



FRANCHISE FAIL

Nicola Broadhurst and Angelica Lovell of Stevens & Bolton LLP outline the options when a franchisor goes bust

When franchisees sign up to a franchise agreement, they know there are risks, but they expect the franchisor to deliver what has been contractually promised.

However, even the best laid plans can go awry. If the franchisor experiences an insolvency event, the two burning questions for a franchisee are: “Can I carry on my business?” and: “How can I make the best of this situation?”.

If a franchisor is insolvent, it means its assets are insufficient to

settle its debts and liabilities. There are different options for an insolvent company, including administration, liquidation, a company voluntary arrangement and receivership. What mechanism is put in place with the franchisor will impact what options the franchisee can take.

If a franchisee relies on the franchisor to supply their products, fill their order book or manage the system, then clearly they may struggle to trade if the franchisor suddenly stops trading. However, this is often not as disastrous as it might

appear and well prepared, organised franchisees may be able to salvage more from the franchisor’s failure than they might expect.

IMMEDIATE IMPACT

Where a liquidator/receiver is appointed, this is usually with the intention of initially protecting the franchisor’s assets and then realising the greatest return.

The liquidator/receiver will often be obliged, in the place of the franchisor, to continue performing its obligations to the franchisees. This makes commercial sense, as the franchise



agreement represents a source of revenue for the franchisor.

TERMINATION OPTION

It's not standard practice for franchise agreements to include a right for franchisees to terminate on the insolvency of a franchisor or even the franchisor's material breach.

In the absence of an express contractual right to terminate, franchisees can seek to rely on a common law right (which exists separately from the contract) to terminate for the franchisor's material breach if the franchisor has failed to comply with its contractual obligations in a way that goes to the heart of the contract.

The insolvency of a franchisor would not in itself be sufficient, unless it meant a complete cessation of trading in such a way that the franchisee's business was severely impacted. Therefore, attempting to exercise this common law right without clear evidence of a material failure affecting the franchisee can be risky.

Even where a franchisee has the right to terminate the franchise agreement, they should consider whether this may do more harm than good. If the franchisee has gained experience in running the business, gains little from the franchisor's support or brand and feels ready to go it alone, termination may be a good option for them.

Franchisees must be careful to observe any restrictions in the franchise agreement that prevent them from competing with the franchisor after termination.

If it can be shown that the franchisee is entitled to terminate because the franchisor is in material breach, it's highly unlikely that the restriction preventing the franchisee from trading will be enforced, as this would permit a franchisor to benefit from its own wrongdoing, but any confidentiality obligations would still apply.

It's also possible that a legal challenge to such action may be mounted by a receiver or liquidator keen to preserve the assets for an onward sale.

Once the franchise agreement is terminated, franchisees cannot

use the intellectual property of the franchisor. This may pose a greater problem for some franchisees than others. There will also be cost implications for a franchisee in having to de-brand the business to remove all visible connection with the franchisor and create its own branding.

If the franchisee is terminating due to the franchisor's material breach, there is likely to be little chance of recovering any damages from the franchisor if it remains in financial difficulty or is wound up. Seeking to sue the franchisor for its breach will be costly and may ultimately be fruitless.

EXTERNAL BUYER

There is a chance that there will be an interested buyer of the franchisor's business, especially if the franchisees' businesses are relatively successful and it appears the franchisor's fate could be turned around.

If a buyer does acquire the franchisor's business as a going concern, the franchise agreements are typically assigned to the buyer, meaning the franchisee ends up with a new franchisor.

Most franchise agreements permit such an assignment without the need for franchisee consent. The new franchisor may bring fresh investment, enthusiasm and a new perspective to tackle any deep-rooted problems that contributed to the initial failure.

If the buyer is a competitor of the franchisor, this could also present challenges for franchisees. The buyer might request that the franchisees rebrand their businesses, which could be expensive and impact the goodwill the franchisees have built up locally.

Even if the franchisees do not rebrand, there could be other problems, such as where the buyer has its own franchisees or corporate owned units in the franchisees' territories.

If a franchisee has signed up to a particular franchise because it likes the people running it or their ethos, it may be disappointed by changes brought about by a buyer trying to put their stamp on the business.

The buyer may also make changes to working practices and fees,



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where allowed under the franchise agreement, which may be unpopular with franchisees who are happy with the status quo.

ABOUT THE AUTHORS

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FRANCHISEE PURCHASE

Franchisees will have knowledge and experience of the franchised business and this tends to make them well placed to apply to acquire the franchisor's assets from a liquidator/receiver and then continue without the franchisor's support.

To do so, one or more of the franchisees would need to acquire ownership of the franchise's key assets, such as the copyright in the system and operations manual and the trademarks.

If there are no other buyers, the franchisees may be able to drive a hard bargain with the liquidator and ultimately end up in a far better situation than they were previously.