The Legal Implications of Reputation Risk Management for Franchisors

Tom Burns
Senior Lecturer in Law
University of Aberdeen
t.burns@abdn.ac.uk

Abstract. Franchisors in Britain face a difficult problem. If they use the techniques of reputation risk management to protect their corporate brands (which is usually their most valuable assets), they may inadvertently increase their exposure to third party tort claims. This paper explains why this may occur and how the franchisor could try to do to deal with this problem. It shall be suggested that a form of reputation risk management should be adopted by franchisors, even where the tort risk remains. This is because the franchisor has much to gain from having an efficient method of protecting the corporate brand where appropriate legal and organisational arrangements can be made to further this goal.

Key words: tort**,** vicarious liability, legal risk, reputation risk management, franchisor, franchisee

1. Introduction

The main purpose of this article is to examine a difficult problem faced by franchisors. If the franchisor attempts use the techniques of reputation risk management to protect its corporate brand (which is usually its most valuable asset), the franchisor may inadvertently increase their exposure to third party tort claims. This is because of the unusual structure of the franchised business and the problems of implementing a risk management system within this structure.

Although the franchised business has the appearance of a single business entity because it operates a chain of outlets under the same name and delivers the same, standardised, quality-assured, product and/or service, it is not one. Many of the franchised outlets are, in fact, small to medium-sized independent businesses linked together by contract with the franchisor. These businesses derive their corporate identity and working methods from intellectual property rights that are licensed to them by the franchisor. The franchisor therefore, does not have the normal, "command and control" power over its franchisees, which the management in many conventional organisations have over their employees. Therefore, the implementation and enforcement of a reputation risk management system to protect the franchisor's corporate brand is not as straightforward as it might be for companies with normal management structures. In addition, the franchisees have a degree of autonomy over how the run their businesses and they may resist the imposition of potentially costly risk management procedures by the franchisor. If the franchisor imposes a reputation risk management system on the franchisees, there may be problems over compliance and enforcement. The imposition of such a system may at the same time increase the scope of the franchisor's tortious liability.

Normally, franchisors are in a favourable position in relation to tort claims. In British law, there is a fairly clear legal boundary between the franchisor and the franchisee because they contract at arms-length to operate the franchise. This means that if a third party suffers harm as a result of the franchisee's negligence the injured person would have a claim against the franchisee as an independent contractor. The franchisor would not normally be involved. However, the franchisor's protection from such tort claims could be undermined if the franchisor introduces a reputation risk management system. Reputation risk management would require the franchisor to exercise greater influence and control over the network than has been the case in the past. One important consequence of this could be to strengthen the claims of third parties against the franchisor under the principles of vicarious liability. This could produce a paradoxical result for the franchisor. In its attempts to control the business risk of damage to its reputation, the franchisor may be inadvertently increasing the scope of its legal risk.

This article shall examine this problem. It shall be suggested in the course of the analysis that a form of reputation risk management should be adopted by franchisors, even where the tort risk remains. This is because the franchisor has much to gain from using a modern and efficient method of protecting the corporate brand if appropriate legal and organisational arrangements can be made to further this goal.

2. The value and the vulnerability of franchised brands

Most franchised businesses are built upon the concept of the brand [1] and the value of the brand to these businesses can be significant proportion of the total value of the company[2] .Indeed, in some cases the value of the brand may be the single most valuable company asset. In the case of the very large franchised businesses the brand value can be worth billions of dollars. In a recent survey of the top 100 brands in the world, the brand value of McDonald's was approximately $26 billion, the KFC (Kentucky Fried Chicken) brand and the Pizza Hut brand were worth approximately $5 billion, the Hertz car rental franchise brand was worth approximately $3.5 billion, and the Starbucks coffee shop franchise was worth $2.5 billion[3]. The world's top brand, as listed by the Interbrand Corporation, the brand consultancy, is a franchised business. It is Coca-Cola, which, like its soft drink rival Pepsi, franchises it bottling operations (Felstead, 1993: 38). According to Interbrand, Coca-Cola's brand value was $67.5 billion, while Pepsi's brand value was worth $12.4 billion.

Although many of the largest franchised brands are immensely valuable, they can also be surprisingly vulnerable. In the twenty-first century it is becoming harder to protect the brands from damaging publicity. For example, if a franchised business were to make a mistake that harmed human health or safety this would be quickly disseminated over the Internet and the 24-hour news channels leaving the business with very little time to investigate the cause of the accident or to respond to its critics. Under these conditions, the corporate reputation may suffer and sales may decline without the full facts of the case being properly investigated. When so much of the value of a franchised business is tied up in an intangible asset that could be affected by bad publicity, franchisors have an incentive to seek new ways to protect their brands. But this is not a straightforward matter because of the peculiar legal structure of the franchised business (examined below).

2.1 The Coke Products Case

Franchised brands can be damaged by the acts and omissions of the franchisor, but also potentially by the acts or omissions of thousands of local franchisees. It is true that in the case of the franchisees, the franchisors are able to set the standards of performance for the brand, but these standards have to be implemented properly by the franchisees to be effective. Normally most franchisees will run their businesses according to the standards set for the brand (for example, in terms of fast and friendly service, the quality of the product, clean premises, good hygiene, etc). However, because franchisees (as independent business people who have put capital into their enterprises) tend not to be monitored as closely as employee-managers running branch operations in a typical, hierarchical, unified corporate structure, there may be a greater chance for things to go wrong at the local level that could have a negative impact on the brand.[4] Furthermore, franchisors are reluctant to become too closely associated with the day-to-day operations of the franchisees' businesses because they fear the legal threat of being held vicariously liable for the defaults of their franchisees (Abell, 1989:90): So the risk to the reputation of the franchised brand can be significant.

Indeed, there have been cases where the acts or omissions of a local franchisee in one country have had a wider negative impact on the brand. For example, in 1999, the Coke brand was damaged in an incident involving

[1] A brand is a trade name used to identify a product or service. It serves to distinguish the goods or services of the owner from those of his competitors. Producers believe that if the invest in the quality of their brands they will build up a brand image to which consumers will respond by asking for the goods by their brand name. Customers may also be prepared to pay a premium for the branded product. See Issacs, A. (2003) "The Oxford Dictionary of Business, Oxford OUP, 43-44

[2] See Magid, J. M., Cox, A. D. and Cox, D.S. "Quantifying Brand Image: Empirical Evidence of Trademark Dilution", American Business Law Journal (Volume 43) 1 at pages 8-9. In early 2002, the Coca-Cola Company had a market capitalization of $127.4 billion, while the book value of its tangible assets was only $8.8 billion. Thus over 90% of the company's value (nearly $120 billion) could be attributed to intangible assets. While Coca-Cola has a variety of intangible assets (e.g., trade secrets, exclusive distribution contracts), most valuation experts consider the bulk of its value to be its dozens of brands and trademarks.

[3] These are the most recent figures produced by the Interbrand Corp survey of "The 100 Top Brands" as published in "Business Week" in July 2005, available at http://www.ourfishbowl.com/images/surveys/best_global_brands_2005.pdf

[4] Franchisors have to be careful how they deal with the franchisees. Heavy-handed supervision might alienate the franchisee and may cause him to leave the franchise. On the other hand, the franchisor has to be sure that the brand will not be damaged by franchisees failing to meet the set standards for service, quality and cleanliness, etc. Therefore, franchisor will inspect the performance of the franchisees in various ways (e.g. by field visits, by "mystery shoppers" who anonymously evaluate the outlet, etc). However, the emphasis is on creating incentives for the franchisee to perform effectively, so that self-control can largely replace external control. See Murray, I. (2003) "How to choose a Franchise" London, Kogan Page Ltd, 141-146

120 people in Belgium and 80 people in France who felt ill after drinking Coke. This temporary illness was attributed to the production operations of the Belgian and French franchisees and was not caused by an act of the brand-owning franchisor, Coca-Cola of Atlanta, Georgia, USA.

On investigation of this incident, it was discovered that the contamination of the Belgian-produced drinks was caused by some defective carbon dioxide being used in a small supply of bottles in the plant of the franchisee in Antwerp. Meanwhile, in France the source of the contamination arose from a fungicide that was used by the franchisee in Dunkirk to spay on wooden pallets. Yet because Coca-Cola management did not intervene either early enough or decisively enough during these crises to allay public concerns, the national media in France and Belgium could justifiably inflame public outrage in these countries. This public outrage led to an unofficial boycott of all Coke-branded drinks and ultimately to a public demand for a total product recall.

The Governments of France and Belgium succumbed to this public pressure (even when it became clear that there was no threat to public health) and they ordered a total product recall. This recall cost Coca-Cola $103 million. Coke's profits subsequently dropped by 31% in these countries and the franchisor had to spend substantial sums in a promotion campaign to restore public confidence in the product (Larkin, 2003). Risk management experts have argued that if a crisis management system (as described below) had been in place in Coca Cola as part of a reputation risk management scheme, the impact on the franchisor's brand could have been much less.

However, damaging bad publicity is not only generated by unfortunate incidents like those occurring in Belgium and France; it is sometimes created by campaigning groups as a way of bringing pressure to bear on franchisors to change their business practices and to galvanise the politicians into making laws to curb the alleged bad practices of business. Environmentalists, trade unionists and anti-corporate activists have all found something to object to in the way certain franchises conduct their businesses. In the case of McDonald's for example, various groups have attacked the reputation of the business by alleging (amongst other things) that it was selling food that may cause obesity; that it was targeting their advertising at children; that it was exploiting its workforce; that it was contributing to the suffering and exploitation of animals, and that it was adding to the environmental problems by producing packaging waste[5] .

Yet whatever faults are to be found in franchised businesses, they are certainly not the "worse offenders" in the corporate world in terms of alleged breaches of social and environmental responsibilities. These businesses become targets for other reasons. For anti-globalisation and anti-corporate activists the large franchised brands are conspicuous examples of the global capitalist system. By bringing pressure to bear on them through a sustained attack on the brands, the campaigners hope to persuade other companies to change their business practices to avoid the same treatment.[6] Franchisors are therefore keen to implement risk management systems that will help to protect their valuable reputations from the various threats described above.

3. The management of the risks to reputation

Risk management consultants have identified some of the main reasons why companies have found themselves in crisis situations where their corporate reputations are seriously at risk. These companies had no effective plans in place to manage the threats to the company's reputation from the damaging incidents that occurred. In many cases the incident that damaged the reputation of the company happened because the company's decision-makers did not know what was going in the lower levels of the organisation. This is a problem that is made more difficult to solve as a company grows in size and complexity and may be particularly acute in the case of franchised networks where the franchisees enjoy a degree of autonomy.

When the damaging incidents occurred, the managers of these companies simply dealt with the problem as it arose without the benefit of effective forward planning. This perhaps explains why, to some extent, the companies' responses to these crises were so poor. This reactive management may no longer be a sensible response strategy. As Neef (2003: p vii) has pointed out "in many ways companies have a lot more to lose today than even ten years ago, simply because the potential for being caught and exposed, by activists, lawyers… government agencies and the media, is greater [now] than ever before". Therefore, companies need to be

[5] The defendants, Steel and Morris, made a number of these allegations about McDonald's in the so-called McLibel trial. See Vick, D.W. & Campbell, K. (2001) "Public Protests, Private Lawsuits, and the Market: The Investor Response to the McLibel Case", Journal of Law and Society, Volume 28, (Number 2) 211-218

[6] McIntosh, M. & Leipziger, D. (1998) "Corporate Citizenship" London, Financial Times/Pitman Publishers, 257. The authors note that: "campaigners tend to target not the worse companies, but those that are most well known…McDonald's being among the most well-known fast food chains, is always vulnerable. Targeting an industry leader puts the whole industry on warning. Companies like McDonald's make good pressure points because they are industry leaders, because they have solid brands with a global identification and because people expect more from them".

proactive. This entails identifying, analysing and implementing solutions to the foreseeable problems that may arise.

3.1 The basic principles of reputation risk management

There are a number of risk management specialists, who have written books on the subject, setting out various frameworks for reputation risk management (Sheldon Green, 1992; Jolly, 2001; Davies, 2002; Neef, 2003; Larkin, 2003; Fishkin, 2006). These vary in their details, but an overall pattern of recommendations does emerge which could be regarded as a common core of the subject. All recognise that reputation is built upon perception and that perception is vulnerable to real and imaginary threats (Larkin, 2003: 86-120). The goal of a reputation risk management system is to identify and prevent the avoidable threats and control and minimise the unavoidable threats.

The first essential step in creating a risk management system is to create a team of managers with the task of focusing on risk management and prevention. This coordinating team needs to have the full backing of the board so that it has power within the organisation to impose the controls necessary to achieve their goals. The first task of these risk managers is to identify the threats to the company's reputation from within the organisation and from outside the organisation. They then have to assess those risks by estimating their probability and their likely effect on the organisation's good name.

Clearly, the threats that are very likely to occur and are very likely to cause grave damage to the organisation are the ones that must be eliminated or at least minimised as a priority. Risk avoidance and reduction methods must be put in place for the other perceived threats to the company's reputation, especially for the low probability but high cost threats that could cause a crisis for the company. This usually involves further training for employees and the promotion of a culture where problems in the business can be reported without the employees having to fear for their jobs or promotion prospects within the company. The risk management experts also seem to agree that the reputation risk management procedures should be accommodated within the company's wider risk management programmes [7] as it may be complementary to, and overlap with other risk management systems, such as financial risk management, health and safety risk management and the requirements of the *Turnbull Report* on the management of internal risks as part of the obligations of the Combined Code on Corporate Governance, as amended 2005.[8]

Finally, the various authors suggest the creation of a detailed crisis management procedure so that if the worst-case scenario happens, it can be dealt with efficaciously. So, for example, there should be an identifiable spokesperson ready to answer questions from the media or regulators about the crisis. There should be a system for briefing all relevant top personnel about the problems and alerting a "trouble-shooting" team. This trouble-shooting team should find out and report on the causes of the problem and the measures that may be necessary to eliminate it, or at least minimise the damage that the problem has caused. There would seem to be a consensus among the reputation risk management specialists that if a crisis were to emerge the preservation of the company's reputation will depend upon how the company is perceived to have managed the problem. This may depend upon the extent to which the company is perceived to have taken full and reasonable precautions to guard against the circumstances which threaten it; how effective the company has been in reacting to and minimising the damage caused to the public, and how far the company is seen to be genuinely concerned about what has happened at a level beyond that of purely business considerations (Sheldon Green, 1992: 171).

4. Legal implications of reputation risk management techniques for franchisors

In the franchised system, the franchisees operate as separate businesses and have a degree of autonomy over how the run their outlets, within the parameters set by the franchise agreement. Franchisors use this structure to limit the possibility of claims being made against them by victims of wrongs committed by the franchisees. The

[7] See Larkin op cit pages 20 -21 and Sheldon-Green op cit, Chapter 4 "The Bottom Line of Reputation Risk Management". In this chapter Sheldon-Green presents a financial case for adopting reputation risk management and one of his points is that a reasonable percentage of the cost of this programme is already in place because of the overlap between the management of reputation risk and the management of other types of risks in the company.

[8] The Turnbull Report sets out the best practice for the internal control of risk and was fist published in 1999. It has now been amended. The directors of listed companies are now required to confirm in the annual report that they have dealt with (or are planning to deal with) any significant failings or weaknesses highlighted by the internal control system. For the new guidance see the "Internal Control: Revised Guidance for Directors on the Combined Code" available at www.frc.org.uk/corporate/internalcontrol.cfm

franchise agreement will make it clear that the franchisees are to be regarded as independent contractors [9] and to encourage these victims to pursue the franchisee the franchisors will usually ensure that the franchisees has the appropriate level of public liability and other types of insurance. This means that when a franchisee commits a wrong, there should be insurance money available to satisfy the claim of the victim.

However, this system does not offer complete immunity to the franchisor. There have been occasions where franchisors have been found to be liable vicariously to third parties. These cases have arisen because the culpable franchisee had no suitable insurance cover or was under-insured. In these circumstances the injured party has had to resort to the "deep pockets" of the franchisor through the mechanism of vicarious liability in order to receive full compensation for the harm done by the franchised business.

In many of these vicarious liability cases, a decisive factor in establishing franchisor liability has been the degree of control exerted by the franchisor over the operations of the franchisees. This is a source of concern for any franchisor wishing to implement a reputation risk management system because such a system requires the franchisor to exercise a greater degree of control than had been the case previously. Unfortunately, the greater the degree of control that the franchisor exerts over the franchise network, the greater is the risk of vicarious liability being established against these franchisors.

5. Under what circumstances might a franchisor be held vicariously liable for the wrongs of the franchisee?

The law gives considerable scope to businesses to structure their agreements in order to reduce or minimise legal risks[10] . By contractual devices and by careful commercial arrangements regarding the operational control of the franchise, the franchisor might be able to prevent the principle of vicarious liability from applying (Collins, 1990, 731).

However, if the victim is to succeed in bringing a claim against the franchisor on the basis of vicarious liability, the victim must establish a nexus between the franchisor and the franchisee sufficient to justify the imposition of this special form of tortious liability. If the victim can show that the franchisor exercised a sufficiently high degree of influence or control over the franchisee to the extent that the franchisee's wrongs can be fairly ascribed to the franchisor, then the victim may have a case against the franchisor. Such a nexus may be established if the victim can show that the relationship between the franchisor and franchisee is analogous to that of the law on master and servant, or to that of principal and agent. However, to keep this article within the word limit only the master and servant issue will be examined.

5.1 The analogy of master-servant relationship

Over the years the British courts have developed three main tests to determine whether or not a master-servant relationship exists between two persons. These are the control test, the organisation test and the "multiple test".

Under the classic formulation of the control test by Bramwell LJ in *Yewens v Noakes*, a "servant is a person who is subject to the command of his master as to the manner in which he shall do his work"[11]. Therefore, where one company can instruct another person on what to do and how to do it, this may be sufficient to establish the existence of a master-servant relationship. If the franchisee's wrongdoing were within the scope of his "employment", a sufficient nexus would exist to make the franchisor vicariously liable to the third party for that wrong[12]. An arguable case can be made that many franchisees are subject to a sufficiently high degree of

[9] The contractual draftsmen will have made it clear by a number of devices that the two parties to the contractual agreement are separate and independent persons. These include the use of clauses declaring the franchise agreement is not a joint venture or a principal-agent relationship. Commercial practices will also be scrutinised by the franchisor's legal advisers so that the operation of the agreement will not give rise to an inference of franchisor control sufficient to bring the doctrine of vicarious liability into play. See Mendelsohn, M. (2004) "Franchising Law" (second edition) Richmond, Richmond Tax & Law Ltd, p123-124

[10] Perhaps this fact can best be illustrated by the vivid judgement of Templeman LJ in a leading case on the nature of corporate liability." English company law possesses some curious features, which may generate some curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary." per Templeman LJ, Re Southard & Co Ltd [1979] 1 WLR 1198 at p. 1208.

[11] (1880) 6 QBD 530

[12] The principle of the employer being vicariously liable for his employee's tort committed within the scope of his employment is well established in Employment Law. See for example, the case of Mersey Docks & Harbour

franchisor control to satisfy the application of the control test to modern circumstances. In modern times, the subordination of the franchisee is not to the direct, personal command of the franchisor, but rather to the rules of the franchisor's bureaucratic system. Most business-format franchises function by making the franchisees follow the detailed procedures set out in the operations manual[13]. These manuals are issued to each franchisee to ensure uniformity of product, process or service. The operations manual may specify the opening and closing hours of the franchisee's business, when he can take his holidays, how he should record his accounts, how he should decorate his premises and how he should dress his staff (Mendelsohn, 1999: 67). A failure to follow the instructions set out in the manual is usually treated as a breach of contract by the franchisor (Felstead 1993:117).

Further examples of the franchisee's subordination to the will of the franchisor may be found in the terms of the franchise agreement (Adams & Prichard-Jones, 1997: 357-388). In this contract the franchisor may determine the sales targets of the franchisee's business as well as what the recommended retail price for the product or service should be. Usually, the franchisee is obliged by a contractual term to share his gross revenues with the franchisor by way of royalty payments (Barrow & Golzen 1994: 70-71) and it is often the case that the franchisee is restricted to buy his supplies from the franchisor by a term in the franchise contract. Thus, the contract and the manual may be the manifestations of control.

The organisation test was created to deal with the problem of persons who appear to be independent of the employer because they are not closely monitored or controlled by the employer but are, nonetheless, essential to the operation of the business. In *Stevenson, Jordan & Harrison v MacDonald & Evans*, Lord Denning stated the control test does not cover every situation. He explained that, "it is often quite easy to recognise a contract of service when you see it, but very difficult to say wherein the difference lies. A ship's master, a chauffeur and a reporter on the staff of a newspaper are all employed under a contract of service; but a ship's pilot, a taxi-man and a newspaper contributor are employed under a contract for services [i.e. self-employed]. One feature which seems to me to run through the instances is that, under a contract of service, a man is employed as part of the business and his work is done as an integral part of the business: whereas under a contract for services his work, although done for the business, is not integrated into it but is only accessory to it"[14] . Reasoning by analogy it could be argued that although the franchisee carries out his work without the close supervision of the franchisor, he is nevertheless performing a function that could be viewed as integral to the franchisor's business[15] .

5.2 The “multiple test”

The third test is the “multiple test”. This is the most sophisticated test of the three. It covers the situation where the various factors that constitute the parties’ relationship seem to contain contradictory elements. Some elements may point to the independence of the worker, while other elements in the agreement point to the existence of a master-servant relationship[16]. This test, when applied to the franchise agreement, would involve the courts considering and then weighing up a number of different factors governing the relationship between the franchisor and the franchisee. Factors which may incline the court towards the view that the relationship is one of employer-independent contractor may include the following: the fact that the person invested his own capital in the business (which is something all franchisees do); the fact that he hires his own workers, uses his own equipment and pays his own income tax and National Insurance contributions, etc. [17]. These factors tend to be present in the typical franchise arrangement and would seem to support the franchisor's contention that it should not be held vicariously liable for the torts of an independent franchisee.

However, the issue is not clear-cut. There are other factors that exist within the franchise relationship that indicate it might be more like an employment relationship. These factors would include the following: firstly, the fact that the franchisee is normally dependent upon the franchisor's managerial and operational knowledge to run the business. Secondly, that the franchisee is expected to follow the operational instructions set down in the

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Board v Coggins and Griffith [1947] AC 1 HL. The concept of the scope of employment has been developed in cases such as, Kay v ITW [1968] 1 QB 140, CA; and Rose v Plenty [1975] ICR 430.

[13] For an example of the breadth and depth of control that the franchisor may exert through the operations manual, see A. Feldstead, op cit p118, especially where the author describes how Mc Donald’s, the fast food franchise issues a 600 page manual of rules and regulations to its franchisees.

[14] [1957] 1 TLR 101 (Denning LJ)

[15] Using Cassidy v Ministry of Health [1951] 2 KB 343 as an analogy for this proposition

[16] This difficulty was recognised by Lord Wright in Young v Montreal Locomotive Works [1947] 1 DLR 161 at169 where he said, “In many cases the question can only be settled by examining the whole of the various elements which constitute the relationship between the parties”.

[17] Barrow, C. and Golzen G: (1994) “A Guide to Taking Up a Franchise”, London, Kogan Page, p40 where the authors point out that,” some contracts state that [the operations manual's] status is paramount over anything said in the agreement".

Operations Manual (the document that is normally issued to franchisees at the outset of the franchise)[18] . Thirdly, that the franchisor normally ensures that the franchisee adheres to the instruction as set out in the manual by reserving the right to carry out inspections of the franchisee's business to monitor compliance. A failure to follow the instruction manual is usually treated as a breach of contract.

There has been a franchise case in the UK where this "multiple test" has been employed. This was the case of *Ready Mix Concrete v Minister of Pensions and National Insurance*[19]. In this case the company dismissed its drivers, sold all its trucks to them and then re-employed them as "independent contractors" (franchisees). The contract specified that the drivers were to wear the company's uniforms, place their trucks at the company's disposal for a certain number of hours and obey orders from the company's foreman. The drivers were expected to pay their own tax and National Insurance, maintain their vehicles and pay all the running costs, and hire substitute drivers if and when necessary, to fulfil the Ready Mix contract. MacKenna, LJ held that the drivers were independent workers (outside the provisions of s1 (2) of the National Insurance Act 1965). In his judgement he noted that the obligation to do work subject to the employer's (franchisor's) control was not always a sufficient condition of a contract of service if other provisions of the contract were inconsistent with it[20]. The fact that the drivers owned their vehicles, bore the financial risk and had the power to hire substitute drivers confirmed their status as independent workers (franchisees).

It would seem therefore that the franchisor could resist the claims of a victim of a wrong on the basis of this case. However, it must be borne in mind that this case only concerned the relationship between the franchisor and franchisee between themselves for the purposes of allocating liability for National Insurance payments to the State. The case did not concern third party rights. Where third party rights have been at stake under the law of tort, the cases show that the courts are influenced by different considerations. Under English Law primacy tends to be afforded to the interests of the tort victim who needs to find a defendant with adequate resources to meet the compensation claim.[21] Thus, if the tortious act by the worker/ franchisee occurred within the scope of his or her employment, or for the purposes of the employer's business, that will normally be enough to settle liability on the employer/franchisor. As Selwyn (2004: p269) notes, "in recent years the courts appear to be gradually extending this principle of legal liability, and to that extent the distinction between an independent contractor and an employee is becoming possibly less important than before".

6. Vicarious liability of the franchisor: the American experience

Unlike other countries, franchising in the UK is not subject to special legislation[22]. Despite the size of franchise networks and their impact on jobs and the economy in Britain [23] , there is relatively little case law on the specific issue of franchising, particularly concerning third party rights under tort. For this reason it may be instructive to look at a common law jurisdiction where franchising has been a frequent issue in litigation, in order to estimate how the problem of torts committed within franchised networks may be handled in this country. The obvious place to look is America. This is so for two main reasons. Firstly, because the Americans developed the concept of business format franchising that is now used throughout the world[24] and secondly, because third party actions against the franchisor for the wrongs of the franchisee has been much more common occurrence there than anywhere else in the common law world.

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[18] [18] Felstead, op cit, p116-121

[19] [1968] 2 QB 497

[20] Lord Justice MacKenna in the case of Ready Mix Concrete v Minister of Pensions and National Insurance set out a three- point test to determine whether or not there was a contract of service between the parties, at p515.

[21] See Selwyn, N. (2004) "Employment Law" London, LexisNexis UK at p269-270. Selwyn gives the traditional reasons for vicarious liability being imposed. He explains that the employer, having initiated or created the situation where the employee has been in a position to cause harm, should properly bear the loss. The second reason he gives is that employee will usually be unable to meet any substantial claim for damages, whereas the employer will normally have the financial resources to provide compensation, or at least will be insured against such contingencies.

[22] The subject matter of this legislation is to ensure that the franchisor discloses all the necessary information about the franchise to prospective franchisees. The legislation is not concerned with third party rights. The countries that have disclosure laws include the USA, Alberta and Quebec in Canada and France. See Adams op cit p323 to 326

[23] A survey carried out on behalf of the Franchise Association for 1999 found that franchising had an annual turnover of £57.9 billion and employed 316,900 people directly in the UK.

[24] See Felstead op cit p39 for the origins of franchising. Although he traces the origins of franchising back to the Middle Ages in Europe, he identifies the origins of corporate franchising and the business format form of franchising to America.

6.1 The use of the employment analogy in America

To impose vicarious liability on the franchisor, the American courts have accepted the franchisor -franchisee relationship may be analogous to the master-servant relationship of employment law. One of the earliest cases to establish this principle occurred in a dispute concerning a petrol station franchise. This type of franchise was granted to an individual operator, called Schneider, by an oil company in the case of *Humble Oil &Refining Co. v Martin.* [25]

In 1949, the Humble Oil Company was found vicariously liable for the wrongful acts of its servant/franchisee when third parties were injured by the negligence of the petrol station staff. The facts were, briefly, these. Mrs. Love was told by garage staff to leave her car in the driveway of the garage. The garage staff said to her that they would move it from there to the workshop for repair. But they acted negligently when they failed to check that the hand break of the car was fully on, or that the gears were engaged. They were also negligent in leaving the car unattended for some time on an incline in the garage's driveway. The car rolled back down this hill on to the road, where it picked up momentum and crashed into a garden striking Mr. Martin and his two young daughters from behind just as they were walking up their garden path to their front door.

In its defence, the Oil Company contended that it was not liable for the injury to the Martin family because the franchisee of the petrol station was an independent contractor. To support its case, the Oil Company pointed to a term in the franchise agreement that clearly identified the franchisee as an "independent contractor". The Company also established that the franchisee believed himself to be an independent businessman and that the staff of the garage considered themselves to be employees of the franchisee (who dictated their terms of employment and paid their wages), and not employees of the oil company.

The Texas appeal court accepted that there were indeed elements in this franchise agreement that seemed to support the appellant's case, but the court also noted that there were other elements in the agreement, which would indicate the existence of a master and servant relationship. What tipped the balance in favour of the respondents was the evidence of the *degree of control* that the Oil Company actually exerted over the franchisee. The franchise agreement demanded that the franchisee, "make reports and perform other duties in connection with the said station that may be required of him from time to time by the Company". The agreement gave the Oil Company the power to dictate the franchisee's hours of work, as well as the type of products he could sell at the service station. In addition, it was established that the Humble Oil Company provided all the important station equipment and was the legal owner of the garage premises. It also paid a substantial part of the operating costs of the garage. The franchisee merely leased the petrol station from the Oil Company. Indeed, the court found that the only real area of discretion that the franchisee had was in the hiring and firing of petrol station staff.

The court concluded that: "all in all, aside from the stipulations regarding [the franchisee] Schneider's assistants, there is essentially little difference between his situation and that of a mere store clerk. Schneider was Humble Oil’s servant and so accordingly were Schneider's assistants who were contemplated by the [franchise] contract" (Klein & Ramseyer, 1997: 14). This extensive operational control exerted by the Oil Company over the franchisee's business justified the court’s finding that the Oil Company was vicariously liable to the Martin family.

In *Billops v Magness Construction Co., the Hilton Hotel and others*[26] (a case concerning assault and defamation), an American appeal court again found a franchisor vicariously liable to an injured third party for the wrongful acts of the franchisee. The appeal court found that the terms of the agreement between the franchisor and franchisee were so detailed as to amount to the subordination of the franchisee to the will of the franchisor analogous to a master and servant relationship. The court focused on the contents of the Operations Manual of the franchise. This manual regulated very many aspects of the daily operations of the franchisee's business. It dictated the franchisee's front office procedures, and its cleaning and inspection service for guests' rooms and for public areas of the hotel. It set the minimum guest- room standard, as well as the food purchasing and preparation standards. It determined the level of "brand name" stock the franchisee should hold and the Manual laid down the franchisee's staff and accounting procedures. The Operations Manual also dictated the level of insurance cover the franchisee should have.

Furthermore, to ensure that these prescriptive rules were followed, the franchisee was required to keep detailed compliance records for the franchisor's inspection. In addition, the franchisor had the contractual right to enter the franchisee's hotel, "to inspect the hotel so as to maintain the high standards and reputation of the system, the goodwill of the public, and compliance with the provisions of this Agreement [the franchise contract] and the Operations Manual" (Klein & Ramseyer, 1997: 40). Although there were other terms in the agreement which granted the franchisee some business discretion, such as the power to hire and fire hotel staff, the appeal court took the view that the franchisor was, in reality, exercising day-to-day operational control over the franchisee's business. This made the franchisor vicariously liable for the wrongs of the Brandywine Hilton Hotel.

[25] 148 Tex 175, 222 S.W.2d 995 (1949)

[26] 391 A. 2d 196 (Del. Sup. 1978)

There are other American cases that similarly focus the extent of the operational and managerial control exercised by the franchisor over the franchisee's business as the basis for allocating liability. Thus, in *Dorsic v Kirtin (1971)*[27], it was held that the franchisor's interference with the operational running of the franchisee's business, particularly by setting the business's hours of work made the franchisor liable to third parties. In *Drexel v Union Prescription Centres (1978)* [28] the detailed operations manual setting the methods of conducting business, including the level of inventory to be carried put the franchisor in a position analogous to a master and therefore made the franchisor vicariously liable.

In conclusion, when the American courts have used the master and servant analogy to decide whether or not the franchisor is to be held vicariously liable to an injured third party for the wrongs committed by the franchisee, the criterion of control has been crucial. It is only when the degree of control extends into the day-to-day managerial and operational functions of the franchisee's business will the franchisor be held to be vicariously liable. It is submitted that a similar approach may be adopted in Britain[29].

7. Is there scope to minimise the potential legal risks?

The problem for the franchisor in applying a reputation risk management system is that it involves extending its control over its franchisees to reduce risks. The greater the degree of the franchisor's control over the network, the more likely it is that the franchisor will be held vicariously liable for the franchisees' torts. However, it could be argued that if the risk management system is implemented and enforced correctly, it can actually reduce tort risk. If foreseeable hazards are identified and eliminated by risk management, the causes of many legal actions against the franchisee and the franchisor are thereby removed (although a low probability, but high impact wrong may still cause trouble for the franchised business).

The main issue facing franchisors is how to ensure the effectiveness of the risk management system within the federated structure of the franchise. The franchisees, as semi-autonomous businesses, may resent the extension of control by the franchisor over how they run their franchised outlets, particularly with regards to the costs and procedures associated with risk management systems. As a possible consequence, some of the franchisees may not fully cooperate with the franchisor. They may perform their risk reduction duties in a perfunctory fashion, so that there is the real probability of errors going undetected, which may give rise to legal liability later. To address this problem the franchisor may have to increase the monitoring of the franchisees and be more willing to take disciplinary action against reluctant or recalcitrant franchisees. But that would increase the costs of the franchisor and make its vicarious liability for any subsequent wrongs all the more likely.

7.1 The possible use of a management services company

One of the most promising methods by which the franchisor could attempt to introduce reputation risk management, and at the same time reduce the risk of vicarious liability, is to use a management services company to provide the risk management systems. The franchisor could contract with an existing company that offers these services or it could set up its own services company as a subsidiary company. This option offers the franchisor a number of potential advantages. The management services company could hire risk management experts to identify and quantify risks, spread best practice on risk control throughout the franchised network and monitor compliance with the rules designed to avoid or minimise risks. The management services company would therefore be able to exercise the control necessary to implement and enforce the risk management system and as a separate legal entity in law it would isolate the franchisor from the risks of vicarious liability (*Adams v Cape Industries plc*)[30] .

However, there are two problems with this option. The franchisor would incur additional costs either by setting up such a company and paying for its services, or by contracting with an independent management services company for such risk management services. But this may be acceptable and a price worth paying if it protects the brand, which is the franchisor's most valuable asset. The second problem may be more serious. By creating or engaging a separate company to manage risks through external intervention, the employees of the franchisor and the franchisees may not see risk reduction as being a core part of their own activities. These employees may regard

[27] 96 Cal Rptr 528 (1971)
[28] 582 F.2d 781 (1978)
[29] There is an interesting British case that might be of relevance. Hitchcock v Post Office [1980] ICR 100. In this case a shopkeeper running his own business had a contract with the Post Office to run a sub-post office from his premises. The Post Office exerted control over the security and financial aspects of the sub post office. Was this degree of control enough to make the Post Office the "master" and the shopkeeper, the "servant"? In this case the answer was, no. The managerial and operational functions of the business still remained with the shopkeeper. This fact confirmed that he was an independent contractor.
[30] [1991] 1 All ER 929

risk reduction as the responsibility of the service company's personnel and may not internalise the need to avoid or reduce risks whenever this is possible. But this is an organisational and management problem rather than a legal problem.

8. Conclusions

Reputation risk management can help to protect the brand, which is the most valuable asset of the franchisor's business. Risk management can also reduce legal risk of legal eliminating the most probable causes of legal liability. For these reasons it will be worthwhile for franchisors to introduce reputation risk management systems.

However, there are problems with such systems. In order to make the risk management system work effectively, the franchisor may have to increase its control over its franchisees. This may be resented and resisted and there is a danger that the system may be difficult to implement effectively in practice. Nonetheless, any attempt to increase control over the network (whether such attempts are efficacious or not) carries another type of risk for the franchisors. Increased franchisor control may make it easier for tort victims of the franchisees to establish vicarious liability on the part of the franchisors in those cases where there has been a failure to manage a particular set of risks.

It has been suggested that transferring the responsibility of reputation risk management to a management services company may reduce this legal risk. The services company would generally isolate the franchisor from the risk of vicarious liability. Whilst there may be organisational and managerial problems with such a strategy, it is still a promising one for franchisors to adopt.