You Too Can Operate A Franchise!

The above representations may overwhelm an unsophisticated investor looking for promising investment opportunities. However, these representations would be misleading if the franchise schemes in question have not been properly developed due to any of the following factors:

(i) the franchised product(s) or service(s) is of inferior quality;

21 See The Times, 3 August, 1984, p. 19.
22 See Financial Times, Monday October 8, 1984, p. 20.
23 *Ibid*., p. 22.

(ii) the marketing techniques are new and untested or if tested the results were not entirely satisfactory;

(iii) the trademark or trade name is new and does not enjoy the goodwill of an established clientele; and

(iv) the franchisor is only playing a "confidence game" and had no intention of providing a proper package of back-up services after entering into a franchise agreement with the prospective franchisee.[24]

In addition, franchisors frequently exploit the ignorance of investors by making the following kinds of claims:

(i) "That the franchisee will be running a business of his own."

The above cannot be true if the franchise agreement contains provisions that allow the franchisor to terminate the franchise at will.

(ii) "That independent business has a higher failure rate than franchise business."

An American writer has argued that there appears to be no valid statistical basis to support statements of this nature.[25] In his opinion, many franchise failures were hidden because franchisors frequently recapture the failed franchise outlets by buying out the franchisees at a fraction of the franchisees' original cash investment.[26]

(iii) "That the franchisee will be buying a profitable business based on the franchisor's profit projections."

The obvious snag in the profit projections is that they are usually based on figures that cannot be substantiated.

The reader may observe that anyone who on the strength of the franchisor's representations invests in a relatively unknown franchise seems extremely gullible. However, it is important to realise that the gullibility of the franchise investors may not be fortuitous, but results from the franchisor's marketing strategy in cultivating unsophisticated investors who are least able to make informed decisions.[27] As noted by an American writer, a US Federal Trade Commission study has revealed that 68% of the sample of American franchisees did not own a business prior to their franchised business and half the franchisees had an annual income below US$10,000 prior to buying the franchise.[28] Statistics of this nature are unavailable in Singapore. However, advertisements of franchise opportunities have frequently appeared in the "Business Opportunities" columns of the Straits Times' classified advertisements.[29] Since investors scouting for investment opportunities that appeared in the columns are unlikely to be experienced or sophisticated, one may draw the common sense inference that the marketing strategy

24 David Churchill, "How To Take The First Steps To Success", Financial Times, October 8, 1984, p. 21.
25 Brown, *supra,* note 6.
26 *Ibid.*
27 Moore *supra,* note 8, p. 390.
28 *Ibid*., p. 387.
29 *Supra,* note 1.

of local franchise promoters is aimed at inexperienced and unsophisticated investors.

It is true that a defrauded franchisee is not without common law remedies. He may bring an action for negligent misstatement and/or a contractual action of misrepresentation or invoke the statutory remedies provided under the English Misrepresentation Act 1967.[30] Unfortunately, these remedies tend to be redressive rather than preventive, and they require only truth in statements volunteered, and not affirmative disclosure of vital information that affect the success or failure of the franchise scheme.[31] Without affirmative disclosure of material information, this information imbalance between the franchisor and investor cannot hope to be corrected. The problem is further exacerbated if franchisors deliberately cultivate unsophisticated investors, as many of these investors are unable to analyse financial statements even if they are provided. They are also ignorant of their rights and are. as such, least likely to enforce their rights against the unscrupulous franchisors.

b. *The Problems in the Franchise Relationship*

A major function of a trademark or trade name is to guarantee consistency in the quality of the product identified by the mark or name. The image of the trademark or trade name will be tarnished if an individual franchisee allows the quality of the product to deterioriate. Therefore, it seems legitimate that franchise agreements should contain provisions that allow the franchisor to exercise important discretionary control in all aspects of the franchisee's business. This results in a one-sided contract with the balance of economic power heavily weighted towards the franchisor. However, troubles ensue when provisions are put into the contract not so much for the purpose of maintaining quality control but for the ulterior motive of increasing the franchisor's profits. For instance, it is frequently provided in franchise agreements that franchisees must buy their supplies from the franchisors or from approved suppliers. Ostensibly, this is to ensure the consistent quality of the ingredients that are to be used. However, such tying arrangements also allow a franchisor to mark up the prices of goods directly supplied to the franchisee. In the event that franchisees are obtaining their supplies from approved suppliers, franchisors may be in receipt of "kickbacks" based upon the dollar amount of the purchases by the franchisees.[32]

Franchisors often take the view that a franchise is merely a grant of a limited licence. A termination clause that allows the franchisor to terminate the franchise on short notice in the event of a breach of contract is considered a reasonable exercise of the franchisor's rights.[33] This is an extremely harsh view as it ignores the fact that the franchise granted to the franchisee is a source of livelihood. It also totally disregards the time, money and effort put in by the franchisee in building-up the local goodwill that has by then attached to his outlet.

30 1967, c.7.
31 Donald S. Chisum, "State Regulation of Franchising: The Washington Experience" (1973), 48 Wash. L. Rev., 291, 300.
32 Brown, *supra* note 6, pp. 1-32.
33 Shannon, *supra,* note 3, p. 239.

Another source of irritation in the franchisor-franchisee relationship stems from the fact that a franchise is by itself a valuable capital asset with a ready market and can be bought or sold in like manner as shares or debentures. In this regard, it is of interest to note that just as there are stockbrokers who facilitate the buying and selling of company securities, there are similarly, franchise brokers in Singapore who operate to provide a like service.[34] Unfortunately, while the status of a shareholder is that of an investor had a part-owner of a company with all the attendant common law and statutory protections, the status of a franchisee remains doubtful and continues to be governed by a one-sided franchise agreement.

If the commercial realities (that a franchise is a saleable capital asset and that the franchisee is an investor in a capital market who needs protection) continue to be disregarded, serious abuses would ensue. For example, there is nothing to prevent a franchisor from concentrating on selling further franchises. If this were to happen, existing franchisees would suffer because the franchisor, distracted by the preoccupation of selling franchises, would be unable to provide efficient and effective back-up services to the existing franchisees. In addition, the further sale of franchises would serve to dilute the value of existing franchises. Even more oppressive is that an unethical franchisor may try to recapture existing franchises as an operating franchise is worth much more than a new franchise.[35] A franchisor is therefore under a constant temptation to harrass his franchisees into selling at bargain prices.[36] As an illustration of how the harrassment can be effected, it is interesting to note that the Singapore Business reported in October 1982 that:[37]

> A judge in Chicago had ruled that the owner of the 14 MacDonald's restaurants in Paris must yield up the franchise. MacDonald's complaints were that the Parisian owner's establishments were smoky and greasy, his apple pie is too hot and his service too slow.... The Parisian owner, however, had counterclaimed unsuccessfully that MacDonald Corporation wanted his restaurants back because they were doing so well that the company regretted its 1972 agreement to give him exclusive rights to open 166 restaurants in and around Paris because they now look more profitable than they did then.

Ignoring the merits of the respective claims and counterclaims the case illustrates how a franchisor may use quality control standards to harrass a franchisee in order to recapture the franchise.

It is also disturbing to take cognizance of the fact that while a public offer of company securities comes under close security by regulatory bodies to weed out fraudulent and unsound offers, dubious and poorly developed franchises can be freely offered to the unsuspecting Singapore public. As an illustration of such a problem, having sold the franchises, there is nothing to prevent a franchisor from deliberately mismanaging the franchisor's business enterprise so that it is unable or ineffective to provide the promised back-up services. Mismanagement may occur in the following way:

34 Errol de Silva, "Finding a Franchise" Singapore Business (September, 1982), p. 35.
35 Brown, *supra,* note 6, pp. 2-14.
36 *Ibid*., pp. 2-14.
37 Sheela Mirchandani, "Something To Crow About" Singapore Business (October, 1982), p. 9.

(i) ineffective quality control measures;
(ii) ineffective advertising;
(iii) poor quality products;
(iv) insufficient stocks to meet demands;
(v) improper keeping of accounts;
(vi) inefficient and dishonest staff; and
(vii) general inaptitude.

It may be difficult to pinpoint deliberate mismanagement, and even if impropriety can be established it would rarely amount to a breach of contractual obligations on the part of the franchisor as the franchise agreement is usually so skilfully drafted that it imposes few positive obligations on the franchisor.

The above discussion is not intended as a compilation of the franchisors' avarice but rather to raise the question whether franchisees ought to be regarded as investors who need legislative protection so that public confidence in an important and growing franchise capital market can be enhanced.

Regulatory measures designed to protect the franchise "investors" have been adopted in Australia, Britain, Japan and the United States. It is implicit in these measures that the status of a franchisee as an investor has been recognised.

In Japan, the Ministry of International Trade and Industry administer a "Franchise disclosure Law".[38] The Ministry had also recently entered into an arrangement with the Japanese Franchise Association to set up a voluntary registration system for franchisors.[39] In addition, the Japanese Fair Trade Commission (J.F.T.C.) has issued its long awaited report entitled "Comments on the Antimonopoly Law in Relation to Franchise Systems" on 20 September 1983, which is directed at the substantive aspects of the Franchise Relationship.[40] It is significant that the report contemplates the reviewing of the legality of a franchise agreement by the J.F.T.C. As noted by a writer, to determine the legality of what is essentially a private agreement, the J.F.T.C. would consider the following factors:[41]

1. Whether the designated supplier charges higher than market prices, and whether alternative suppliers are allowed;
2. Whether excessive controls are imposed on any or all franchisees;
3. Whether sales quotas are imposed and whether they are reasonable in the light of the market conditions and the franchisor's reciprocal obligations to the franchisee;
4. Whether the franchisee has a right to terminate the agreement and under what conditions;

[38] Law No. 101, September 29, 1973.
[39] For a discussion of this Law see Philip F. Zeidman, "International Franchising— Japan: Fair Trade Commission Issues Comments on Franchising and The Antimonopoly Law" Int'l. Bus. Law., (February, 1984), 53.
[40] *Ibid.*
[41] *Ibid.*

5. Whether the duration of the agreement is too short or too long for the franchisee to benefit from the investment; and

6. Whether there is a "lack of balance" between the parties.

The existing Japanese regulatory thrust in franchising is one of disclosure. However, the report issued by the J.F.T.C. clearly indicates that interference with the franchise relationship is necessary. Perhaps we might not have to wait too long before Japanese regulatory agencies actively interfere with franchise relationships in order to redress the unequal bargaining positions between franchisors and franchisees.

In the United States both the Federal Trade Commission (hereinafter referred to as "the F.T.C.") and the Securities Exchange Commission (hereinafter referred to as "the S.E.C.") are empowered to perform the task of franchise regulation at the federal level. Under the 1933 Securities Act the meaning of "securities" has been defined *inter alia,* to include an "investment contract."[42] The question then was whether American courts would construe "investment contract" in such a manner that it was to include a franchise scheme so that franchising could be brought within the administrative machinery of the S.E.C. However, this prospect was not to materialise because in 1946 the U.S. Supreme Court decided in *S.E.C.* v. *W.J. Howey Corporation*[43] to construe the term "investment contract" restrictively and stated that:

> An investment contract for purposes of the Securities Act means contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the effort of the promoter or a third party.[44]

This test has the effect of excluding franchise schemes from securities regulation because the requirement that the franchisee must be led to expect profits solely from the effort of the other person has been hard to satisfy since a typical franchise requires the franchisee to put in time and effort to operate the franchise outlet.[45] As a result, the F.T.C. assumes a key role in franchise regulation at the federal level. And following a 30,000 page report on franchising[46] the F.T.C. became the undisputed regulatory agency that possesses expertise to regulate franchising. Trade regulations having the force of law were soon promulgated under section *5* of the Federal Trade Commission Act[47] and became effective on October 21, 1979. In essence, the regulatory thrust of these regulations is one of disclosure. Franchisors are required to provide "offering circulars" to prospective franchisees which contain information in critical areas. Oral or written representations of potential sales, income and profits are prohibited unless they can be substantiated. Unfortunately, the offering circular need not be reviewed by the F.T.C. and can be furnished directly to the prospective franchisees. As pointed out by one commentator,:

42 See s. 2(1) of the U.S. Securities Act of 1933, 73d Cong. sess. 1 Ch. 38.
43 238 U.S. 293. (1946).
44 *Ibid.*, pp. 298-299.
45 Randall L. Freedman, "An Analysis of the Franchise Agreement under Federal Securities Laws" (1976) 27 Syracus L. Rev. 919, 930.
46 The report is entitled "Statement of Basis & Purpose relating to Disclosure Requirements and Prohibitions concerning Franchising and Business Opportunity Venture"; 43 Fed. Reg. 59, 621 (1978).
47 The Trade Regulations are entitled "Disclosure Requirements and Prohibitions concerning Franchising and Business Opportunity Ventures."

> ... it is difficult to understand why the federal agency most intimately concerned with franchising would forego all forms of direct contact with the disclosure process.[48]

In contrast to federal regulation, state regulation of franchising goes beyond disclosure. To prevent an unethical franchisor from imposing unreasonable standards of performance or burdensome restrictions on a franchisee, a few states have franchise legislation that impose "good faith" standards of conduct upon the franchisor and franchisee.[49] In addition, some states like Delaware, New Jersey and Virginia have laws which restrict the right of a franchisor to terminate the franchise except for a "good cause".[50] Franchisees are correspondingly given the right to recover damages for unjust termination.[51]

Having briefly reviewed the regulation of franchising in Japan and the U.S., it is not the author's intention to suggest that some of these laws or regulatory regimes be imported. Our local regulatory environment does differ from that existing in Japan or in the U.S. Notably, we do not have a Fair Trading Commission. In this connection, little can be learnt from the British experience because franchising in Britain is self-regulated by the British Franchise Association.[52] The prospect that a self-regulatory organisation like the British Franchise Association can be established in Singapore is rather remote.

On the other hand, the Australian experience in franchise regulation is very relevant. The Singapore Companies Act[53] is extensively modelled upon the 1961 Australian Uniform Companies Act,[54] and the Australians have brought franchising under the regulations passed pursuant to this Act.[55]

However, although franchising is an important economic activity in Singapore, there is presently no perceived demand for franchise regulation. The reason may be that the susceptibility of franchising to frauds and abuses has yet to be fully appreciated. Perhaps we are all waiting for the first major franchise fraud in order to jolt us into action. Despite the inertia, it would, however, be reckless for any franchise promoter in Singapore to assume that public offers of franchises would be free from statutory regulation. The legal catch is that a franchise may constitute "interests other than shares or debentures" under Part IV, Division 5 of the Singapore Companies Act.[56]

ARE FRANCHISES "INTERESTS OTHER THAN SHARES OR DEBENTURES" UNDER PART IV, DIVISION 5 OF THE COMPANIES ACT

Part IV, Division 1 of the Companies Act is primarily concerned with regulating the advertising and issue of shares and debentures to the

48 Brown, supra, note 6, pp. 6-13.
49 Examples of such states are Hawaii and Washington State. See generally, "Note: Regulation of Franchising" (1975) 59 Minn. L. Rev. 1027, 1036.
50 *Ibid., p.* 1047.
51 *Ibid.*
52 For a discussion of self-regulation in franchising see John Adams, *Franchising,* (1981), pp. 5-7.
53 *Supra,* note 2.
54 See Paterson and Ednie, *Australian Company Law* (2nd Ed., 1976), p. 5003.
55 See Part IV, Division 15 of the 1961 Australian Uniform Companies Act.
56 See definition of "interest other than shares or debentures" in s. 84(1) of the Act.

public. The main requirements of the provisions are that a public offer of securities cannot be made unless it is accompanied by a prospectus that has been duly registered with the Registrar of Companies.[57] Division 5 of Part IV extends a similar regulatory regime to a public offer of "interest" other than shares and debentures. Given the ingenuity of entrepreneurs, it should occasion no surprise if other forms of financial or business undertakings offering investment opportunities other than in the form of shares or debentures can be developed. A typical example of this other forms of financial or business undertakings is the unit trust which offers to an investor an interest other than a share or a debenture.

The term "interest" is defined in section 84(1) of the Companies Act (which forms part of Part IV, Division 5) as follows:

> Any right to participate or interest whether enforceable or not and whether actual, prospective or contingent —
>
> (a) in any profits assets or realisation of any financial or business undertaking or scheme whether in Singapore or elsewhere,
>
> (b) in any common enterprise whether in Singapore or elsewhere in which the holder of the right or interest is led to expect profits rent or interest from the efforts of the promoter of the enterprise or a third party; or
>
> (c) in any investment contract; whether or not the right or interest is evidenced by a formal document and whether or not right or interest relates to a physical asset, but does not include —
>
> (d) any share in or debenture of a corporation; or
>
> (e) any interest in or arising out of a policy of life insurance.

The words "investment contract" is further defined as:

> any contract, scheme or arrangement which in substance and irrespective of the form thereof involves the investment of money in or under such circumstances that the investor acquires or may acquire an interest in or right in respect of property which under or in accordance with the terms of investment will, or may at the option of the investor, be used or employed in common with any other interest in or right in respect of property acquired in or under like circumstances.

The above definition of "interest" is so widely drawn that it creates rights hitherto unknown to the law. It refers to more than a recognisable legal or equitable interest, for the definition expressly states that the "right to participate or interest may be actual, prospective or contingent; and whether enforceable or not." The definition goes on to state that the right or interest is not required to be evidenced by a formal document and there is no need for it to relate to a physical asset. In fact, the meaning of the word "interest" is so flexibly drawn that dubious investment opportunities which are offered to the public easily fall within the section. At this juncture, it is necessary to note that there is an almost word-for-word similarity between section 76 of the 1961 Australian Uniform Companies Act and section 84 of the

[57] Tan Pheng Theng, *Securities Regulation In Singapore and Malaysia* (1978), p. 75.

Singapore Companies Act.[58] The differences, if any, are minor and inconsequential. The Australian experience has shown that Australian judges often adopt a remedial approach in applying and interpreting section 76 of the 1961 Act to dubious investment schemes. Very often, a literal interpretation giving effect to the wide meaning of the terms used to define "interest" is employed in preference to a more restrictive purposive approach. As an illustration, Young C.J. of the Supreme Court of Victoria said in *A Home Away Pty. Ltd. & Ors.* v. *Commissioner For Corporate Affairs*:[60]

> I have given careful consideration to the question whether the court should look at the literal construction of the language used by parliament and, if it finds that the scheme falls within it, hold that it is prohibited or whether the court should look at the substance of the scheme and say whether the scheme as a whole falls within the general type of scheme which it is thought it is the purpose of the legislation to prevent.
>
> ... In my opinion, the former approach is the correct one for the court to adopt....
>
> ... When one looks at the actual language used it is, I think, impossible to find any class of scheme to which reference can be made and which can be said to be the type of scheme to be prevented.[61]

As a result, the scope of Division 5 is extremely wide and apart from unit trust arrangement, it has been held in Australia to extend to pine forest investment schemes[62] and a "time-share" accommodation scheme.[63]

Faced with a particularly nasty franchise arrangement in *Hamilton v. Casnot Pty. Ltd.*,[64] Mr. Justice Wallace of the Western Australian Supreme Court made the momentous finding that the franchise scheme in question came within the definition of "interest" under Division 5. In this case, the defendant, Casnot Pty. Ltd. had placed an advertisement in the "The West Australian" newspaper that read:

> Cleaning Business, full price $7,500, including equipment. Metro Cleaning Business using new system which opens untapped market; work from home, etc. All contracts arranged. Company guaranteed income; finance on $2,500 deposit. Apply for appointment, 325 2455, Accent Service 159 Adelaide Terrace, Perth."

In answer to the above advertisement, inquirers were advised that the business involved was that of cleaning carpets and curtains and that substantial profits could be made by entering into a franchise agreement with Casnot. A deposit of A$3450 was required and the franchisee

58 S. 76 of the 1961 Australian Uniform Companies Act is now s. 164 under the 1981 Act; and "interest other than shares or debentures" is now referred to as "prescribed interest" under the new Act.
59 *Supra,* note 54.
60 [1980-81] 5 A.C.L.R., 299.
61 *Ibid*., p. 301.
62 *Australian Softwood Forests Pty. Ltd. & Ors.* v. *A.C. for N.S.W.* [1981-82] 6 A.C.L.R., 45.
63 *A Home Away Pty. Ltd. & Ors.* v. *Commissioner for Corporate Affairs* [1980-81] 5 A.C.L.R., 299.
64 [1980-81] 5 A.C.L.R., 279.

was also required to purchase plant and equipment costing A$3670. A royalty payment of 20 per cent of all gross income was payable to Casnot. Casnot would on its part expend substantial sums of money in advertising and employ staff to locate customers for the franchisee. In addition, each franchisee was to be granted territorial exclusivities in his area of operation.

The question for Mr. Justice Wallace was whether such an agreement came within the definition of "interests" in section 76 of the Australian Uniform Companies Act. Noting that authority to date had placed a wide construction upon the abovementioned definition of "interests" Mr. Justice Wallace in a very brief judgment held that:

> … both "investors" and Casnot became engaged in a common enterprise pursuant to which the investor held the right to expect profits from the efforts of Casnot and thus came clearly within the definition of para, (b) of s. 76(1) of the Companies Act. Such a conclusion is in my opinion in accordance with the decision of the Full Court in *W.A. Pines* v. *Hamilton.* See the reasons of Jones, Brinsden JJ.[65]

If not for the fact that Mr. Justice Wallace's judgment is expressed to be in accordance with the authority in *W.A. Pines* v. *Hamilton*,[66] it is given almost without reason. Thus, in order to understand the *Casnot* decision one must have regard to the decision in *W.A. Pines* v. *Hamilton*.[67]

At this juncture, it is important to realise that once a franchise has been held to fall within the definition of "interests" under Division 5 of the Companies Act, the way is open to franchisees of other existing franchise schemes to challenge the legality of the franchise agreements which they have earlier concluded with their respective franchisors. Unfortunately, it follows that unethical franchisees may take advantage of the situation and unilaterally decline to continue their royalty payments.

In *Butterworth & Anor.* v. *Legemo Pty. Ltd. & Anor.*[68] the franchisee suffering declining business at his outlet, had refused to continue to pay rent and royalties to the franchisor. Some months after the franchise was legally terminated by the franchisor, the franchisee continued to operate the outlet using the franchisor's recipes, logos, get-up and packaging, and the business premises continued to bear all the appearance of premises operating under a franchise. The seemingly unreasonable franchisee then took the franchisor to court seeking a declaration that the defendants were not entitled to recover damages under the franchise agreement, and that the defendants were not entitled to maintain actions for damages for the infringement of the franchisor's trademark. The legal basis for the action was that the franchise agreement was illegal and void as it was entered into in contravention of provisions under Part IV, Division 5 of the Companies Act. In view of the pending litigation, the judge was informed that the other fellow franchisees of the plaintiff franchisee were also stopping their royalty payments. The case therefore assumed the added dimension of being a test case.

65 *Ibid*., p. 281.
66 [1980-81] 5 A.C.L.R., 101.
67 For a discussion of the case see *infra* at p. 273.
68 [1983-84] 8 A.C.L.R., 737.

Knowing full well that the defendant franchisor would suffer injustice if the *Casnot* decision was followed, Nicholson J. of the Supreme Court of Victoria distinguished the *Casnot* decision and came to the conclusion that the franchise arrangement in the instant case did not fall within any of the definitions of "interests" under Division 5. However, it will be shown in the subsequent discussion that Nicholson J. has disregarded the true nature of a franchise relationship and has made many superficial findings in order to come to the desired conclusion.

a. *Paragraph (a) of section 84(1): Is a Franchise a "Right to Participate or Interest in Any Profits Assets or Realisation of Any Financial or Business Undertaking or Scheme"?*

In order to come within the above definition, the investment opportunity that was offered to the investor must arise out of a business undertaking or scheme. The other important requirement is that the investment opportunity that was offered must be in the form of "a right to participate or interest in any profits assets or realisation of the business undertaking or scheme."

(i) *Is a franchise arrangement a "business undertaking or scheme"*?

In a tree-planting investment scheme an investor is required to pay for the trees that would be planted in an exclusive area of land for his benefit. This arrangement being part of an overall scheme is participated in, by other investors who would similarly pay for such trees to be planted for their eventual benefits. Thereafter the trees are to be exclusively cared for and maintained by the promoters or their agents until they reach maturity. To the investors, the proper care and maintenance of such trees by the promoters or their managing agents is therefore vital to the success of their investments. Dealing with such a tree-planting scheme, Mason J. of the Australian High Court remarked in *Australian Softwood Forests Pty. Ltd. & Ors.* v. *A.G. for N.S.W.*[69] that:

> ... it is not an objection to an enterprise qualifying as an undertaking or scheme that it consists of a number of parts or elements, the participation of individual parties being limited to one of these parts or elements, their profits or remuneration being derived and, if I may add, from the activities carried on in their exclusive parts or elements in which they engage. There is nothing in the notion of an undertaking or scheme that requires or implies that there is joint participation in everything comprised in the plan or that there must be a share or pooling of profits or receipts.[70]

In a typical franchise arrangement franchisees are required to participate in the management of their respective business outlets. Therefore, there are, at least, two separate and independent business enterprises — one managed by the franchisor and the other(s) by the franchisee(s). This arrangement operates to refute the suggestion that there is one business undertaking or scheme in a typical franchise arrangement as required under the definition. However, although the business enterprises are separately managed, the franchisor business enterprise often retains discretionary control in the operations of the

[69] *Supra,* note 62.
[70] *Ibid.*, pp. 50-51.

franchisees' business enterprises. As a result, franchisees must continue to rely and depend on the viability and proper management of the franchisor's business enterprise for their own successful operations. In this respect, the similarity between a tree-planting scheme and a franchise arrangement is complete in that the promoters of both types of schemes continue to exercise important managerial functions that affect the success or failure of the investment schemes.

It is submitted that Mason J.'s criteria ought to apply to a franchise arrangement so that the scheme constitutes a business undertaking as a whole despite the fact that franchisees theoretically manage their own business outlets and individually derives profits from the activities carried on at their respective outlets.

(ii) *Is a franchise a "right to participate or interest in any profits, assets or realisation of the business undertaking or scheme"?*

Applying the above criterion, it is essential that a franchise should confer a right to participate or interest in assets that constitute the assets of the business undertaking or scheme as managed by the franchisor. Therefore, any business arrangement which in fact operates as a sale of a business cannot come within the definition.

In a typical franchise arrangement, the franchisee would first enter into a franchise agreement with the franchisor. Thereafter he would then proceed to establish his own franchise outlet with the help of the franchisor. However, in *Butterworth* v. *Lezemo*[71] Nicholson J. made the finding that the franchise outlet was originally set up in premises leased and fitted out by the franchisor in accordance with its requirements, and was then sold to the franchisee as an operating business. The franchise agreement was then entered into contemporaneously as part of the above transaction.[72] As a result, Nicholson J. formed the view that what was acquired was an operating business. Therefore the transaction would not fall within paragraph (a) and, for that matter, would not fall within any other definitions of "interest" because it cannot be the intention of the legislature to control as sale of businesses.[73]

Nicholsen J.'s view is erroneous because he assumes that a franchisee is an entrepreneur who would actively manage his own business and does not require public protection.[74] This ignores the fact that many franchise frauds or abuses occur at the time of the sale before the franchisee could exert any control over the business. Furthermore, a typical franchise scheme that is offered to the public often assumes that the franchisee is inexperienced and knows little or nothing about site selection, market conditions, work layout, product mix, business management and the many other ingredients in a successful franchise. The success or failure of the franchise therefore depends on the competence, judgment and financial soundness of the franchisor. With the matter viewed in this light, the sale of a franchise outlet cannot be regarded as a sale of a business simply because the franchisor himself

71 *Supra,* note 68.
72 *Ibid*., p. 740.
73 *Ibid*., p. 748.
74 Robert A. Prentice "The Sale of Business Doctrine: New Relief From Securities Regulation or a New Haven for Wolshers?" (1983) 44 Ohio St. L.J. 473, 512.

took the trouble of setting up the outlet. The wider ambit of the arrangement must be considered.

Having decided that the sale of the franchise outlet in the instant case is a sale of an operating business, Nicholson J.'s other consideration was whether the franchisee's right to use the trademark and other industrial property of the franchisor constituted an interest in the assets of the franchisor's business undertaking. On this question Nicholson J. came quickly to the conclusion that a mere right to use industrial property without more cannot amount to an interest in it.[75] Similarly, a mere right of user cannot be equated with a "right to participate," which in Nicholson J.'s view means an eventual right or expectation of receiving something in respect of it.[76]

It is submitted that Nicholson J.'s approach of analysing a franchise in accordance with traditional property concepts is out of tandem with what in fact should have been done. It is submitted that the correct approach is to examine the true nature of the "investment opportunity" as offered by the promoter to determine whether it possesses the elements that constitute it to be "assets" of the franchisor's business undertaking. From the franchisor's point of view, the "asset" of his business undertaking is the successful and unique business system which he has developed. From the franchisee's point of view, a franchise as offered to him by the franchisor is valuable and constitutes an "interest" in the "asset" of the franchisor's business undertaking because it allows him to adopt and participate in the successful and unique marketing system. He implicitly joins a large business organisation that has promised to provide him with all the assistance he needs to sell what apparently is already a well-known quality product or service. The right to use the trademark and other industrial property is, therefore, only a part of what is essentially a package of rights and benefits. In this sense a franchise is an interest in the assets of the franchisor's business undertaking. The true nature and the wider ambit of a franchise scheme must be examined. Thus, with respect, Nicholson J. was wrong to arbitrarily unscramble a franchise package to its barest form, that is, a sale of a business with an accompanying right to use the franchisor's trademark. And on this basis to declare that a franchise does not constitute an asset in the franchisor's business undertaking is extremely parochial.

In *W.A. Pines Pty. Ltd.* v. *Hamilton*,[77] a case approved and followed by the *Casnot* decision, Brinsden J. adopted a similar approach of examining the wider ambit of an investment scheme. In dealing with a tree-planting investment venture, identical to that in *Australian Softwood,* Brinsden J. took the view that it would not matter whether it is the tree(s) or the land upon which the tree(s) grows which constitute(s) the "assets" of the franchisor's business undertaking.[78] Once it is observed that an investment opportunity or more specifically, an interest arises in the activity of growing trees it constitutes an interest in the assets of the company or scheme.[79]

75 *Supra,* note 67 p. 749.
76 *Ibid.*
77 *Supra,* note 65.
78 *Ibid.*, p. 113.
79 *Ibid.*

In essence, "interest" in the "assets" of the promoter's business undertaking should not be taken to mean proprietary interest in physical assets owned or managed by the promoter. In *Australian Softwood Forests Pty. Ltd. & Ors.* v. *A.G. for N.S.W.*[80] Mason J. expressed the view that the association of the word "interests" with the expression "right to participate" in the definition provides additional support for the view that it has a larger content than that of a proprietary interest.[81] What should be regarded as an "interest" in the "assets" of the business undertaking is the right to participate and benefit from the activities undertaken by the promoter. Especially, if this right to benefit from the activities has been offered to the investor as constituting valuable investment opportunities. In further support of such a view, the reader may recall that the general definition of "interests" expressly states that:

> the right to participate or interest may be actual, prospective or contingent; whether enforceable or not; whether or not the right and interest is evidenced by a formal document; and whether or not the right or interest relates to a physical asset.[82]

b. *Paragraph (b) of section 84(1): Is a Franchise a Right to Participate or Interest in Any Common Enterprise in which the Holder of the Right or Interest is led to expect Profits, Rent or Interest from the Efforts of the Promoter of the Enterprise or a Third Party?*

There are two requirements in the definition. Firstly, a common business enterprise must be in existence. Secondly, the holder of a right or interest in the common enterprise must be led to expect profits, rent or interest from the efforts of the promoter of the enterprise or a third party.

In a one-product franchise or more specifically a business opportunity franchise, the franchisee is usually not required to participate in the management of the retailing outlets. He in effect, becomes a sleeping partner of the franchisor's business enterprise. His expected return is to share in the profits derived from the efforts of the franchisor or his managing agent. In such an arrangement, there is no doubt that there is a common enterprise existing between the franchisor and franchisee, and that the franchisee has been led to expect profits from the efforts of the promoter or a third party.

However, in a business format franchising scheme the franchisee is required to participate in the management of his own independent business outlet and it may be argued that this fact operates to refute any suggestions that there is a common enterprise existing between the franchisor and franchises, and that the franchisee is led to expect profits from the efforts of the promoter or a third party. This argument, however, ignores the fact that investment in a franchise is really a two-level investment.[83] It is fair to say that at one level the franchisee is investing in his own business when he establishes his own independent business outlet. However at another level, the franchisee by paying

80 *Supra,* note 61.
81 *Ibid., p.* 53.
82 See s. 84(1) of the Singapore Companies Act.
83 The idea of a franchise being a two-level investment has been canvassed by Brown, *supra,* note 6, pp. 3-4 and by Bernard Goodwin, "Franchising Law Matures'", (1973) Bus. Law. 703, p. 719.

the initial franchise fees and subsequent royalty payments is also investing in the franchisor's business enterprise. The investment is made on the expectation that the franchisor has the ability to provide all the essential back-up services vital to the success of the outlet. It is also made on the expectation that the franchisor's business enterprise the "parent" organisation, would continuously maintain and enhance the goodwill of its trademark by advertising and adopting other necessary measures. Unless the franchisor is committed to such objectives there is no reason why a franchisee should part with a sizeable sum of money in the form of an initial franchise fee and subsequently pay royalty payments to the franchisor. In essence, under the arrangement the franchisor and the franchisee are dependent upon each other for their eventual income and profits. There is therefore a common enterprise existing between them.

It is interesting to note that the above view received judicial support in the *Australian Softwood Forests Case* where Mason J. said:[84]

> The argument is that in order to constitute a "common enterprise" there must be a joint participation in all the elements and activities that constitute the enterprise. I do not agree. An enterprise may be described as common if it consists of two or more closely connected operations on the footing that one part is to be carried out by A and the other by B, each deriving a separate profit from what he does, even though the two operations constituting the enterprise contribute to the overall purpose that unites them. There is then an enterprise common to both participants and, accordingly, a common enterprise. For this reason also the interest acquired by the grower falls within statutory definition.

In *Butterworth* v. *Lezemo* Nicholson conceded that a common enterprise existed between the franchisor defendant and the franchisee plaintiff. He said:[85]

> The common enterprise was the sale of chicken and associated products under the Chicken Spot trademark, using the get-up of the defendants. Both parties had an interest in its successful outcome, in the sense that it was in the plaintiffs' case their own business, from which they no doubt hoped to derive profit, and in the defendants' case it had an expectation of income based upon a percentage of the facts as establishing a sufficient commonality of purpose to satisfy the definition.

There is, however, greater difficulty in satisfying the requirement that the franchisee is led to expect profits from the efforts of the promoter of the enterprise or a third party since the typical franchise requires the franchisee to put in time and effort to operate the franchise outlet. The implicit rationale of this requirement seems to be that those persons who rely on the efforts of others to create their investment return must be afforded protection.[86] By contrast, franchisees who participate in the management of their own enterprises can adequately safeguard their own interests.[87] Such a view overlooks the realities of a franchise scheme where the franchisee exercises only limited control

[84] *Supra,* note 62, p. 54.
[85] *Supra,* note 68, p. 750.
[86] *Supra,* note 45, p. 930.
[87] *Ibid.*

over his business enterprise. It also ignores the fact that franchisees who buy franchises that are *offered to the public* are mainly inexperienced investors and businessmen.

At this juncture, it must be pointed out that in drafting the definition of "interest" under paragraph (b) the Australian draftsmen have turned to the United States Securities Act of 1933 (Fed.).[88] The Act places restrictions on the offering of "securities" to the public. The word "securities" has been legislatively defined to include an "investment contract". The term "investment contract" is not further defined by the Securities Act and has been broadly construed by American courts so as to afford the investing public a full measure of protection.[89] Form was frequently disregarded for substance and emphasis was placed upon economic reality in the interpretation of the words "investment contract".[90]

As noted in the earlier discussion,[91] although franchise schemes are excluded from securities regulation since a typical franchise requires the franchisee to "manage" his own independent outlet and therefore cannot be said to have led to expect profits "solely" from the effort of other persons as required by the Howey test.[92] However, the lesson to be learnt from the American experience is that when pressed by the sharp and fraudulent practices of unconventional franchise schemes such as a pyramid sales plan, the U.S. courts were quick to react, holding such schemes to be investment contracts even though the franchisees were required to expend effort in canvassing for prospects for the plan. One way of achieving this is by refining the Howey test so that instead of emphasizing the "solely from the efforts of others" requirement a more realistic test of "whether the efforts made by the franchisor are undeniably significant ones, those essentially managerial efforts which affect the failure or success of the enterprise in question" is adopted.[93] This test is realistic because by focussing on the actual managerial functions performed by the parties the court can qualitatively determine who plays a more pivotal role in affecting the failure or success of the enterprise.[94] The potential application of this test to conventional franchises such as a business format franchise is obvious. However, the U.S. courts in accordance with the policy of preferring franchising

88 See Paterson, Ednie and Ford, *Australian Company Law* (3rd Ed., 1982), Vol. 2, pp. 56, 602.

89 *Per* Murphy J. in *Securities Exchange Commission* v. *W.J. Howey Co.* and *Howey-in-the-Hills Service,* Inc. 328 U.S. 293, 298; 90 L. ed. 1244, 1249.

90 An example of such an approach can be found in the case of *S.E.C.* v. *CM. Joiner Leasing Corporation* 320 U.S. 344 (1943), rev'g 133 F. 2d. 241 (5th Cir.). In this case the Supreme Court held that an offer of interest in oil leases constitutes an "investment contract" and not just an interest in land because the offer included the promise that the loiner Corporation would drill a test well in the area in addition to the offer of the leasehold rights. This allowed the court to find that in substance the lease takes effect as an investment contract as the investor was paying for a lease as well as for a development project. It is implicit in the court's finding that so long an investor is led to expect profits solely from the efforts of the promoter or a third party in a common enterprise the contract, transaction or scheme in question ought to be regarded as an investment contract.

91 See discussion in this paper on p. 266.

92 *Ibid.*

93 The test was developed and applied by the court in *S.E.C.* v. *Glenn Turner* 384 F. Supp. 766 (D. Ore 1972), and adopted by the Court of Appeals, Fifth Circuit, in *S.E.C.* v. *Koscot Interplanetary, Inc*., 497 F. 2d 473 (5th Cir. 1974).

94 *Supra,* note 85, p. 948.

to be regulated by the F.T.C. have consistently refused to extend the test to include conventional franchises. Such a consideration is irrelevant in Singapore. Singapore courts should therefore consider themselves free to adopt the more realistic test to determine whether a franchisee is led to expect profits from the efforts of the franchisor. The task is made easier by the fact that the difficulty imposed by the word "solely" in the Howey definition has been avoided as it had been dropped from the legislative definition of "interest" in paragraph (b).

Some semblance of such an approach was adopted by Wallace J. in the *Casnot* decision.[95] In his judgment, Wallace J. implicitly held that franchisees of a franchise arrangement that provided carpet-cleaning services held the right to expect profits from the efforts of the franchisor because the franchisor company was obliged by the franchise agreement to advertise at its own expense and employ staff to locate customers for the franchisees. The proper performance of such duties is of course vital to the failure or success of the enterprise.

Unfortunately, Nicholson J. in *Butterworlh* v. *Lezemo*[96] failed to embark on a qualitative assessment of the franchisor's obligations to determine if they constitute important managerial functions that will affect the success or failure of the whole venture. Instead Nicholson J. proceeded on a narrower basis and drew a somewhat artificial and conceptually unsound distinction between activities that operate to assist in the obtaining of profits and activities that directly lead to a production of profits. In his opinion, efforts in advertising at the franchisor's expense to locate customers for franchisees as it was done in *Casnot*[97] would operate to lead the franchise to expect profits from the efforts of the franchisor.[98] In the instant case, where the franchisor merely promised to coordinate advertising activities on behalf of and at the expense of the franchisees, such activities might help to generate revenue, but they would not directly and necessarily produce profits.[99]

It is difficult to detect the logic behind Nicholson J.'s arguments. In particular, the writer is unable to perceive why advertisements to locate customers would directly and necessary lead to a production of profits whereas advertisements to attract customers to patronise the various franchise restaurants are merely supportive in nature and would not necessarily and directly produce profits. It is conceptually unsound to assume that essential managerial functions can be broadly categorised in the manner suggested by Nicholson J. Common sense dictates that there must be some managerial functions (such as the development and implementation of quality control measures) which do not directly lead to a production of profits and yet are so important that if they are not properly performed no profits can eventually be expected.

Nicholson J.'s approach also ignores the fact that locating customers may be an appropriate or even necessary marketing strategy for franchise schemes that provide a service (especially a door-to-door service). However, it is ludicrous to expect franchisors of fast-food franchise schemes to locate customers for the fast-food restaurants

[95] *Supra,* note 63.
[96] *Supra,* note 68.
[97] *Supra,* note 64.
[98] *Supra,* note 96, p. 751.
[99] *Ibid.*

operated by their franchisees. Nicholson J.'s rather simplistic view would suggest that all franchise schemes that do not provide a service cannot hope to come within the definition of "interest" in paragraph (b).

It is submitted that a qualitative assessment of the managerial functions to be undertaken and performed by the franchisors ought to be the right approach to determine the question of whether the franchisees have been led to expect profits from the efforts of the franchisor.

(c) *Paragraph (c) of section 84(1): Is a Franchise an "Investment Contract"?*

"Investment contract" is further defined by section 84(1) in the following words:

> "Investment Contract" means any contract, scheme or arrangement which in substance and irrespective of the form thereof involves the investment of money in or under such circumstances that the investor acquires or may acquire an interest in or right in respect of property which under or in accordance with the terms of investment will, or may at the option of the investor, be used or employed in common with any other interest in or right in respect of property acquired in or under like circumstances.

In order to fall within this category, three requirements must be satisfied:

(i) there must be an investment of money;

(ii) the investor must acquire an interest; and

(iii) such interest or right will or may at the option of the investor be used or employed *in* common with any other interest or right in respect of property acquired in like circumstances.

(i) *Is there an Investment of Money?*

In the Australian case of *Munna Beach Apartments Pty. Ltd.* v. *Kennedy & Ors.*[1] McPherson J. held that entry into a sales contract with the intention of using such contract for investment purposes would not change such sales contract into an investment contract.[2] He pointed out that there is a generic difference between an investment contract and a contract of sale. A contract of sale merely requires a payment of money whereas a true investment contract is one which obliges an investment of money. In his opinion, "an investment of money implies that some form of return, of income or profit or otherwise, is expected or in contemplation. Otherwise, the money is not ordinarily described as "laid out" or invested but simply as "paid."[3]

In *Butterworth* v. *Lezemo*[4] Nicholson J. took the superficial view that the franchise fee paid by the franchisee in exchange for a licence to use the relevant industrial property during the currency of the agreement and, therefore, was paid without any expectation of return could not be properly regarded as an investment.[5] However, in sub-

1 [1982-83] 7 A.C.L.R., 257.
2 *Ibid.*, p. 262.
3 *Ibid.*
4 *Supra,* note 68.
5 *Ibid.*, at p. 753.

stance and in the context of commercial realities, a franchisee does expect returns in paying the franchise fees. To the franchisee the franchise is a source of his livelihood. It is also a valuable capital asset with a ready market. A successful operating franchise actually appreciates in value and is worth much more than its original value.

At this juncture it is interesting to take note that the definition of investment contract in section 84(1) expressly states that:[6]

> 'Investment contract' means any contract scheme or arrangement *which in substance and irrespective of the form* thereof involves the investment of money....

In ascertaining the meaning of an investment contract it must be borne in mind that it is the substance and not the form of the transaction that matters. On this premise, it is submitted that Nicholson J.'s views ought not to be followed.

(ii) *Has the Franchise Investor acquired an "Interest in or a Right in respect of Property"?*

Nicholson J. in *Butterworth* v. *Lezemo* conceded that a franchisee's right to use the industrial property may constitute a right or interest in respect of the industrial property in question.[7]

(iii) Will or may "Such Interest or Right... at the Option of the Investor be Used or Employed in Common with Any other Interest or Right in respect of Property Acquired in like Circumstances"?

In *Munna Beach Apartments* v. *Kennedy*[8] McPherson J. found himself faced with an argument that tenants in common of a piece of land have the rights to go upon the physical land and if two such tenants elect or agree to go upon the land simultaneously they would be using their respective rights "in common".[9] In an extremely illuminating speech McPherson replied that:

> It is, of course, true that two or more of the tenants in common might elect or even agree to go upon the land simultaneously; but if they then proceeded to do so, it does not seem to me that they would be using their respective rights "in common". On the contrary, each of them would then be severally exercising his individual right, even though he might be doing so contemporaneously with others.... In order to attract the definition, the right must be exercised "in common with" others, and that is not done simply by exercising a common right contemporaneously... .[10]

However, McPherson J. conceded that the above requirement might be satisfied if the tenants in common exercise their respective rights to go on the common property in order to hold a joint function.

In the context of franchising, there is no doubt that the franchisees in a franchise scheme are severally exercising their respective rights to use the franchisor's trademark or business name for the benefit of their

6 See p. 278 *supra.*
7 *Supra,* note 67, p. 753.
8 *Supra,* note 1.
9 *Ibid.*, pp. 260-261.
10 *Ibid.*

respective outlets. On this basis, Nicholson J. in *Butterworth* v. *Lezemo* had no difficulty in coming to the conclusion that the right enjoyed by the plaintiff franchisee of the franchise scheme in question was not employed in common with the other rights held by the other franchisees.

From the foregoing discussion it is clear that the application of paragraph (c) of section 84(1) raises many difficult questions. In this regard, we can understand why the judges in *W.A. Pines* v. *Hamilton* [11] and *Casnot*[12] did not deal with paragraph (c) and also why Wilson J. in *Australian Softwood*[13] said:

> Whether or not the arrangement also constitutes an "investment contract" is a question of greater difficulty, the definition of such a contract raising a number of issues which it is neither necessary nor profitable to discuss.[14]

In conclusion it is clear that Nicholson J.'s judgment in *Butterworth* v. *Lezemo* must be regarded with caution and in the light of its peculiar facts. It is submitted that the cases of *Australian Softwood, W.A. Pines* v. *Hamilton, Casnot* and others must continue to be regarded as authorities that provide acceptable guidelines to the interpretation of "interests".

Is the Regulatory Scheme Imposed by Part IV, Division 5 of the Companies Act Suitable for Franchise Regulation?

It is expedient that courts in considering whether a particular business scheme ought to fall within the "Division" should also take into account the suitability of the regulatory regime that will be brought into operation under the "Division". However, Australian judges pressed by the urgency to provide protection to defrauded investors often adopt a remedial approach in interpreting the corresponding Australian provisions and ignore the consideration of whether the resultant regulatory scheme is suited to regulate the business activity in question.

Once it has been determined that a franchise constitutes an "interest" the following results flow from the rest of the provisions under "Division 5":

(1) No person except a public company may offer an issue to the public for subscription or purchase or shall invite the public to subscribe for or purchase any interest (section 89 read with the definition of "company" in section 84(1)).

(2) No company may issue to or offer to the public for subscription or purchase or purchase or shall invite the public to subscribe for or purchase any interest unless the company issues or causes to be issued a statement which is deemed by section 90(1) to be a prospectus issued by the company.

(3) In addition, under section 91(1) a company shall not issue or offer to the public for subscription or purchase or invite the public to subscribe for or purchase any interest unless, at the

[11] *Supra,* note 66.
[12] *Supra,* note 64.
[13] *Supra* note 62, p. 54.
[14] *Ibid*., p. 59.

time of the issue, offer or invitation, there is in force, in relation to the interest, a deed that is an approved deed.

(4) In order to obtain an approved deed, the deed must, under section 85 make provision for the appointment of an approved trustee for the holders of interests issued or proposed to be issued; and in addition, the deed must incorporate all the detailed covenants set out in section 88. These covenants are binding on the management company as well as the trustee.

(5) Under section 92 the management company must keep a register of all the holders of "interests" and under section 93 it is required to lodge annually certain returns, statements, lists and summaries with the Registrar of Companies.

(6) It is, however, important to take note that under section 96 the Minister may exempt any company, subject to such terms and conditions, from complying with all or any of the provisions of this Division.

(7) Finally, it should be noted that the definition of "security" in the 1973 Securities Industry Act[15] includes interests other than shares and debentures as defined in section 84(1). This means that a person carrying on a business of dealing in "interests other than shares or debentures" is required by section 9 of the Securities Industry Act[16] to be licensed before he can do so.

It is obvious that the above onerous requirements are designed to operate principally in the field of "Unit Trusts". A unit trust scheme usually involves the acquisition of a group of investments by a manager and the vesting thereof in a trustee under a deed which, *inter alia,* creates units that are purchased by members of the public. The trustee is required by the deed to perform a watch-dog role in order to safeguard the interests of the holders of the units. The regulatory regime of Division 5 is totally unsuited to franchise regulation as it is unrealistic to require a franchisor to operate a franchise system under a trust deed.[17] It is also unjustifiable to prohibit individuals and private companies from engaging in franchising activities as some highly innovative franchising ideas come from small business persons. This criticism is especially valid in Singapore because it is a widely publicised fact that enterprising local entrepreneurs have successfully broken into the fast food market. In any event, if this legislation was in force in United States when Colonel Harland Sanders was travelling and sleeping in the back of his car trying to sell his chicken franchise there would have been no Kentucky Fried Chicken today.

The operation of the regulatory regime in Australia soon came under scathing attack for being cumbersome in the extreme and ineffective in regulating franchise activity.[18] Franchisors in trying to comply with the onerous requirements were experiencing costly delays.

[15] See s. 2 of Securities Industry Act, No. 17 of 1973.
[16] *Ibid.*
[17] This is only one of the many scathing criticisms made by Warren Pengilley in his article, "Franchising: The Present Law and the Likely Impact of Franchising Legislation", {1983) Austl. Bus. L. Rev. 335,
[18] *Ibid.*

The operation of the regime seriously restricted new entry of small businesses into franchising.[19]

The ineffectiveness of the regulatory regime is appositely described by an Australian commentator in these words:[20]

> In summary, the only present enforcement of the Code provisions are the various letters written by some Corporate Affairs authorities when a franchise is advertised. All that is happening is that advertisers are now describing their arrangements as "Businesses", "Distributorship" or "Marketing Opportunities" thus evading Corporate Affairs Commission correspondence even though, in fact, a franchise is what is being offered. Cosmetically this keeps franchising advertising off the front pages but it is a little akin to treating jaudice by painting the patient pink. The real problems are not attacked at all. Despite all this ineffectiveness of real result, the Code is a substantial inhibiting fact to those law-abiding franchisors who feel that their obligations are to comply with the views of the Corporate Affairs authorities, whether they agree with such views or not.

These criticism finally led the Australian National Corporate Securities Commission (hereinafter referred to as "the Commission") to issue a policy statement on 29th August, 1983 declaring that the Commission was prepared to exempt a public company from complying with all or any of the provisions of Part IV Division 6 of the 1981 Australian Companies Act.[21]

Unfortunately the Commission took the view that a franchisee is not an investor in the pure sense because he usually undertakes to operate the franchise outlet.[22] This led the Commission to accept that "the typical franchisee is more readily prepared and equipped to assume some risk and requires less continuing protection than the typical investors".[23]

Based on these assumptions the Commission declared that:[24]

> While the Commission is concerned that potential franchisees should be protected from frandulent and unfair promotion activities, it also wishes to ensure that the marketing of responsible franchising schemes is not unduly hampered by the imposition of unnecessary business costs to secure such protection.

As a result, the Commission will exempt franchisors from the requirements of registering a statement and otherwise complying with the prospectus provisions if the franchisor, at least three business days prior to the signing of the franchise agreement, provides the franchisee with a disclosure document which includes details relating to the franchisor and its officers, prior business experience of the franchisor or related

[19] *Ibid.*
[20] *Ibid.*, p. 337.
[21] The Commission is empowered by s. 176 of the 1981 Australian Companies Act to do so. A similar power is given to the Minister by s. 96(1) of the Singapore Companies Act.
[22] See Paragraph 5 of Release 118, NCSC Guidelines.
[23] *Ibid.*, para. 6.
[24] *Ibid.*

areas and the last audited accounts of the franchisor.[25] In addition, the franchisor must provide the franchisee with a summary of the rights and obligations of the franchisee including financial commitments, territorial restrictions and conditions relating to termination, renewal and assignments. Particulars of any representations on earnings or profitability and the assumptions on which they are based are also to be disclosed to the franchisee and must be accompanied by a cautionary note to be worded in the following manner:[26]

> *CAUTION*
>
> These figures are only estimates. There is no assurance that you will do as well. If you rely upon these figures you must accept the risk of not doing as well.

The key weakness of the disclosure regime is that the disclosure document is not required to be reviewed either by the National Corporate Securities Commission or the state Corporate Affairs Commission. This means that no enforcement machinery is in operation to guard against infringements of the disclosure requirements.

The Commission will also exempt a franchisor from the requirements of an approved trust deed and an approved trustee if he enters into a written contract with the franchisee and the agreement contains certain terms. In the Commission's view, these requirements offer an adequate degree of protection for franchisees in the on-going franchise relationship and should not impose unduly onerous business costs on responsible franchisors. The more important of these terms are as follows:

(i) a covenant binding the franchisor that all moneys paid by the franchisee to the franchisor will be held by the franchisor on trust for the franchisee in a trust account maintained with a nominated bank, pending their use for the purposes for which they were paid; moneys intended to be used for specific purposes such as goods or advertising may be withdrawn from the trust account as expenditure is made for those purposes; general accounts for training or a franchise fee in the nature of "profit costs" will be held in trust until such time as the franchisor has substantially delivered, transferred or provided to the franchisee the elements of the right or interest to which the agreement relates;

(ii) a covenant binding the franchisor that he will:

  (i) keep or cause to be kept a separate trust ledger for each franchisee into which all payments and receipts in relation to that franchisee are entered;

  (ii) permit the franchisee or his authorised representative to inspect his ledger account at all reasonable times and

  (iii) send or cause to be sent by post to each franchisee a statement of his ledger account within two months of the end of the financial year;

  (iv) instead of the "buy-back" covenant normally required for prescribed interests, a covenant that the franchisor will

[25] See "International Franchising" (March, 1984) Int'l. Bus. Law, p. 99.
[26] See Release No. 118 N.C.S.C. Guidelines.

not unreasonably withhold his consent to the franchisee's transfer of his right or interest in the franchise;

(v) a covenant binding the parties to the agreement that if the franchisee elects, by written notice to the franchisor within seven days of the date of the agreement, to terminate the agreement, all moneys paid by the franchisee to the franchisor or to any other party to the agreement will, forthwith upon receipt by the franchisor of the notice, be refunded to the franchisee — other than, where provision in the agreement is made for a non-refundable deposit of not more than 10 per cent of those moneys, that deposit.

It is implicit from the foregoing that the Commission recognises that the franchise agreements are essentially one-sided and are unfairly weighted towards the franchisors. The above covenants therefore are designed to counter-balance the one-sided contract.

The requirement that all moneys paid by the franchisees to the franchisor is to be held in a trust account to be withdrawn only for specific purposes implicitly recognises the fact that franchisees are not entrepreneurs as they have no control over the reasonable use of their investment. The requirement is also put in to ensure that a franchisor substantially delivers what he has impliedly or expressly promised to deliver to the franchisees in the course of the franchise relationship.

On balance, it is not difficult to perceive the overall regulatory strategy of the Commission. The easy requirement of an unreviewed disclosure document is surely an attempt to lower the entry barriers for new franchise schemes. However, the regulatory bite is that once the franchise has been offered to the public, the franchisor must be prepared to accept a curtailment of his bargaining power as a result of the incorporation of the prescribed covenants into the franchise agreement. In brief, the Commission is relinquishing the blue-sky[27] regulatory approach in exchange for more substantive protection in the franchise relationship. The effectiveness of the new regulatory scheme is yet to be gauged.

CONCLUSION

In regulating franchising, the regulatory machinery that has allowed the Australian National Corporate Securities Commission to modify the original regulatory regime under the relevant Division is provided by section 176 of their Companies Act.[28] Its provisions empower the Commission to exempt any company, subject to such terms and conditions as it may impose, from complying with all or any provisions of the Division. It is this ability of the Commission to impose new terms and conditions upon any grant of exemptions that has allowed it to virtually replace the existing regulatory regime under the Division with one that is more attuned to the needs of franchise regulation. In Singapore, such powers are similarly conferred upon the Minister by

27 "Blue-sky" are words used in the United States to describe regulatory laws which provide for the regulation and supervision of securities offerings and sales, for the protection of citizen-investors and to prevent them from investing in fraudulent companies.

28 *Supra,* note 14.

section 96 of the Companies Act. The Minister will normally act upon the recommendations of the Registrar of Companies. The Australian experience has shown that once a franchise is held to be an "interest other than shares or debentures" a ready regulatory machinery exists under our Companies Act that can be fine-tuned to regulate franchising in a substantive manner. It should also be noted that the definition of "security" in the 1973 Securities Industry Act includes "interests other than shares or debentures",[29] it follows that any person dealing in the aforesaid "interests" is required by section 9 of the Act to be licensed before he can do so. The conclusion to be drawn is that the existing Singapore regulatory environment is capable of regulating the franchising activities in Singapore.

However, even assuming that a similar regulatory regime modelled upon the one in Australia is adopted in Singapore, it can be described as nothing more than a first step in the right direction. Outstanding issues in a franchise relationship like "tying arrangements", "kickbacks", "recapturing of operating franchises by harrassment" await the urgent attention of the legislature. A comprehensive franchise legislation may prove to be the only answer to solve many of the problems and abuses that plague franchising.

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[29] *Supra,* note 15.

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