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International Franchising in a Changing World

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WHAT IF YOUR FRANCHISEE BECOMES INSOLVENT?

May 10, 2017

Washington, D.C U.S.A.

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This paper will discuss the impact of the insolvency laws in the USA and Australian on franchise relationships with special focus on master franchise relationships. Workout and assistance agreements are also discussed together with practical examples from the Australian franchises of Baskin Robbins (Allied Brands) and Krispy Kreme.

1. The Impact of Insolvency Law in the US on franchise relationships

1.1. In the event of an insolvent franchisee and if a workout or Assistance Agreement is not an option (see further below) then a franchisor or master franchisee, as applicable, may seek protection under US insolvency law. Alternatively, one or more of the franchisors/master franchisee's creditors may seek redress through the courts in the US to protect their collateral or other interests, particularly if they believe that the franchisee is behaving in a fraudulent or reckless manner.[1] The types of insolvency procedures and protections that are available in the US are similar to those in other jurisdictions. Reorganization, known as a "Chapter 11" filing under US federal bankruptcy law, is the most commonly used procedure and remedy for insolvent enterprises.[2] Liquidation, known as a "Chapter 7" filing, provides for a complete wrapping up of the enterprise's business and typically the sale of its assets to satisfy claims of creditors in an order of priority that is set by law.[3] Finally, a receiver can be appointed under both state and federal law, often at the request of a secured lender, to take control of all or parts of an insolvent enterprise in order to preserve collateral and other interests of creditors.[4]

1.2. Franchisors in the US are most familiar with Chapter 11 reorganization filings because it is what they encounter most frequently with insolvent franchisees. A franchisee typically seeks this protection at its own initiative, and often because their franchisor has sent them a demand or default notice for past due receivables such as royalty payments. Franchisees will particularly seek this protection when they know or believe that a lawsuit by the franchisor is pending to attempt to collect past due receivables, or when the franchisor has already obtained a judgment and is now seeking to enforce the judgment. A Chapter 11 filing by the franchisee will result in an automatic stay of all pending judicial actions against the franchisee, including existing cases, the enforcement of judgments and the filing of new actions.[5]

1.3. The case of a master franchisee filing for Chapter 11 protection will be different from that of a typical unit franchisee, primarily because a master franchisee has more non-monetary obligations to the franchisor than a unit franchisee does. Non-monetary obligations must be cured in order for a master franchisee to maintain and pursue reorganization under Chapter 11.[6]

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[1] Matthew B. Gruenberg, John W. Mills, and Suj M. Pandya, *Protecting the System: Ways that Franchisors Can Plan for Franchisee Financial Distress and Navigate Franchisee, Receiverships and Bankruptcies*, 33 Franchise L.J. 3 (Winter 2014).
[2] 11 U.S.C. §§ 1101 to 1174.
[3] 11 U.S.C. §§ 701 to 784.
[4] *See* Gruenberg, supra note 1, at 384, and Elaine A. Panagakos and Peter J. Klarfeld, *Franchisees in Federal Receivership: Strategic Considerations for Franchisors*, 26 Franchise L.J. 2 (Fall 2006).
[5] 11 U.S.C. § 362.
[6] *See* Gruenberg, supra note 1, at 390.

The effect of this rule is that master franchisees who cannot show that all non-monetary defaults will be cured will not have the option of assuming (i.e. keeping) a master franchise agreement.[7]

1.4. In a typical Chapter 11 case in the US, an administrator (or trustee in US terminology) will generally not be appointed by the court unless there is evidence of fraud or gross misconduct by the debtor.[8] Instead, the debtor will continue to operate the enterprise while enjoying temporary protection from other judicial proceedings, and while a plan of reorganization is formulated by the debtor and its creditors through the judicial process. While the plan is being formulated, a debtor may choose to assume or reject executory contracts. A master franchise agreement, like any franchise agreement, is considered an "executory contract" under US insolvency law.[9] Since a master franchisee entity is typically required by the master franchise agreement to be a single purpose entity, it is highly unlikely that a master franchisee would choose to reject the master franchise agreement in the context of a Chapter 11 case. If the goal is to emerge from the case as a going concern (which is the basis of Chapter 11 reorganization), then maintaining the master franchise agreement will be essential.

1.5. Every Chapter 11 case is unique, and that would certainly be no exception with a case involving a master franchisee of a franchise system. A master franchisee's creditors will need to approve the plan of reorganization.[10] It's impossible to predict every scenario, but the franchisor and other creditors may be willing to accept less than the full amount they are currently owed if they value the revenue stream from the master franchisee and believe that its business is viable in the medium to long term. If this turns out to be the case then approving a plan of reorganization may be the best bet for a franchisor if its options to replace the master franchisee or otherwise continue to grow the brand in the territory are limited.

1.6. If a master franchisee does not want, or does not believe it is viable, to continue the business, it may opt to file under Chapter 7 of the bankruptcy code, which typically results in the liquidation and winding up of the business.[11] Under Chapter 7, liquidation is the only option, and a trustee is immediately appointed by the court upon filing of the case. The franchisor will be by far one of the principal creditors, and should be able to provide assistance to the trustee and the other creditors in finding the best use of the assets of the master franchisee. In this situation the franchisor will typically either step into the shoes of the master franchisee or seek a replacement master franchisee that can acquire most of the assets and continue relationships with other vendors and, in particular, the sub-franchisees.

1.7. It would be more rare for a receivership case to be initiated by a master franchisee's secured creditor, but it is an option that is open to the secured creditor if it fears that its collateral is being misused, or its value is being dissipated.[12] This might be more likely in the case of a master franchisee that also operates its own units and owns large amounts of real estate or equipment that are subject to lender liens. The franchisor would have the

[7] Id.
[8] Id. at 387.
[9] Id. at 389.
[10] Id. at 390.
[11] 11 U.S.C. §§ 701 to 784.
[12] *See* Gruenberg, supra note 1, at 384-385.

right, as well as a strong interest, in intervening in the receivership case to protect its interest. If the secured creditor believes that its collateral can be adequately protected under the continuation of the brand in the territory then it may be open to working with a franchisor to provide for a transition to a new master franchisee. Unlike Chapters 11 and 7 of the federal bankruptcy code, a receivership is a creature of the common law and is an equitable remedy available in both federal and state courts in the US.[13] Because it is an equitable remedy, courts have discretion to give receivers a broad array of rights, including the power to take control of the enterprise for a period of time.[14] The franchisor may even choose to enter into a temporary arrangement with the receiver to carry out the duties of the master franchisee while a plan is developed to continue the business after the termination of the receivership.[15]

2. The Impact of Insolvency Law in Australia on franchise relationships

2.1 Background

2.1.1 The mandatory statutory regime governing franchising in Australia the Franchising Code of Conduct [16] (the "**Code**") is well known and applies to all franchises operating in Australia even where the franchisor is located overseas. The Code provides in clause 29(1)(b) that a franchisor may terminate a franchise agreement without prior notice if a franchisee should "become bankrupt, insolvent under administration or an externally-administered body corporate." However the Code does not allow a reciprocal right to a franchisee if its franchisor is similarly bankrupt. It also does not address what happens when a master franchisee is insolvent with sub-franchisees that continue to operate. Here we will focus on such an example where there is an overseas based franchisor having granted a franchise in Australia to an Australian company including a master franchise which in turn has granted sub-franchises.

To examine what the rights are of the parties outside of the couple of lines in clause 29(1)(b) of the Code and to understand their meaning it is necessary to look at the Corporations Act 2001 (the "**Act**") and how it treats corporate insolvency in Australia. The Act applies to all corporations in Australia. Insolvent individuals are covered by the Bankruptcy Act 1966, a discussion of which is beyond the scope of this paper. Both Acts define insolvency as being unable to pay debts as and when they become due and payable. [17]

The forms of external administration for an insolvent body corporate (company) in Australia are essentially:

i. Receivership;

ii. Voluntary Administration; and

iii. Liquidation (also called "winding up").

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[13] Id.
[14] Id. at 385.
[15] Id. at 386.
[16] *Competition and Consumer (Industry Codes-Franchising) Regulation 2014*
[17] See section 95A of the Act

2.2 Receivership

2.2.1 A company most commonly goes into receivership when a receiver is appointed by a secured creditor who holds security or a charge over some or all of the company's assets. The receiver's primary role is to collect and sell enough of the company's charged assets to repay the debt owed to the secured creditor. The terms of the parties' security agreement will set out events of default which allow the appointment of a receiver to protect the secured assets. A receiver has broad powers and can carry on the business of the company and may be able to negotiate the sale of the business as a going concern which protects the position of the secured creditor but also help preserve jobs and commercial relationships[18].

2.3 Voluntary Administration

2.3.1 Voluntary administration is when an external administrator called a (the "**voluntary administrator**") is appointed. While a voluntary administrator is usually appointed by a company's directors, after they decide that the company is insolvent or likely to become insolvent, a voluntary administrator may also be appointed by a liquidator, provisional liquidator, or a secured creditor. A company in voluntary administration may also be in receivership.

2.3.2 The role of the voluntary administrator is to investigate the company's affairs, to report to creditors and to recommend to creditors whether the company should:

2.3.2.1 enter into a deed of company arrangement (the "**DOCA"**);

2.3.2.2 go into liquidation, or

2.3.2.3 be returned to the directors and the administration end. [19]

2.3.3 The objective of an administration is to provide for the business, property and affairs of an insolvent franchisee company to be administered in a way that maximises the chances of the company, or as much of its business as possible, continuing in existence, or if that is not possible results in a better return for the company's creditors and members than would result from an immediate winding up of the company.[20]

2.3.4 The Act enables the administrator to carry on the company's business and manage its property and business affairs, terminate or dispose of all or part of that business or property, and to perform any function, and exercise any power, that the company or any of its officers could perform or exercise if the company were not under administration. Directors cannot use their powers while the company is in voluntary administration. Another responsibility of the voluntary administrator is to report to the regulator, the Australian

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[18] M. Murray & J. Harris "Keay's Insolvency: Personal and Corporate Law and Practice" (Thomson Reuters 9th ed, 2016) [18.30]
[19] See section 439C of the Act
[20] See section 436A of the Act

Securities and Investments Commission (the "**ASIC**") on possible offences by people involved with the company (such as trading while insolvent or fraud).

2.3.5 Administration gives the company and its directors some breathing space from its creditors. The appointment of an administrator creates a statutory moratorium, whereby a court proceeding against the company or in relation to any of its property cannot be begun or proceeded with, except with the administrator's written consent or with the leave of the Court and in accordance with such terms (if any) as the Court imposes. [21]

2.3.6 Two meetings of creditors must be held during the voluntary administration. The voluntary administrator must call the first creditors' meeting within eight business days after the voluntary administration begins. The purpose of the first meeting is for creditors to decide whether they want to form a committee of creditors, and, if so, who will be on the committee, and secondly whether they want the existing voluntary administrator to be replaced by one of their choice.

2.3.7 The role of a committee of creditors is to consult with the voluntary administrator about matters relevant to the voluntary administration and receive and consider reports from the voluntary administrator. Where a franchisee has entered voluntary administration the franchisor may wish to join the committee (assuming it is a creditor) but should in any case ensure it is kept informed by the administrator of developments.

2.3.8 After investigating the affairs of the company and forming an opinion on which of the three options available to creditors (outlined above), is in the best interests of creditors, the administrator must call a second creditors' meeting. At this meeting, creditors are given the opportunity to decide the company's future. Before the second meeting of creditors, the administrator will circularise a Report to Creditors which will determine the fate of the company and, will make recommendations and provide a comparative on the return to creditors if the company was to be wound up versus the return to creditors if the company was to accept a DOCA proposal by the director. If there are proposals for a DOCA, the voluntary administrator must provide creditors with a statement giving enough details of each proposal to enable creditors to make an informed decision. If the director fails to provide a DOCA proposal to its creditors, at the second meeting the company will likely resolve that the company be wound up and a liquidator appointed.

2.3.9 What is in a DOCA or "deed"? The types of proposals allowed in a DOCA are very flexible. Typically, a proposal will provide for the company to pay all or part of its debts, possibly over time, and then be free of those debts. It will often provide for the company to continue trading. How these things will happen varies from case to case, as the terms allowed in a DOCA are very flexible. If the creditors approve the company entering into a deed it may lead to a successful restructuring of the company and the business may return to profitability. Alternatively it may act as a means to maximise the outcomes for

[21] See section 440D of the Act.

the creditors by way of a dividend return from a more structured sale of the company's assets in its winding up.[22] The deed must ensure employee entitlements are paid in priority to other unsecured creditors unless eligible employees have agreed to vary their priority.

2.3.10 When a DOCA is executed the voluntary administration ends.[23] The rights and obligations of the creditors and the company are then governed by the terms of the deed. The DOCA binds all unsecured creditors, even if they voted against the proposal. It also binds owners of property, those who lease property to the company and secured creditors, if they voted in favour of the deed. The voluntary administrator will become the deed administrator whose role is to ensure the company (or others who have made commitments under the deed) carries through these commitments. The extent of the deed administrator's ongoing role will be set out in the deed.

2.4 Liquidation/Winding up

2.4.1 There are two types of insolvent liquidation:

2.4.1.1 creditors' voluntary liquidation or winding up; and

2.4.1.2 court liquidation.

2.4.2 The most common type is a creditors' voluntary liquidation, which usually begins in one of two ways:

2.4.2.1 creditors vote for liquidation following a voluntary administration or a terminated DOCA; or

2.4.2.2 an insolvent company's shareholders resolve to liquidate the company and appoint a liquidator. Within 11 days of being appointed by shareholders, the liquidator must call a meeting of creditors who may confirm the liquidator's appointment or appoint another liquidator of the creditors' choice.

2.4.3 In a court liquidation, a liquidator is appointed by the court to wind up a company, following an application, usually by a creditor (as a consequence of the creditors statutory demand process described below.) Others, including a director, a shareholder and ASIC, can also make a winding-up application.

2.4.4 Generally, on the liquidator's appointment there will be a freezing of the company's accounts and general investigations into the affairs of the company (in an effort to determine the primary reasons as to why it became insolvent). The Liquidator will also occupy the premises, collect the company books and records, ensure the directors complete a report as to affairs, collect the company's debts, realise assets of the company and pay a dividend (if any) to the franchisee's creditors. The liquidator's role is also to investigate and report to creditors about the company's affairs, including any unfair preferences

[22] Keays [20.05]
[23] Section 435C(1) of the Act

which may be recoverable, any uncommercial transactions which may be set aside, and any possible claims against the company's officers. The liquidator must also enquire into the failure of the company and possible offences by people involved with it and report to ASIC.

2.4.5 In a voluntary liquidation, the company must cease to carry on business except for what is needed for the winding up.[24] Property of the company does not vest in the liquidator unless there is a specific court order.[25] Proceedings and enforcement processes against the company are stayed in a creditors' voluntary winding up unless the court gives leave to continue and subject to such terms as the Court imposes.[26] Alternatively, if the company is in the middle of proceedings against a third party at the time the liquidator is appointed, the liquidator may elect to continue with those proceedings (for example, for the recovery of money owing to the franchisee) as part of the powers provided to him or her under section 477(2)(a) of the Act.

2.4.6 A creditor (including an unsecured creditor) with an outstanding debt exceeding the statutory threshold of $2,000, may instigate a court liquidation through issue of a Creditors Statutory Demand for Payment of Debt (the "**Demand"**).

2.4.7 If the Demand is not satisfied (i.e. paid) within 21 days from service, the creditor may make an application to the Court to wind up the debtor company and appoint a liquidator as the company is then presumed to be insolvent.

2.4.8 There are three options available to the debtor company in responding to the served Demand:

Option 1: Paying the sum claimed in the Demand as above;

Option 2: Entering into an acceptable payment arrangement with the creditor; or

Option 3: Applying to the Court to have the Demand set aside.

2.4.9 In relation to Option 3, the debtor company must have grounds to make an application to the Court to set aside the Demand, for example, that it disputes the existence of the debt or it has an off-setting claim which exceeds the debt owed to the creditor. Before issuing a Demand, the creditor should consider whether the debtor company has raised a "genuine dispute" with respect to the outstanding debt. If a dispute has been raised, it should consider instead commencing debt recovery proceedings against the company and obtain a judgment before issuing the Demand. For a claim of unpaid royalties by a franchisor there is unlikely to be a dispute as to the debt.

2.4.10 With respect to Option 2, if an instalment arrangement is agreed to, this technically will satisfy the Demand and the creditor will not be able to rely

[24] See section 493 of the Act.
[25] See section 474(2) of the Act
[26] See section 500 of the Act

upon the Demand to commence winding up proceedings (even if the instalment arrangement falls over). This means a fresh Demand will need to be served again by the creditor for any unpaid balance (and the above process starts all over again).

2.4.11 Once presumed insolvent, the only option for the debtor company to avoid being wound up is to defend the proceedings on the basis that it is solvent (that is, able to pay its debts as and when they fall due). This is an expensive exercise for the debtor company as it requires a defence being filed, followed by evidence from an insolvency expert.

2.4.12 After the assets have been realised and the affairs of the company have been completed (assuming the company is unable to settle or have set aside any Demand issue), the liquidator will then apply to ASIC for the company to be deregistered.

2.5 Insolvent Master Franchisee Scenario

2.5.1 So the scenario we are discussing is this an Australian master franchisee company is experiencing cash flow difficulties, its trade creditors are not being paid within their credit terms and royalties have stopped being paid to the master franchisor. In the midst of this dilemma, the creditors of the master franchisee and possibly disgruntled sub-franchisees are taking legal action against the company. At this point, the alarm bells would be deafening as the master franchisee is at risk of trading whilst insolvent. If this is proven to be correct, the directors of the company are at risk of being exposed to being held personally liable for debts incurred by the company whilst trading insolvent.

2.5.2 It has been observed that franchisors (which would include master franchisees) are different from other corporations as they may be able to raise additional capital through selling more franchises and therefore be able to hide their impending insolvency from franchisees for longer than they could hide it from traditional finance sources or from a supplier.[27] This may also allow a master franchisee to hide its situation from its overseas franchisor until the situation has become quite dire.

2.5.3 Other than implementing the default process under the Code and the master franchise agreement to have the master franchisee remedy its defaults or terminate for failure to do so, what can the overseas franchisor do with respect to a master franchisee in a situation of suspected insolvency? It should be noted that the right of immediate termination under clause 29(1)(b) of the code arises only where the company has entered one of the forms of external administration above. It is not enough if the company is merely insolvent (or likely to be). While it is common that upon seeking advice as to the likely insolvency of the company the directors will appoint a voluntary administrator or liquidator, the master franchisor, if a creditor, may instigate

[27] J. Buchan 'Franchising: A Honey Pot in a Bear Trap' (2014) 34 Adelaide Law Review 283-315, 291

the process of issuing a statutory demand (or it may consult with another creditor to have it do so) under section 459E of the Act.

2.5.4 Once a master franchisee is insolvent under administration through appointment of liquidator, administrator or receiver the franchisor may immediately terminate the master franchise agreement and the consequences of termination will be governed by the terms of the master franchise agreement. It may have the right or even the obligation to step in and take over the role of the master franchisee under the sub franchise agreements. As in any termination it will need to assess for itself whether or not the cost of doing so outweighs the damage to brand reputation from the collapse of the system in Australia. In the case of insolvency the likelihood of unpaid employees, suppliers, landlords as well as dissatisfied franchisees is high and an injection of funds is likely if the franchisor intends to step into the shoes of the master franchisee and keep the enterprise afloat.

2.5.5 As a creditor the franchisor will have the usual rights in the administration or liquidation of the master franchisee as set out above. But it is important to consider the rights of the voluntary administrator or liquidator of the master franchisee and what happens with respect to the contracts the company has entered with the sub franchisees, landlords and suppliers.

2.6 Sub franchise Agreements

2.6.1 As stated at the beginning, the Code does not give the franchisee the right to terminate the franchise agreement if the franchisor (or master franchisee) goes into insolvent administration. Unless the agreement itself provides for termination, the franchise agreement remains in place and payments due to be paid by the franchisee continue to be payable. Franchisees are unlikely to be creditors and therefore will have no vote at creditors meetings. Voluntary administrators or receivers looking to maximise income and a return on sale of the business will want to keep the franchise agreements continuing. A liquidator can disclaim a contract (including a franchise agreement) if it is unprofitable or otherwise with leave of the court.[28] If the master franchise agreement is terminated and the sub franchise agreements are not novated or assigned to the franchisor or a nominated entity, those agreements will also end and the sub-franchisees will lose their rights to make use of the system and IP. The Franchisor may elect to enter into new agreements with the sub-franchisees or grant master franchise rights to a new entity to do so. This will effectively remove from the administration of the master franchisee its source of revenue and lead to its inevitable winding up.

2.7 Leases

2.7.1 Many franchisors and master franchisees of retail systems hold the leases directly and sublease or licence them to the franchisees. Under section 568 of the Act liquidators (but not administrators) have the power to disclaim leases as onerous. If a liquidator disclaims a lease the sublessee franchisee will lose its premises unless it can negotiate a new lease. For a franchisor considering

[28] Section 568(1A)

taking over the Australian operation of a master franchisee in liquidation the task of negotiating new leases for those sites to be retained is considerable.

2.7.2 In the case of a voluntary administration, the administrator must within five business days after their appointment, notify the landlord of property occupied by the company whether they intend to continue to occupy or use the property. If the voluntary administrator decides to continue to do so, they will be personally liable for any rent or amounts payable arising after the end of the five business days. This means that the voluntary administrator is only likely to continue a lease where it is assured that the subtenant will pay the rent or where the continuation of the lease is to the advantage of the company's administration.

2.7.3 To assist understanding we examine two case studies of external administration which involved a US franchisor and an Australian franchisee below in section5, both of which came to a head in October 2010.

2.8 Pending legislative changes – Australia

2.8.1 On 28 March 2017, the Australian Government released an exposure draft of legislation dealing with two key areas of insolvency and restructuring law reform.[29] The proposed legislation will provide directors of a company with a 'safe harbour' from civil liability for insolvent trading when they are attempting to restructure the company and take a course of action that is reasonably likely to lead to a better outcome (than administration, liquidation, a scheme or receivership) for the company and its creditors.

2.8.2 Importantly for franchisors, the draft legislation restricts the ability to enforce (the "**ipso facto**") clauses where an administrator is appointed, subject to exceptions for certain excluded contracts. It is likely that the right to terminate a franchise agreement under a provision reflecting section 29(1)(b) of the Code when a company enters such external administration will not be exercisable in these circumstances. From our examples below the Krispy Kreme case was one where the parties co-operated to achieve an outcome such as that envisaged by this new legislation. At the time of writing public submissions on the new Bill were just closing so if enacted it will likely not be in effect until late 2017 or 2018.

3. Workouts and Assistance Agreements with Insolvent Master Franchisees

3.1. When a master franchisee is struggling and unable to meet all its obligations to its creditors, it may ask the franchisor for assistance, particularly if some form of forbearance, restructuring of debt or other assistance from the franchisor alone can give the master franchisee the time and breathing room it needs to put its business back on solid footing. Before offering an Assistance Agreement, a franchisor should assess its options in the territory. If the master franchisee's insolvency is, in the franchisor's opinion, due to lack of business acumen or operational competence, then the franchisor will likely consider other options such as termination of the master franchise agreement

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[29] *Treasury Laws Amendment (2017 Enterprise Incentives No. 2 Bill) 2017*.

or trying to effectuate an assignment of the master franchise agreement to a better capitalized and more competent operator. On the other hand, if a franchisor assesses that some or all of the master franchisee's difficulties were due to circumstances beyond the control of even a very competent operator, then the franchisor may want to offer a helping hand to get their master franchisee through its current difficulties so that the system can be preserved in the territory.

3.2. A properly drafted Assistance Agreement can have many advantages. It can document all past due receivables, establish additional oversight of the master franchisee for a period of time, allow the closure of under-performing units, offer conditional debt forgiveness, and outline certain rights of the franchisor if the master franchisee ultimately comes under the protection of bankruptcy or insolvency laws. The Assistance Agreement should take a comprehensive approach that seeks to put the master franchisee and the franchise system in the territory back in good health over a period of time through a combination of concessions by the franchisor and commitments from the master franchisee.

3.3. First and foremost, an Assistance Agreement should document any past due receivables and other monetary and non-monetary obligations that the master franchisee has failed to meet. The master franchisee should be required to waive defenses, offsets and counterclaims with respect to the documented failures to comply with the master franchise agreement, particularly with respect to all monetary obligations. This will help protect the franchisor in the event of litigation or in the event of a bankruptcy or insolvency proceedings.

3.4. The Assistance Agreement should lay out how the past due receivables will be repaid, possibly by putting the receivables into a promissory note from the master franchisee to the franchisor. Some of the receivables could be paid up front, and some could be forgiven if the master franchisee carries out all its obligations under the Assistance Agreement. The schedule for repayment will be the forbearance period, and the franchisor should make clear that it has the right to seek immediate termination of the master franchise agreement if the repayment schedule is not fully and timely honored.

3.5. Since a franchisor will only choose an Assistance Agreement when it has reasonable faith in the ability of the master franchisee to continue building the brand in the territory, the franchisor should look at every aspect of the system's health in the territory and use the Assistance Agreement to lay out additional actions and timelines to improve the system's health. For example, it may make sense to allow the closure of units that have been under-performing for a long period and have little hope of rebounding. This will help the master franchisee's cash flow quickly, and that alone may even return the master franchisee to profitable operations over time.

3.6. Along with closing under-performing units, the franchisor may require that the master franchisee invest in units that have upside. For example, there may be profitable units that could be even more profitable over time with a remodel or upgrade. This can also help to improve the overall image of the brand in the territory. The franchisor can analyze and project the cash flow that will result from the concessions it is making to the master franchisee over time and can require investments like this at a time when the franchisor projects that the master franchisee's financial health will allow it. The franchisor may also choose to contribute to the upgrades as additional assistance to both the master franchisee and the overall health of the brand.

3.7. During the period of forbearance, there should be heightened oversight of the master franchisee. Regular and detailed financial statements should be provided to the franchisor, and there should be restrictions on transfers of assets, capital expenditures, dividends and other forms of compensation, and the further encumbering of assets without the franchisor's written consent. A minimum liquidity reserve can be established, and the franchisor can monitor and limit the master franchisee's spending on certain things such as general and administrative expenses.

3.8. This is not a complete list of the mix of concessions and incentives that an Assistance Agreement can include, and all situations will be unique. However, the key is that all concessions, including forbearance, debt forgiveness and franchisor investment in the brand in the territory, will be withdrawn in full if the master franchisee does not meet its obligations under the agreement. It is an all or nothing proposition for the master franchisee, and all past receivables will become due if it does not meet its obligations under the Assistance Agreement. Likewise, if the master franchisee enters a bankruptcy or similar insolvency proceeding, the franchisor's claim will be for the entire amount of all receivables and will not be reduced pursuant to any undertaking by the franchisor in the Assistance Agreement.

4. Drafting Master Franchise Agreements to Prepare for Potential Insolvency of the Master Franchisee

4.1. Master franchise agreements tend to be very long documents that attempt to foresee every potential circumstance that could evolve during the long period of time that they are intended to be in effect. Most contemplate the potential insolvency of the master franchisee, and in particular contemplate a situation where the master franchisee seeks or comes under the protection of the insolvency laws of the territory where it operates. Typically the master franchise agreement will make it a default with an automatic right of termination if the master franchisee comes under the protection of such laws.

4.2. A master franchise agreement should contain a right for the franchisor to step into the shoes of the master franchisee and assume the franchise agreements with the sub-franchisees in the event that the master franchise agreement is terminated. The master franchisee should be required to cooperate with the transition and to execute any assignment or other documents necessary to assign the franchise agreements with the sub-franchisees. The franchisor would then be able to either operate the system in the territory directly, or seek a replacement master franchisee at the earliest possible time.

4.3. The above provisions are most typical, and while they provide some protection against the unhappy circumstance of a master franchisee insolvency, they are by no means a guarantee that a franchisor will be able to protect its brand in the applicable territory. If the insolvent master franchisee does not cooperate then there is no easy way for the franchisor to assume the franchise agreements with the sub-franchisees. The franchisor may then have to reach out to the sub-franchisees directly, and this can be difficult if the brand has a large number of sub-franchisees in the territory. In such a situation, it may make sense for the franchisor, as one of the master franchisee's primary creditors, to avail itself of the insolvency laws of the territory in order for it and the other creditors to try to salvage the situation. Local laws will differ, but if a trustee, administrator or receiver can be appointed, they may have the ability to help provide for a more favorable disposition of the franchise agreements with the sub-franchisees when the master franchisee is not cooperating. Every situation will be unique and will depend on local laws and traditions as well as the level of cooperation expected from the master franchisee and the sub-franchisees.

5. Case Studies

5.1. Allied Brands – Baskin Robbins

5.1.1. In 2004 an Australian subsidiary of ASX listed Allied Brands Limited (ASX:ABQ) entered into a master franchise agreement with a US franchisor entity (owned by Dunkin Brands Inc.) for the Baskin-Robbins ice-cream brand in Australia. Allied Brands Limited operated a number of franchise systems. In June and July 2010 Allied Brands Limited appeared to be in financial trouble announcing to the market two profit downgrades and in August significant bad debts.[30] In September 2010, the US franchisor attempted to terminate the master franchise agreement, but the notice was subsequently withdrawn or was ineffective. It should be noted that the directors of Allied Brands later blamed this purported termination for losses caused to the company.[31]

5.1.2. On October 21, 2010, following notice and opportunity to cure default (as required by the Code), the franchisor terminated the master franchise Agreement and began directly servicing the Baskin-Robbins franchise system in Australia. The master franchise agreement (also reflected in the sub-franchise agreements) provided for novation of the sub-franchise agreements directly to the franchisor. The parties then formalised the master franchise termination, and novation arrangements to enable a smoother transition for the US entity to take over control of the franchise network in Australia. Within days of the termination Allied Brands Limited entered voluntary administration. At the time the administrators said "*attempts to obtain additional funding from third parties collapsed when Baskin Robbins terminated its master franchise agreement with Allied Brands late last month*". This meant "*the company was no longer able to trade as a going concern*".[32] Additionally, upon the termination of the master franchise agreement, receivers were appointed by secured creditor Westpac Bank to the master franchisee and another subsidiary.

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[30] Report to Creditors-Allied Brands Limited 11 April 2011 by Peter Dinoris (Administrator) p5

[31] Report to Creditors p10

[32] Sydney Morning Herald November 3, 2010 "Allied Brands grew too fast, say administrators" http://www.smh.com.au/small-business/franchising/allied-brands-grew-too-fast-say-administrators-20101102-17cct.html

5.1.3. On assuming ownership and control of the system in Australia, Dunkin Brands set about rebuilding the system, including the supply chain and the confidence of the sub-franchisees.[33]

5.1.4. Subsequently in 2013 a new master franchise agreement was granted by Dunkin Brands to Palm Oasis Ventures (a subsidiary of Galadari Brothers Co. LLC). The brand survives to the present day in Australia under that structure. Allied Brands Limited eventually entered into a DOCA with its creditors but ceased to exist in its previous form.

5.2. Krispy Kreme Doughnuts

5.2.1. Krispy Kreme opened in Australia in 2003. The Australian company Krispy Kreme Australia Pty Ltd (the "**KKA**") held the sole right as franchisee to use the Krispy Kreme brand name in Australia and New Zealand from Krispy Kreme Doughnut Corporation (the "**KKDC**"). This was not a master franchise arrangement however with KKA directly operating the Australian outlets. It appears from the Report to Creditors that during a period of rapid expansion KKA fell behind in loan repayments to its secured creditor and in amounts due to KKDC including royalties. Through negotiation with its creditors it was agreed to defer repayments pending a business restructure through a proposed DOCA.

5.2.2. On October 29 2010, in the same week as the termination of the Baskin-Robbins master franchise, KKA entered into a strategic voluntary administration and DOCA in which KKDC agreed not to terminate the franchise agreement and to accept no breach of the franchise agreement had occurred, meaning that there would therefore be no acceleration of payment obligations of the company under the franchise agreement.[34] Further, a revised development and franchise agreement conditional on a DOCA being entered into became effective on 1 November 2010.

5.2.3. The purpose of appointing be to voluntary administrators was stated by the directors to accommodate a restructure and close unprofitable stores:

"Due to a number of underperforming stores adversely affecting the business, the company was at risk of not meeting its financial obligations if

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[33] QSR Media 22 March 2011 "Nigel Travis, CEO, Dunkin' Brands talks about plans for Baskin-Robbins in Australia" - See more at: http://qsrmedia.com.au/franchising/in-focus/nigel-travis-ceo-dunkin-brands-talks-about-plans-baskin-robbins-in-australia#sthash.WVMhZrgO.dpuf

[34] Proposal Report to Creditors 24 November 2010 by M.J.M Smith & P.Hillig (Joint & Several Administrators) http://www.smithhancock.com.au/getDocument.cfm?dcd=CE80B729-CF2D-7DA6-4AF6DCCEEF7F7480

it continued trading under its current model," the company said in a statement.[35]

"*Directors have determined that a restructure is necessary and the appointment of a voluntary administrator is the responsible action in view of the risk of insolvency if the company continued to operate in its current form," [the director] said.*

The chain closed 24 stores (out of 59) and laid off 201 staff. Creditors approved a DOCA with a $2.3 million fund to satisfy claims by creditors with all employee and landlord entitlements being paid in full.[36]

5.2.4. The franchisor was owed over AUD$3.2 million as an unsecured creditor upon the appointment of the administrators.[37] As part of the agreement the franchisor agreed to postpone payment of the amount owed until the completion of a sale of the company's business or refinancing.

5.2.5. After execution of the DOCA and the short period of administration the company continued to operate with its reduced chain.

5.3. Conclusion

It can be seen here in the Krispy Kreme example, that the tools of external administration were used effectively with one franchisor's cooperation to avoid insolvent trading and the collapse of the chain in Australia and the franchisee. It should be noted however that KKA did not grant any sub franchises, which made the closure of stores a much easier exercise than in the Allied Brands scenario. However with a cooperative franchisor and creditors, a similar outcome may be achievable for a master franchisee which takes effective action rather than leaving the situation to deteriorate. In a situation where a franchisor wishes to step in and take over from a potentially insolvent franchisee, an examination of the options discussed available to creditors needs to be considered, together with requirements of the Code or other local laws which may apply so that any termination is both lawful and the correct strategy.

Acknowledgement: Acknowledgement and sincere thanks to Andrew Tanna Associate Holman Webb Lawyers Sydney for his assistance and advice regarding the intricate web of corporate insolvency

[35] "Krispy Kreme calls in administrators" The Australian November 1 2010 http://www.theaustralian.com.au/archive/business-old/krispy-kreme-calls-in-administrators/news-story/14ea860a6ba2af5080a1a56a0e81bb96

[36] "A leaner Krispy Kreme out of administration" Sydney Morning Herald December 3, 2010

[37] See Proposal Report to Creditors 24 Nov 2010 p11

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