The Law and Regulation of Franchising in Malaysia’s Islamic Finance Industry: Problems, Prospects and Policies

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Abstract

With the increasing expansion of the global Islamic finance industry beyond its traditional strongholds, there is a gradual increase in the global franchising opportunities in Islamic finance. As one of the pioneering studies on franchise in Islamic finance, this paper examines the Malaysian legal framework on franchising within the Islamic finance industry. Over the years, there has been tremendous growth in the franchise industry in Malaysia and the Islamic financial institutions are not left out in this welcome development. While the franchise industry contributed RM24.6 billion or 2.8% to the Malaysian GDP in 2013, it has been projected that such contribution will reach RM25.4 billion by the end of 2014. The study adopts a qualitative legal method in analyzing the relevant legislations, as they are applicable to Sharī’ah-compliant business of Islamic financial institutions. The study finds that there is no specific framework for Sharī’ah-compliant business in Malaysia, including Islamic finance business. Malaysia has vast opportunities in expanding its franchise industry through the amendment of the relevant legal framework to cater for Islamic finance business. This is expected to project Malaysia as a global hub for Islamic finance products and a destination for Sharī’ah-compliant franchise businesses at the global level.

Keywords: Islamic finance; Franchise; Sharī’ah-compliant business; Malaysia; Islamic law; Regulation of franchise

Introduction

With the increasing nature of demand and supply and the proclivity of the consumers to certain brands, franchising is gradually becoming the best option for quick and easy business penetration and expansion into new frontiers. The dominant effect of such cross-border business penetrations is gradually being felt in the global Islamic finance industry (Oseni, 2014b). Undoubtedly, customers and investors alike prefer certain global brands, even in the Islamic banking sector, that have over the years become tested and trusted, and as such, Islamic finance franchising is gradually picking up an unprecedented momentum. As a matter of fact, the halal branding has significantly paved the way for Islamic finance franchising in the last two decades. A GIF Magazine report reveals the top 10 franchises in Islamic banking and finance. These are: BarCap Barclays Capital, Noor Takaful, Dubai SME, Dubai Islamic Bank, HSBC Amanah, CIMB Islamic Bank, Methaq Takaful, Islamic Bank of Asia, Al Rajhi Bank, and Jordan Islamic Bank. While some of these financial institutions offer franchising in banking products, others venture into sukuk and takaful franchising (GIF Magazine, 2011). Though over the years a number of franchising has been taking place in the Islamic finance industry, there has not been much academic focus on this uniquely important aspect of Islamic finance. While previous studies have understandably focused on efficiency, marketability, product offering, and Sharī’ah compliance of products in Islamic finance, and more recently, dispute resolution and insolvency, there has not been much focus on legal issues relating to franchising (Oseni,
2012; Oseni & Hassan, 2011). On top of that, most of the existing franchise laws in Muslim-majority countries, including those in the Gulf Cooperation Council (GCC) region and Association of Southeast Asian Nations (ASEAN) are either based on civil law or common law. The implication of this on the Islamic finance industry is enormous; hence, the need to come up with a robust Shari‘ah-compliant legal framework that will regulate Islamic finance franchising (Oseni, 2013). With a specific focus on the Malaysian legal framework, this study examines the current legal framework for franchising and its suitability or otherwise for the Islamic finance industry. One may recall that on 27 July 2010, Malaysia established the Law Harmonisation Committee (LHC) under the auspices of the Central Bank of Malaysia. One of the terms of reference for LHC was to come up with laws that will help revise the relevant Malaysian laws as major reference for international Islamic finance transactions (Bank Negara Malaysia, 2013: 5). While other laws and court rules such as the National Land Code 1965, Companies Act 1965, Contracts Act 1950, and Rules of High Court 1980 have been closely examined and in some cases, revised accordingly, there is no mention of the Franchise Act 1998 in the recent report of the committee (Bank Negara Malaysia, 2013). Against this backdrop of the ongoing harmonisation of laws in Malaysia, and with a view to providing an acceptable Shari‘ah-compliant legal framework for the Islamic finance industry, this study begins with an overview of the existing legal framework for franchise business in Malaysia. The next section examines two major legal challenges facing Islamic finance franchising in Malaysia. Subsequently, the need for harmonisation of laws is discussed in the next section while considering a unique legal framework for Islamic finance franchising.

The Existing Legal Framework for Franchise Business in Malaysia

Although the principal legislation regulating franchising in Malaysia is the Franchise Act 1998 (Act 590) as amended by the Franchise (Amendment) Act 2012, other relevant substantive legislations include: the Contracts Act 1950 (Act 136) (Contract & Agency), the Copyright Act 1987 (Act 332) (Intellectual Property); the Trademarks Act 1976 (Act 175) (Intellectual Property); and the Patents Act 1983 (Act 291) (Intellectual Property). In the light of the foregoing legal framework, this section examines the existing legal framework for franchise business in Malaysia. Section 4 of the Franchise Act 1998, which is the principal Act, defines what a franchise entails. The extensive definition has been further revised by section 3 of the Franchise (Amendment) Act 2012 which defines franchise as:

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

Though the implication of the amendments in the light of current developments in the franchise sector within the context of Islamic financial services industry is discussed below, it suffices to note here that law reforms are often driven by change in the nomenclature of relevant transactions and the crystallization of franchising business, particularly in the 21st century.

The Malaysian Franchise Industry

With the release of National Franchise Development Master Plan (NFDMP) 2012-2016, the Malaysian government hopes to have about 650 franchisors and 6,050 franchisees by the end of 2014. In addition, NFDMP reveals that the country seeks to reach a record high of 15,710 franchised operating outlets by the end of 2014. Meanwhile, in boosting the contribution of the franchise industry to the GDP of the country, the country is putting necessary policies in place to ensure that the contribution of the total number of franchise sales to the GDP reaches 3.3% by 2014. A number of schemes have been introduced by the Ministry of Domestic Trade, Co-operatives and Consumerism to groom and attract potential franchisors and franchisees from all over the world. In 2013, 43 new franchisors were registered in different sectors. The relevant regulatory body in the franchise industry in Malaysia has introduced some incentives to encourage more franchises in the country. This has positively impacted the franchises approved under the existing legal framework.


Though relevant legal issues on franchising in the Islamic finance industry and some instances of non-compliance with Shari‘ah principles are examined in section 3 below, it suffices to give a general overview of the legal framework here. With a total of 61 provisions, there are seven parts in the Franchise Act 1998. They are: Preliminary (sections 1-4); Appointment of Registrar of Franchises, Registration, etc. (sections 5-17); Franchise Agreement (18-28); Conduct of Parties and Termination of Franchise Agreement (29-34); Franchise Advisory Board (sections 35-36); Offences and Penalties (37-41); Enforcement (sections 42-52); and Miscellaneous (53-61). The main objectives of this law include the need to protect both franchisees and franchisors. For the franchisors, the use of a restriction of trade clause in the franchise agreement is recognized by the law where the franchisee will not be allowed to conduct similar business during the pendency of the franchise agreement, and within two years after the expiration of the franchise agreement. On the other hand, the law seeks to protect the franchisees through mandatory registration process, operation of a cooling off period of a minimum of seven days, territorial right, a minimum of five year tenor for the franchise agreement, and the inclusion of a non-discrimination clause.

In the Malaysian franchise industry, some changes were introduced in the existing legal framework in 2012 with the enactment of the Franchise (Amendment) Act 2012 which came into operation on 1 January 2013. Apart from extending the scope of the Franchise Act 1998, the new amendments attempt to introduce a more stringent legal and regulatory framework for franchising in the country (Ling, 2013). But there has not been any move towards ensuring franchises involving Islamic finance business in the country are well regulated to reflect the original value proposition of Islamic financial intermediation. While the Islamic finance industry is highly regulated, it appears prospective franchisees and franchisors in the industry may have to rely on the existing franchise legal framework while compromising on some issues. In the new legislation regulating the Islamic finance industry in Malaysia – the Islamic Financial Services Act 2013 (IFSA 2013) – there is no mention of franchising since there is a totally different law that regulates such contractual arrangement.
Franchising in Islamic Commercial Law: Drawing Parallels?

In the contemporary Arab legal literature, franchise contract is commonly known as ‘aqd al-imtiyāz al-tijārī even though there is no direct correlative concept in classical Islamic law (Mohammed, 2012). Though it is generally believed by some contemporary researchers such as Al-Sa’awi (2011) that commercial franchise is Sharī’ah-compliant, Mohammed (2012) believes there are some Sharī’ah issues that need to be addressed, as such a contract does not appropriately fit into any of the Islamic law contracts utilised in commercial transactions. Though one would have drawn some parallels between the modern commercial franchise contract and goodwill partnership (shirkat al-wujūh) in Islamic commercial law, the two contracts seem to be different when it comes to the practical details of each of them. In defining a franchise, section 4(f) of the Franchise Act 1998 expressly clarifies that the relationship between a franchisor and a franchisee shall not be considered as that of a partnership. However, clause 3 of the Franchise (Amendment) Act 2012 clearly provides for the deletion of paragraphs (d) and (f) of the Franchise Act, 1998. The implication of such deletion of a provision that stipulates that a franchise shall not be considered a partnership within the context of Islamic finance business is far reaching. In a way, such a deletion may be considered by some as giving the legitimacy of such franchise contract in Islamic finance with special reference to partnership contracts mentioned above. Al-Ghalayini (1999) explains the relevance of franchising for market expansion in the modern Islamic finance industry.

The franchising concept generally allows expansion in a manner that allows more control over the new activity than in a strategic partner and requires fewer resources than acquiring an ongoing business. Franchising combines reduced utilization of resources with somewhat reduced risk. A relevant example of franchising would be a conventional bank acquiring a comprehensive Islamic product offering from an Islamic service provider in order to access the Islamic marketplace in a more efficient manner (Al-Ghalayini, 1999: 272). Franchising has been justified by some Muslim scholars while referring to the socio-economic benefit derived from such a noble cause which is realized through mutual cooperation encouraged in the Qur’an: ‘…..help each other in righteousness and piety, but do not cooperate among you in sin and rancour…..’ (Qur’an 5:2) (see GIF Magazine, 2013). While such a holistic approach to legalization of franchising within the ambit of Islamic might not be out of place, one needs to look deeper into the specific details of a typical franchise agreement. Such specific details require a firm grasp of the provisions of the modern franchise legislations and, of course, franchise agreements. Some of these challenges are discussed in section 3 of this paper with specific reference to the legal framework of the Islamic finance industry in Malaysia.

Some Legal Challenges facing Islamic Finance Franchising in Malaysia

A number of Sharī’ah-related legal challenges face franchising in the Islamic finance industry in Malaysia. For this section, references are made to the existing legal framework and some prevailing practices in the franchise industry. But it is important to clarify that under the general rule of permissibility (ibāḥah) in commercial transactions, a contractual arrangement involving franchising is permissible subject to some issues that need to be considered in the process of harmonisation of laws which is expected to snowball into a robust legal framework for Sharī’ah-compliant franchising in the financial industry. In order to realize this laudable objective, two significant legal challenges are identified: prohibition against similar business, and the unrestricted use of the Liquidated Assessment Damages (LAD) clause in franchise agreements. These two legal issues will negatively impact Islamic finance franchising if the necessary amendments are
not made to provide a unique framework for the Islamic finance industry.

**Prohibition against Similar Business**

There is a restraint of trade in section 27 of the Franchise Act 1998 which may not pass the fair trade test of Islamic commercial law. In this provision, the franchisee is restricted from carrying out similar business within two years after the expiration of the franchise agreement. The non-compete clause usually inserted in the franchise agreement is considered valid generally, as it is binding on the franchisee, but not enforceable against the staff or employees of such business outfit. Extending such restriction to the staff and employees of the business outfit will be considered arbitrary restriction of a person from exercising his or her right to engage in a lawful business or employment. The Competition Act 2010 (Act 712) prohibits anti-competitive conducts in business dealings, including, domestic and cross-border franchising agreements having some effects on the Malaysian market.

In the decision of a Northern Territory Supreme Court in *Murray Pest Management Pty Ltd v A & J Bilske & Ors* (2012) 165 NTR 28, such a strict restraint of trade was held to be void, particularly when the elements of the restraint are cast too widely. In Islamic law, market monopoly or *iḥtikār* is prohibited, and as such a similar analogy might be made of an unreasonable restraint of trade (al-Douri, 2000). Hasan (2007) aptly defines *iḥtikār* as “a single person or company being the only producer of a commodity either goods or service of which there is no close substitute available in the market.” This perfectly fits into the discussion on the two year statutory restriction on franchisees.

While Islamic law seeks to protect all parties, including the products and brand name of the franchisor, when a restraint is cast too widely to an extent when it becomes unreasonable, the Islamic legal maxim of “Harm may neither be inflicted nor reciprocated in Islam” (*lā ḍarara wa lā ḍirāra fī al-islām*) will prevail (al-Sabuni, 1982). There is an additional Islamic legal concept which prohibits any legitimate exercise of right which will have adverse effect on others’ rights (*sū isti’māl al-haq*). Hence, the default rule in Islamic law for a restraint of trade in a franchise agreement which takes effect after the expiration of the franchise agreement is void subject to some reasonable restraint that may be permissible under the law to protect the franchisor. An unreasonable restraint clause in franchise agreements will affect Islamic finance businesses since the products offered in the Islamic finance industry are quite unique.

**Liquidated Assessment Damages in the Franchise Agreement**

The common practice of stipulating Liquidated Assessment Damages (LAD) in the franchise agreement is a form of speculation or excessive uncertainty (*gharar*) which will not be proper in the case of Islamic finance franchising (Badawi, 2010). Apart from the speculative character of the LAD clause, it might also be considered to be unjustifiably exploitative when one considers the most common clause used in the Malaysian franchise industry which provides for a LAD amount equal to four times the Master Franchise fee preceding a breach. It is pertinent to however note that LAD is usually used in overseas Master Franchise/Licensing Agreement, and it is not applicable to local franchisees as the risk of the latter is smaller compared to the former; hence, the need for LAD clause in cross-border Master Franchise/Licensing Agreements.

In Islamic law of contract, at the time of concluding the contract, parties cannot stipulate an amount of damages payable to the inured party in the event of a breach of a fundamental term (Hassan, Kayed, & Oseni, 2013). Thus, damages are not usually predetermined or assessed in advance in Islamic law of transactions, particularly when it involves unquantifiable things such as intellectual property or goodwill.
of the business (Saleh, 1989). Therefore, the LAD clause will not perfectly suit the nature of Islamic finance business; and as such, it should be clearly proscribed under the proposed framework of Islamic finance franchising in Malaysia.

**Franchising in Islamic Finance Industry in Malaysia: The Need for Harmonisation of Laws**

While the proposed framework for Islamic finance franchising will require a distinct legal framework, the prospects of harmonization of laws sound more convincing when one considers the nature of the Malaysian legal system. Therefore, in structuring a distinct legal framework for Sharī'ah-compliant business, particularly in Islamic finance business, there is a need for some sort of Regulations to be issued by the regulatory agency to reflect the true spirit of Sharī'ah-compliant business (Oseni & Hassan, 2015). The Regulations may be made pursuant to section 60(1)(g) of the Franchise Act 1998 which empowers the Minister of Domestic Trade, Co-operatives and Consumerism of Malaysia to make such Regulations that will provide for such other matters as are contemplated by, or necessary for giving full effect to, the provisions of the Act and for their due administration.

In the light of the foregoing statutory backing, one cannot agree more with Mohd. Ma’sum Billah who suggested that an Islamic finance franchising framework should address the following ten principles of Sharī’ah that relate to such contractual arrangement: “(1) Exclusive division (Shariah compliant/Islamic Finance); (2) Conceptual understanding of Shariah (Maqasid al-Shariah) affecting the franchising of Islamic finance; (3) Regulatory frameworks (relevant Shariah rulings) governing the franchising of Islamic finance; (4) Shariah approved documentations (policies, guidelines, forms and procedures); (5) Technical know-how (with the Shariah standard) facilitating the franchise objective affecting Islamic finance); (6) Operational mechanisms (with Shariah compliance) for an effective management of franchise objective of Islamic finance; (7) Customers’ rights, obligations and behaviour as per approved by the Shariah principles in participating in, contributing to, cooperating with and benefiting from franchised Islamic financial operation; (8) Public awareness plan of franchising of Islamic financial system; (9) Shariah secretariat (Shariah compliance division with research and development); and (10) Shariah council (for advising and decision making)” (GIF, 2013). The above proposal will provide a good synergy for the ongoing efforts in the harmonisation of laws in the Malaysian finance industry.

Another important aspect of the proposed reforms is the need for a distinct and Sharī’ah-complaint framework for Islamic finance franchise dispute resolution. Since Islamic finance franchising involves financial transactions, there are bound to be disputes (White, 2012). In Malaysia, disputes arising out of franchising agreements are mostly litigated in the civil courts. Though the Franchise Act 1998 recognizes the relevance of disclosure document as part of the registration process, it however did not stipulate the relevant details that should be contained in such a document. As a guide, Article 6(2) (L) of the Model Franchise Disclosure Law 2002 of the International Institute for the Unification of Private Law (UNIDROIT) stipulates the need to provide for dispute resolution, including mediation and arbitration, in the disclosure document if such information is not included in the franchise agreement. In a similar vein, Part 4 of the Trade Practices (Industry Codes – Franchising) Regulations 1988 (made pursuant to the Trade Practices Act, 1974) of Australia provides for a complaint handling procedure which makes mediation mandatory for all franchise disputes and this must be clearly provided for in the franchise agreement.

From the Islamic law perspective, Islamic finance disputes, whether they emanate from a franchise agreement or not, should be handled
in a professional manner that will promote the original value proposition of Islamic financial intermediation, and such process should be Shari’ah-compliant. In Malaysia today, there are a number of dispute resolution bodies that are established to handle such Islamic finance disputes. For instance, the Kuala Lumpur Regional Centre for Arbitration (KLRCA) could easily arbitrate related Islamic finance franchise disputes under its i-Arbitration Rules 2012 (Revised 2013). Another forum for settling related disputes where experts in Islamic finance will be able to help is the Financial Mediation Bureau (FMB) subject to its jurisdictional limit (Oseni, 2009). In fact, the newly introduced Financial Ombudsman Scheme (FOS) in IFSA 2013 as contained in section 138 provides a good basis for a Shari’ah-compliant dispute resolution framework for Islamic finance franchise disputes in Malaysia (Oseni, 2014a). Besides, a Shari’ah-compliant dispute resolution framework will allow for the application of the principles of ta’wīdh (compensation for actual loss) and gharāmah (penalty for late payment) as contained in Order 42 Rule 12A of Rules of Court 2012 to late payment claims under franchise agreements to avoid the ribā (usury) element (Mohamad, 2012; Zakaria, 2013).

Conclusion and Policy Recommendations

With the increasing expansion of the Islamic finance products into new frontiers beyond its original strongholds, the franchise industry plays a significant role which cannot be discountenanced. Such benign role will be better enhanced when there is a strong legal framework that supports Islamic finance franchising. With particular reference to Malaysia, this study has explained the need for some strategic reforms in the law and regulation of Islamic finance franchising. As a matter of fact, Malaysia aims to be the global hub for Islamic finance in the world and it seeks to promote franchise businesses in the country in order to grow its economy as evidenced in the Tenth Malaysian Plan (2011-2015) and National Franchise Master Plan (2012-2016) respectively. Since the Islamic finance industry requires specific regulations, there is a need for a separate regulation for Islamic finance franchising which can be easily made pursuant to section 60(1)(g) of the Franchise Act 1998. The regulations should take into consideration some of the existing legal challenges discussed above in order to come up with acceptable rules that will reposition Malaysia as a choice destination for Islamic finance franchising. Future research in this field may focus on the imperative need for a separate regulation for Shari’ah-compliant franchising for the halal industry.

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