

## Revisiting Agency Theory in Franchising Law in Malaysia

Zahira Mohd Ishan<sup>1</sup>, Farhah Abdullah<sup>2</sup>

<sup>1</sup>Department of Management and Marketing, Faculty of Economics and Management  
Universiti Putra Malaysia, 43400 UPM Serdang, Selangor, Malaysia

<sup>2</sup>Law Department  
Universiti Teknologi MARA (Terengganu), 23000 Dungun, Terengganu, Malaysia

Received: October 4, 2014  
Accepted: December 9, 2014

---

### ABSTRACT

Franchising being developed from a hybrid body of laws including agency. Applying the qualitative approach by means of inductive reasoning, this article aims at exploring the limits of agency theory in relation to franchising in Malaysia by the method of historical approach. The elements of franchisors' controls, often lead to the debates of whether franchisors are principals to their franchisees and whether their relationship is fiduciary in nature or at an arm's length. The former issue is common in a third party claim on franchisor's liability over the act done by his franchisee. The latter issue is common in the day-to-day relationship of the franchisor and his franchisees. On September 20, 2012, the Malaysian Parliament amended the Malaysian Franchise Act 1998 (effective 1st January 2013) which has gone through a number of changes, some of them notable. With statutory intervention, the finding shows that the agency theory may have a very limited role in the national franchise industry.

**KEYWORDS:** Franchising, Agency, Fiduciary Relationship, Control, Partnership.

---

### INTRODUCTION

Regulating franchising law in global new economy is a continuous process of healthy and controlled development in this industry. Franchising as a business method is a unique and relatively new area of commercial law. There is no specific law on franchising at common law as franchising emanates not from a separate distinct legal tradition, rather, franchising resulted from commercial practices and conveniences developed by franchisors drawing upon rules of law in relevant areas of commerce and contract [1]. Hence, franchising relationship mirrors a reflection of several forms of business relationships including agency [2]. In fact, courts and jurist [3-10] alike have sometimes resorted to agency theory when deciding on or justifying franchising issues such as relationship between the franchisors and franchisees.

### REVIEW OF LITERATURE

#### Agency as Distinguished from Franchising: A Brief Study

The definition of an agent as propounded by [11] is universally accepted and not disputed in this paper. Section 135 of the Contracts Act 1950 (Act 136 Malaysia) defines an agent as "a person employed to do any act for another or to represent another in dealings with third parties."

According to [12], a franchise agreement was originally labelled as a sales agency, where apparently agency by actual authority is the comparable form of creation. In a similar context, in [13] reasoned the development of the principal-exclusive agent relationship to a franchisor-franchisee arrangement.

"Agents became more and more dependent on a sole manufacturer for the majority of goods they sold. Furthermore, agents were required to invest heavily in the equipment and even provide service to consumers. Agents entered into these arrangements in exchange for the "sole right to sell a manufacturer's products in a given area."

Agents would soon develop into franchisees as they became further linked to a manufacturer's brand name and product line [13]"

The above statement shows that the evolution from agency to franchising was basically due to the need to expand the business faster and cost efficiently. It is worthy to note that this evolution should be limited to the United States (US) experiences since it is the US through Albert Singer in 1851 that has started the modern concept of franchising. Apparently elsewhere, the modern concept of franchising just seeped through the business community

---

**Corresponding Author:** Farhah Abdullah, Law Department, Universiti Teknologi MARA (Terengganu), 23000 Dungun, Terengganu, Malaysia, E-mail: farha523@tganu.uitm.edu.my

who later practised franchising as a method of doing business with little consideration of the complex legal implications franchising would carry [14]. It took 120 years for franchise law to respond in the US and the response is partial. In other countries, the development has been sporadic. For Malaysia, it took her 28 years after the first legislation introduced in the US. Singer franchise business system reached Malaysia in 1940s [15]. Whether or not the franchise is a product or distributorship franchise, business format franchise or manufacturing franchise, or the combination thereof, agency and franchising are different because a franchisor is not a principal. The franchisee owns his business separately from the franchisor and not on the franchisor's behalf. At the same time, it is dependent upon the franchisor guidance and support.

### **The Judicial Applications of Agency to Franchising**

In business format franchising, the controls exercised by franchisor on his franchisees are meant to preserve the trademark and enhance the goodwill associated with the mark [16]. However, according to [17], this control may cause the franchisor to be held as a principal, particularly if he exercises close supervision over certain operations in franchisees' businesses. In such situation, an actual agency may arise and the franchisor may be liable for the acts of his franchisee.

In some franchising cases in the US and Canada, the issue of whether franchisor will be liable to a third party over the acts done by his franchisee have caused the court to decide on agency ground. According to [16], these have been the view of some American courts in the cases of gasoline stations. In *Mobil Oil Corporation v. Jeremy Barnsford*, for example, the respondent was attacked by an employee of a gas station owned by franchisor but leased to a leaseholder. Respondent filed suit against franchisor on the basis of an apparent agency relationship with leaseholder. This is due to franchisor owned the property, franchisor's products were sold in the station, franchisor's trademarks and logos were used, where the franchise agreement required use of franchisor's symbols and products. The majority observed that agency relationship occurs if:

“By contract or action or representation, the franchisor has directly or apparently participated in some substantial way in directing or managing acts of the franchisee, beyond the mere fact of providing contractual franchise support activities... In cases of alleged apparent agency, something must have happened to communicate to the plaintiff the idea that the franchisor is exercising substantial control. Our law is well settled that an apparent agency exists only if each of three elements [are] present... [18]” (emphasis added).

The majority held that mere use of franchise logos and related advertisements did not indicate that franchisor had actual or apparent control over substantial aspect of leaseholder's franchise business or employment decision. In a non-gasoline station case, a similar finding was made in *Ronald Cislav et al. v. Southland Corporation*. In this case, the appellants filed a wrongful death action alleging that their son's death resulted from his use of certain cigarettes sold at one of respondent's franchise stores. The court found that the franchisor did not control the means or manner in which the franchisees ran the store, and that the franchise agreement was not terminable at will. Therefore, there was no agency relationship established in this case [19].

In a Canadian case of *Beuker v. H & R Block Canada Inc.* [20], *Dovell J.* held that an apparent or ostensible authority arises in the franchise relationship. He referred to the leading textbooks on this subject, which state that apparent authority exists when a third party reasonably believes that a person is an agent. *Dovell J.* also referred to Lord Diplock in *Freeman & Lockyear v. Buckhurst Park Properties (Mangal) Ltd.*, who set out four conditions that must be fulfilled to entitle a contractor to enforce against a company a contract entered into by an agent on behalf of the company where the agent had no actual authority to do so. It must be shown:

- i. That a representation that the agent had authority to enter on behalf of the company into a contract of the kind sought to be enforced was made to the contractor;
- ii. That such representation was made by a person or persons who had “actual” authority to manage the business of the company either generally or in respect of those matters to which the contract relates;
- iii. That he (the contractor) was induced by such representation to enter into the contract, that is, that he in fact relied upon it; and
- iv. That under its memorandum or articles of association the company was not deprived either to enter into a contract of the kind sought to be enforced or to delegate authority to enter into a contract of that kind to the agent [21].

Indeed, franchisee may appear to be an agent by apparent or ostensible authority if a third party believed him to have an actual authority and the reliance was reasonable. Customers are normally assured of the quality and safety of the products or services by the consistent and predictable level of quality of their recognized trademark [22].

Apparently, this perspective is valid in so far as the franchisors are themselves aware of the need to develop and maintain customer confidence. Customers' confidence will lead to the issue of goodwill from a legal perspective. However, this perspective may not have relevancy in relation to agency. The Ronald Cislav case can be used as an example. There is no issue of goodwill being raised in this case. Rather, the court considers the franchisor's exercise of control over his franchisee. It is found that the franchisor in Ronald Cislav has not exercised any control over the franchisee's decision by way of promotion, advertisement or merchandizing the inventory including the disputed clove cigarettes sold at the 7-Eleven store [19]. This evidence saves the franchisor from being liable because in the law of agency, reliance argument must be established together with the other required elements.

There are arguments that imply that when franchising becomes common knowledge or popular, it will be more difficult to prove the third party reliance. Franchising is often based on the uniformity of appearance and operations throughout the business system. As the franchising business proliferates and the level of awareness of existence of franchising increases, the reliance by the third party will be more difficult to sustain [23]. It must be noted that third parties' reliance is considered not on the basis of public awareness of the existence of the representation but on the third party's individual awareness as stated by Lord Diplock in *Freeman & Lockyear* and analyzed on a case by case basis.

The argument against the third party reliance could also depend on the availability of obvious signs and notices notifying the franchisees are independently-owned. In the UK, the Business Names Act 1985 requires that the true owner of a business trading under a name other than that of the proprietor is identified on notepaper and elsewhere. The franchisor can use the notice to exempt him from agency relationship liability. It seems that the principles of law on exemption clauses with regard to exhibition of notices are also relevant.

It should be noted that there have been debates over whether a franchise is also fiduciary in nature like agency or an arm's length relationship. A fiduciary relationship arises when each party in the relationship stands in confidence to each other. The party is obliged to disclose material facts to the other party. An arm's length relationship is a relationship of equal treatment. There is no duty to disclose material facts to another.

A fiduciary relationship involves duties of trust, confidence and loyalty. However, no duty of loyalty arises in franchising, whereby the franchisor may compete with the franchisee by setting up his own subsidiary outlet near his franchisee. There is also a problem of equity of treatment by franchisor to his franchisees. This of course leads to potential conflicts of interest among the franchisor's other franchisees. Killion's observation on the range of the US case laws shows that fiduciary duty is used by franchisees to support claims on tortious breach of contract, failure on the part of franchisor to disclose material information during pre-sale, self-dealing, estoppel of the franchisor to plead the statute of limitations, or a franchise agreement otherwise terminable at will being terminable only for cause. He finds that the majority of courts refused to recognize the existence of fiduciary obligations between franchisor and franchisee in an ordinary franchise relationship [24]. Similar view by Rau shows that this duty may only be imposed by some of the courts when the prospective franchisee is a particularly unsophisticated, gullible or otherwise vulnerable [25].

While fiduciary relationship in general cannot find its place in franchising, it is also a debatable issue whether franchising is an arm's length relationship. Some authors [26-27] describe it on the basis of the supposedly equal bargaining power between franchisor and franchisee because of their mutual interdependence and desire to ensure each other's success. Pitegoff claimed in 1989 that 'there is no "inherent" inequality' between franchisors and franchisees due to legislative disclosure requirement and growth of many small businesses companies as franchisors [28]. This claim is followed by Chinonis who notes that the emerging judicial trend in franchise relationship is placing them equal. There are hundreds of franchises from which franchisees could choose that they can refuse to enter agreements that may not appear fair to franchisees where there are sophisticated and experienced franchisees who own numerous franchises [29].

However, some valid arguments state that franchising is a one-sided agreement due to the fact that franchising is mainly a contract of adhesion [30]. The franchisor has greater bargaining position unlike normal consumer negotiation due to the control over the use of trademark and marketing system. Abell notes that the franchisors' bargaining power grows with the growth of the franchise network [31]. This leads to onerous and unscrupulous business practices in franchising such as allowing franchise location very near or side by side the existing franchisee, or setting up franchisor's company subsidiary to compete with existing franchisee. Therefore, franchising is also not an arm's length transaction.

## **RESULTS AND DISCUSSION**

### **Statutory Limitation**

While judges at common law have the tendency to interpret agency into certain franchising relationship situations, there have been steps taken to safeguard franchisors from the claim made by any third party due to the

fault of franchisees. In Malaysia, for example, prior to 2013, the definition of 'franchise' in section 4 of the Franchise Act 1998 explicitly stated that the franchise relationship shall not at any time be regarded as an agency [32]. Starting from 1st January 2013, the Franchise (Amendment) Act 2012 deleted the provision. The amendment seeks to strengthen the definition of "franchise" by eliminating the elements of franchise which are not crucial to define franchise business. The word 'franchise' is now defined as "franchise" means a contract or an agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) the franchisor grants to the franchisee the right to operate a business according to the franchise system as determined by the franchisor during a term to be determined by the franchisor;

(b) the franchisor grants to the franchisee the right to use a mark, or a trade secret, or any confidential information or intellectual property, owned by the franchisor or relating to the franchisor, and includes a situation where the franchisor, who is the registered user of, or is licensed by another person to use, any intellectual property, grants such right that he possesses to permit the franchisee to use the intellectual property;

(c) the franchisor possesses the right to administer continuous control during the franchise term over the franchisee's business operations in accordance with the franchise system; and

(d) in return for the grant of rights, the franchisee may be required to pay a fee or other form of consideration.

The Malaysian judges and practitioners including the mediators and arbitrators were statutorily reminded against deciding franchising relationship, at any time, as an agency. It can be argued that the statutory limitation was imposed in order to set a demarcation line, albeit a thin one, between agency relationships from that of franchising. The authorities needed to differentiate between negligent act of franchisee and defective product of franchisor. In agency law, negligent act of an agent can be imputed to the principal. It would still be questionable if the Malaysian court were to decide according to the statutory provision strictly or interpret the definition of franchising more loosely in depending on the situation. For the latter, the defective product issue needed to be solved by the law of tort on product liability, not agency.

In terms of the franchisor-franchisee relationship issues, the amendment further imposes some obligations on franchisees, including broader confidentiality and non-compete obligations, a mandatory notice period for availing itself of the renewal rights under the Act, and a prohibition on termination by franchisors without good cause. Although the proposed amendments are welcome in order to ensure that this Act is consistent and up-to-date with current development of the franchise business in Malaysia, franchisors, especially foreign franchisors with comprehensive franchise agreements, do not really need such protections as their agreements already address such issues [33].

In Australia, the Franchise Code of Conduct is also silent on whether agency theory could play its role in franchising. Clause 4 of the code only excludes the landlord/tenant relationship, employer/employee relationship, partnership relationship, cooperative agreement recognized under state and territory law and fractional franchises from the scope of franchising. However, by excluding partnership relationship, it can be implied that agency theory may have a very limited role in franchising mainly because a partnership contract employs the basic ground rules of contract law and the general principles of agency as its foundation [34].

## CONCLUSION

The relationship between franchisor and franchisee in franchising bears a close semblance to that of agency. However, franchising is not an agency, which means that franchisor will not be liable for the franchisee's act towards a third party. Be it as it may, in certain franchising cases judges have sometimes resorted to the law of agency and caused franchisors to be liable for their franchisees act. It is a good step made by the legislator, therefore, to put a limit on the application of agency into franchising. The connection between franchisor and franchisee only in relation to the business method inclusive of training, trademark, goodwill and other matters that ensure uniformity of the business system but not to the ownership of the business. This is to ensure that the uniqueness of franchising law is distinguished from agency theory and this status should remain intact. With this amendment, it is clear that the Malaysian franchise legal compliance burden will become even more onerous.

## ACKNOWLEDGEMENT

The authors would like to thank Mr Zairi Ismael Rizman for his guidance and assistance in getting this paper published.

## REFERENCES

1. Ishan, Z.M., 2006. The Multi-Dimensional Nature of Franchising. *Malayan Law Journal*, 1: 35-36.
2. Pengilley, W. 1999. Franchising Code of Conduct: Does Its Coverage Address the Need? *Newcastle Law Review*, 3 (2): 1-48.
3. Tracey, P. and O. Jarvis, 2007. Toward a Theory of Social Venture Franchising. *Entrepreneurship Theory and Practice*, 31: 667-685.
4. Castrogiovanni, G.J., J.G. Combs and R.T. Justis, 2006. Resource Scarcity and Agency Theory Predictions Concerning the Continued Use of Franchising in Multi-outlet Networks. *Journal of Small Business Management*, 44 (1): 27-44.
5. Brickley, J.A., 1999. Incentive Conflicts and Contractual Restraints: Evidence from Franchising. *The Journal of Law and Economics*, 42 (2): 745-774.
6. Agrawal, D. and R. Lal, 1995. Contractual Arrangements in Franchising: An Empirical Investigation. *Journal of Marketing Research*, 32 (2): 213-221.
7. Brickley, J.A., F.H. Dark and M.S. Weisbach, 1991. An Agency Perspective on Franchising. *Financial Management*, 20 (1): 27-35.
8. Dnes, A.W., 1992. 'Unfair' Contractual Practices and Hostages in Franchise Contracts. *Journal of Institutional and Theoretical Economics*, 148 (3): 484-504.
9. Krueger, A.B., 1990. Ownership, Agency and Wages: An Examination in the Fast Food Industry. *The Quarterly Journal of Economics*, 106: 75-102.
10. Lafontaine, F. and P.J. Kaufmann, 1994. The Evolution of Ownership Patterns in Franchise Systems. *Journal of Retailing*, 70 (2): 97-113.
11. W. Bowstead, 2007. A digest of the law of agency. The Lawbook Exchange.
12. Gellhorn, E., 1967. Limitations on Contract Termination Rights: Franchise Cancellations. *Duke Law Journal*, 1967 (3): 465-521.
13. Gurnick, D. and S. Vieux, 1999. Franchising Law Symposium: Case History of the American Business Franchise. *Oklahoma City University Law Review*, 24: 37-65.
14. Leagle Inc., 2009. STATE of Nebraska ex rel. Counsel for Discipline of the Nebraska Supreme Court v. Jeffrey L. ORR. Retrieved from <http://www.leagle.com/decision/In%20NECO%2020090130283>.
15. K. Ryan, 2003. Guide to franchising in Malaysia. Deacons, pp: 1-4.
16. John N. Adams, Julian J.B. Hickey and K.V. Prichard Jones, 2006. Franchising: Practice and precedents in business format franchising. Bloomsbury Professional.
17. Morgan, F.W. and J.J. Stoltman, 1997. Vicarious Franchisor Liability: Marketing and Public Policy Implications. *Journal of Business & Industrial Marketing*, 12 (5): 297-314.
18. Zahira, M.I., 2008. Unconscionability in the law and practice of franchising, Phd thesis, Universiti Putra Malaysia, Kuala Lumpur, Malaysia.
19. Justia US Law, 1992. Ronald Cislav et al. v. Southland Corporation. Retrieved from <http://law.justia.com/cases/california/court-of-appeal/4th/4/1284.html>.
20. Law Society of Saskatchewan, 2014. Summary of Beuker v. H & R Block Canada Inc. Retrieved from [http://canliiconnects.org/en/summaries/4672?&related\\_filter\[author\]=&related\\_filter\[publisher\]=&related\\_filter\[type\]=summary](http://canliiconnects.org/en/summaries/4672?&related_filter[author]=&related_filter[publisher]=&related_filter[type]=summary).
21. J. Chitty, 2012. Chitty on contracts: General principles. Sweet & Maxwell, pp: 816.
22. H. Beale, D. Tallon, S. Vogenauer, Jacobien W. Rutgers and Bénédicte F.-Cosson, 2010. Cases, materials and text on contract law. Hart, pp: 369.

23. Mendelsohn, M. and R. Bynoe, 1995. *Franchising*. London, UK: FT Law & Tax, pp: 50.
24. Killion, W.L., 2008. The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship. *Franchise Law Journal*, 28 (1): 23-33.
25. Rau, L.A., 1992. Implied Obligations in Franchising: Beyond Terminations. *The Business Lawyer*, 47 (3): 1053-1081.
26. Robert T. Justis and Richard J. Judd, 2002. *Franchising*. Dame Publications.
27. Rodney, H., 2009. Submission on draft unfair contract terms. Retrieved from [http://archive.treasury.gov.au/documents/1547/PDF/Mr\\_Rodney\\_Hackett.pdf](http://archive.treasury.gov.au/documents/1547/PDF/Mr_Rodney_Hackett.pdf).
28. Pitegoff, T.M., 1989. Franchise Relationship Laws: A Minefield for Franchisors. *The Business Lawyer*, 45 (1): 289-331.
29. Chinonis, T.J., 1998. Implied Covenant of Good Faith: A Two-Way Street in Franchising. *DePaul Business Law Journal*, 11 (2): 229-256.
30. Iglesias, J., 2004. Applying the Implied Covenant of Good Faith and Fair Dealing to Franchises. *Houston Law Review*, 40: 1435-1436.
31. M. Abell, 1989. *The franchise option: A legal guide*. Pergamon Press.
32. Laws of Malaysia, 2006. Franchise Act 1998 (Act 590), pp: 9. Retrieved from <http://www.agc.gov.my/Akta/Vol.%2012/Act%20590.pdf>.
33. Zeidman, P.F., M.G. Brennan and T. Xu, 2012. Malaysia amends and expands its franchise law. Retrieved from <https://www.dlapiper.com/en/asiapacific/insights/publications/2012/11/malaysia-amends-and-expands-its-franchise-law/>.
34. Alam, S.M.N., 1996. Doctrinal Conflict in Partnership Contract. *Current Law Journal*, 3: 5-6.