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Insolvency of a franchisor or franchisee- some considerations

Considerations for the Franchisor

Prior to the commencement of the Franchising Agreement

As a starting point, a franchisor should always conduct adequate due diligence on a franchisee during the pre-selection process, including from a financial perspective.

In that regard, there is a deal of information that is readily available in the public domain, including by way of searches of the records of ASIC, NPII/ITSA, the ACCC, the BSA (or other industry watch dogs), the Titles Office, the PPSR, Credit Reference Agencies, the Courts, the internet and social media, such as LinkedIn and Facebook.

In addition, a franchisor should seek to include terms that provide 'pre-emptive' protection in the event of the insolvency of the franchisee. Such terms may include financial reporting obligations which enable the franchisor to detect early signs of financial stress and inability to pay debts as and when they fall due. Such obligations can also assist in managing the risk of franchisee royalty fraud.

The Franchisor should also require an appropriate statement of solvency from a prospective franchisee prior to entering into a franchising agreement, which can address the usual indicia of insolvency, indeed the sorts of things a franchisor must disclose in respect of their own solvency under the Franchising Code (**the Code**) (which will be discussed below).

After commencement of the Franchising Agreement

The Code offers protection for franchisors in the event that a franchisee becomes insolvent after the commencement of a franchising agreement.

Section 23 of the Code provides that where a franchisee becomes ***bankrupt, insolvent under administration or an externally administered body corporate,*** the franchisor may terminate the contract immediately without having to comply with the prescribed notice procedure contained in sections 21 and 22 of the Code. Importantly, those insolvency scenarios involve a form of external appointment, rather than a franchisor's belief, rightly or wrongly held, that the franchisee may be unable to pay its debts as and when they fall due.

Often, though, franchise agreements will stipulate that other 'insolvency related events', such as a franchisee's inability to pay it's debts as and when they fall due, will amount to an insolvency default, justifying a clause 21 Notice to Remedy Breach.

So as to assist in identifying any early warning signs, a franchisor could also consider getting franchisees (such as builders) to report on the steps they take each year to ensure their licences to operate in their given industry.

It is also worth noting that in the event a franchisee becomes insolvent, it will be difficult for a liquidator to realise much if any of the value in the franchisee's business for the benefit of the franchisor and other creditors, on the basis that the franchisee's right to operate the business will usually (quickly) end upon their insolvency.

In such situations, the major objective of the franchisor is to ensure the integrity of the network is not adversely affected, a quick return by the franchisee of all intellectual property, and possibly a fresh start with a new franchisee, with a re-letting of any premises owned or head-leased by the franchisor. Franchisors, who are also landlords, should, in such situations, also be conscious of their right to terminate under their lease, and ensure they are consistent with those under their franchise agreement.

A franchisor should also weigh in mind the potential that an externally appointed administrator of a franchisee tenant may take matters into their own hands and seek to exercise various rights of disclaimer in respect of the franchise agreement and/or lease, or, on the contrary, that a voluntary administrator may seek to prevent a franchisor from re-taking possession of its premises during the course of the VA, which could frustrate attempts by a franchisor to mitigate its loss or damage.

The impact of a franchisee becoming insolvent may spread beyond the franchisee business to supplier relations, consumer perceptions of the network and the financial position of the franchisor. In addition to pre-emptive preventative measures, franchisors ought to have certain 'controls' or procedures in place to mitigate the ongoing effects of insolvency.

Considerations for the Franchisee

Prior to the commencement of the Franchising Agreement

A franchisor must provide a disclosure document in the form specified by the Code to the franchisee prior to entering into a franchising agreement.

The Code mandates that certain information regarding the solvency and past and present financial position of the franchisor be disclosed, to enable the franchisee to make an informed decision prior to electing to join or renew the business. In the disclosure document the franchisor must disclose, among other things:

(a) The relevant business qualifications/experience of all officers of the business (cl 3);

(b) Whether the franchisor or a director of the franchisor has been bankrupt, insolvent under administration or an externally-administered body corporate in Australia or elsewhere in the 10 years preceding the agreement (cl 4.2 and 4.3);

(c) Earnings information for the franchise (cl 19);

(d) A statement as at the end of the last financial year, signed by at least 1 director, whether in its directors' opinion there are reasonable grounds to believe that the franchisor will be able to pay its debts as and when they fall due (20.1)

(e) Financial reports for each of the last 2 completed financial years (20.2), or alternatively, an independent audit (20.3)

It is in the franchisee's interest to try to negotiate terms that address the risk of insolvency of the franchisor. As set out below, such pre-emptive terms may provide the only protection for franchisees, due to an existing lack of protection in the Code, although this may change depending on what happens with the current review of the Code.

After commencement of the Franchising Agreement

The Code contains no like provisions for the protection of franchisees, specifically no right to terminate the franchising agreement in the event the franchisor becomes insolvent.

While this may be detrimental to the interests of the franchisee, the inability of the franchisee to terminate enhances the opportunity a liquidator of the franchisor has to sell the business as a going concern, which will inevitably procure greater interest in the purchase of the business as a whole.

The insolvency of the franchisor will necessarily inhibit the movement of monies and assets of the franchise. As a consequence, the ability of the franchisee to run their business will be impacted to the franchisee's detriment, and a franchisee needs to consider what those likely impacts might be in advance of a franchise agreement, and seek to address them.

In the event the franchisor holds the head lease over the property used for the purpose of the franchise, this may be terminated by the head lessor upon solvency and cause the usurping of the franchisee business premises.

For any queries, or assistance with franchising matters, including in the context of insolvency, please contact Warren Scott on 03 9605 0984, Stephen Dickens on 07 3228 0445 or Tim Cox on 07 3228 0442.

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