The Bankrupt Franchisee -
What Every Franchisor Needs to Know!
By Edward (Ned) Levitt

Introduction

In this difficult economic climate, the insolvency and ultimate bankruptcy of franchisees is an increasing reality. There is no better time to review the fundamentals of the laws and practical considerations of which every franchisor should be aware. The *Bankruptcy and Insolvency Act* ("BIA")[1] has no special rules regarding franchises, but franchise relationships are affected by the provisions of the BIA when a franchisee seeks protection under it or is forced by a creditor into bankruptcy.

Franchise Agreement

An ounce of prevention….! The franchise agreement should have provisions regarding the possible bankruptcy of the franchisee. It should list insolvency events as "material defaults," which would trigger the termination of the agreement. Such events could include: the franchisee committing or threatening to commit an act of bankruptcy; the franchisee making a proposal or filing a notice of intention to make a proposal under the BIA or making a general assignment for the benefit of creditors; the franchisee becoming insolvent; the filing of a petition in bankruptcy against the franchisee; the declaration by a court that the franchisee is bankrupt or insolvent; the appointing of a receiver, a receiver manager, trustee, liquidator or other custodian for the franchisee or any material portion of the franchisee's assets; or the franchisee ceasing to operate for a period of a few days.

However, it should be kept in mind that section 65.1 of the BIA would prohibit the franchisor from terminating the franchise agreement following the filing of a notice of intent to make a proposal by the franchisee. Although, ultimately, a proposal must be filed and voted on by the creditors. If voted down or not filed within the permitted time period, the franchisee will be deemed to have made an assignment in bankruptcy and the termination provision of franchise agreement can take effect.

The franchise agreement should also include a clear provision that states that in the event of one of these material defaults, the franchise agreement would be terminated upon written notice with no opportunity to cure.

Leases

It is common either for the franchisor to hold the head lease and sublease the premises to the franchisee or for the franchisee to hold the head lease directly.

In a situation where the franchisee holds a sublease from the franchisor, the franchisor has the advantage of having 'location control'. However, the disadvantage to the franchisor is that the franchisor will continue to be liable notwithstanding the bankruptcy of the franchisee. In past recessions, this approach to leasing in franchising has been one of the most significant contributors to the ultimate failure of franchisors, as too many franchisees failed, leaving the franchisor liable for the leases. Another concern in a sublease scenario is the right of the franchisee's trustee under subsection 38(2) of the *Commercial Tenancies Act* (*Ontario*)[2] to assign the sublease to a "person fit and proper to be put in possession of the leased premises," which may deny the franchisor the ability to acquire the premises.

---

[1] R.S., 1985, c. B-3
[2] R.S.O. 1990, CHAPTER L.7

In a situation where a franchisee holds a direct lease from a third party landlord, section 136(1)(f) of the BIA plays a significant role. This provision gives a landlord a preferred claim limited to the value of the chattels located on the premises. The landlord's preference is for three months of rental arrears preceding the bankruptcy and further arrears of three months following the bankruptcy (subject to their being an acceleration provision in the lease).

However, a bankruptcy order against a tenant in possession will defeat a potential distraint by a landlord and will allow creditors with fixed security over the chattels to have priority. The franchisor will often be the third party most interested in acquiring the lease and chattels on the leasehold property, particularly if it wants to maintain the franchised business as is. As such, a franchisor will want to have security under the *Personal Property Security Act (Ontario)* ("PPSA")[3] to maintain priority with respect to the chattels vis-à-vis the landlord's distraint and any other registered security interests, with the possible exception of the franchisee's bank.

Alternatively, whether or not the franchisor is protected under the PPSA, the franchisor may want to petition the franchisee into bankruptcy to opt for a friendly receivership in order to acquire the premises against a reluctant landlord.

Enforcement of Personal Property Security Agreement by the Franchisor

With respect to the chattels, the franchisor, who does not hold a security interest under the PPSA, will have to deal with a potential distraint by the landlord and enforcement of a prior security interest commonly registered by the franchisee's banker.

Ideally, the franchisor will hold a personal property security interest over the chattels of the franchisee. If this is the case, the franchisor may appoint a receiver to seize and sell or foreclose on the assets of the insolvent/defaulting franchisee under the security agreement. Any security interest is subject to prior registered securities against the same assets, so a franchisor may rank after other charge holders, most commonly at least the franchisee's banker.

How Recent Amendments to the Bankruptcy and Insolvency Act Impact Franchisors

The BIA has recently undergone amendments, some of which affect franchisors who are dealing with the bankruptcy of a franchisee. The first is the priority charge given in favour of employees who are owed remuneration at the time a bankruptcy happens. This priority charge in the BIA reflects new legislation called *Wage Earner Protection Program Act* ("WEPPA"),[4] which allows employees to apply to the Wage Earner Protection Plan for arrears of wages and compensation earned within six months immediately preceding the bankruptcy or receivership. This new Employee Remuneration Charge, which secures up to a minimum of $2,000 in respect of wages, salaries, commissions or compensation for services, and up to $1,000 in respect of disbursements owing to travelling salespeople, may erode the value of a secured creditors' collateral. To cushion the blow, the priorities in section 136 of the BIA have been amended to provide secured creditors with a preferred claim equal to any erosion in the value of their collateral resulting from the Employee Remuneration Charge. Nonetheless, a franchisor, even if a secured creditor, may not be able to recover any value from the franchisees chattels as a result of the priority given to employee remuneration.

Furthermore, as mentioned above, the same provision of the BIA that would restrict the rights of a franchisor from terminating the franchise agreement because the franchisee has filed a notice of intention to make a proposal or has made a proposal, section 65.1, has been amended to specifically include security agreements. As such, a franchisor who is also a secured creditor will be prohibited from terminating, amending, or accelerating payment by reason only of the fact that the debtor is insolvent or has initiated bankruptcy proceedings under the BIA. However, if the franchisee defaults on payment, the franchisor can still realize on its security.

On a more favourable note to the franchisor who also acts as a supplier to the franchisee, the BIA was amended to permit an unpaid supplier to demand possession of goods delivered within the 30 days prior to a bankruptcy or

[3] R.S.O. 1990, CHAPTER P.10

[4] R.S. 2005, c. 47, s. 1

receivership. The supplier will have 15 days from the date of the bankruptcy or the date the receiver is appointed to demand possession. This is a more advantageous position for the supplier who, prior to the amendments, had to deliver a claim within 30 days of the date the goods were supplied, at which time the debtor must have been bankrupt or a receiver must have been appointed.

In order to maximize this right, a supplier franchisor should keep current on the franchisee's situation so that it can learn as quickly as possible if there is a receivership or bankruptcy, and act quickly upon receiving a notice from a trustee or receiver. The franchisor should also have invoicing with identifying features of goods supplied and avoid terms which extend credit beyond 30 days.

Conclusion

The interconnection between bankruptcy laws and franchise laws is important to keep in mind in a franchise system from as early as the time of drafting the franchise agreement. This article has highlighted only some of the matters a franchisor should consider for inclusion in a franchise agreement, the taking of a security interest in the franchisee's chattels, dealing with leases and the bankruptcy process.

Byline

**Edward (Ned) Levitt is a partner at Dickinson Wright LLP, Toronto, Canada. He served as General Counsel to the Canadian Franchise Association from 2000 to 2007 and, as a member of the Ontario Franchise Sector Working Team, was instrumental in the creation of Ontario's franchise legislation. Among his many publications is Canadian Franchise Legislation published by Butterworths/LexisNexis. Mr. Levitt can be reached at 416-646-3842 or nlevitt@dickinsonwright.com.*