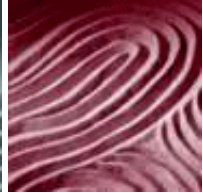
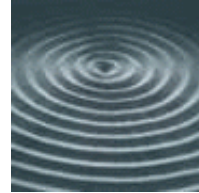
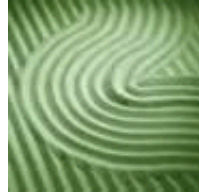


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The Insolvency of a Franchisee: How a Franchisor can Respond to it and Prepare for it

by Gordon G. Plottel
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THE INSOLVENCY OF A FRANCHISEE

How a Franchisor can Respond to it and Prepare for it

INTRODUCTION

No matter how carefully a franchisor selects its franchisees and no matter how much support and assistance may be provided, sometimes a franchisee's insolvency is unavoidable. It is essential, therefore, to respond appropriately to the fact of a franchisee's insolvency when it occurs. If a franchisor can maximize its financial recovery and minimize the negative effects on its system, the best can be made of an unhappy situation. More importantly, by planning ahead, the franchisor can prepare for the possibility of an insolvency so as to limit its immediate financial effects and its long-term effects on the system.

CONSEQUENCES OF INSOLVENCY

There are a variety of legal definitions of insolvency, for different legal purposes. However, in one way or another, they all relate to an inability to pay debts as they become due and an insufficiency of assets relative to liabilities. A franchisor will usually recognize a franchisee's insolvency by the failure to receive royalties and advertising fund contributions, or the presence of other creditors taking steps to recover their debts.

Furthermore, insolvency can bring about a variety of legal consequences. Some of these are as follows:

- (a) Receivership. A receiver can be appointed by a creditor, usually a secured creditor. The receiver's role is to collect and sell the assets (usually the secured assets) of the franchisee. A receiver-manager is a type of receiver that has the additional power to carry on the franchisee's business. However, most franchise agreements provide that an event of default occurs if a receiver or receiver-manager is appointed and, therefore, the franchisor would be entitled to terminate the franchise agreement if another creditor were to appoint a receiver or receiver-manager. Receivers and receiver-managers can be appointed by the Court, but they can also be appointed under the terms of the secured loan agreement. A franchisor holding security for its debts could also appoint a receiver to facilitate the recovery and realization of the franchisee's assets.

- (b) Bankruptcy. Bankruptcy is a legal status that can occur if the franchisee is insolvent and commits an "act of bankruptcy." The most common act of bankruptcy is the failure to meet liabilities generally as they become due. Most bankruptcies occur either because a creditor petitions the court to declare the franchisee bankrupt, or the franchisee voluntarily elects to assign itself into bankruptcy. The Court is not required to approve of a voluntary assignment into bankruptcy. A bankruptcy can also occur if a franchisee's proposal (see below) is not accepted or if the franchisee defaults on its terms.

- (c) Proposals. A debtor can make a formal proposal to its creditors under the *Bankruptcy and Insolvency Act*. A proposal is simply an offer by the debtor to satisfy his creditors, which the creditors vote to accept or reject. Before the proposal is prepared, and while the proposal is being considered, the franchisee will be immune from creditors taking steps to seize assets or obtain judgments or take other steps to seek remedies against him. *As well, contracts with the debtor cannot be terminated based on the insolvency, so a franchise agreement could not be terminated while the proposal was being prepared and considered.* Not all creditors

must accept the proposal for it to become binding on all creditors, but the court must also approve it and determine that it is fair and reasonable. Usually, proposals are designed to offer creditors a result slightly better than the result they would achieve in a bankruptcy, since if the proposal is not accepted by the creditors, or if the franchisee defaults on its terms, bankruptcy automatically results. A successful proposal will allow the franchisee to keep some of its assets and carry on business.

- (d) Companies Creditors Arrangements Act (CCAA). The CCAA is a process similar to a proposal in that it allows the debtor to keep its assets and hold off creditors while it prepares a debt restructuring plan. It has received much notoriety in recent years, but is unlikely to be available to many franchisees, as the threshold amount of debt is \$5 million before a company can invoke the protection of the CCAA.

BANKRUPTCY PROCESS

When a franchisee goes bankrupt, a trustee in bankruptcy will be appointed. The trustee in bankruptcy is a specialized form of accountant with certain insolvency credentials. The fees and expenses of the trustee are paid out of the debtor's assets, or "estate", before payments to creditors. If a creditor petitions a franchisee into bankruptcy, and there is some doubt as to whether the franchisee's estate will be sufficient to pay the trustee's expenses, the trustee may require a retainer from the petitioning creditor.

When a franchisee is bankrupt, no lawsuits can be commenced or continued against the franchisee for debt collection by the franchisor or any other creditor.

The trustee's role is to gather up the unsecured assets of the bankrupt franchisee, assess claims of creditors made against the franchisee, liquidate or sell as a going concern the franchisee's assets and distribute rateably to the proven creditors the proceeds recovered from the sale of the franchisee's assets. The trustee can also commence or continue lawsuits on behalf of the franchisee if he considers doing so will benefit the estate.

The secured creditors of the franchisee can realize on their security and need only resort to the bankruptcy distribution if they suffer a deficiency in their claims after selling the secured assets. Thus, the secured creditors only share with the unsecured creditors for that amount of their claims that remain unpaid after realization of their security.

Government claims, certain landlord claims, employee claims and other special classes of creditors enjoy certain preferences in the distribution of the assets in a bankruptcy.

FRANCHISOR AS SECURED CREDITOR

Why Take Security

As a secured creditor, a franchisor can obtain priority over unsecured creditors (such as trade creditors) to the franchisee's assets. In a franchise context, the security over assets that relate to the system are especially important. For example, a franchisor should ensure that it has control over specialized equipment or inventory that the insolvent franchisee may have. If a trustee in bankruptcy or receiver has access to important elements of the system, other franchisees or competitors could undermine the franchisor's control over the supply of such assets by acquiring them at discount prices from the trustee or receiver, or those assets could be seized and sold by creditors enforcing a judgment. Maintaining the integrity of the franchisor's system is crucial; therefore, every effort should be made by the franchisor to keep control over the key assets that an insolvent franchisee may possess.

How to take Security

A simple security agreement is all that is needed to take security over a franchisee's assets. Although there are advantages to having an elaborate agreement, even a short paragraph that establishes a security interest can greatly improve the franchisor's position in an insolvency situation. A provision giving security to a franchisor can be contained in the franchise agreement itself. However, it is better to provide for a separate security agreement, since combining it in the franchise agreement may result in the imposition of certain statutory obligations that could inadvertently apply to the entire franchise agreement.

If a security agreement is entered into, it is essential that notice of the security interest is registered in a Provincial Registry known as the Personal Property Registry. Failure to properly register can result in a loss of priority as a secured creditor. In particular, failure to register or a material

error in registration will allow a trustee in bankruptcy to ignore a franchisor's claim as a secured creditor, even if the debtor clearly signed an elaborate security agreement. Registration is a fairly simple and inexpensive process.

Security can be taken for any unpaid franchise fees, future royalty payments, advertising fund contributions or any other indebtedness that the franchisee may have at the time, or even in the future. Additionally, security can be taken in assets of the franchisee that it then holds, or may acquire in the future. No new agreements or registrations are required to take security in after-acquired assets if the agreement and registration are properly worded.

Priorities Between Secured Creditors

Typically, the franchisee will have financed its operation with financing from a bank. The bank will nearly always hold security in the assets. Therefore, if the franchisor purports to take a security interest and registers that interest, the bank will note that registration and propose that the franchisor subordinate its priority position to the bank's security. Obviously, if the franchisor can resist subordinating its priority, it will have first access to the assets. However, if the franchisee cannot obtain financing to establish the franchise without the bank taking priority on its security, the franchisor may have little choice but to agree to subordinate its security position.

It is still advisable to take security even if the franchisor must subordinate to the bank. First, the bank's claim may not exceed the value of the security, in which case the franchisor will obtain the residual realization value of the security after the bank's claim is fulfilled. Second, franchisors can make an agreement with the bank to buy at cost any inventory or specialized equipment should the bank seize those assets as its security. In that way, the bank will have a ready market for realizing its security, and the franchisor will avoid the bank's receiver or bailiff selling those assets at a discount to other franchisees or competitors.

THE FRANCHISOR AS AN UNSECURED CREDITOR

In Bankruptcy

An unsecured franchisor can make a claim in the bankruptcy of his franchisee for any arrears of royalties or other payments owing as of the date of bankruptcy, as well as a claim for the loss of the benefit of the remaining term of the franchise agreement. The benefits lost include the loss of the stream of future royalty payments, advertising fund contributions and possibly further unit franchises that may have been required to be established by an area developer. Further, if the franchisor is the sub-landlord, the franchisor will have a preferred claim in the bankruptcy for up to three months of arrears of rent, but only a regular claim for no more than three months' accelerated or future rent.

Even if the franchise agreement states that bankruptcy will terminate the franchise agreement, a franchisor cannot terminate the franchise agreement after the bankruptcy has occurred. The trustee is entitled to review the franchise agreement and can choose to disclaim the agreement, or to operate the franchise in an effort to sell the business as a going concern for the benefit of the creditors generally. Most well-drafted franchise agreements will provide that any assignment of the trade-mark and franchise rights requires the consent of the franchisor. Therefore, a franchisor will still maintain some control over the trustee's efforts to find a replacement. If a trustee operates the franchise, the franchisor is entitled to recover royalties and other payments called for under the franchise agreement from the trustee.

It is important for a franchisor to work with a trustee where the trustee is considering selling the business as a going concern. Indeed, the franchisor may be the best source of potential purchasers, either through existing franchisees or by its known pool of prospective franchisees. The franchisor may also consider purchasing the assets from the trustee directly and either re-selling to a new franchisee, or operating the location as a corporate site.

The franchisor should become an inspector in the bankruptcy. An inspector is a creditor who supervises the actions of the trustee. In that way, the franchisor will have more control and knowledge of the process and decisions of the trustee.

Receivership

A receivership will usually be an event of default under the franchise agreement. The fact of a receivership would not prevent the franchisor from being able to terminate the franchise agreement. The bank who has appointed the receiver will usually have priority, as a secured creditor, over the franchisee's assets. However, the franchisor would still retain its right to approve any assignment if the receiver sought to sell the business as a going concern.

FRANCHISOR AS HEAD OR SUB-LANDLORD

Trustee's Rights

Leases are treated specially in a bankruptcy. When the franchisor holds the head or sub-lease and the franchisee becomes bankrupt, the franchisor cannot terminate the lease unilaterally after the bankruptcy occurs. The trustee is entitled to take possession of the premises and can exercise the following options:

1. retain the leased premises for a maximum of three months (or until the expiration of the term, whichever is shorter). The trustee will owe the franchisor rent, called "occupation rent". The trustee would do this if he chose to carry on the franchise business in an effort to sell it as a going concern;
2. surrender the premises to the franchisor by disclaiming the lease. The trustee is entitled to enter the premises and assess them without becoming liable for paying rent;
3. assign the lease to a new tenant and franchisee. *This can be done even over the objection of the franchisor as head or sub-landlord.* The trustee can go to court and have the court order that a new tenant, who may not be acceptable to the franchisor, should be able to have the lease assigned to him. Although the franchisor is usually reasonably entitled to reject a purchaser as a new franchisee, the franchisor does not have that same right to reject a new tenant in a bankruptcy situation. Therefore, it is possible that the trustee could find a new

tenant that wishes to use the premises for some purpose other than the franchise system. In that way, a valuable location might be lost, and the franchisor could acquire a sub-tenant in an entirely different business. That business could even be a rival franchise.

Distrain

Normally a franchisor as head or sub-landlord can seize and sell assets of the franchisee that are on the premises if there is arrears of rent and the lease has not been terminated. That process is called distraint. However, if a bankruptcy occurs and the distraint is not completed (i.e. the process of seizing, appraising and selling the seized assets), the distraint cannot continue, and the Trustee will be entitled to take the seized assets for the benefit of the creditors generally.

However, if the franchisor relies on his security agreement to seize the assets, and does not need to rely upon a right of distraint, the franchisor will be able to keep those assets (provided he has priority for the security).

GUARANTEES

A well drafted personal or corporate guarantee of the franchisee's obligations can normally be enforced if the franchisee becomes bankrupt. Bankruptcy of the franchisee, as principal debtor, is one of the main reasons such guarantees are taken.

However, there are circumstances in which the franchisor can lose his right to pursue a guarantor in circumstances of insolvency.

One situation that can limit the right to pursue a guarantor of a lease or sub-lease is where there is a bankruptcy of the franchisee, and the trustee disclaims the lease. If the wording of the guarantee in the lease is not appropriate, the result can be that the disclaimer of the lease by the trustee terminates not only the obligations of the franchisee under the lease, but also the obligations of the guarantor of the franchisee under the lease. An astute guarantor, who is also a director of the corporate franchisee, can assign the franchisee into bankruptcy to bring about this result and thereby escape liability. Therefore, it is important that the wording of the

guarantee be carefully considered to ensure that recourse against the guarantor under the lease is not lost by virtue of a bankruptcy.

A second scenario that can limit recourse against a guarantor is where security is taken, but the priority to that security is lost, perhaps due to a failure to register. A guarantor is entitled to have assigned to him any security held for the debt. If, by an error of the franchisor the ability to assign that security is lost, the guarantor can claim that he has been prejudiced and, thereby, escape liability.

A third scenario affecting the ability to pursue a guarantor is where there is some variation in the financial arrangements between the franchisor and franchisee for which no express notice is given to the guarantor. The guarantor can then argue that the nature of the risk he has guaranteed has changed without his consent. This argument has succeeded even where the personal guarantor is the director and officer of the company that is the primary debtor and, thereby, the guarantor was in fact aware of the changes. It is essential that the personal guarantor, in his capacity as guarantor, consents to any changes. The sort of changes that would be important to have such consent for would include renewals, royalty increases, territory alterations, etc. It is a good practice for the franchisor to have a personal guarantor expressly consent to any amendment to the franchise agreement or sub-lease in writing.

ADVANTAGES OF BANKRUPTCY

When the bankruptcy of a franchisee occurs, a different legal regime applies. Some aspects of that regime are described above. However, there are some elements of the bankruptcy process that can be advantageous to a franchisor.

Priorities

The effect of a bankruptcy can alter the priorities amongst creditors. For example, if a franchisor is a secured creditor, its priority position over certain government claims can be improved in a

bankruptcy situation. For that reason, the franchisor may wish to petition the franchisee into bankruptcy so as to improve its recovery.

Attacking Franchisee's Transactions

A bankruptcy provides greater ability to attack transactions by which the franchisee may have disposed of his assets to its own shareholders or other "friendly" creditors. A trustee in bankruptcy has more powers than a private creditor to investigate and set aside such transactions, and the scope of vulnerable transactions is broader than outside of bankruptcy.

Uncooperative Franchisee

If there are appropriate grounds to petition a franchisee into bankruptcy, doing so may be a viable alternative to seeking an injunction against an insolvent franchisee who may be operating contrary to or in competition with the franchisor's system. By a bankruptcy, the trustee will take over the franchise operation and prove a more reasonable and cooperative party to deal with than the franchisee. The trustee's interest is to maximize recovery to the unsecured creditors, not to unfairly compete with the franchisor. A maverick franchisee will lose the ability to carry on the business in a bankruptcy.

PRACTICAL STEPS

In any insolvency situation in which a receiver or trustee has been appointed, it is usually preferable for the franchisor to work cooperatively with the receiver or trustee in bankruptcy. The receiver or trustee may well look to the franchisor to provide prospective purchasers of the business as replacement franchisees. It is always preferable to find your own replacement franchisee than to have one thrust upon you by a desperate trustee or receiver.

Additionally, the franchisor should quickly consider what legal rights it has to any available assets, by way of distraint or security. However, it is important to analyze the priority positions of the various creditors before steps are taken and money is expended that may prove to be fruitless.

If a trustee, or receiver-manager, is operating the franchise, even for a short time, it is important to work with them to maintain the integrity of the system. Undoubtedly, other franchisees will be concerned and will want to see that the franchisor is doing everything possible to minimize the effect of one franchisee's insolvency on the system as a whole.

Finally, the best practical advice for dealing with the insolvency of a franchisee is to consider these scenarios well in advance and ensure that your documentation and practices take into account the possibility of insolvency.

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