Franchisor Insolvency in Australia: Profiles, Factors, and Impacts

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Franchisor failure is enduring and important in terms of cost, nationally and internationally. This article presents research into Australian franchisor firms that went into a form of bankruptcy protection known in Australia as “voluntary administration.” The research was driven by the commonality and divergence of the interests of franchisors and franchisees. The article provides an insight into franchisor failure and its effect on franchisees. It presents the substantial literature survey that was used to frame questions for franchisor administrators to understand issues associated with franchisors in administration. The limited data demonstrate diversity in the treatment of franchisees during the franchisor’s administration. In Australia, franchisees remain a captive, financially committed counterparty during insolvency and potentially deliver a great financial benefit to the franchisor’s creditors. The article concludes that administration of franchisors does not take into account the distinct relationship between franchisors and their franchisees and provides policy recommendations to address this matter.

Keywords: Australia, bankruptcy, business format franchising, franchise business processes, franchisee insolvency, franchisor failure, franchisor insolvency

Business format franchising is an important method of distribution of goods and services and, as such, is a form of marketing channel that is one of the exclusive subjects for articles in the Journal of Marketing Channels (2015). Business format franchising continues to expand throughout the world as evidenced by articles in this journal (e.g., Dant & Grühnhen, 2014). In Australia alone in 2014 (Frazer et al., 2014), there were 1,160
business format franchisors. There were an estimated 70,000 franchisee-owned business units. More than 460,000 people were employed directly in franchising. And with sales turnover estimated to be AU$144 billion, this sector is an important actor in the Australian economy.

Franchisees are key stakeholders in a franchise system. Franchisors protect themselves from the risk of being sued for engaging in misleading or deceptive conduct by warning their prospective franchisees that the success or failure of their individual franchisee business will be up to them. However, franchisees invest in what they believe to be the franchisor’s proven and solvent business.

In Australia, franchisors and franchisees are legally separate entities with some interests in common and others that diverge. Franchisors and franchisees rarely contemplate franchisor failure (Frazer & Winzar, 2005). The legal instrument designed to regulate the conduct of participants in franchising toward other participants in franchising is the Competition and Consumer (Industry Codes–Franchising) Regulation 2014, the Franchising Code of Conduct (“the Code”). Franchise agreements provide rights for franchisors on franchisees’ failure, but the Code ignores franchisor failure, and agreements rarely provide specific rights to franchisees on the failure of the system’s lynchpin, its franchisor (Buchan, 2013; Garrison, 2008).

The number of failed franchisors also masks the number of franchisees impacted by each franchisor’s demise. We contend that understanding the challenges and cost of franchisor failure is as important as understanding franchise success. The roles franchisees occupy within a franchise system (including, e.g., as suppliers of equity and borrowed capital to promote the franchisor’s brand, as suppliers of labor, and as takers of risk) and the potential for franchisees to be severely adversely affected by their franchisor’s failure give rise to questions that include whether the current positioning of franchisees within the insolvency regime as, typically, unsecured creditors, is appropriate.

The research question behind the research presented in this article was “What are the consequences of franchisor failure on franchisees?” As a result, the article focuses on failure studies. Franchise failure can mean either the collapse of the franchisor’s business or failure of the franchisee’s business (and sometimes both). The majority of research has concentrated on failure at the franchise-unit level, often comparing franchising with independent small business. Fewer studies have focused on franchisor failure. Also, there is a paucity of research about the effect of franchisor failure on franchisees, thus underscoring the research question.

This article commences with an extensive literature review as there does not appear to be such a review in the literature. First, the sporadic studies of franchisor failure that have been undertaken since the 1970s are reviewed, with the most important studies being acknowledged. The second theme developed in the article raises issues related to potential limitations in previous studies of franchise failure.

The article then moves to the theoretical perspectives of franchise failure. In particular, our discussion turns to whether the extent of franchisor failure is substantial enough to warrant further research. The theory section concludes that the impact of franchisor failure is far reaching and affects the health of the sector. The section of the article on results of research on franchisors examines the impact of franchisor failure on franchisees—an area that has largely been neglected in the literature—and assesses the vulnerability of the franchisee under such circumstances.

This article presents the effects of franchisors in administration in Australia. It finally provides a discussion of the findings before presenting some conclusions and recommendations for further work. The experience of the franchisor administration process, and the fate of most franchisees whose franchisors enter administration, is unknown and is the focus of our research.

LITERATURE REVIEW

Overview

The past few decades of research have concentrated on the unique characteristics of franchising, such as contractual arrangements, the nature of the franchising relationship, economic incentives for franchising, and expansion strategies. Most attention has been devoted to the positive benefits of franchising to the economy, small business, and consumers. Some researchers have also explored the negative aspects of franchising, including franchising relationship conflict (e.g., Spinelli & Birley, 1996; Tikoo, 2005; Weaven et al., 2010), the propensity for opportunistic behavior among franchisors and franchisees (e.g., Davies et al., 2011; Gassenheimer et al., 1996), asymmetry (e.g., Doherty, 1999; Lapiadera et al., 2012; Sen, 2001), and the incidence of failure (e.g., Castrogiovanni et al., 1993; Hunt, 1977; Ozanne & Hunt, 1971/2011).

This literature review on franchisor failure provides a synthesis of the current knowledge about this issue and identifies common themes and gaps in our understanding of this phenomenon. A multidisciplinary approach is taken to review the literature, including research from the disciplines of accounting, economics, entrepreneurship, law, management, marketing, and politics.
Introduction to the Literature

A central objective behind the initiation and operation of a commercial enterprise is to provide a financial return to its owners. In the franchisor context in Australia, this means a return to its shareholders. Choosing to establish a commercial enterprise as a vehicle to achieve a financial return is motivated partially by an expectation of a higher rate of return than that achievable by remaining as an employee. As market conditions and achievable returns on investment are not constant, the objective of financial return is sometimes constrained by the need to survive as an entity to make a future return. It could therefore be stated that the purpose of a commercial enterprise is first to survive and second to provide a return on input resources of capital and time that meets the shareholders’, and the financier’s, expectations.

The dual aims of survival and return have been brought into sharp focus during the global financial crisis. The franchise sector has not escaped the impact of that crisis (Einbinder & Dunn, 2011). One of the effects of this impact on franchising is some well-publicized franchisor failures (Gehrke, 2012a).

In franchising the initiator of the franchise, called the franchisor, and the entity that replicates the business system specified by the franchisor, called the franchisee, have fundamental interests that are in some respects alike and in others diverge. Both of these legally separate entities have a similar purpose in surviving and providing an acceptable return. Yet they cannot fully have the same purpose, as their business models are different, as are the expectations of each party. This divergence of purpose and expectation is likely to cause tension and reflects some of the risks and challenges that are inherent in franchising and the franchisor–franchisee relationship (Hoy, 1994).

Some of this tension is managed through the franchise agreement upon which each franchise relationship is based. The franchise agreement is a legally enforceable and complex contract (Justis & Judd, 2002) and is usually in a standard form (Spencer, 2008). The agreement is drafted by the franchisor’s legal advisors or representatives and offers little room for negotiation of changes by individual franchisees. Franchise agreements usually canvas aspects of the franchisor–franchisee relationship and will often provide a series of obligations on the franchisee in the case of the termination of the agreement by the franchisor or following the demise of the franchisee. The standard form of the franchise contract makes sense from the franchisor’s perspective as consistency of terms (for potentially hundreds of franchise agreements in a system) makes day-to-day administration of the franchise system more manageable.

However, the franchise agreement seldom addresses franchisor failure and its consequences or provides specific rights to the franchisee on the franchisor’s failure (Buchan, 2010, 2013; Garrisson, 2008). The franchisee rarely has a right to terminate the franchise agreement in the event of the insolvency or bankruptcy of the franchisor (Goldman, 2003). Indeed, exercising that right may seriously disadvantage the franchisee whose investment is in the system and brand, known within the law as the franchisor’s intellectual property, that the franchisor controls. Those same franchise agreements and valuable items of intellectual property will be viewed as assets with the potential to satisfy the insolvent franchisor’s creditors, irrespective of franchisees’ investment.

Consistent with the tenor of franchise agreements, franchises are bought on the basis of predicted success as was found in the review of the Code (Wein, 2013). The scale and the international reach of this apparent success has driven important research on franchising, although much of franchising research in the 20th century responded to a relatively narrow focus on the unique characteristics of franchising (Dant et al., 2011; Elango & Fried, 1997), particularly ownership-redirection theories (Dant, 2008). Relatively little research has been directed at commercial failure within franchises. We contend that understanding the causes and impact of franchise failure is as important as understanding franchise success.

To investigate franchise failure this article develops five important themes arising from an extensive examination of extant literature. First, it follows the somewhat intermittent debate concerning franchise failure from the early 1970s to the present by considering the important studies that span this period of time. The review then addresses some fundamental research problems constraining the debate on franchise failure that are identified by a consideration of those studies. We then assess the extent and significance of franchise failure to determine whether it represents a serious problem worthy of research or if its importance is more peripheral.

Having made this assessment, the article concludes by adopting a specific position in the debate by examining the impact of franchisor failure on franchisees and also assessing defensive strategies that franchisees might consider upon the failure of their franchisor entity. Future possibilities for theoretical and empirical research are indicated based on the outcomes of this review of literature. The review of literature thus framed is not only thorough and intensive but also is considered the first substantial attempt to complete such a review referencing franchising in the context of disciplines as diverse as economics, law, and media studies.

The Debate on Franchisor Failure

As early as 1971 franchise failures were noted in the literature, with 54 fast-food franchises having failed in
the United States (U.S.) during 1968–1969, thus spelling possible disaster for their many franchisees (Ozanne & Hunt, 1971/2011). Ozanne and Hunt (1971/2011), originally published in 1971, proposed that measures should be adopted to protect franchisees from franchisor ineptness and failure. Hunt (1977) repeated this assertion in noting that evidence was beginning to mount that many franchises were failing. This assertion by Ozanne and Hunt seemed to have resulted in a muted response as robust debate on franchise failure is not evident during the 1980s.

Bates examined survival patterns of franchisees as early as 1988 and offered an informed comparison of franchise failure with independent small business failure in his examination of business start-ups (Bates, 1998). By analyzing small firm formations from 1984 to 1987, he found that franchise discontinuance rates were “dramatically different” (p. 27) from those cited by media commentators, franchisors, and franchise associations. He cited Castrogiovanni et al. (1993) as academics who have maintained an expectation for lower risk when comparing franchises with independent start-ups.

Bates (1998) was critical of the assertion made in a study commissioned by the International Franchise Association that declared that 96.9% of franchise units opened in the U.S. in the previous 5 years were still in operation. He also cast doubt on the “conventional wisdom” (p. 26) in a statement in Business Week magazine that illustrated what a safe bet a franchise was by suggesting that a franchise had a 4 times greater chance to succeed than an independent business. From a sample of 1,276 franchise start-ups and 19,278 independent business start-ups, Bates found that franchise start-ups exhibited both higher rates of discontinuance and lower mean profitability than independent businesses.

Castrogiovanni et al. (1993) made one of the first methodical analyses of franchise failure. They considered that the primary referent for the risk of franchise failure indicated “that less than four per cent of all franchises fail each year” (p. 105). They sought to corroborate this assessment and isolate franchisor-specific factors influencing franchise failure rates, where a failure was defined as a closure within a franchise organization. Castrogiovanni et al. reported that data were collected from a random sample of 140 franchisors from an International Franchise Association directory because, as the authors noted, there was no central repository of franchisor information. They concluded that the annual franchise failure rate “most likely is close to 4 percent” (Castrogiovanni et al., 1993, p. 112).

In 1994 Hoy continued the argument surrounding franchise failure and observed that “franchising has received friendly attention in the media, both popular and academic” (Hoy, 1994, p. 26). Despite the title, his article was not aimed at profiling the dark side of franchising so much as using the predictive theory of Bull and Willard (1993) to find that there are risks as well as advantages inherent in franchising. He specifically identified the halo effect surrounding franchising in that the “widely heralded” (p. 29) low failure rate for franchises of less than 5% in comparison to independent small businesses is taken as a proxy for franchising being perceived as far more successful and less risky than independent businesses. He concluded that franchise failure rates were understated and independent small business failure rates were overstated. Hoy’s article did not reference Bates (1995) but did cite the related article of Castrogiovanni et al. (1993) in identifying a small study by Justis et al. (1992) that confirmed the low franchise failure rate of less than 5%.

Ozanne and Hunt (1971/2011), as well as Hunt (1977), identified franchise failure as a problem worthy of consideration and explanation and asserted that, although the franchise failure rate could not be accurately determined, it was much higher than previous estimates indicate. Castrogiovanni et al. (1993) departed from these views in confirming the low failure rate of 4% prevalent in academic and nonacademic assessments during the period of their study, although Bates (1995) and Hoy (1994) argued against Castrogiovanni et al.’s comparatively low assessment. Shane (1996) found franchisor start-up failures similar to nonfranchise start-up failures, thereby adding a slightly different dimension to the debate. Michael and Combs (2008) extended the debate in marketing channel research by investigating how franchisors affect franchisee failure, but only in established franchisors.

Shane (1996) published one of a series of articles that considered the survival of new franchisors. His research applied agency theory to determine whether organizational forms, such as franchising, allowed firms to grow faster and improved the likelihood of survival. Shane examined a sample of 138 franchises that first published franchise-offering documents in 1983 and analyzed their progress over 10 years. He asserted that his sample was representative of the population of U.S. franchises that started in 1983 and found that franchising enhances firm survival and growth. Shane also found that the failure rate of franchises was over 75% for the 10 years that he studied; he considered this similar to nonfranchise organizations.

The first decade of this century saw a repeat of the 1980s hiatus in the debate concerning franchise failure. The debate has been more evident in legal academic and practitioner journals than those from the fields of marketing, management, and economics. Tractenberg (2000) advised on what the franchise lawyer needed to know about bankruptcy. Tractenberg’s article is written to advise the franchisor on franchisee bankruptcy, but he suggested that similar strategies would apply to
franchisor bankruptcies. He also suggested that “knowledgeable drafting will yield dividends and more predictable outcomes in the event that bankruptcy is filed” (p. 7). Abell et al. (2009) also sought to advance understanding of insolvency, but again they advanced that understanding from the franchisor’s point of view on a franchisee’s insolvency. Einbinder and Dunn (2011) considered the franchisee’s position on the bankruptcy of the franchisor.

Perrigot and Cliquet (2004) commenced inquiry into franchisor failure outside North America by calculating the number of franchisor failures in France over a 10-year period. They provided an explanation of the bankruptcy process, examined the possible effect on a franchisee’s business, and offered practical recommendations to franchisees to respond to franchisor bankruptcy. Michael and Combs (2008) provided a contribution to the muted debate from the marketing channels perspective by analyzing 88 restaurant chains, focusing on the failure of franchisees and the use of agency- and resource-based theories to determine how franchisors affect franchisee failure. Michael and Combs specifically constrained their research to study franchisee failure in established franchises, thus avoiding franchisor failure entirely. It is perhaps telling that of 55 articles and reports referenced by Michael and Combs, only 9 were published in the current millennium and of these 9, none specifically addresses franchisor failure.

These studies, between 1971 and 2011, seek to explain different aspects of the complex process of franchise failure, yet many of their arguments diverge (e.g., as to the effects of failure) and not all are examining the same event (e.g., some examine the failure of the franchisor and others the bankruptcy of franchisees) or the same subjects (i.e., the economic analysis is likely to differ from a legal one). We will return to the events and subjects in the next section of this article.

Beyond the evidenced attempts to establish how many franchises, franchisors, or franchisees fail, franchisor failure has received little academic (Morris, 2006), practitioner, or government attention (Buchan, 2013). We assert that the divergence of approach in the cited studies reflects some of the fundamental research problems that have constrained the important debate on franchisor failure thus far.

Seven Fundamental Problems in Researching Franchisor Failure

Attempts to compare the findings of the studies by Ozanne and Hunt (1971/2011), Hunt (1977), Castrogiovanni et al. (1993), Bates (1995), Hoy (1994), Shane (1996), Tractenberg (2000), Perrigot and Cliquet (2004), Michael and Combs (2008), Abell et al. (2009), and Einbinder and Dunn (2011) highlight some of the fundamental problems confronting researchers of franchisor failure. We identify these problems to both inform the review of the literature and to establish parameters and constraints to condition a research design for future empirical research. We have identified seven such problems, setting them out next.

Meaning of “failure”. The term franchise failure demands clarification. Failure is a complex matter as there is uncertainty as to what franchise failure means. A franchise failure may refer to the failure of an entire franchise network (including the franchisor and all its franchisees), a failure of a franchisee, or a failure of a franchisor. It may also refer to a partial failure of any of the just mentioned aspects of a franchise. It may include failure that is rectified when it is followed by restructuring through a process such as the U.S. Chapter 11 process or Australia’s Deed of Company Arrangement (DOCA). The U.S. Chapter 11 is designed to provide a company with protection from its creditors as it reorganizes. The DOCA is a binding agreement between the company, creditors (but generally excludes secured creditors, such as the bank), the deed administrator, and the company’s shareholders. The DOCA has an effect similar to U.S. Chapter 11 protection and provides for debts to be compromised or paid over an extended period. A clear and specific definition of what is meant by franchise failure is essential (Eljelly & Mansour, 2001).

Timing. Having defined the concept of franchise failure, it is necessary to specify when a franchise failure occurs. Failure is unlikely to be a binary opposite to success; it is more of a process that spans a period of time. Failure may relate to a negative equity position, a loss of solvency, or liquidation. It is necessary to define that part of the life cycle of the selected franchise entity where failure is deemed to occur.

Geography. Although franchise failure has been researched in the United Kingdom (UK) (Lafontaine & Shaw, 1998), France (Perrigot & Cliquet, 2004), and Australia (Buchan, 2006b, 2010), most peer-reviewed articles on franchise failure are restricted to franchise failure in the U.S. The arrangements in these different jurisdictions may vary.

Research design. There are research design constraints in describing and specifying the population to be researched and the manner that the sample is selected from the identified population (Eljelly & Mansour, 2001). This may be due to the lack of centralized and complete information concerning franchises and the consequent reliance by academics and industry
commentators on databases that are sourced from representative and partial organizations as opposed to government-sourced data (Stanworth et al., 1997).

Data collection. There is uncertainty of data collection methods relating to the prevalent use of samples of existing franchise organizations, thus excluding failing or failed franchises (Hoy, 1994) and their franchisees and a further inadequacy in studies that collect data solely from franchisors, as they may be unwilling to report franchisee failure. Dant et al. (2011) observed that failure numbers at franchisee level can be masked by franchisors deciding to acquire underperforming units rather than allowing the franchisee to become insolvent. This further serves to “muddy the waters” in that it can distort failure figures and definitions.

Disciplinary differences. Hoy (1994) also observed that the references available to inform research on franchise failure were derived from the marketing literature and noted that research on franchising is thematically dominated by examining the franchising process through marketing channels. Hoy advocated a multidisciplinary approach using a wider range of theoretical perspectives that could be applied to analyze franchising including, but not limited to, legal theory, contract law, organizational theory, information theory, and financial theory. Dant (2008) echoed the need to think critically about the applicability of various theories to the specific context of franchising.

Terminology. Terminology is an ongoing source of confusion for franchise practitioners and researchers (Buchan, 2013, 2014a, 2014b). This problem is one that also confounds research into franchisor failure. Some studies refer to franchise failure but focus uniquely on franchisee failure, although other studies deal with franchisor failure, also terming it franchise failure. Yet others frame their research in terms of “success” but describe a success rate lower than 50% (Perrigot & Cliquet, 2004). Despite the media reporting on failure at a national level in Australia (e.g., Carter, 2013), there appear to be no studies that address master or area franchisor failure or their consequences.

The confusion over terminology does not end with the question of whose business failed. Failure itself is termed bankruptcy in U.S. law, whereas in other jurisdictions corporate failure is termed insolvency.

The initial, divergent presentation of arguments surrounding franchise failure, illustrated by the cited articles, and the fundamental problems affecting research on franchise failure, may have contributed to the observed decrease in the intensity and even the maintenance of the debate. It is possible that the strong growth exhibited by franchising in many of the decades since the 1950s (and in many countries) has resulted in franchising achieving excessively generous attention in the popular and academic media (Hoy, 1994) so that a halo effect has developed with respect to franchising. Although no causality is suggested between the friendly attention observed by Hoy (1994) and the absence of sustained and vigorous debate on franchise failure, it is noted that research on franchise-related topics that might have supported further investigation along initial lines drawn by Hoy have been conspicuously absent.

Response to the Seven Fundamental Problems

This literature overview specifically responds to the fundamental problems detailed previously by:

a. Specifying that part of the complex debate of franchise failure at which it is directed as the failure of the franchisor entity at the time the administrator is appointed. From that moment the franchisor directors cease to be in absolute control of the future of the network.

b. Defining the exact moment of franchisor failure as the time when an administrator is appointed to the franchisor entity. Corporate insolvency instruments are a set of statutory procedures that a company can move through, or be moved through, from a situation of financial stress to a resolution of that stress. In Australia, one of these is voluntary administration and this form of administration is distinct from receivership or liquidation.

The appointment of an administrator is the first of these statutory procedures that affects all of the debtor’s creditors and can be compared with the granting of a Chapter 11 status in the U.S. An administrator is appointed to determine whether the company is (1) able to be returned intact to the control of the directors, (2) restructured and returned to the control of the directors, or (3) put into liquidation. Strict time frames are accorded to each step in the insolvency process.

In Australia, for example, from the time the administrator is appointed, the first meeting of creditors must be held within 8 business days. Following the first meeting of creditors the administrator has up to 30 business days to evaluate the potential for the company, formulate a recommendation to creditors, and hold the second creditors’ meeting. At the second creditors’ meeting the creditors vote to pursue one of the three outcomes just mentioned as required by the Australian Corporations Act 2001, s 439A(1). Similarly, in the U.S., the Chapter 11 route
facilitates reorganization for companies in distress that believe continuing in business is a viable option.

The process allows the subject enterprise time to rearrange its business pursuant to a plan of reorganization so that it can exit bankruptcy as a viable, continuing operation (Einbinder & Dunn, 2011). This may involve a future for the company without franchisees.

c. Situating the current research within the Australian franchise sector and referencing internationally, thus not only progressing research on franchisor failure in the Australian franchise sector but also adding to the internationalization of the debate.

d. Establishing a data set. Research on the impact of franchisor failure on franchisees and the economy has been hampered by lack of data, the cost of buying data, and the difficulty of locating and interviewing former franchisees who are often financially and emotionally traumatized by their experience and do not wish to participate or are unable to participate in research for fear of breaching the nondisclosure contracts they have signed as a condition of exiting the franchise (Buchan, 2006b). They, like the Cheshire cat, often disappear from view with alarming speed when the franchisor fails (Buchan, 2006a; Gehrke, 2012a, 2012b).

This inability to access data as a base for empirical research has hampered the evolution of policy to address any deficiencies in the law (Buchan, 2013). This article identifies a population of failed franchisor entities by comparing successive Franchising Australia biennial surveys1 and identifying the franchises that ceased to exist.

This review has not restricted itself to one discipline. We have sourced empirical, theoretical, and practitioner-oriented articles from accounting, business organization, economics, entrepreneurship, finance, labor relations, law, management, marketing, public policy, and the business press. The Appendix summarizes the literature that has informed the review and provides a ready reference for other researchers.

Of the 66 publications identified in the Appendix, 16 are from Australia, 3 are from Canada, 1 is from Finland, 2 are from France, 1 is from Spain, 1 is from Sudan, 4 are multijurisdictional, 6 are from the UK, and 32 are from the U.S.; 26 are concerned with franchisee failure and 40 with franchisor failure. The discipline focus of the articles referred to is as follows: 2 from accounting, 12 based in the field of economics, 3 are by academics from within enterprise studies, 5 from entrepreneurship, 1 from finance, 2 from labor and urban affairs, 22 from law, 13 from management, 4 from marketing, and 2 are cross-disciplinary. The large number from law is likely to be a consequence of a number of legal practitioners taking an active role in writing in this field.

In addition to specifying the way that the seven fundamental problems identified are approached, this section of the article elucidates the particular consequences of franchisor failure on franchisees. We now turn to that topic.

The Importance and Extent of Franchisor Failure

One attribute of the business model is that franchisees outnumber franchisors (Buchan, 2013). Each franchisor has between one and thousands of franchisees. The average ratio of franchisors to franchisees is about 1:60 in Australia (Frazer et al., 2012). This ratio assumes that one franchisee operates one outlet, although multiunit franchisees are common (Buchan, 2013). It can be concluded that the complete failure of a franchisor entity is likely to have a domino effect on many of its franchisees.

In Australia, estimates of the size of the problem of franchisor failure are varied. McCosker and Frazer (1998) found that in the 6-month period from checking firm details in the Telstra White Pages on the Internet to follow-up of nonrespondents to a survey that they conducted, 127 out of 946 franchisor entities could not be located: they were presumed to be no longer operating. The Franchising Australia 2014 survey revealed that some 89 franchise systems ceased operating and a further 48 ceased franchising in the 2-year period from 2012 to 2014 (Frazer et al., 2014).

Connors (2010) speculated that there was a ratio of six franchisor failures to one success over a period of 20 years. Buchan et al. (2011) found that the Franchise Council of Australia’s Australian Franchising Yearbook and Directory 1999 (Franchise Council of Australia, 1999) listed 347 franchisors and of these 251 (72%) were no longer franchising by 2011. Although this assessment of 72% included franchisors that had exited franchising but possibly remained in business, many of the franchises in the assessment of 72% can be identified due to the public notification requirements surrounding insolvency processes. Eight identified franchisees carried the potential to seriously affect the survival or profitability of slightly less than 1,000 franchisee businesses.

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1The biennial Franchising Australia surveys have been published since 1998.
The identified franchises included Kleenmaid with 15 franchisees, Kleins Jewellery with 134 franchisees, Traveland with 270 franchisees, Beach House Group with 60 franchisees, Healthzone Limited with 80 franchisees, Refund Home Loans with 320 franchisees, Tyrecorp with 33 franchisees, and Worldwide Online Printing with 85 franchisees (Buchan et al., 2011). Any attempt to analyze the failure of franchisors in Australia suffers from problems similar to those identified in relation to data collection in the U.S. No public database of franchisors or franchisees is available in Australia, let alone those of failed franchisors; consequently, researchers must develop their own data sets.

In the U.S., Cross (1994) found that the only systematically compiled statistics on franchise failures have been provided by the Franchising in the Economy reports. These reports were produced up until the late 1980s by the U.S. Department of Commerce but have since been discontinued. Cross also cited periodic membership surveys by the International Franchise Association as a source of information on franchise failure but recognized that both data sets are based on potentially incomplete and inaccurate data submitted by franchisors.

Shane and Spell (1998) found that fewer than 25% of franchise systems begun in the first year of their longitudinal study were still around 10 years later. Blair and Lafontaine (2005) used U.S. Department of Commerce data from 1988 to report the number of franchisor failures and departures out of an estimated population of 2,177 franchisors in 1986. They assessed that a total of 104 franchisors operating 5,423 outlets failed during 1987. That the problem of franchisor failure is continuous in the U.S. is instanced by Einbinder and Dunn (2011), who named eight large and three small U.S. franchisors.

In the UK, Stanworth et al. (1997) could only describe one franchise in four as an unqualified success over a 10-year period; Lafontaine and Shaw (1998) observed that around half of their initial sample was judged to have failed completely and utterly. Similarly, in France, Perrigot and Cliquet (2004) studied 952 franchising networks during the period 1992–2002 and found that only 42.13% survived.

The studies we have just reviewed considering Australia, U.S., UK, and France indicate that the problem of franchisor failure is continuous, international, and important. It is of particular importance to franchisees that may have no warning of the impending failure of their franchisor. The failing franchisor will be unlikely to meet any of its contractual obligations to its franchisees (Einbinder & Dunn, 2011) and the franchisees will find little or no remedy in the franchise agreement (Buchan, 2010; Spencer, 2008).

Bankruptcy is most often an opportunity for a troubled company to solve its operational or financial problems and emerge as a more viable company. Bankruptcy provides a useful business tool for a company to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure. For example, bankruptcy may assist a franchisor in addressing the following challenging business issues: overexpansion in the market and the need to eliminate units, an unworkable equity structure, desire to sell or merge with another entity, threat of franchisee litigation. … (p. 1)

More than 40 years ago, Gilson (1971) noted that as “franchising matures during a torpid economy, trademark problems of failing franchisors are beginning to rise” (p. 467). The interrelated nature of the franchisor and franchisee’s business together with the pattern of contractual relationships that bind the franchise network are strengths that become weaknesses for franchisees if a franchisor fails. The standard form of the franchise agreement limits the ability of the franchisee to self-protect (Jenvey, 2006) and insolvency legislation, in existence long before franchising became popular, exposes the full extent of the franchisees’ vulnerability.
If a franchisor fails, there are important differences between the effects on the franchisor’s employees, suppliers, and independent contractors on the one hand and on franchisees on the other. Holding (1995) rightly observed that employees are vulnerable in their employer’s insolvency, but the law plays out even more opportunistically when franchisees are left out of the insolvency equation.

The “currency” that liquidators trade in is debtors and creditors, assets and liabilities: a franchisee may not be any of these to its franchisor. Eljelly and Mansour (2001) provided an example of how articles about business failure do not consider franchisees to be affected by such failure. They referred to business failure as being a subject of concern for many parties, including those who have a direct interest in the business (such as shareholders, employees, and creditors) and those who are less directly related to the business (such as regulators and governments). Yet a franchisee, although directly affected by a franchisor failure, does not meet the specification offered by Eljelly and Mansour and within Australian law may not be considered a direct stakeholder in the administration process.

Franchising is often promoted as being a less risky alternative to independent small businesses. In particular, first-time business operators often become franchisees because of the benefits attached to a recognized brand and the support promised by the franchisor. In Australia, consumer protection legislation within the Competition and Consumer Act 2010 (No. 51, 1974, Compilation No. 100) provides for a franchisor’s duty of disclosure through the Code. This includes the duty to provide a signed statement of solvency of the franchisor entity.

Empirical evidence shows that a surprisingly large number of franchisors do fail and that their franchisees may suffer grave consequences from such failure, notwithstanding the existence of the previously mentioned provisions. Neither franchisees nor prospective franchisees will be able to respond to a franchisor’s impending failure if they do not have access to reliable and up-to-date information on the franchisor’s state of solvency (Buchan et al., 2011).

Advance notice of the financial difficulties of the franchisor may be critical to the ability of the franchisees to organize and coordinate an effective strategy to deal with a pending insolvency. In re Country Style Food Services Inc (2002 O.J. No. 1377), Madam Justice Feldman of the Court of Appeal for Ontario, on an application for leave to appeal a court order approving a proposal under the Companies’ Creditors Arrangement Act (CCAA), wrote,

I note that the franchisees as a group were not considered to be people to be officially served with and included in the CCAA process. . . . Although the process under the Act contemplates the participation and protection of creditors, the debtor company and possibly the shareholders, in cases where the debtor company is a franchisor, the franchisees may have an interest in the ultimate structure of the franchise operation as proposed by the Plan process. . . . It may therefore be appropriate where a franchisor seeks CCAA protection, to consider whether the franchisees ought to be given notice of the proceedings and the opportunity to request the ability to participate on an appropriate basis. (Colraine, 2003, p. 14)

Prudent franchisors are able to shelter their personal assets through their structuring of their franchise system. It is much more difficult for franchisees to shelter assets as they need to convince the franchisor that they have sufficient funds for the purchase and operation of the franchise business (Buchan, 2008b). Existing franchisees may not be aware that the franchisor is experiencing financial difficulty. In the case of the Kleins Jewellery franchise, one franchisee noticed a substantial drop in stock deliveries that were controlled by a company related to the franchisor entity 6 months before the administrator was appointed (Buchan, 2008b). As a result, it had some advance notice of the appointment of the administrator although another Kleins franchisee had no warning at all from Kleins concerning the instigation of the insolvency process, receiving a brief notice directly from the administrator subsequent to his appointment. Another franchise entity in administration, Strathfield’s, did not consult with franchisees before the administrator decided on a course of restructuring (Thomson, 2009).

Not only franchisees but also their professional advisors (i.e., lawyers, accountants, and franchise consultants) may not be able to predict the future solvency of the franchisor. This was indicated by the National Australia Bank, described as Klein’s largest secured creditor, that was still identifying Kleins as one of its Accredited Franchise Systems on its website even after the administrator had been appointed (Buchan, 2008a). In any event, although the appointment of an administrator to a franchisor entity triggers a requirement under the Code that the franchisor advises the franchisee, it does not usually represent a breach of the franchise agreement. Thus, it does not give rise to an action for breach, and anticipatory breach is a difficult cause of action in Australia (Aitkin, 2012).

The number of franchisees at the time of the franchisor failure is often an underrepresentation of franchisees affected by the failure as many may have already left the network, disenchanted at the lack of franchisor support, slow stock deliveries, or other problems symptomatic of
the impending business failure of the franchisor. For example, Strathfield Car Radio was placed in administration at a time when it identified 75 outlets, some franchised, but 20 unprofitable stores had already been closed in the year prior to the administration process (Thomson, 2009). Similarly, pet shop retail franchise Wonderland of Pets had 10 franchisees at its peak but only 3 at the time it failed (Buchan, 2013).

The impact of franchisor failure on franchisees is shown to be potentially severe on a franchisee and the average ratio of franchisors to franchisees, internationally, predicts that this severity will be multiplied many times over. The impact of franchisor failure is exacerbated by the lack of protection that the franchisee has through the franchise agreement, statute, and common law. Although the impact of franchisor failure can be severe and legal protection for the franchisee’s business limited, the franchisee can sometimes implement some defensive strategies to avoid or mitigate the full effects of an impending or actual franchisor failure.

Defensive Strategies for Franchisees on Franchisor Failure

The probability of success for franchisee investors in the 3,000 plus franchise systems operating in the U.S. varies greatly by system (Wadsworth & Cox, 2011) and it is virtually impossible to predict a priori those that will succeed and those that will fail (Lee et al., 2011). These observations are fundamental to risk assessment, irrespective of national boundaries, but how does a prospective franchisee maximize the chance of his or her success within a particular franchise and avoid joining a franchise that may become involved in the administration process? Once joined, how does a franchisee advance the sustainability of their franchise business if the franchise entity to which they are enfranchised is trading poorly or becomes insolvent?

Many of the actions that may point to the likelihood of a franchisor entity’s poor trading or potential or actual insolvency need to be undertaken prior to making a commitment to the franchise by executing the franchise agreement. This requires thorough due diligence by the prospective franchisee and the franchisee’s professional advisors prior to commitment. It must be acknowledged that a franchisee’s ability to conduct due diligence ex ante or ex post also suffers from a lack of access to comprehensive, objective data.

Ongoing due diligence can be seen as a defensive strategy to facilitate the identification, as early as possible, of a franchisor’s poor trading or financial difficulty. These ongoing defensive strategies will increase in number and intensity as the financial and trading condition of the franchisor is observed to deteriorate. Australian courts have developed a set of 13 indicia of a company’s impending insolvency and Buchan et al. (2011) have noted franchise-specific indicia including

- a breach of a franchisor’s obligations to provide advertising support, equipment and inventory on a timely basis (Borradale, 2009; Colraine, 2003); an evasive answer to the franchisor’s queries when a franchisor default has taken place; a landlord’s notice of demand; or restructuring on the part of the franchisor. Where restructuring has been arranged for the franchisor company, the franchisees may see invoices from different companies (Hughes, 2011). Also, when the probability of company’s insolvency increases, both the operating costs and the revenues of the firm will be adversely affected. (Jensen & Meckling, 1976, p. 341)

A franchisee should investigate the franchisor’s accounting methods to determine whether or not the company is using generally accepted procedures (Cheng & Kregor, 1973). The franchisee should look for signs of the franchisor’s reduced liquidity and profitability. Various ratios, especially the current ratio and the asset-test ratio, should be accessed, provided that the franchisor is obliged, by agreement or by public listing procedures, to make them available. Attention should also be directed to the leverage of the company, as it may be heavily in debt. Analysis of these ratios and debts of the franchisor entity may assist the franchisee to identify possible financial problems for the future (Cheng & Kregor, 1973) or identify a trend earlier than would otherwise be possible.

Australian credit firm Dun and Bradstreet finds that companies that have had legal action taken against them are nearly 11 times more likely to fail than those that have not (Gome, 2008). Thus, willingness to resolve disputes through litigation may provide an early indicator of increased risk for franchisees. Disruption to supply chains, stock dumping, and diminished franchisor support are other indicators that the franchisor has financial problems (Buchan, 2006b; Gehrke, 2012b). Unfortunately, the restricted availability of accurate information concerning many franchisor entities, such as those that are proprietary limited-liability companies or trusts, makes it more difficult for franchisees to measure such risk accurately (Lafontaine & Bhattacharyya, 1995).

In the absence of such specific information, decision hierarchies wherein higher-level agents ratify and monitor the decision initiatives of lower-level agents and evaluate their performance can also limit damage to a franchisor entity. This implies observing if the franchisor entity has an appointed board of directors and developing an awareness of their qualities, qualifications, and experience. A board of directors, particularly one that includes independent directors, will establish an apex of decision-control systems wherein decision agents do
not bear a major share of the wealth effects of their decisions. An apex structure can also help to ensure separation of decision-management and control. Unfortunately such decision hierarchies are not common in franchises where the owner or owners of the franchise entity and the board are often the same (Fama & Jensen, 1983).

Franchisees also have a statutory right of association, certainly in Australia and Canada, and franchisees should use this right to pool information and formulate a strategy for dealing with the possible insolvency of the franchisor. Information, and the ability to act on it quickly, are of fundamental importance in insolvency, particularly when reorganization proceedings may be under way (Colraine, 2003).

It is possible that if the franchisor has a close relationship with its franchisees the franchisor may be able to avoid formal insolvency. This may be effected by a group of franchisees, with the franchisor, formulating a rescue plan that may include negotiating with the franchisor’s bank, landlord, and other creditors (Mackie & Owen, 2012). It is conceivably more likely that a group of franchisees will be able to support themselves, their franchise, and even their franchisor through the administration process compared with one or a number of franchisees working independently toward the same end.

Conclusions from the Literature and Theory

Franchising will continue to be a business model that crosses the boundaries between the corporate distribution model of the franchisor and the small (independent) business model of the franchisee. The impact of franchisor failure on franchisees remains under researched. Given that only two of the publications referred to in the Appendix reflect cross-disciplinary research and only a small number are cross-jurisdictional, we suggest that it is timely for properly funded multidisciplinary and cross-jurisdictional research to be conducted in the field of franchisor failure. Both the academic community and industry participants will benefit from a more comprehensive understanding of the complexities and nuances of franchisor failure.

This literature review and theory leads us to a clearer understanding of the potential problems for franchisees arising from franchisor failure as well as providing insights into franchisee failure. It forms a backdrop for our substantive research in Australia that is set out next.

OUR RESEARCH IN AUSTRALIA

Overview

The research undertaken in Australia was to explore the issue of franchisor failure and the flow-on effects to franchisees. This research focused on franchisors under administration. Throughout the period of administration, the administrator and franchisees are bound by the provisions of the Code enforced by the Australian Competition and Consumer Commission. The administrator also has statutory obligations under the law that governs the operation of businesses in Australia, known as the Corporations Act 2001 (Cth). This act is regulated by the Australian Securities Investments Commission (ASIC).

This dual regulatory oversight can cause tension. For example, some franchisees in the Kleins Jewellery franchise tried to exercise their right under the Code to request mediation with the administrator. Under the legislation that regulates the conduct of insolvency, the Corporations Act 2001 (Cth), franchisees have no such right.

Although the period of administration is ideally short, the opportunities created by the existence of franchisees can lead to the administration being prolonged. An example is found in the matter of Kleins when it was tried in an Australian Federal Court case. This results in considerable but undocumented uncertainty for franchisees.

During the period when a business is “in administration” there is a possibility it will exit administration and continue trading. For franchisees this possibility exacerbates the already pronounced information asymmetry of the franchisor–franchisee relationship. Once the liquidator is appointed the possibility of continued trading no longer exists and any ambiguity concerning the future of franchisees within the brand is past.

Data in our empirical study were sourced from administrators of franchisors. As a consequence, the research enhanced our understanding of franchisor administration by providing a better understanding of the impact of the franchisor in administration on franchisees and related stakeholders and by identifying tensions experienced by administrators in meeting conflicting statutory obligations.

Method

First, we listed franchisors that had self-identified as within the cohort of 1,025 franchisors (62,000 franchisees) in the Franchising Australia 2010 survey (Frazer et al., 2010) but that were not present in the corresponding cohort of 1,180 franchisors (65,000 franchisees) in the Franchising Australia 2012 survey (Frazer et al., 2012). That is, the comparison was drawn from data in each of the 2010 and 2012 Franchising Australia surveys. We identified 50 franchisors in the 2010 Franchising Australia survey found to have ceased franchising in the period from 2010 to 2012. These formed our primary sample.

On completing the data collection we discovered a further list of 55 franchisors that had declined to
participate in the 2010 survey. These formed our auxiliary sample. Although these were included in the number of 1,025 franchisors existing in Australia in 2010, they were not included in our primary sample. We subsequently reviewed the auxiliary sample to identify if there were further potential franchisors that had entered administration in that list. One of the failed franchisors (i.e., Strathfield) appeared in both lists.

Second, we sought to identify the individual administrators handling the administration of the sample franchisors with the intent of obtaining their contact details to conduct a survey about their experience in relation to the franchisor’s administration. Franchisors are identified by their trading name in the 2010 and 2012 surveys. The identity of the legal trading entity is not captured. Where we could discover the entity name, we grouped these franchisors according to their current legal and financial status—whether they had ceased trading, entered administration, become insolvent without entering administration, or were no longer franchising (and what their entity names were).

We could not verify the legal entity for 4 franchisors in the sample. A further 14 franchisors had been deregistered without appointing an administrator. That is, the research identified that some franchisors ceased trading without going into administration. (This may be by direct liquidation.) In these cases, it is not clear what became of their franchisees. As a consequence, they merit future investigation.

We then telephoned the identified administrators. In some cases we made two calls before we connected with someone who agreed to take a message or complete the survey. In two cases the relevant administrator had left the firm and no one felt able to answer the survey. In a small number of cases no one answered the phone. Fifteen administrators initially agreed to answer the survey and one of them subsequently declined. Eight responded and this sample size permits us to make only very tentative conclusions (see Table 1).

**Findings**

All eight administrators notified the franchisees of their appointment. The balance of this section sets out their responses.

**Business continuity.** When asked, “If you were appointed as receiver, was an administrator subsequently appointed?”, two replied in the affirmative, three in the negative, and three did not respond. The appointment of an administrator after a receiver suggests that either there was some prospect of recovery from insolvency or that there were certain assets over which a secure creditor was asserting an interest.

When asked, “Did you seek a time extension for the convening period of the second creditors’ meeting?”, three replied in the affirmative and five in the negative. All three extensions were granted for periods ranging from 90 days to a few months. In each case, the franchisees were notified of the extension. In each of the three cases, the reason provided to the Court was to maximize the possibility of selling the business (including the franchise network) as a going concern. These responses indicate that the administrators were trying to maximize the opportunity to sell the franchisor as a going concern, but the effect of this may or may not be to the benefit of franchisees.

When asked, “Did you obtain a list of franchisees when you were appointed?”, seven of the eight administrators answered in the affirmative. The one respondent who did not obtain a list initially did not subsequently attempt to acquire a list of franchisees because the company advised that it had only two premises. These responses indicate that the administrators recognized

<table>
<thead>
<tr>
<th>Solvency status</th>
<th>Cannot verify legal entity</th>
<th>Verified but not in sample</th>
<th>Could not identify administrator</th>
<th>Could not contact administrator</th>
<th>Surveyed no response</th>
<th>Surveyed and responded</th>
</tr>
</thead>
<tbody>
<tr>
<td>In administration between 2010 and 2012</td>
<td>3</td>
<td>0</td>
<td>2</td>
<td>10</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Deregistered between 2010 and 2012 without entering administration</td>
<td>1</td>
<td>13</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Insolvent before 2010</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ceased trading, deregistered before 2010 or after 2012</td>
<td>0</td>
<td>7</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Still trading</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
the importance of the franchisees, even if only as prospective unsecured creditors.

When asked, “How did you communicate with the franchisees during the administration/receivership process? (More than one response may be selected)”, the answers were as shown in Figure 1. The figure suggests that franchisees were not contacted directly to a great extent and were likely to have been treated as if they were merely unsecured creditors.

When asked, “Which of the following strategies did you adopt?”, the answers were as shown in Figure 2. In Figure 2, the term “Other” indicates termination of some franchisees and sold the franchisor and its arrangements to new operators not associated with old directors and receivership—all franchisees debadged.

The effect of both of the “Other” outcomes was the loss of the franchise by the franchisees. The extent that the liquidation option was applied suggests little opportunity for franchisees to protect their businesses in other ways.

When asked, “Were all franchise agreements treated in the same way?”, there were three positive responses and five administrators did not respond. When asked, “Did the franchisor hold the head lease for a majority of franchisees?”, there was one affirmative response, two negative responses, and five administrators did not respond. When asked, “What action did you take in relation to the leases?”, the answer was that they were transferred where possible. Where the decision was made to terminate the lease of an individual franchise, the administrators used the liquidation of the company (franchisor) to break the lease. The affirmative response and the approach to breaking leases confirms the difficult position of franchisees without their own property interest in the event of franchisor failure as set out next.

Two administrators confirmed that they specifically invited the franchisees to make an offer for the franchisor’s business, one did not make such an invitation, and five did not respond. The potential for an administrator to sell the franchisor’s business to either individual franchisees or to a joint venture of franchisees is a little explored option that could potentially be beneficial to both the franchisees and to the other creditors.

There were a variety of responses as to why a liquidator was appointed. They were that company was trading insolvent; no DOCA was proposed; there was no DOCA presented and the company was insolvent, hence winding-up was the only option available; no proposal for a DOCA and company was insolvent; and the underlying businesses of the companies had been sold, preserving the businesses and the majority of employees in the hands of a new (properly capitalized) business.

A concern that had been observed in earlier research (Buchan, 2010) was that in some cases franchisors had continued to sell new franchise units even though they themselves were insolvent. In at least one previous case the franchisor had knowingly been trading insolvent for longer than 12 months and had continued to sell franchises during this time. Three of the eight administrators replied that there was evidence that this behavior was present in the franchises they were administering.

The sale of franchises gives franchisors access to immediate cash in the form of fees for franchises and, in some cases, payment for options to open future outlets. A franchisor facing the prospect of insolvency that is a head tenant may collect rent and outgoings from the franchisee subtenant but pay it to a “squeaky wheel” creditor rather than to the landlord. This puts the franchisor, and thus the franchisee, into default under the lease.

**Trademarks.** One of the most valuable assets a franchisee gains is a license to use the franchisor’s trademarks, but franchisors do not always own their own
marks. Consequentially, the franchisor might lose access to the marks through having breached the relevant license by becoming insolvent. One of the eight franchisors in the sample did not own its own trademarks. This response is at odds with previous research findings about trademark ownership (Buchan, 2009) and merits further investigation as it presents a further risk to franchisees.

Statutory obligations. Franchisors have statutory obligations under the Code. An administrator in theory assumes these obligations that only end when the liquidator is appointed or the company is put back into the hands of the directors. We asked the administrators, “How did you manage your statutory obligations under the Code during the administration period?” Four answered this question.

One answered, “Through careful advice as to our obligations and ensuring we worked to protect the overall franchise and maintain the value of the group.” The second answered, “By ongoing reporting to the franchisor and providing some underwriting of franchise losses during the receivership to hold the network together through the sale process.” For the third the Code was not seen as relevant as the business ceased to trade upon the appointment of the administrator. The fourth stated he or she had operated in full statutory compliance. (This last response was ambiguous but we assume that the administrator was confirming compliance with statutory obligations under the Corporations Act 2001 (Cth) as breach of these obligations would create a personal liability for that administrator.)

All eight administrators notified the franchisees of their appointment. Three of the eight were initially appointed as receivers. Of those, one franchisor subsequently had an administrator appointed.

Under s 436E Corporations Act 2001 (Cth), the first creditors’ meeting must be convened within 8 business days of the administrator’s appointment. The second creditors’ meeting is generally required to be held within 20 days of the appointment of the administrator but the court has discretion, under s 439A(6) of the Corporations Act 2001 (Cth), to delay this meeting if the administrators provide compelling reasons. Two of the eight administrators sought an extension of time for the convening of the second creditors’ meeting. The meeting time was extended by 90 days in one case and several months in the other. All franchisees were advised of the extension.

Communication between administrators and franchisees. Although franchisees are stakeholders in a franchise system to the extent that the franchise agreements will be assets or liabilities, franchisees themselves are not always creditors or debtors. Accordingly they may not be in direct communication with an administrator in the same way as, for example, creditors would.

As four of the five administrators obtained a list of franchisees when appointed, we asked them what methods they used to communicate with franchisees during the administration. More than one method could be identified. Two administrators communicated via direct meetings with franchisees, four issued releases on the administrator’s firm’s website, and/or three communicated through a franchisee committee of creditors. Four administrators communicated via correspondence (including e-mail) and one administrator did not communicate with franchisees directly.

Real property interests. It is common for landlords of shopping centers to require franchisors to hold the head lease. In this situation the appointment of the administrator to the franchisor would potentially entitle the landlord to terminate the head lease and would place the franchisee’s tenure as subtenant/licensee at risk. This may not be a default event under the franchise agreement. We asked, “When no liquidator was appointed, did the franchisor hold the head lease for a majority of the franchisees?” Three responses were received: one “yes” and two “no.”

Franchisee as creditor. Three of the administrators answered the question “Were any franchisees creditors of the franchisor?” All answered “no.” In those cases the franchisees were debtors of the franchisor. In two of those cases the administrator specifically invited the franchisees to make an offer to buy the franchisor’s business; the third administrator did not make that invitation.

Post administration. The failure of the franchisor is not always a death knell for its franchisees’ businesses, so we asked whether the franchisees continued trading. In one case all did, in two cases some did, in two cases none did, and the final three administrators were unsure.

Data on public record. The report completed to comply with s 439A Corporations Act 2001 (Cth) is the major report to creditors wherein the administrator sets out the progress of the administration, makes recommendations, and seeks the creditors’ input on the administrator’s proposed strategy for the company. Our understanding is that the s 439A report is automatically provided to all creditors but is not filed with ASIC unless ASIC itself is a creditor. This means it cannot always be obtained from the regulator via a (paid) search.

Some firms providing insolvency services routinely provide access to the s 439A report, along with all other communication relevant to the administration, via their
websites: most, however, do not maintain such comprehensive websites. Of the eight in our sample, four provided us with a copy of the s 439A report and one declined to do so.

Although we did not survey the administrators of the auxiliary sample of 55 franchisors, we did search the company records for as many of them as we could identify. Interestingly, 23.6% of these 55 were no longer in a position to accept notices by the time we conducted our research. This compares with 4.4% of the franchisors who did participate in the Franchising Australia 2010 survey (Frazer et al., 2010). When the two groups are combined this brings the number of franchisors identified in the Franchising Australia 2010 survey (i.e., 50) and those subsequently entering administration before the Franchising Australia 2012 survey (Frazer et al., 2012) was conducted (i.e., 55) to 105 (10.2% of the population of 1,025 franchisors reported in the Franchising Australia 2010 survey).

The median number of franchise units in a system was 22 in 2009 although nearly a third of systems had 50 or more franchisee-owned units (Frazer et al., 2010, p. 27). In 2010, start-up costs for franchised units ranged from AUS$1,600 to AUS$1.2 million (Frazer et al., 2010, p. 47), with the average for those operating from retail premises AUS$275,000. Readers will quickly appreciate the multiplier effect the administration of each franchisor has on franchisees, their financiers, and landlords.

**DISCUSSION**

Few prospective franchisees would consider the prospect of the failure of the entire franchise system prior to entering the franchise agreement. Although in Australia the Code now requires a Risk Statement to draw attention to the possibility of franchisor failure, the concept of risk is far removed for an inexperienced franchise investor. Gatekeepers, however, are often in a position to know how profitably a business is trading. In franchising gatekeepers include funding bodies making a decision to fund a venture, regulators, accountants authorizing franchisors to confirm they are solvent, lawyers, retail landlords, and industry bodies promoting franchisor members.

Franchisees are faced with a dilemma, in that, although they may have negotiated an _ipso facto_ clause providing a right to terminate the franchise agreement in the event of the insolvency or bankruptcy of the franchisor (Goldman, 2003), such a termination may seriously disadvantage the franchisee whose investment is in the system and brand (including the franchisor-controlled intellectual property) and its own franchisee-owned outlet. Those same franchise agreements and franchisor’s intellectual property are assets with the potential to satisfy the insolvent franchisor’s creditors, irrespective of franchisees’ investments. The franchisee has funded the purchase of the outlet and needs it to continue to generate income.

As we have shown, the scale and international reach of franchising has inspired considerable research on the model. Research in the franchise failure area has, to a great extent, concentrated on failure of franchisees, often comparing franchising with independent small business. Fewer studies have focused on franchisor failure. Moreover, there is a paucity of research about the effect of a franchisor’s failure on its franchisees.

We do not have enough evidence at this preliminary stage of data collection to arrive at conclusive findings. But even our limited data demonstrate the considerable diversity in the treatment of franchisees during the franchisor’s administration.

Where administrators secure extra time from the court to conduct the administration, this enables them to negotiate with parties interested in purchasing parts of the troubled business. A franchisor in administration seldom follows the path of being returned in its original form to its original directors. The appointment of an administrator also places the franchisees in a state of limbo for the duration of the extended administration as franchisees remain bound by their franchise agreement until a liquidator disclaims it as an onerous contract (Buchan, 2013). Under the Corporations Act 2001 (Cth) s 568(1) liquidators (but not administrators) have the power to disclaim onerous contracts. This means that the franchisees are a captive, financially committed counterparty.

Where franchisees are the lessees of their premises they impose little burden on the administration but potentially deliver a great financial benefit to the franchisor’s creditors (Buchan, 2013). They are, for instance, a motivated sales force for the franchisor’s unsold stock. As there is a chance they might be able to stay in business following a successful sale of the system or may be released to rebrand independently, franchisees have an incentive to treat their own customers well so as not to lose them to competitors.

We are not aware of the courts seeking input from franchisees as to whether to grant extra time for the administration. Although a court needs to be satisfied that the extensions would benefit the franchisor’s creditors, the franchisees themselves would not have standing to inform the court of the potential impact of these extensions of time on their businesses. In the context of the application to court, the franchise agreements, intellectual property rights, and premises leases/subleases are assets or liabilities on the franchisor’s balance sheet.

Where franchisees are not creditors they will have no statutory right to attend creditors’ meetings, even
though they do have a vital interest in the progress of the administration. It is interesting to note that one of the eight administrator respondents did not have a list of franchisees: further investigation would reveal whether the franchisor itself had a current list. It could also be used to reveal whether the franchisees participating in the committee of creditors passed information about the administration to noncreditor franchisees.

The nature of the franchise model means that franchisees are likely to be widely dispersed across a country or even dispersed internationally. This makes face-to-face meetings difficult. In earlier research some franchisees reported only hearing about the administration through the media (cf. Buchan, 2006b). This leaves them with many questions. Communication throughout the administrator’s term can occur through a designated intranet or by postings on the administrator’s website, resulting in a more neatly managed information-dispersal process and a reduced chance of unfounded rumors. Franchisees have chosen franchising for its “command and control” style of management. It is suggested they would respond well to an orderly information-dissemination process throughout the administration.

Not all franchisees operate from fixed premises, but about 73.5% did in 2008, with the remainder operating from home or from mobile units, vans, or trailers (Frazer et al., 2008, p. 47). Where a franchisee does occupy fixed premises there are at least 13 different possible tenancy relationships linking the landlord to the franchisee (Buchan & Butcher, 2009). Where the franchisor is a key link in the chain of title, the franchisee is vulnerable as the franchisee pays the franchisor the rent that is then forwarded to the landlord. In addition it is common in a retail setting for the franchisee to provide the rental guarantee for the premises, regardless of whether the franchisee or the franchisor is the head tenant. Although one would expect it to be common practice for the franchisor to hold this rent in trust, a franchisor experiencing cash-flow problems may receive the rent from the franchisee but not pay it on to the landlord (Buchan, 2013, pp. 32–39).

A tenant wishing to retain premises must, obviously, be an acceptable credit risk for a landlord. The franchisor’s failure to pay rent would be an act that enabled the landlord to terminate the lease. Similarly the lease in the name of the franchisor might prove to be a burden that is disclaimed by a liquidator. From the little empirical research on franchisor/landlord/tenant structures we do know that different tenure structures present different risks for franchisees and administrators (cf. Buchan & Butcher, 2009; McCoy, 2012).

Franchise rhetoric may claim that franchisee businesses often survive the failure of their franchisor’s business. The fact that three of the administrators surveyed had no knowledge of how the franchisees fared indicates that there is an element of chance involved. The total number of franchisees impacted by each franchisor’s administration is also unclear.

Particularly troubling is the finding that any franchisor had continued to sell franchises when they were themselves trading insolvent. Although insolvent trading is not an issue unique to franchisors, this raises concerns from at least two perspectives. First, these franchisors misled the franchisees involved. This is conduct in breach of the consumer protection legislation. But, there is a stay on proceedings under the Corporations Act 2001 (Cth) s 440D during the administration so the franchisees could not commence action against the franchisor. Instead they rely on the insolvency practitioner, who may not know of their existence. They could, however, commence action against any other person (including the franchisor’s directors) involved in the conduct (Competition and Consumer Act 2010 s 84; also cf. Wheatley, 2007).

Second, it is common for the same bank to fund both franchisor and franchisee. This arises from franchise processes that recommend the franchisor’s bank to a new franchisee. We did not ask about the funding arrangements in this survey, but we do suggest that banks funding franchisors need to re-evaluate the credit worthiness of these franchisor customers before agreeing to fund other customers (i.e., franchisees) into a vulnerable position of financial risk.

As with rental premises, the franchisees’ continued access to the franchisor’s trademarks, registered designs, and other items of protectable intellectual property may be paramount for the franchisee’s continued success. The solvency of the entity that holds the intellectual property assets will mean the assets cannot be grouped together with the assets of the insolvent parties to pay creditors. If the intellectual property-owning entity is solvent, the administrator may decide not to invest resources in negotiating an ongoing license. Clearly the effect of the fate of intellectual property rights—a cornerstone of franchising—on the failure of the franchisor merits further investigation. Seven of the eight administrators said the trademarks were owned by the franchisor. This did not adhere to the more common situation in franchising where the franchisor does not own its intellectual property but shelters it in a separate entity. That entity enters a license agreement with the franchisor for the use of the intellectual property.

In addition to managing risk by owning their intellectual property in a separate entity, franchisors often establish other entities (e.g., companies and trusts) to supply product and services to franchisees. The result may be a large group of companies. The Code does not require disclosure of the entire group. If it did, franchisees’ advisors...
would be in a much stronger position to conduct prepurchase due diligence for their franchisee clients and to provide better informed advice.

Another troubling issue is the one of direct insolvency (i.e., where the franchisor has been wound up or deregistered without the administration process). Clearly, there will be some instances where a franchisor exits in an orderly fashion leading to its winding-up and deregistration. Similarly, there will be some cases where a franchisor will move swiftly from receivership to liquidation in common with other failed firms. However, the impact of franchisor failure on franchisees is likely to be greater than the effect on nonfranchisee unsecured creditors as a result of the issues discussed in this section.

CONCLUSION AND RECOMMENDATIONS

In the expansion of business format franchising, franchisees are key stakeholders in a franchise system. Despite warnings, franchisees invest in what they believe to be the franchisor’s proven and solvent business. However, franchisors do sometimes fail. The distinct relationship between franchisors and their franchisees suggests that the positioning of franchisees within the insolvency regime is problematic.

This article has shown how the review of the literature on insolvency in franchising was used to create a survey of administrators of franchisors in Australia. It also presented those results.

In our literature review we confined our search to literature specific to franchising. There exists a large body of research into the field of business failure where franchised businesses undoubtedly formed part of the sample studied but were not specifically identified in the resulting articles. Beyond failure, areas such as corporate governance merit attention through the lens of business failure. To what extent, for instance, does a franchisor or an administrator need to consider franchisees when making decisions that accord with good corporate governance? As noted by Gould and White (1986),

human behaviour is affected by only that portion of the environment that is actually perceived; our views of the world and the people in it are formed from a highly filtered set of impressions and our images are strongly affected by the information we receive through our filters. (p. 28)

Limitations

The data currently collected are too small in number for us to draw definitive conclusions. The important differences in practice among different administrators and in different franchisor administration situations do, however, confirm our sense that there is no clear path through their franchisor’s administration for the franchisees.

Summary of Key Findings

This study found that although the franchisee may have a right to terminate the franchise agreement in the event of the insolvency of the franchisor, the termination may seriously disadvantage the franchisee. In particular, the franchisee may lose access to valuable intellectual property and to the physical premises its franchise operates from.

Franchisees remain captive and financially committed counterparties during insolvency. They impose little burden on the administration but potentially deliver a great financial benefit to the franchisor’s creditors. Where franchisees are not creditors they have no statutory right to attend creditors’ meetings, potentially depriving them of information and the opportunity to provide input into decisions affecting them. The number of franchisees impacted by each franchisor’s administration is unclear.

The administration of franchisors does not take into account the distinct relationship between franchisors and their franchisees. This relationship creates specific issues when a franchisor enters administration including the complex franchisor group structures and the consequent effects on both intellectual and real property rights and on administration. The fact that the Code obligations apply to administrators who ignore them, that the ability of franchisees to access s 439A reports is not guaranteed, and that some franchisors pursue a strategy of direct insolvency (i.e., winding-up without first appointing an administrator) add to the risk of franchisees being marginalized, invisible stakeholders throughout the franchisor’s insolvency.

Policy Recommendations

We make five policy recommendations regarding franchisor insolvency practice. The first recommendation aims to address the problem of complex franchisor group structures and the consequent effects on licensing of intellectual property. Our recommendation is that the Code be amended to require that franchisors disclose their complete group and associates structure to franchisees on grant of franchise and as it changes from time to time. In this context, the disclosure document must be able to be relied upon by professional advisors (including insolvency practitioners) as a single source of full and accurate information in a context that is not misleading.
The second recommendation is designed to deal with the fact that Code obligations apply to administrators. We recommend that insolvency practitioner training and best practice guides reflect administrator obligations in respect of franchisors. As a result of the complexity in this area, there is scope for franchise advice and franchisor insolvency to become specializations within the accounting and insolvency professions.

The third recommendation targets the absence of trust structures with respect to monies received by the franchisor from franchisees for payment to third parties. Our recommendation is that all monies received by franchisors from franchisees for payment to third-party suppliers relating to any interest in real property must be held in trust by the franchisor and not placed into a general revenue account.

The fourth recommendation deals with the matter of the s 439A report. We recommend that the Code be amended to require insolvency administrators to provide a copy of the s 439A report to each franchisee. This is the major report to creditors wherein the administrator sets out the progress of the administration, makes recommendations, and seeks the creditors’ input on the administrator’s proposed strategy for the company. It would also seem reasonable for insolvency practitioner training and best practice guides to recommend that s 439A reports be lodged with ASIC as company disclosures. This is often done in the case of publicly listed companies and could be extended to all franchisors in insolvency.

The final recommendation addresses the dilemma of direct insolvency. Our recommendation is to require that receivers and liquidators have a disclosure obligation to franchisees in the case of franchisor insolvency to the same extent that they have to unsecured creditors.

These recommendations will not reduce the instance of franchisor insolvency. However, they may assist in an orderly administration and, particularly, assist franchisees to survive franchisor insolvency.

Further Research

We conclude that the specific area of franchisor failure, proving to be enduring and important in terms of cost, nationally and internationally, warrants further investigation. Collecting data has also raised some specific issues that we have recommendations about. These are set out next.

We recommend that future research should attempt to source data from both franchisor and franchisee entities. Particular effort should be directed toward the inclusion of franchisor and franchisee representatives, and franchise financiers, who have experience with the administration process within insolvency.

The due diligence process was not central to this study as its traditional focus is on the time prior to the execution of the franchise agreement. However, advisors should note that due diligence should continue after the prospective franchisee becomes an actual franchisee. Ongoing due diligence is clearly a prudent business practice for franchisees.

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**APPENDIX**

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<th>Field of research</th>
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<tbody>
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<td>U.S.</td>
</tr>
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<td>U.S.</td>
</tr>
<tr>
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<td>Management</td>
<td>U.S.</td>
</tr>
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<td>Economics</td>
<td>U.S.</td>
</tr>
<tr>
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<td>UK</td>
</tr>
<tr>
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<td>U.S.</td>
</tr>
<tr>
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<td>Entrepreneurship</td>
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</tr>
<tr>
<td>Frazer (2001)</td>
<td>Marketing</td>
<td>Australia</td>
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<td>Entrepreneurship</td>
<td>U.S., UK, Europe</td>
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<td>U.S.</td>
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### Franchisor Failure Literature

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<td>U.S.</td>
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<td>Marketing</td>
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<td>U.S.</td>
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<td>UK</td>
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<td>UK</td>
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<td>UK</td>
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<td>Law</td>
<td>Canada</td>
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<td>Law</td>
<td>Canada</td>
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<td>Management</td>
<td>France</td>
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<td>Law</td>
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<td>Australia</td>
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<td>Management</td>
<td>U.S.</td>
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<td>Law</td>
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<td>Multi-country</td>
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<td>Management</td>
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