24TH ANNUAL OBA FRANCHISE LAW CONFERENCE

FRANCHISE LAW

Underwater: Managing Insolvency and Bankruptcy in Franchise Systems

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"***How did you go bankrupt? Two ways: Gradually, then suddenly*."
Ernest Hemingway, *The Sun Also Rises*

1. Introduction

I. Preliminary Remarks

Franchise relationships are inherently interconnected, requiring constant coordination between franchisors and franchisees to sustain brand integrity, operational stability, and financial performance. However, when either party experiences financial distress, the relationship becomes particularly vulnerable - affected not only by the intricacies of federal insolvency law, but also by provincial franchise legislation, secured lending, commercial leasing and principles of contract law.

While insolvency practitioners may approach such matters primarily through the lens of creditor recovery, franchisors will inevitably view things from a broader business perspective. Their role extends beyond collecting arrears to preserving brand reputation, ensuring system-wide continuity, and managing the potential contagion effects that one failing franchisee can have on others within the network. A single insolvency can potentially disrupt customer relationships, strain supplier arrangements and even erode public confidence in the brand, both locally and system-wide.

Accordingly, franchisors would be wise to implement proactive monitoring and early warning systems that are designed to identify signs of financial distress before they escalate. Regular oversight, supported by strong communication protocols and financial reporting mechanisms, enables franchisors to anticipate problems, engage early with franchisees, and take steps that may rehabilitate a struggling operation rather than lose it to insolvency. When financial distress does lead to formal proceedings, a franchisor's preparedness - and its understanding of the remedies available to key stakeholders such as landlords, lenders, and trustees - can significantly influence its ability to protect assets, recover amounts owed and retain control over the franchise location.

Missteps in responding to insolvency - whether due to delay or lack of coordination - can have consequences beyond a single outlet, potentially undermining the stability of the entire franchise system. These circumstances demand a blend of legal, operational and strategic responses, ranging from formal insolvency processes such as receivership, bankruptcy or court-approved sales to informal remedies available under franchise agreements.

This paper offers a practical framework for franchise counsel navigating the complexities of franchisor and franchisee insolvency in Ontario. It examines:

1. The principal insolvency proceedings applicable to franchisees and franchisors;

2. Considerations before commencing (or being pulled into) insolvency proceedings;

3. The operation of statutory stays and their effect on franchise agreements and lease agreements; and

4. The strategic role for franchisors participating in insolvency sales processes.

By combining proactive monitoring with a well-informed response strategy, franchisors and their advisors can better navigate financial distress within their networks, mitigate risk to the brand, and preserve long-term value across the franchise system.

Canada insolvency laws are primarily governed by two main federal statutes: the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*. While the focus on this paper is on the topic of insolvency, where insolvency laws and proceedings inevitably overlap with provincial law, our focus will be on the laws of Ontario. It also goes without saying that this is a complex area, so this paper will only deal with insolvency from a high level perspective. No doubt you will breathe a sigh of relief in reading this.

II. General Objectives of Insolvency Law

Insolvency can threaten viable businesses across all sectors of industry. When dealing with insolvent or impecunious franchisees, all involved parties must recognize the complicated and interwoven legal relationships that tie together insolvency and franchise law. This section presents a high level overview of various insolvency proceedings that a franchisor or franchisee may be subject to in the event of insolvency.

A. Restructuring

When the spectre of financial distress raises its head in the franchise context, the common response is to anticipate a formal bankruptcy (*i.e.* a liquidation) and the cessation of the business. However, as discussed below, this is not always the only option available to a company in these circumstances.

A franchisor or franchisee seeking to avoid bankruptcy may attempt to restructure its financial affairs by presenting creditors with a "plan of arrangement" under the *Companies' Creditors Arrangement Act*[1] ("**CCAA**") or a "proposal" under the *Bankruptcy and Insolvency Act*[2] ("**BIA**"). Both frameworks allow financially distressed businesses to negotiate compromises with creditors while benefiting from a temporary stay of proceedings, giving the debtor time and stability to develop a restructuring plan. The underlying purpose is to provide an opportunity for an organization to avoid bankruptcy and continue to operate, while allowing creditors to receive some form of compensation for amounts owing to them by the organization that is superior to what they would receive in a bankruptcy.

Under the BIA, when a debtor files a Notice of Intention to Make a Proposal ("**NOI**") pursuant to section 50.4(1), or subsequently files a proposal under section 62, an automatic stay of proceedings is automatically triggered.[3] This stay prevents creditors from commencing or continuing enforcement actions, seizing assets, or otherwise realizing on security without court authorization. Similarly, under the CCAA, when a debtor applies for protection and the court issues an "Initial Order" under section 11,[4] a stay of proceedings is imposed - ordinarily

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1 *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 (as amended) [**CCAA**].

2 *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 (as amended) [**BIA**].

3 BIA, ss. 69 and 69.1.

4 CCAA, s. 11.

lasting up to ten days[5] - which can later be extended by the court. In both regimes, the purpose of the stay is to preserve the debtor's business operations and asset base while providing an opportunity to formulate and negotiate a viable restructuring proposal. While the stay is in effect, this will prevent franchisors from enforcing their contractual rights or commencing proceedings.

Creditors are organized into classes based on commonality of interest, and each class votes on whether to accept the proposed plan or arrangement. Approval requires a double majority - that is, a majority in number and two-thirds in value of the creditors within each class. If the required majority of creditors approve, a subsequent application is made to the court, which will grant final approval if the plan meets legal and fairness requirements. Upon approval by the court, the plan or proposal becomes a legally binding agreement on all creditors (even those who voted against the proposal). If approved, it allows the business to continue operations and avoid bankruptcy - provided it performs in accordance with the approved terms.

In the case of an NOI proceeding, where a debtor company is unable to secure approval from the majority of creditors, the consequences are immediate and automatic: the debtor is deemed bankrupt, and the proposal trustee assumes the role of bankruptcy trustee. Similarly, if a CCAA plan of arrangement is rejected by either the creditors or the court, the stay of proceedings is usually lifted, allowing creditors to pursue their pre-existing rights and remedies.

During the restructuring process, secured creditors are generally barred from enforcing their security unless they can demonstrate to the court that their interests are being unjustly prejudiced by the stay or that they took possession of the collateral before the filing of the NOI or the commencement of CCAA proceedings.

B. Bankruptcy

There are a few routes to a company entering bankruptcy. As noted above, a company can be automatically deemed to be bankrupt where it fails in its attempt to have its proposal approved. It may also become bankrupt involuntarily as a result of a bankruptcy application initiated by one or more its unsecured creditors. Alternatively, the debtor may acknowledge that its financial difficulties are insurmountable and decide to voluntarily make an assignment into bankruptcy for the general benefit of its creditors. The debtor will be deemed to be bankrupt upon the date that the bankruptcy order is made or an assignment is filed.

Under any of these scenarios, on the filing of the bankruptcy order, s. 69.3(1) of the BIA provides for an automatic stay of proceedings.[6] The practical effect is that the franchisor will be precluded from commencing an action against a debtor franchisee for any reason, including with respect to any arrears or unpaid royalties arising under the franchise agreement. However, the bankruptcy of the debtor does not preclude a secured creditor from otherwise realizing or dealing with its security.[7] In light of this, a franchisor should ensure that

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[5] CCAA, s. 11.02(1).

[6] BIA, s. 69.3(1).

[7] BIA, s. 69.3(2)

its franchise agreement contains a provision for the granting of security interests over the assets of the franchisee and for the franchisor to register its security interest under *Personal Property Security Act* (Ontario).[8]

The governing philosophy of a bankruptcy is that it is a process for the orderly, fair, and efficient liquidation of an insolvent debtor's estate. To that end, all of the debtor's right, title and interest in all of its assets and property vests in the bankruptcy trustee from that point forward.[9] The trustee's mandate then becomes collecting and realizing upon the bankrupt's assets to maximize recovery to the estate.

C. Receiverships

A receivership proceeding is the "middle ground" between liquidation and restructuring. In almost every case, a receivership is creditor-oriented as the process is typically initiated by a significant secured creditor of the business, such as a lender. If the creditor is successful, a court order is granted appointing a court-appointed receiver (a licensed insolvency trustee) over all of the assets and property of the debtor company.

Upon appointment, although the business' assets do not vest in the receiver as is the case with a bankruptcy trustee, the receiver is responsible for taking possession and control of the assets or business operations. A typical receiver's mandate is to formulate a sale process to realize upon the assets and property of the debtor for the benefit of all creditors and stakeholders. To achieve this, the receiver may elect to operate the business for a period of time with a view to effecting a sale of the business as a going concern in order to maximize recoveries for creditors, preserve jobs and maintain supplier relationships.

The order appointing a receiver normally includes a stay of proceedings and arms the receiver with a broad array of powers including taking possession and control of assets, conducting investigations, selling property or liquidating assets and distributing the proceeds based on the legal priorities established by law.

2. Considerations Before Commencing Insolvency Proceedings

I. Pre-litigation Searches & Information Gathering

Before initiating proceedings, a creditor franchisor should first determine whether litigation is strategically and financially justified. Conducting comprehensive pre-litigation searches can help assess the franchisee's financial position and the likelihood of recovery should judgment be obtained. Even when the goal is not primarily to "send a message" to the network, these searches can reveal whether the pursuit of a claim is economically worthwhile.

Where the franchisee has previously consented, obtaining a credit bureau report is a valuable first step. Such reports provide insight into the franchisee's credit and payment history, outstanding obligations to other creditors, and up-to-date identifying information. In addition, personal property security searches offer visibility into existing security interests, liens, or encumbrances affecting the franchisee's assets. Franchisors who have taken security

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8 *Personal Property Security Act*, RSO 1990, c P.10, as amended [**PPSA**]

9 BIA, s. 71.

interests themselves should pay close attention to the renewal and expiry dates of their registrations under their provincial *Personal Property Security Act* ("**PPSA**") to ensure continued protection of their security interest. Depending on the nature of the business and financing, a search under the *Bank Act*[10] may also be appropriate to determine whether a financial institution or lender holds a security interest in the franchisee's assets.

Further due diligence should include bankruptcy and insolvency searches to identify whether the franchisee is already subject to formal proceedings, execution searches to uncover any judgments or writs registered by other creditors and litigation searches to determine if the franchisee is engaged in ongoing court actions. Real property searches can reveal whether the franchisee or its principals own land that might support recovery efforts, while driver's licence searches may assist in locating current addresses for service of legal documents or demand letters.

Basic internet and social media searches should not be overlooked. In an era of pervasive digital footprints, publicly available online information can offer useful insights into a franchisee's activities, business reputation or possible changes in operations or location.

Systematic information gathering and monitoring are essential components of an effective franchise relationship. Beyond facilitating good communication and operational continuity, these measures enable franchisors to identify early signs of financial distress. The more current and accurate information a franchisor maintains, the better equipped it will be to assess risk, plan targeted interventions and - where possible - avert formal insolvency proceedings. Implementing structured monitoring protocols and recognizing early warning indicators can make the difference between a manageable restructuring and a complete business failure.

II. Remedies

Most commonly, the franchisor's goals are to preserve the location, protect the brand, quickly place a new operator or franchisee and recover any outstanding royalties. Meanwhile, the franchisee may be trying to remain open, seeking another buyer, or simply limiting exposure under guarantees.

Early recognition of these dynamics is critical, allowing the parties to act cooperatively - either to accomplish a voluntary winding down of the business or to facilitate a transition to a corporate store or new franchisee. Solutions are fact-specific and vary by business type and location. The earlier the franchisor has relevant information, the more options are available, ranging from providing extraordinary (including, perhaps financial) support, terminating the franchise agreement, enforcing security through a "soft" or full blown court-appointed receivership or exercising remedies under a lease agreement.

A. Foreclosure or Power of Sale

Where a franchise agreement grants a security interest in the franchised business's assets in favour of the franchisor, the franchisor can rely upon remedies under Part V of the PPSA (Ontario), equivalent provincial statutes and the BIA. The security interest is typically included

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[10] *Bank Act*, SC 1991, c 46.

in the franchise agreement or a separate general security agreement. The franchisor must provide the notices required under section 244 of the BIA, along with any notices stipulated in the franchise agreement. After the statutory 10-day notice period - or a shorter period if the franchisee consents or the court orders otherwise - the franchisor may elect to sell the collateral under a statutory power of sale or retain it in satisfaction of the debt through a foreclosure process.

Foreclosure is rare, however, as it extinguishes any residual debt and limits the franchisor's ability to enforce guarantees. It may be suitable where there are no guarantees, the franchisee is insolvent, and the collateral's value exceeds the outstanding debt. If the asset value is insufficient, other parties, such as banks or shareholders, may redeem the assets.

More commonly, franchisors prefer to exercise their power of sale through the mechanism of a receiver or receiver-manager. There are two ways to involve a receiver. The first is a privately appointed receiver (appointed under the terms of the security agreement) who acts as the franchisor's agent and who must act in a commercially reasonable manner when realizing upon assets, maximizing asset value and making independent operational decisions. Alternatively, the franchisor can seek a court-appointed receiver under the BIA, PPSA, or section 100 of the *Courts of Justice Act* (Ontario).[11] As a court-appointed receiver is an officer of the court, the court can issue directions to the receiver on key issues - including environmental, employment, product liability, leasing, and contracts - through an initial appointment order and subsequent court orders. While more expensive, this approach is normally the preferred method as it mitigates post-sale disputes, gives protection to the receiver by way of court approval of its actions and provides affected parties with a forum to challenge or modify the proceedings.

B. Termination of the Franchise Agreement

The franchisor will usually have many monetary and non-monetary events of default set out in the franchise agreement. The courts are consistent in finding that any termination by the franchisor must be done in accordance with the franchise agreement. This judicial strictness is likely because of the common existence of unequal bargaining positions at inception of the franchise agreement. A franchisor can usually anticipate liberal application of the rule of *contra proferentum*, meaning that ambiguities in the franchise agreement will usually not be resolved in its favour.

Outside a stay of a proceedings, courts may scrutinize terminations under the duty of fair dealing in s. 3 of the *Arthur Wishart Act*[12], ("**AWA**"), which requires both parties to act in good faith and in accordance with reasonable commercial standards.[13]

C. Injunctions (and Alternatives)

Interlocutory injunctions are an extraordinary remedy with significant implications for the franchise relationship. A successful interlocutory injunction application can heavily influence the ultimate outcome of a dispute. From a franchisor's perspective, injunctions are most often

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11 *Courts of Justice Act*, RSO 1990, c C.43, as amended.

12 *Arthur Wishart Act (Franchise Disclosure), 2000*, SO 2000, c 3 [**AWA**].

13 *Avante Automobile (2017) Corporation v BMW Canada Inc***.**, 2025 ONSC 87.

used to enforce non-compete clauses, protect intellectual property, secure royalty payments, or address the sale of products on terms that violate the franchise agreement. Given the costly, time-consuming, and potentially destructive nature of injunction proceedings, alternative remedies should generally be explored first.

As an alternative option, a franchisor may also choose to serve a notice of termination of the franchise agreement and lease. If the franchisee contests, it would need to seek relief from forfeiture, and a court will likely require the franchisee to remedy all breaches of the agreement. In this way, the franchisor achieves the practical effect of an injunction without giving an undertaking or meeting the strict criteria for injunctive relief.

Arbitration offers another potential route if the franchise agreement contains an arbitration clause. Having an arbitrator decide on the injunction can be attractive: the arbitrator is selected by the parties, is likely more familiar with franchising, and conducts proceedings that are confidential. Arbitral orders are generally final, with judicial review available only in limited, time-consuming, and costly circumstances.

D. Landlord Remedies

When the franchisor acts as landlord - either through ownership of the premises or as the head-tenant under a lease - it has a range of remedies in addition to any rights granted under security interests in the franchise agreement. Key options include:

1. **Distress** - Distress is a self-help remedy that allows the landlord to seize a tenant franchisee's assets to satisfy unpaid rent, provided the lease remains in effect. The right of distress is contingent on the existence of a valid lease, meaning that termination of the lease generally precludes this remedy. Attempts to simultaneously terminate the lease and exercise distress are often unsuccessful under judicial scrutiny. Distress "follows the goods,"[14] and courts may impose a punitive obligation - potentially double the value of the assets - if goods are wrongfully removed from the premises without the landlord's consent.[15]

2. **Lease Termination** - A franchisor may elect to terminate the lease if rent remains unpaid pursuant to the terms of the lease, thereby regaining control of the premises. This is particularly advantageous when bankruptcy is imminent, as it allows the franchisor to bypass complications such as occupation, disclaimer or assignment of the lease by a bankruptcy trustee. If the franchisor is a sub-landlord under a head lease, it can negotiate directly with the head landlord to either retain or surrender the head lease, withdraw from the location, or insert a new subtenant without requiring assignment of the lease or, in some cases, landlord approval.

3. **Litigation** - The franchisor may also pursue legal action under the lease's covenants, including claims for accelerated rent or other contractual remedies.

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[14] *Commercial Tenancies Act* [**CTA**], s 48.
[15] *CTA*, s. 50.

These remedies provide franchisors with significant leverage to protect their interests in a strategic location when a franchisee is experiencing financial distress, helping to safeguard both the property and the continuity of operations.

E. Self Help

Outside of the remedies discussed above, the following is a summary of optional remedies that may be available under the applicable franchise documents or from the franchisor's conduct in administering the franchise. They are generally available without the need for initiating a formal court proceeding, though we caution that some carry significant risk for the franchisor.[16] These include:

1. Taking steps to mitigate the risk of an insolvency by providing financial accommodations or concessions to the franchisee, including reducing royalty fees or "payment holidays", providing the franchisee with a reasonable time frame to sell the franchised business, stepping in to manage the franchisee's business on a temporary basis to right the ship, etc.

2. Entering into a forbearance agreement which provides a payment plan to address payment arrears and includes franchisor-friendly provisions, such as an acknowledgement of the debt, a consent to judgment and enhanced financial reporting. This can be done in conjunction with the financial accommodations noted above.

3. Adjusting payment terms or tightening trade credit for the franchisee, such as moving to a COD basis. This can be seen in industries like marine or automobile dealerships where parts are needed daily. The governing agreement should be consulted (along with legal advice being sought) before taking any steps in this regard.

4. Increasing supervision or consulting frequency at the franchisee's expense, which can convey a message about performance expectations while providing the franchisor with better operational information.

5. Altering rebates or volume allowances, taking advantage of broad contractual discretion to adjust timing, disclosure or allocation of entitlements to incentivize or signal performance expectations within the network. Again, the governing agreement should be reviewed before making any adjustments.

6. Buying the franchise back from the franchisee.

7. Exercising the right of distraint (discussed above under the subtopic "Distress").

Such practices may be ingrained in the operations of long-established franchise networks and often implemented without legal guidance. However, in today's judicial environment, these

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[16`] The authors make no recommendations in respect to any of these remedies. Legal advice should be obtained before pursuing any of these options.

actions can carry significant risks for franchisors. If a franchisor is accused of failing to uphold its duty to deal fairly and act in good faith,[17] these actions are likely to be judged negatively.

As such, the franchisor is always advised to obtain a legal opinion before continuing or commencing any of these types of remedies to know where the dangers lie.

III. Priorities of Stakeholders in Insolvency Proceedings

Regardless of the form of insolvency process, the rights and remedies of the various stakeholders to the franchised business will inevitably come into conflict due to the resulting scarcity of debtor resources. The following parties are typically the key stakeholders that will end up jockeying for priority in the context of an insolvency. The perspective of six primary stakeholders in the franchise context (franchisor, landlord, lender, tax authorities, suppliers and employees) will be analyzed from an insolvency perspective. This broad overview aims to provide a guide for franchisors to alert them to the competing priorities that must be navigated in the midst of a franchisee's potential or actual financial failure.

A. Landlords

There are two typical leasing scenarios in the franchise context: (1) the franchisor may become the head tenant under a lease with a third party landlord and then sublet the premises to the franchisee pursuant to a sublease; or (2) the franchisee can enter into a lease directly with a third-party landlord. As the franchisor has less control over the leasing relationship in the second scenario, we will focus on the rights and remedies of a landlord and how they are impacted by an insolvency proceeding.

Pre-Insolvency

As mentioned above, where there has been a default under a real property lease, landlords generally possess two mutually exclusive remedies: (1) the right to distrain against the assets of the tenant; and (2) the right to terminate the lease and sue for damages. The right of distraint can be very powerful as the landlord may seize the tenant's goods, chattels and inventory as security for rent arrears. This can directly impact secured creditors as the landlord's right of distraint ranks ahead of a general security interest, provided that the landlord distrains prior to enforcement by the secured creditor.[18] The competing claims to priority in tenant property between secured creditors and distraining landlords often lies in the 'race of the swiftest' - whomever acts first obtains practical priority over the assets.[19] In Ontario, the remedy of distraint is carved out of the PPSA, so it is not governed by the priority rules established in the PPSA.[20]

Things become more complicated where a head landlord seeks to distrain against goods of a subtenant (the franchisee) due to a payment default by the head tenant (the franchisor). The

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17 AWA, s. 3.

18 *Leavere v Port Colborne (City)* (1995), 22 OR (3d) 44, 122 DLR (4th) 200 (Ont CA).

19 F. Bennett, "Distress: A Procedural Guide" in H. M. Haber and R. D. Malen, eds, *Distress: A Commercial Landlord's Remedy*, 2nd ed. (Thomson Reuters, 2021), p. 185.

20 PPSA, s. 4(1); *Commercial Credit Corp. v. Harry D. Shields Ltd.*, 1981 CanLII 1840 (ON CA) at para 2.

subtenant's goods and chattels, etc. may be exempt from the seizure provided that the subtenant/franchisee complies with section 32(2) of the CTA. Under section 32(2) of the CTA, the subtenant provides a statutory declaration that includes a statement that, among other things, the assets are solely the property of the subtenant and that the head tenant has no interest in the goods.

Post Insolvency

The analysis changes significantly upon the occurrence of a bankruptcy. Where a tenant becomes bankrupt before the landlord has completed a distraint - such as when the proceeds of sale have not yet been received - the priority between the landlord and a secured creditor is effectively reversed.[21] Upon the tenant's bankruptcy, all of the tenant's property automatically vests in the bankruptcy trustee.[22] As a result, the landlord must return any distrained property to the trustee and its rights of distraint are stayed. Once the bankruptcy has commenced, a secured creditor is free to enforce its security interest. For this reason, it is not uncommon for a secured creditor to strategically initiate a bankruptcy application to "reverse priorities" vis-à-vis a distraining landlord.

In a bankruptcy scenario, the landlord not only loses its rights of distraint, but is also precluded from terminating the lease due to the operation of the statutory stay of proceedings. In Ontario, a bankruptcy trustee is entitled to remain in possession of the leased premises for a period of three months following the bankruptcy.[23] If the trustee elects to remain in possession, it is required to pay occupation rent during that three month period. Within this time, the trustee may decide to disclaim or retain the lease agreement for the remainder of its term or, alternatively, to assign it to a third party.[24] As discussed in greater below, in order to assign the lease, all rental arrears must first be brought current and any proposed assignee must be approved by the court.[25] Section 84.1 of the BIA further confirms the trustee's statutory right to assign a lease.

Nevertheless, the landlord retains certain limited protections in a bankruptcy. Under section 136(1)(f) of the BIA, the landlord is classified as a preferred creditor with respect to rent arrears for the three months preceding the bankruptcy and for accelerated rent for up to three months, provided that such acceleration is permitted under the lease. Upon disclaimer of the lease, the landlord's claim is limited to its preferred claim for up to three months' accelerated rent in respect of the unexpired term of the lease, to the extent of value of the assets on the premises. Where the value of the assets on the premises is not sufficient to cover the landlord's claim, it is entitled to recover any unpaid balance of its preferred claim as a regular unsecured creditor.[26]

By contrast, where a lease has been disclaimed in the context of a BIA proposal, the landlord has no entitlement to claim accelerated rent. In that situation, the landlord's claim is restricted

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21 *BIA*, s 71.
22 *Ibid* at s 70.
23 CTA, s. 38(2).
24 *Ibid* at s 38(2).
25 CTA, s. 38(2).
26 *Curriculum Services Canada/Services Des Programmes D'Études Canada (Re)*, 2020 ONCA 267

to either: (1) actual damages arising from the disclaimer (subject to mitigation); or (2) the lesser of (a) the aggregate of rent for the first year following the disclaimer plus 15% of the rent for the balance of the term, or (b) three years' rent.[27]

The CCAA does not provide specific rules for the valuation of landlord claims. As a result, it must be determined by the debtor in its plan of arrangement.

B. Lenders

In nearly all franchised businesses, the franchisee will require financing from a third-party lender to support operating costs. Typically, the lender will require that the borrower grant a first-ranking security interest over all present and future personal property of the borrower by way of a general security agreement. To ensure that it holds first-ranking priority, the lender may require waivers or enter into subordination agreements with any existing creditors, including franchisors and landlords. Loan agreements commonly also include provisions permitting the lender to review the franchisee's financial records periodically, as well as covenants requiring the franchisee to maintain all tax remittances in good standing.

Where such measures are in place, the lender is positioned to occupy a senior position in the creditor hierarchy in the event the franchisee defaults or becomes subject to insolvency proceedings. Secured creditors generally fall outside the stay provisions of the BIA and are entitled to enforce their security in bankruptcy. Provided the security interest has been properly perfected, the secured creditor retains its security in receivership, BIA or CCAA proceedings, subject to claims of the Crown or court-ordered charges arising in those proceedings.

It is important to note, however, that the enforcement rights of a secured creditor may be stayed by the commencement of BIA proposal proceedings, unless the creditor has delivered a *Notice of Intent to Enforce Security* under section 244 of the BIA more than ten days prior to the initiation of the proposal or the filing of a *Notice of Intention to Make a Proposal*. Similarly, secured creditors may be stayed in CCAA proceedings. In either proceeding, the claims of secured and unsecured creditors alike may be compromised.

C. The Crown

Federal and provincial authorities possess extensive powers regarding unpaid tax remittances, which may materially affect the rights and priorities of creditors in commercial relationships. Notwithstanding the measures taken by a creditor to obtain security and establish priority vis-à-vis other creditors, the creditor may be subject to super-priority claims of the Crown upon the insolvency of the debtor. Creditors dealing with an insolvent debtor must generally contend with two principal types of federal Crown claims:

1. **Employee Payroll Source Deductions**: Employers are required under the *Income Tax Act*[28] (the "**ITA**") to remit amounts deducted from employees' wages for income tax, Employment Insurance, and Canada Pension Plan contributions (collectively,

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27 *Ibid* at s 65.2(4).
28 *Income Tax Act*, RSC 1985, c.1 (5th Supp.).

"**source deductions**") to the Receiver General. Pursuant to section 227(4)[29] of the ITA, such source deductions are deemed to be held in trust for Her Majesty, separate from the employer's property. Failure to remit source deductions activates a deemed trust, that attaches to all property of the employer in respect of the arrears and continues until the obligations are satisfied. For enforcement purposes, this deemed trust is accorded super-priority over all other security interests (except for specified prescribed security interests), thereby ranking ahead of secured creditors.

2. **Harmonized Sales Tax (HST) Arrears**: Under the *Excise Tax Act*[30] (the "**ETA**"), HST collected but unremitted similarly constitutes a deemed trust. The deemed trust attaches to all real and personal property of the debtor and ranks in priority to security interests, subject only to prescribed security interests.[31]

In addition to being subordinated to super-priority Crown claims, a secured creditor that has previously received payments from a tax debtor may face the risk that such payments could be "clawed back" by the Crown. The Crown has a statutory right of action against such recipients,[32] which presents a significant challenge for secured creditors, as there is no independent mechanism to verify whether the debtor has properly remitted source deductions or HST. This difficulty is compounded by the fact that deemed trust claims for source deductions and HST do not need to be registered[33], creating a complex landscape for enforcement analysis.

Once a franchisee becomes subject to bankruptcy or a proposal under the BIA/CCAA, many Crown claims lose their special status and are treated as unsecured claims.[34] A key exception is the deemed trust for employee source deductions, which retains its super-priority in all insolvency proceedings.[35] In contrast, HST deemed trust claims generally lose their priority in bankruptcy and proposal proceedings, making these claims less secure.[36] For this reason, creditors sometimes consider bankruptcy proceedings as a way to alter statutory priorities. Receiverships, however, do not affect the statutory priorities of deemed trust claims, which continue to rank ahead of most secured interests.

This summary provides only a high-level overview of the complex framework governing Crown claims and related enforcement remedies. Franchisor creditors and other stakeholders are strongly advised to consult experienced insolvency counsel to navigate the intricate legal and practical considerations involved.

D. Suppliers

In a typical insolvency scenario, unpaid suppliers of goods are simply unsecured creditors, meaning that these claims rank below secured creditor claims and other preferred claims.

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29 *Ibid* at s. 227(4.1).
30 *Excise Tax Act,* RSC 1985, c E-15 (as amended) [ETA].
31 *Ibid* at s 222.
32 *Canada v Toronto*-Dominion *Bank*, 2018 FC 538, 293 ACWS (3d) 433 (FC).
33 *ITA*, *supra* note 14 at s 227(4.1).
34 *BIA*, s 86; *CCAA*, s 38(1).
35 *BIA*, s 87.
36 *Century Services Inc v Canada (Attorney General)*, 2010 SCC 60 (CanLII), paras 44-45.

However, to counteract the unfairness of suppliers that have supplied goods to a debtor that is unable to pay due to financial pressures, the BIA includes special priorities for suppliers. For example, section 81.1 of the BIA (known as the "30 Days Goods Rule") provides that unpaid suppliers may repossess goods delivered any time in the 30 days prior to a bankruptcy or receivership, provided they act within 15 days of the bankruptcy filing. Section 81.1(5) permits the trustee, receiver or court to extend the 15-day period before its expiry. Section 81.1(4) makes the unpaid supplier rule applicable to situations where a debtor initially proceeded by way of proposal rather than bankruptcy or receivership.

To invoke this right, the supplier must submit a written demand to the trustee or receiver in a prescribed form detailing the transaction and the goods being claimed. At the time the demand is delivered, the goods must be in the possession of the trustee or receiver, identifiable and unpaid, and remain in substantially the same condition as when delivered. The goods must not have been resold at arm's length or be subject to a *bona fide* agreement for sale at arm's length.

Once a valid demand is made, the trustee or receiver may either comply and return the goods, pay the supplier for their value, or refuse the demand. If the trustee or receiver refuses, the supplier may appeal to the court for relief. While the "30-Day Goods Rule" provides priority over other claims with respect to the reclaimed goods, its practical application is often limited. The supplier must have timely knowledge of the insolvency and act within the fifteen-day window, which can be challenging if notice of the bankruptcy or receivership is delayed.

Where the supplier is unable to reclaim goods under section 81.1, there may still be an opportunity to assert a right of set-off under section 97(3) of the BIA. Set-off allows debts owed mutually between the supplier and the insolvent franchisee, which arose prior to the bankruptcy or receivership, to be netted against each other. This remedy ensures that the supplier is not unfairly required to remit funds to the trustee or receiver while being unable to collect amounts owed to it. In addition, set-off rights may be expressly recognized in the supplier's contract with the franchisee, including provisions within the franchise agreement itself.

E. Employees

Both legislation and insolvency law recognize that employees are essential contributors to a business by granting them certain protections in an insolvency.

In most bankruptcies, the employees are immediately terminated, leaving them with outstanding claims for unpaid wages, vacation pay, severance or termination pay. But for the protections afforded to employees discussed below, they are unsecured creditors ranking behind secured lenders (*e.g.* banks).

As a bulwark to an employee's subordinate position, employees can access compensation through the *Wage Earner Protection Program* ("**WEPP**").[37] WEPP provides limited compensation to employees who lose their jobs due to bankruptcy or receivership.[38] An

37 *Wage Earner Protection Program Act*, S.C. 2005, c. 47 [**WEPPA**].

38 WEPPA, s. 5(1).

employee can submit a claim through Service Canada for payment through WEPP for unpaid wages, vacation pay, severance, and termination pay.[39] Employees can obtain a maximum payout up to an amount equivalent to 7 times the maximum weekly insurable earnings under the *Employment Insurance Act*, less any amounts prescribed by regulation.[40] In 2025, the maximum is $8,844.22 per employee.

The government is then subrogated to the rights of the unpaid employee for amounts paid under the WEPP and receives a limited super-priority claim against the current assets of the debtor company in the amount of the compensation actually paid out (including vacation pay, but not termination or severance pay),[41] to a maximum amount of C$2,000 per employee.[42]

Any balance that exceeds this amount does not have priority over secured creditors.

It should be noted that WEPPA does not extend to employees of franchisees undergoing protection under the CCAA.[43] Directors, officers, and controlling shareholders of the insolvent company are also ineligible to access WEPP payments. In addition to wage claims, bankruptcy or receivership triggers a super-priority charge for unremitted pension plan contributions, including the employer's required portion. Unlike wage claims, the pension charge is not subject to a monetary limit and ranks ahead of all claims by secured creditors, with the sole exception of the WEPP charge.[44] This charge does not arise in a BIA proposal or CCAA proceeding.

3. Impact of the Statutory Stay on Franchise Agreements

Franchise relationships are uniquely vulnerable in insolvency proceedings, given the interdependence between franchisors and franchisees and the highly contractual nature of their arrangements. When a franchisee becomes insolvent, the resulting proceedings under the BIA or CCAA can significantly affect the parties' respective rights and obligations. In particular, issues frequently arise concerning (i) the franchisor's ability to terminate the franchise agreement; (ii) the potential assignment of the franchise agreement to a third party as part of a restructuring or sale; and (iii) the power of trustees or the debtor company to disclaim unprofitable or burdensome agreements.

The following sections examine these three key areas of interaction between franchise law and insolvency law, highlighting how courts have balanced the need to preserve enterprise value with the protection of franchisor and franchisee rights.

I. Restraint on Termination of Franchise Agreement

Franchise agreements frequently include provisions that define insolvency or bankruptcy as an event of default, allowing the franchisor to terminate the agreement. However, courts have

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39 WEPPA, s. 2(1).

40 WEPPA, s. 7.

41 BIA, s. 81.3(9).

42 BIA, ss. 81.3 (if an employer is bankrupt) and 81.4 (if the employer is subject to a receivership).

43 However, provisions of the *BIA* and *CCAA* give employee wage claims priority in *BIA* and *CCAA* restructurings: *BIA* at s 60(1.3); *CCAA*, at s. 6(5).

44 *BIA*, ss. 81.5 and 81.6.

consistently held that such termination rights cannot be exercised while a statutory stay of proceedings is in effect. Consequently, if a franchise agreement has not been terminated prior to the commencement of insolvency proceedings, the franchisor will generally be prevented from ending the agreement due to the stay imposed by those proceedings.

For example, where a franchisee files a Notice of Intention to Make a Proposal, thereby initiating proposal proceedings under the BIA, the franchisor is barred from relying on any contractual provisions—commonly referred to as **"*ipso facto* clauses**" - that permit termination upon the franchisee's insolvency. Section 65.1 of the BIA specifically invalidates such *ipso facto* clauses once a debtor files a proposal or a Notice of Intention to Make a Proposal. A similar restriction appears in section 34 of the CCAA, which operates in the same manner when proceedings are commenced under that statute.

In situations in which a receiver has been appointed, standard receivership orders typically include a "no interference" clause. When the debtor is a franchisee, this provision prevents any party from "discontinuing, failing to honour, altering, interfering with, repudiating, terminating, or ceasing to perform any right, renewal right, contract, agreement, licence, or permit" benefiting the franchisee, unless the receiver provides written consent or a court grants approval. Despite the existence of a stay, the debtor or receiver remains obligated to pay for any goods or services provided by the third party after the insolvency event, as discussed further below.

In the case of a straightforward bankruptcy, a franchise agreement is not automatically terminated solely because the franchisee or franchisor has become bankrupt. In practice, however, trustees will typically decide to terminate or disclaim the agreement after evaluating whether continuing it would benefit or burden the estate. Although the BIA does not expressly authorize trustees to terminate contracts, it is well-established at common law that trustees possess this power.[45]

II. Assignment of Franchise Agreement

Franchise agreements commonly restrict assignment without the franchisor's consent. Notwithstanding such contractual limitations, these restrictions may be overridden in insolvency proceedings. Franchisors should be aware that both the BIA and the CCAA permit a debtor to obtain a court order assigning its rights and obligations under an agreement as part of a restructuring plan.[46] Likewise, a receiver or trustee could seek court approval to assign franchise agreements in the context of a going-concern sale.[47]

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[45] *New Skeena Forest Products Inc. v. Kitwanga Lumber Co.*, 2005 BCCA 154 (CanLII) at para. 29.

[46] *BIA*, s 84.1; *CCAA*, s 11.3. For instance, in *In the Matter of The Body Shop Canada Limited*, the court granted an assignment order under section 11.3 of the CCAA to assign leases and material agreements to a purchaser, facilitating an asset sale: In the Matter of The Body Shop Canada Limited, 2024 ONSC 7052 (CanLII), paras 25, 28.

[47] In *Re Aeropostale Canada Corp. (Notice of Intention)*, the court approved the assignment of a lease under section 84.1 of the BIA to an assignee, even though the lease contained prohibitions on assignment without landlord consent: *Re Aeropostale Canada Corp. (Notice of Intention)*, 2018 ONSC 1468 (CanLII), paras. 3, 5, 7 and 43

While franchisors may oppose such assignments, courts frequently prioritize the preservation of value and employment. A refusal to consent may be overridden where the franchisor's concerns can be addressed through appropriate conditions. In considering an application for an order assigning an agreement with the debtor, the court may exercise its discretion upon examining whether: (i) the court officer has approved the proposed assignment; (ii) the proposed assignee is capable of performing the obligations under the agreement; and (iii) it is otherwise appropriate to authorize the assignment.[48] To protect the non-debtor party, all monetary defaults - other than those arising as a direct result of the insolvency- must be remedied by a date fixed by the court.[49] The court's discretion is broad.

In *Ford Credit Canada Ltd. v. Welcome Ford Sales Ltd*.[50] ("**Welcome Ford**"), the trustee in bankruptcy of a franchisee applied pursuant to s. 84.1 of the BIA for an order assigning the rights and obligations of the franchisee after the franchisor would not provide consent to the assignment. Both the trial judge and the Alberta Court of Appeal found that the franchisor's refusal to provide its consent was unreasonable and found that the contract was assignable. The Alberta Court of Appeal stressed that, so long as the provisions of the statute are met, the agreement can be assigned. Further, the trial judge had found that the proposed assignee "had an excellent track record in terms of operating a profitable Ford dealership and had received many national awards from Ford over the years".[51] This was sufficient evidence to support the appropriateness of the proposed assignee and its capacity to fulfill the obligations under the dealership agreement.

Therefore, where an assignment of the sublease is possible but there is some doubt or opposition to the idea of assigning the related franchise agreement, an application pursuant to Section 84.1 of the BIA should be considered.

Accordingly, franchisors should be mindful that courts may permit the assignment of a franchise agreement, particularly where the debtor's estate stands to benefit. A franchisor's contractual rights are not necessarily subordinated to the interests of other creditors; however, where it can be demonstrated that the proposed assignee has the capacity to fulfill the obligations under the agreement (*e.g.* through another franchisee), the court is more likely to authorize the assignment.

III. Disclaimer of Franchise Agreements

In insolvency proceedings, trustees or a debtor company may seek to disclaim executory contracts that are unprofitable or burdensome. Section 65.11 of the BIA and s. 32 of the CCAA permit disclaimers with notice to counterparties. If disclaimed, the franchisor has a provable claim for damages, typically unsecured, for lost royalties and future payments. The franchisor may object and seek a court declaration that continued performance is necessary or that the disclaimer is prejudicial.[52]

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48 *BIA*, s 84.1(4); *CCAA*, s 11.3(2).
49 *BIA*, s 84.1(5); *CCAA*, s 11.3(4).
50 2011 ABCA 158, [2011] 8 WWR 221 (Alta CA) [*Welcome Ford*].
51 *Ibid* at para 62.
52 BIA, *supra* note 2 at s. 65.1(6); CCAA, *supra* note 1 at s 32 (2)

In the case of *Re Target Canada Co.*[53](‘**Target**”) Justice Morawetz dismissed a motion seeking, in part, an order that the disclaimer of the franchise agreements by the franchisor, Target Pharmacy Franchising LP, not be permitted. The Court based its decision on section 32(4) of the *CCAA*. Pursuant to this section, the Court must consider: (a) whether the monitor approved the proposed disclaimer or resiliation; (b) whether the disclaimer would enhance the prospects of a viable compromise or arrangement; and (c) whether the disclaimer would cause significant financial hardship to a party to the agreement. The Court stated that these factors should be considered against the broader context that, once operations at Target ceased, the store would “go dark” and franchisee pharmacists would not be able to operate.

Regarding the second factor, the Court (a) noted that since the stores would ultimately be closing soon, setting aside the disclaimer would provide little assistance to the franchisees and would ultimately prejudice the other creditors; extending the time before the disclaimers took effect would require the franchisor to divert assets to the pharmacists in priority to other unsecured creditors; and (b) emphasized the high bar required to find that the disclaimers would cause significant financial hardship to the franchisees. The judge noted that while the pharmacist franchisees would face financial hardship, settling aside the disclaimer would not improve their situation given the ultimate shut down of the Target stores. In addition, the judge concluded that the accommodation provided by the franchisor to the pharmacists was constructive, practical and equitable. Its proposal allowed the pharmacies to operate for an additional period following the disclaimer. The Court found this to be a reasonable compromise that addressed the franchisees' concerns.

The Target case underscores the delicate balance courts strike when evaluating disclaimers of franchise agreements in insolvency proceedings. Courts will weigh the practical impact of the disclaimer, including whether it enhances the prospects of a successful compromise and whether it would impose undue hardship on affected franchisees. As demonstrated, even where franchisees experience financial hardship, judicial review can often prioritize the orderly administration of the debtor’s estate and the equitable treatment of all creditors.[54] Franchisees navigating insolvency scenarios must therefore plan proactively, balancing the protection of their financial and operational interests, while remaining mindful of the high evidentiary threshold required to challenge a disclaimer successfully.

IV. Assignment & Disclaimer of IP Rights in Insolvency Proceedings

Upon the bankruptcy of a franchisor or a franchisee, all assets vest in the trustee.

This would include, in the bankruptcy of a franchisor, the right to any trademarks or trade names that it owns. A bankruptcy trustee may assign the rights in them for what they are worth. For this reason, it is important for franchisees that they have a licence in their agreement to use the trademarks and tradenames.

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53 *Re Target Canada Co.* (2015), 2015 ONSC 1028.

54 Even where financial hardship can be demonstrated, Canadian courts have held that this may not be a sufficient reason to disallow the disclaimer where doing so risks the restructuring of a larger entity: *Laurentian University of Sudbury*, 2021 ONSC 3272 (CanLII) (Ont. S.C.J.) at paras. 74 to 75, leave to appeal refused 2021 ONCA 448 (CanLII) (Ont. C.A.).

Conversely, in the event of the bankruptcy of the franchisee, the trustee is vested with all the assets of the franchisee, including rights arising under a licence agreement. Under insolvency law, rights granted by licenses, which includes IP licenses, are treated as contractual rights as opposed to property rights.[55] Consequently, the franchisor should ensure that the provisions of the franchise agreement restrict the transfer of that licence. In this way, the franchisor may be able to retain control over any assignees who must then enter into new agreements with the franchisor if they wish to continue the bankrupt's business.

A. Intellectual Property Risks Arising from Franchisor’s Insolvency

Where franchisees continue to operate during the course of a stay in favour of a insolvent franchisor, there exists a risk that the value of the franchisor’s assets may be diminished. In particular, the goodwill associated with the franchisor’s trademarks may be adversely affected by unsupervised franchisee operations, potentially impairing the overall value that the trustee or receiver seeks to preserve and ultimately sell.

Under section 65.11(7) of the BIA and section 32(6) of the CCAA, if a debtor or company has granted a party rights to use intellectual property pursuant to an agreement, the disclaimer or termination of that agreement does not affect the licensee’s entitlement to continue using the intellectual property for the duration of the agreement, including any automatic extensions, provided the licensee continues to fulfill its obligations under the agreement - such as payment of royalties.

In *Arrangement relatif à Endoceutics Inc*.[56] the court considered the scope of section 32(6) of the CCAA. The decision is known as the first Canadian interpretation of usage rights under the CCAA with respect to IP usage rights post-insolvency. Section 32(6) provides that if a debtor resiles from a contract (for example, a licence or distribution agreement), the party who has the right to use the intellectual property under that contract does not lose the right to use the intellectual property - including the party’s right to enforce an exclusive use - as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property. The Court noted that the contractual obligations for continuing use go beyond mere payment of royalties/licence fees - they include other “obligations under the agreement” (e.g., marketing/distribution efforts).

B. Intellectual Property Risks Arising from Franchisee’s Insolvency

As mentioned above, the trustee’s operation of the business as a going concern, the use of its trademark and the impact that this will have on the franchisor’s goodwill in the marketplace, will be of particular concern to the franchisor.

If a franchisee (or its trustee/receiver) continues to operate during insolvency, it may continue using trademarks and system materials. As the franchisor will be concerned about misuse or reputational harm in those circumstances, it would be prudent for the franchisor to provide written notice to the court officer upon learning of the initiation of insolvency proceedings to assert the franchisor’s ownership and demanding adherence to brand standards. Another

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55 *Royal Bank v Body Blue*, 2008 CanLII 19227 (ON SC), at para. 15.

56 *Arrangement relatif à Endoceutics inc*., 2024 QCCS 1482.

good practice is to negotiate interim operating protocols (payment of royalties, brand compliance, insurance) that must be abided by during the management and operation of the insolvent business.

Another concern is the possibility that the public may perceive that the bankruptcy of the franchisee is a reflection that the entire franchise is in peril. To avoid this, the franchisor and trustee/receiver have the option of working on a cooperative basis to maintain the standards until a mutually suitable replacement franchisee is found. For these reasons, the franchisor should ensure that the franchise agreement provides that the trademark cannot be transferred without its consent and that an assignee must enter into a new franchise agreement if it wishes to continue the business of the bankrupt.

On other hand, if the franchisor has terminated the franchise agreement before the bankruptcy (or the term in the agreement has expired), the franchise agreement does not form the property of the estate. As the contractual relationship between the parties has expired, it cannot be resurrected through the bankruptcy proceedings. This leaves the franchisor free to negotiate new franchise agreements with (hopefully) financially stable franchisees. Having said this, it is certainly possible that a trustee could take the position that the franchise agreement was not validly terminated prior to the filing of the bankruptcy application. In most cases, the franchise agreement will be one of few valuable assets that could be sold or form part of a reorganization plan. If it is unclear whether the franchise agreement was validly terminated before the bankruptcy, the franchisor may consider bringing an application in Bankruptcy Court for a declaration that the agreement was validly terminated and does not fall within the property of the estate.

To avoid the cost of bringing such an application, it is recommended that a franchisor include a clear termination clause in the franchise agreement to ensure that there is no ambiguity regarding the steps that the franchisor must follow in terminating the franchise agreement and the effective date for the termination. Assuming that the franchise agreement includes these elements, this will certainly minimize any dispute with the trustee or receiver as to whether the agreement was terminated before the bankruptcy of the franchisee.

C. Reverse Vesting Orders Protections to Intellectual Property Licensors and Licencees

Reverse Vesting Orders (or "**RVO**"s) have emerged in recent years as a powerful tool in Canadian restructuring proceedings under the CCAA and similar insolvency frameworks.

Under a traditional vesting order, a purchaser acquires desired assets from an insolvent company free and clear of all claims and liabilities. In contrast, a reverse vesting order flips the script as the desirable assets and agreements remain with the corporation, whereas unwanted liabilities and contracts are "vested out" (or transferred) into a separate newly incorporated entity (usually referred as to a "residual company"). The result is that the purchaser can acquire the shares of a "clean" corporation with all of its key licences, permits, contracts and other critical rights intact. This has proven to be especially valuable where regulatory approvals, licenses, or contractual rights cannot be easily transferred.

Although courts have emphasized that RVOs are an "unusual or extraordinary" measure,[57] when utilized in appropriate circumstances, RVOs can provide great flexibility in restructuring insolvent businesses. The process requires court approval, including evidence that the structure is necessary, at least as favorable as any alternative, and does not leave stakeholders worse off.[58]

To demonstrate how an RVO could be utilized in the franchise context, consider the following scenario in the context of a franchisee insolvency:

> A franchisee operating several restaurant locations under a national brand enters CCAA or proposal proceedings. The operations are viable, but the franchisee has significant secured debt and unpaid taxes. After running a sale process, a third party purchaser is identified who wishes to acquire the franchisee's operations while preserving the existing franchise rights, permits, and leases. In order to leave the operations, key contracts (including the franchise agreement) and the corporate structure intact, the restructuring company or trustee could seek an RVO instead of a simple asset sale approval. The court order transfers the unwanted liabilities, claims, and excluded assets to a new residual company, while the "clean" franchisee entity is acquired by the purchaser. The effect of this is that the RVO allows the purchaser to effectively "step into" the existing corporation that holds the franchise rights.

This would clearly constitute a change of control that could be contested by the franchisor. While there is no yet franchise-specific RVO case that squarely addresses change-of-control objections, courts have approved an RVO over objections that it circumvented certain contractual consent rights on the basis that the RVO was necessary to preserve going-concern value.[59]

Conversely, if a franchisor were to become insolvent, an RVO could prove to be a valuable mechanism to preserve and transfer the franchise system intact to a new investor or acquirer. As the franchisor's principal assets will include the trademarks, IP and franchise agreements, a purchaser will likely want to preserve its value so that the franchisor entity and system remains intact, but unwanted liabilities (*e.g.* legacy debt, litigation, tax claims, unsecured obligations) are "vested out" (or transferred) into a new residual entity. In short, an RVO would allow the same legal franchisor entity to continue operating the system seamlessly (albeit under new ownership) and franchisees would remain bound to the same franchisor, eliminating any contractual disruption.

In summary, RVOs provide a flexible and powerful mechanism in franchising restructurings, offering protection for franchise agreements and intellectual property while segregating unwanted liabilities. For an insolvent franchisee, they may protect the franchisor's contractual and proprietary rights. For an insolvent franchisor, they protect the franchisees' ongoing rights. When applied carefully and with court approval, RVOs can mitigate the disruptive

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57 *Harte Gold Corp. (Re)*, 2022 ONSC 653 at para. 38.

58 *Harte Gold Corp. (Re)*, 2022 ONSC 653 at para. 23.

59 *Quest University Canada (Re)*, 2020 BCSC 1883.

consequences of insolvency and maintain value for all stakeholders within the franchise system.

4. The Strategic Role of Franchisors in Sales Processes & Key Considerations

If a franchisee becomes subject to insolvency proceedings, the franchisor must determine its ultimate objective in responding to the situation. Depending on the circumstances, this objective may involve: (1) abandoning the location and ensuring that it is no longer associated with the franchised system; (2) recovering amounts owed without regard to preserving the location within the network; or (3) seeking to preserve the location as part of the system in a manner that aligns with the franchisor's broader strategic interests.

In some instances, the franchisor may be able to achieve its desired outcome independently. However, several practical and legal challenges may arise in doing so:

1. **Enforcement by Secured Creditors** - A secured creditor may have obtained an order appointing a receiver over the franchisee's property, thereby limiting the franchisor's ability to participate in or influence the sales process without the receiver's cooperation. In certain cases, the franchisor might consider appointing its own receiver, though such an approach will depend on the specific facts and the relative priority of the franchisor's security.

2. **Limited Control of Premises** - The franchisor may also encounter difficulties in exercising control over the premises. Where the franchisee is the tenant, the bankruptcy trustee may refuse to recognize any step-in rights or tri-party agreements that would otherwise permit the franchisor to assume the lease, and may elect to disclaim it altogether. Conversely, where the franchisor is the head tenant and has sublet the premises to the franchisee, the trustee may either affirm or disclaim the sublease, again limiting the franchisor's ability to control the space.

3. **Assignment** - In addition, the trustee may have the statutory ability to assign the franchise agreement to a third party, potentially over the franchisor's objections.

When the franchisor's objective is to sever the relationship and terminate any association between the insolvent location and the system, careful attention must be paid to the de-identification process. The franchise agreement should contain strong provisions to ensure that all indicia of system affiliation - such as trademarks, signage, branding, and trade dress - are promptly and completely removed.

If the franchisor's goal is limited to maximizing recovery of amounts owed, there may be little that can be done beyond cooperating with the trustee or receiver to facilitate the realization of the franchisee's assets and supporting efforts to achieve the highest possible return. In many cases, the franchisor's most productive role will be to provide information and insight into the business that might assist the trustee or receiver in understanding why the location failed and in assessing whether a sale as a going concern is commercially realistic. This can include providing valuation input regarding the assets and franchise's goodwill.

I. Finding a Buyer

More importantly, a franchisor should seek to collaborate on a robust marketing/sale process to effect a "going concern" sale. The franchisor will most likely be aware of other established franchisees within its system who may be interested in acquiring an additional franchise. Not only will identification of these interested parties assist the sale process, but it will also increase the likelihood that a prospective purchaser is acceptable to the franchisor.

In most cases, a trustee or receiver will encourage the involvement of the franchisor and seek its assistance and input in order to maximize recoveries and more importantly – avoid opposition from the franchisor of a prospective sale. Ideally, this would result in a situation in which the franchisor works with the receiver to approve a buyer, who must then enter into a new franchise agreement with the franchisor as a condition of sale. This allows the brand to maintain consistency while the receiver satisfies creditor claims. The result is a beneficial outcome to the franchisor that meets its objectives in preserving the location within the franchised system, while protecting the franchisor's brand, network integrity and long-term interests.

In seeking court approval for a sale, the following factors will be considered by a court: (1) did the receiver make a sufficient effort to get the best price and has the received not acted improvidently?; (2) were the interests of all parties considered?; (3) did the process by which offers are obtained have sufficient efficacy and integrity?; and (4) has there been any unfairness in establishing the sales process?.[60]

II. Disclosure Exemption?

If there is a sale of the franchisee's business to a buyer who will remain in the franchisor's system, then the franchisor must consider its disclosure obligations. As a preliminary question, it should be confirmed whether or not the franchisor has an obligation to provide disclosure. In order to properly assess this obligation, regard must be had to the AWA.[61] The AWA provides the following exceptions, among others, to a franchisor's statutory disclosure Obligation:

(a) the grant of a franchise by a franchisee if;

- (i) the franchisee is not the franchisor, an associate of the franchisor or a director, officer or employee of the franchisor or of the franchisor's associate,
- (ii) the grant of the franchise is for the franchisee's own account,
- (iii) in the case of a master franchise, the entire franchise is granted, and
- (iv) the grant of the franchise is not effected by or through the franchisor;[62]

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[60] *Royal Bank of Canada v. Soundair Corporation,* 1991 CanLII 2727 (ON CA), 4 O.R. (3d) 1 (C.A.) 67.
[61] *Copp v Medi-Dent Service* (1991), 3 OR (3d) 570, 26 ACWS (3d) 1190 (Ont Ct J (Gen Div)).
[62] *AWA, supra* note 4 at 5(7)(a).

(d) the grant of a franchise by an executor, administrator, sheriff, receiver, trustee, trustee in bankruptcy or guardian on behalf of a person other than the franchisor or the estate of the franchisor.[63]

Where a franchisor takes a passive role, merely agrees to the sale, and does little else beyond providing some documents, an argument may be made that the disclosure requirements under s. 5 of the AWA are not triggered.64

However, to the extent that the franchisor is involved in the sale process as proposed above, a more likely scenario is that a franchisor will require the anticipated purchaser to sign a new franchise agreement, conditional upon sale approval. As a result, the statutory disclosure obligation must be satisfied.

In extraordinary cases, relief from the franchise disclosure requirements can be obtained from the court in appropriate circumstances. A recent example of this is found in In the Matter of The Body Shop Canada Limited65, where Justice Osborne granted relief from the mandatory franchise disclosure requirements under the AWA in the context of a CCAA sale. TBS Canada, a retailer operating 105 stores under a franchise license from its UK parent, was undergoing court-supervised sale proceedings. The sale required both an asset purchase agreement with TBS Canada and a franchise agreement with the UK parent, with a closing date critical to preserve over 500 jobs, maintain commercial leases, and ensure operational continuity during the holiday season. Preparing and delivering the franchise disclosure document within the statutory timeline would have delayed closing by several months, threatening the transaction and triggering significant economic consequences. As the purchaser was a highly sophisticated entity experienced in franchise operations and, had access to extensive pre-contractual information, and because the relief aligned with the legislative purpose of franchise disclosure given the unique commercial circumstances, the Court was satisfied that it was appropriate to grant the declaratory relief dispensing with compliance with the mandatory disclosure provisions.

Clearly, this is a very unique situation which warranted to court's assistance, but it demonstrates how creative approaches and judicial flexibility can assist in creating outcomes that benefit all stakeholders involved.

5. Conclusion

The intersection of insolvency and franchise law in Canada highlights the inherent tension between two competing policy objectives: the realization of assets for creditors and the preservation of the brand and contractual control within a franchise system. The underlying objective of an insolvency proceeding is to maximize value and allocate the proceeds fairly amongst creditors, whereas the focus of franchise legislation is on the relationship between a franchisor and its franchisee, ensuring proper disclosure, fairness and system uniformity.

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[63] *AWA*, *supra* note 4 at 5(7)(d).

[64] *MEDIchair LP v DME Medequip Inc*, 2015 ONSC 3718 at para 12, 257 ACWS (3d) 104 (Ont Sup Ct), rev'd on other grounds 2016 ONCA 168, 129 OR (3d) 161 (Ont CA).

[65] *Re: The Body Shop Canada Limited* (CV-24-00723586-00CL, Endorsement dated December 14, 2024)

As can be seen, these regimes do not always completely align. When a franchisee becomes insolvent, the intervention of insolvency proceedings shifts operational control of the franchised business away from both the franchisee and the franchisor and potentially puts the franchisor's intellectual property and unique operational procedures at risk. The franchisor must navigate this transition carefully by cooperating with a court officer to sustain going concern value, while protecting the integrity of the franchise system, goodwill, trademarks and confidential information. A court overseeing these types of proceedings must also carefully balance these interests, ensuring that the franchisor's contractual rights are respected, but not exercised in a way that frustrates the realization process or undermines creditor recovery.

The most effective outcomes arise when the franchisor engages early and works constructively with the receiver or trustee to identify suitable purchasers and maintain operational continuity. Properly managed, the insolvency process can serve not necessarily as a termination point for a franchise relationship, but as a mechanism for its potential renewal which includes the involvement of a new operator, the preservation of employment, the protection of creditors and sustaining the franchisor's market presence.