Franchisor insolvency

The Angus & Robertson/REDgroup case* – highlighting the issues involved

1. A & R began selling books in 1886.

2. Only began to franchise its system in 1977.

3. In 1990, it merged with Bookworld - its first ever merger in over 100 years.

4. In 2001, it was purchased by WHSmith, who invested heavily in expansion.

5. In 2004, it was acquired by a venture capitalist, Pacific Equity Partners (PEP).

6. In 2009, PEP formed the REDgroup Retail Pty Ltd ('REDgroup'), and loaned REDgroup $138m to assist it in acquiring Borders, with the debt being cross-collateralised across the REDgroup [after ACCC cleared the way].

7. Later in 2009, PEP consolidated A & R, Borders and Whitcoulls book brands under the REDgroup umbrella. It was a very complex structure, with 18 companies and trusts across a number of countries. A company other than the franchisor also owned the trade marks. However, as a group, REDgroup had 20% of the Australian book market, but owed PEP $118m.

8. For year ended 30 June 2010, REDgroup reported a trading loss of $43m, and breached its financial covenants. The breaches were waived by its lenders.

9. Start of 2011, REDgroup had 260 bookstores. A & R itself had 185 bookstores, of which 124 were franchisor and 61 were franchisee owned. One third of Borders stores in the US were unprofitable, causing REDgroup to lose $2m per day.

10. In February 2011, Borders USA went into a Chapter 11 arrangement, and PEP appointed VAs (Ferrier Hodgson) over the REDgroup. REDgroup then owed $170m to creditors. No new gift cards were issued thereafter.

11. From March to June 2011, the VAs closed 42 franchisor owned A & R stores, and began to sell down the remaining assets. By June 2011, there were only 19 A & R franchisor owned stores and 48 franchisee owned stores remaining. To accommodate the sale of same, the VAs obtained an extension of the convening period for the 2nd creditors meeting.

12. During the sale process, the remaining franchisees could only sit back, and watch from the sidelines. They had no right to terminate under their contracts for franchisor insolvency, were in the hands of the VAs, and absent a sale to a new franchisor, faced an uncertain future. On the flipside, though, the VAs expected them to continue trading 'as per normal', but things were far from it.

13. When the VAs said they would not honour redeemed gift cards and began using company owned stores to sell books at heavy discounts, franchisees suffered a 50% decline in revenue.

14. As against that lack of support by the VAs, they were still expected to pay royalties and marketing contributions to the franchisor.

15. As a matter of public interest, the VAs had been keen to get all employees (as priority creditors) 100% of their entitlements, and the payments by franchisees together with stock realisations assisted them in ultimately doing that, but other unsecured creditors got very little.

16. Significantly, in the early phase, a group of about 25 A & R franchisees had formed an action group, and threatened to terminate the franchise agreements, so as to break away from the network and 'go it alone'. But in the absence of any right to terminate for franchisor insolvency, the franchisees would have had to argue a breach of essential terms. There was a question mark as to whether the lack of support by the VAs amounted to such a breach, and in the face of stiff opposition from the VAs, it was going to be a costly fight. The threats to terminate were subsequently resolved. It was critical to the VAs that they kept as many of the franchisees in the network as possible, to maximise value for sale.

17. A further flow on effect was that a number of Gloria Jean's stores, which had co-branded with Borders at 14 Australian locations, by way of licenses to occupy from the REDgroup, had to close. They had no proprietary rights in their particular premises, so no security of tenure, and depended somewhat on the Border stores for traffic.

[*Please note that the writer has drawn on the work of Jenny Buchan, in Chapter 8 of her book Franchisees as Consumers: Benchmarks, Perspectives and Consequences, 7 November 2012, Springer, Dordrecht ISBN 9781461456148, see pages 125 to 129]