Journal of Business Law

2006

Developing a franchise: could securitisation be a serious funding option for franchisors in the United Kingdom?

Tom Burns

Subject: Banking and finance. **Other related subjects:** Commercial law

Keywords: Franchising; Securitisation; Special purpose vehicles

*J.B.L. 656 Introduction

Franchising and securitisation are both innovatory features of modern commerce. One is a business method; the other is a method of business finance. If they could be combined the results could be potentially significant for the services sector of the economy where franchising has an important role to play.1

In essence, franchising is a licence to manufacture, or to market a product, or to provide a service under the established brand name of the franchisor.2 It is a form of business that has been growing rapidly in the United Kingdom since the 1980s.3 Asset-backed securitisation (involving commercial companies' assets) ***J.B.L. 657** is of a more recent lineage.4 It is a modern financing technique that can provide companies with relatively cheap finance through the capital markets and this technique has been growing in popularity amongst companies and investors in the United Kingdom since the 1990s.5 A marriage between these modern forms of commerce and finance would seem to be an attractive proposition. Indeed, some writers have speculated that securitisation could bring tangible benefits to those franchisors that are determined to expand their operations both domestically and internationally6 . It is thought that the use of securitisation techniques in this sector could be a realistic possibility because franchised businesses often have assets with a proven track record of producing strong cash flows and would therefore appear to have ample capacity to repay the debt (with interest). Furthermore, there is the widely publicised view that franchised businesses have relatively low business failure rates. This can make lending to such businesses much less of a risk than may be the case with other types of businesses.7 These special features of franchising would suggest that lenders may have good reasons to ***J.B.L. 658** be interested in attempts by franchisors to raise money through securitisations. However, despite some high expectations on this issue, there has been, as yet, no rush on the part of British franchisors to securitise their assets, despite the promise of relatively cheap loans and a pool of potentially interested lenders in the financial markets. While it is true that there have been some significant, large scale securitisations of franchised businesses in the United Kingdom,8 it remains to be seen whether these securitisations by British franchisors are the start of a major trend towards securitisation in the franchising sector, or whether they are exceptional cases.

It is the purpose of this article to explore the potential attractions of securitisation for a wide range of franchisors and to explain the apparent reluctance on the part of a significant number of franchisors to engage in this activity. This article will try to account for the current limited use of securitisation techniques by franchisors by considering whether there might be particular business and legal risks9 that may persuade many British franchisors that the costs and the risks of securitisation might simply outweigh the potential benefits that it could bring to them. To carry out this analysis, the legal structure of the franchise will be ***J.B.L. 659** examined to determine how this franchise structure may influence the extent to which the franchisor may seek external funding. We shall then consider the legal characteristics of securitisations to see how far securitisations could be structured to meet the needs of the franchise sector and thereby become amore serious option for franchisors.

The legal structure of the franchise, its significance and its capital

requirements

From relatively small beginnings franchising is now big business in the United Kingdom and it is continuing to grow in size and importance.10 From the recent figures produced by both the NatWest Bank and the industry body for franchised businesses, the British Franchise Association, it is evident that the franchising sector is a significant contributor to the British economy in terms of being a major employer and a provider of many goods and services. From the most recent survey of the "business format" franchising sector, it is estimated that the annual turnover of this particular type of franchising alone is in the region of £9.2 billion in 2003. Some 324,900 people were directly employed in the sector (which is an increase on the 316,000 working in the sector in the 2002 survey).11

There were an estimated 677 franchise systems in the United Kingdom12 with 201 franchisors operating their franchised systems internationally.13 These franchised businesses provide a vast range of goods and services that include: accounting and tax services (for small businesses and traders); beauty salons, building and construction services; credit and debt collection services; employment agencies; health clubs; hotels; and nursing homes. The list also includes a wide range of retail businesses, such as ice cream shops, dry cleaners, shoe and heel bars, health food shops and travel agencies. There are other, specialist franchised businesses that include tree services, vending machine operations, and wigs and hairpieces specialists. Many of the largest franchised products are household brands, like Coca Cola and Pepsi-Cola and many of the retail franchises are well-established names in most British high streets (such as McDonalds, Pizza Hut, Dunkin Donuts, Kentucky Fried Chicken and Burger King, Clarks Shoes, Monsoon (the ***J.B.L. 660*** clothing store), Dolland & Aitchison (opticians), Vision Express (opticians), and Tie Rack, etc.).14

Although one could argue that franchising is really a quasi-corporate form of doing business,15 in strict legal terms, the franchise is essentially a licensing arrangement between two independent persons: the franchisor and the franchisee.16 It may take a number of forms. The franchisor may grant a licence to the franchisee permitting the latter to manufacture patented or proprietary products,17 or to distribute goods such as cars or petrol within a specified territory.18 Another form of franchising (which is now becoming the dominant form of franchising) is where the franchisor grants the franchisee the right to carry on trade under the franchisor's name and operating systems. This works in the following way. In return for the payment of an initial fee and various on-going charges (such as royalty payments), the person who decides to become a franchisee under this "business format" relationship receives training and support and the business "know how" of the franchisor, as well as the use of the franchisor's trade marks.19 Typically, the franchisee is an individual seeking to run his or her own business. However, this individual is also likely to be someone who is anxious to minimise the risk of business failure by purchasing the right to use products and services which are already established in the market place, thanks to the business flair of the franchisor. The initial costs to set up an independent business can be substantial for most individuals. According to recent statistics,20 the average start-up cost for a franchisee joining a "business format" franchise in the retail sector is £62,200.21 Many will put their own cash into the business. Fifty-two per cent of franchisees ***J.B.L. 661*** have to borrow at least part of this sum and 79 per cent of them have to borrow that money from the commercial banks. The average amount borrowed from the banks by franchisees is £43,100.22 In law, therefore, a radically different picture of franchising emerges from the one that might be imagined by the public. Although the general public may believe that the franchised businesses on the high street are similar to company-owned chain stores forming part of a unified business (like Tesco or Marks & Spencer), the franchised businesses are, characteristically, contractual networks made up of many small, semi-independent businesses. These businesses co-operate with the owner of the intellectual property rights (i.e. the franchisor) to promote the sale of the franchisor's products or services and it is these franchisees that usually provide most of the operational capital of the franchised business.23 This franchising arrangement allows the franchisor to accelerate its corporate growth, with less capital expenditure on its part, by simply recruiting more franchisees and increasing the

number of franchised outlets. The franchisees, as self-employed persons, can be expected to be better motivated to engage in profit-making activities than may be the case with most employees and this, in turn, may help to make the monitoring costs of supervising the operations of the franchised outlets lower for the franchisor than may be the case with wholly-owned chains.24 As a result of these special characteristics, many franchisors with mature businesses may have relatively less debt on their balance sheets and consequently may have greater borrowing capacity to finance business expansion, both domestically and internationally, if they decide to utilise external funding.25

Why franchisors may be interested in securitisation

In this section, we shall consider the potential advantages and attractions of this method of financing for franchisors. Essentially, there are four main reasons why franchisors may find securitisation an attractive option for funding their businesses. First, it may be a cheaper way to obtain funds for long-term strategic projects than borrowing from traditional lenders (such as the banks). Secondly, the securitisation may provide the franchisor with immediate liquidity on the ***J.B.L. 662** sale of the future cash flows to the special purpose entity that will implement the securitisation. Thirdly, the securitisation will transfer the credit risk to the investors who buy the securities issued by the special purpose company that will hold the revenue-producing assets. And, finally, it may be possible for the franchisor to continue to administer the assets and collect the revenues on behalf of the special purpose company and earn a fee from providing those services.

Although the obvious reason for seeking external funding is to finance a major expansion of the business domestically or internationally, there are other important reasons why franchisors may need to call upon external funds and why securitisation may become one of the funding options.26 The borrowed funds could be used to finance a take-over bid of a related business,27 or to buy back some of the business owned by the franchisees.28 Some franchisors may even wish to convert their business from a franchised network to a wholly-owned group and may only have used franchising as an interim step to achieve that goal.29 Another reason why franchisors may seek external funds might be to clear an existing loan. When market conditions change and interest rates fall, it may be worthwhile for the franchisor to consider re-financing the business (for example, by replacing an existing loan with one that may have less onerous covenants30 and lower rates of interest payable on the loan).31

***J.B.L. 663** Until securitisation became a realistic possibility for commercial companies in the 1990s, franchisors had to rely on traditional sources of funding.32 These included the utilisation of retained profits, the use of the proceeds from new share issues and the recourse to borrowing from the banks and other lenders. Each method has its own particular set of advantages and disadvantages and it will be for the franchisor's board of directors to determine what particular financial mix might be best for its business. However, the amount of each type of funding that a franchisor may ultimately be able to command is normally a compromise between its own desires and what the market is willing to provide. Although much may depend on the market conditions at the time, new share issues are not generally favoured as the first choice option for raising funds for long-term programmes, if there are other options available to the business.33 This is because (among other things)34 new share issues may further dilute the founders' control of the franchise and the share issue may even send the wrong signals to the market about the prospects for the business.35 By way of contrast, there may be a major advantage of financing the business with debt.36 Amongst other things, it can, for example, lower the cost of capital in terms of the impact on earnings ***J.B.L. 664** per share. As a result, the use of external borrowings (in conjunction with the utilisation of retained earnings) plays an important role in the funding of many long-term business projects. Furthermore, it has been noted in the corporate finance literature that where businesses generate a lot of cash through their operations (such as those franchised businesses operating in the services sector) they tend to show a preference for using retained earnings as an important element of their medium-term funding.37 Such franchises are also willing to use retained earnings

to help finance long-term projects to reduce the risks of relying too heavily upon external borrowings.38 Consequently, many franchised businesses may have a greater reserve borrowing capacity to assume more external debt to take advantage of some especially good investment opportunity than many other types of business.39 This type of financial profile may make it easier for franchisors to borrow from traditional lenders and this could reduce the demand for securitisations in the sector. Indeed, the potential appeal of securitisation amongst franchisors could be diminished if the traditional lenders were prepared to reduce their lending rates and ease their restrictive covenants further to reflect the fact that lending to franchisors may carry a lower risk of default in many cases. However, this financial profile may also make securitisations easier to structure and this might encourage franchisors to consider the prospect of cheaper borrowing through securitisations as an attractive alternative to traditional lending sources.

Another factor that may encourage franchisors to consider a wider range of options for external funding, including securitisation, is what I shall call the "rapid growth imperative" of this peculiar type of business. A number of authors on the business format franchise have noted that most of the franchisors operating in the retail sector want to expand their business quickly.40 Rapid growth is seen by these franchisors as a way to survive and compete in the marketplace. This emphasis on ***J.B.L. 665** growth and market penetration in the franchising sector is more pronounced than in other business sectors. As Professor Bradach highlights in his empirical research on franchising, rapid growth is a key management objective of most franchisors.41 In his survey of successful franchised restaurant chains, Professor Bradach notes that the key to success lies in the franchisor increasing its number of outlets.42 This is done, not only by increasing the number of franchisees recruited on to the network, but also by establishing franchisor-owned outlets to be run by employees of the franchisor. The crucial result of this expansion is to raise the profile of the brand. The more outlets there are in the market-place, the more the public will be aware of the market presence of the franchised brand. Furthermore, the more franchised outlets there are in the network, the more money the franchisor will have at its disposal to advertise the brand and thereby increase sales and attract more franchisees. As Bradach observed:

"even in [an] increasingly competitive market…and the saturation of many local markets with the [franchised] chain's units, the addition of units remained a key way that chains grew".43

This "rapid growth imperative" may encourage franchisors to consider securitisation as an option for funding this type of expansion and perhaps as an alternative to traditional sources of borrowing.

Traditionally, as has been indicated above, most of the external financing for franchised businesses has come from conventional lenders, such as the banks, finance companies (for hire purchase and lease-back finance), and (occasionally) venture capitalists.44 Franchised businesses have also, on occasion, obtained funds through the Enterprise Investment Scheme.45 The typical factors that might influence the franchisors' choice of where to obtain its external funding might be determined by some well-known principles of business borrowing. A prudent business will borrow where it is least expensive in terms of interest and other costs (including transaction costs). Such a business may also borrow where the repayment terms can be met without seriously affecting cash position (i.e. its liquidity). Finally, a prudent business will borrow where the protective clauses ***J.B.L. 666** in the debt contract are least restrictive on the management's ability to determine the uses of the business's assets.46 These basic principles of business borrowing will require the management to compare and evaluate all the possibilities in each potential borrowing transaction. This is inevitable because, in practice, a business may find that it is not possible to borrow at the lowest cost with the most generous repayment terms whilst incurring the least restrictions. Rather, it is normally the case that, in order to obtain a low interest rate, the management may be required to accept certain restrictions on its business activities and abide by strict repayment terms.47 Although the management may obtain a waiver on these restrictions, this might come at the cost of shortening the maturity of the loan and agreeing to repayment terms that may have the effect of depleting the firm

of cash. In contrast, securitisation may offer a way of avoiding some of the practical difficulties associated with conventional borrowing. Unfortunately, securitisations can be relatively costly to set up, but if they are structured appropriately, they may produce even higher financial benefits to the franchisors. This is because securitisations are designed specifically to access cheaper funds through the capital markets.

How a typical securitisation works

The process of securitisation may be described briefly. A company (known as an "originator" in the terminology of securitisation) may wish to access funds from the capital market because it is likely to provide a cheaper source of funds than a conventional loan, even after the relatively high transaction costs of setting up the securitisation have been taken into account.48 The company/originator has to identify the revenue-generating assets that can be sold to a newly-created, insolvency-remote, special purpose vehicle ("SPV"). These assets will be the rights to payments at a future date (such as the franchisor's right to receive periodic royalty payments from its network of franchisees). Such assets are referred to as "receivables" (in the terminology of securitisation). Once these assets/receivables have been identified and sold to the special purpose vehicle, this SPV will then issue bonds or other securities (secured by the rights to these future cash flows). The funds that are raised by the bond issue will then be ***J.B.L. 667*** used to pay the franchisor/originator for the assets it transferred to the SPV. The franchisor will then have millions of pounds to use to develop its business. The success of the scheme depends upon the attractiveness of the bonds to the potential investors (who are often sophisticated investors, such as institutional investors). The potential attractiveness of the bonds issued by the SPV will be judged according to their risk of default by both the institutional investors and by the credit-rating agencies. There are a number of factors that may help the bonds to achieve a high credit rating. If the SPV is independent of, and insolvency-remote from, the originator, this would help to improve the credit rating of the bonds. In addition, if there is a large pool of receivables due from many sources, and if these payments are reasonably predictable, then the bonds can be expected to receive a high credit rating. Highly rated bonds are likely to be popular among investors seeking a secure type of investment, perhaps to balance their equity portfolios. Because these bonds are relatively low risk investments, they may be able to offer lower interest rates and still maintain their attractiveness to investors, thereby making the securitisation a relatively cheap way for the originator to raise significant sums compared to conventional borrowing.

Customised securitisation structures for franchisors

There a number of different ways to structure a securitisation in law. However, on the assumption that the franchisor would probably be interested in setting up a flexible legal structure that could provide the franchisor with additional financial and other benefits, then it is possible that a customised, or "one off" securitisation structure may be used.49 In such a customised or "one off" securitisation structure, the franchisor might be advised to utilise at least two SPVs (although it is possible that more may be utilised for tax planning purposes).50 This would serve at least two main purposes. It could minimise the risks to the franchisor's network in the event of the bond-issuing SPV failing to meet its bond-repayments' obligations, and it could minimise the risk to the creditors of the issuing SPV in the event of the franchisor's creditors claiming assets belonging to the SPV following the franchisor's insolvency. These special purpose companies51 could be set up by the franchisor as subsidiary companies. They could even be set up as wholly-owned subsidiaries of the franchisor. If the latter choice is made, it would give the franchisor the opportunity to collect any surplus assets from these SPVs at the end of the securitisation when the bond holders have been paid off in full.52 It is often the case that there will be surplus funds available at the end of the securitisation because excess assets are often used as a credit enhancement measure to ensure ***J.B.L. 668*** that the debt repayment obligations are more than covered. Under a customised securitisation structure, it is

possible to arrange matters so that one of the SPVs can hold the intellectual property rights of the franchise. This SPV can then license these rights to the second SPV. These intellectual property rights would include the right to use the brand, the right to sell additional franchised outlets to existing, or new franchisees, and the right to administer the franchise network. The second SPV would then be responsible for issuing the bonds, collecting the revenues, selling new franchises and paying the bond holders. If the second SPV were to collapse into insolvency, the vital intellectual property rights of the franchisor would be protected from the claims of the second SPV's creditors.

A further attraction of this "one-off" or customised securitisation structure is that a franchisor who sells the "receivables" to the issuing SPV may also act as the manager of those assets on behalf of the SPV and thereby earn fees for the services rendered. In the terminology of asset-backed securitisations, the franchisor would then be acting as the "seller-servicer." In the role of "servicer" the franchisor would be able to select new franchisees and generally administer the franchised network. The franchisor would also be able to maintain the personal ties that it has built up with its franchisees over the years of co-operative endeavour, albeit that these new arrangements would have to be done in the name of the issuing SPV. There is, however, a potential legal risk with this type of arrangement. There is a possibility that the creditors of the franchisor may seek to make a claim on the assets of the SPV in the event of the franchisor's insolvency. Furthermore, if the credit-rating agencies believe that the SPV is not sufficiently "insolvency remote" from the franchisor-originator, then the credit rating of the SPV's bonds could be damaged. If this were to happen, the potential cost savings of the securitisation for the franchisor could be significantly reduced. This is an issue of major concern in America and it is much discussed in the literature on asset-backed securitisation.[53] However, in the United Kingdom this concern is probably of less significance because there are different rules on when the veil of incorporation might be lifted. In the United Kingdom, the principle of the separate personality of a company is one that has been strongly endorsed in the British courts ever since the *Salomon* judgment,[54] not only in cases such as *Woolfson v Strathclyde Regional Council,*[55]*Adams v Cape Industries*[56] and *Yukon Lines Ltd of Korea v Rendsburg Investments Corp of Liberia (No.2),*[57] but also in recent cases specifically related to franchised businesses, such as *Williams v Natural Health*[58] and *Ord v Belhaven* ****J.B.L. 669*** *Pubs Ltd.*[59] In these franchising cases the franchisees claimed damages for losses incurred by them when the franchisor's projections on the amount of trade that could be expected at the franchised outlet, and the probable turnover, proved to be misleading. In each case the franchisor was a company, and it was either no longer trading, or it was insolvent. Therefore, in order to find a solvent tortfeasor, the franchisees in these cases sought to have the veil of incorporation lifted. In the *Ord* case, the claimant tried to sue the parent company and in the *Williams* case, the claimant tried to sue the managing director (who also happened to be the originator of this particular health food franchise). In neither case was the claimant successful. Even where the company is a wholly owned subsidiary, the courts have been most reluctant to impose liability on the parent[60] in the absence of facts that would allow the claimant's case to be pigeon-holed into one of the established categories of cases where, in the past, the courts have been prepared to lift the veil and hold the managers, or the shareholders, or the parent company liable to account to the claimant.[61]

However, in order to reduce even further the small risk that the assets of the British franchisor and the SPV might be treated as one for the purposes of insolvency, the franchisor could take additional precautions in the way in which the SPV is set up as well as in the way the seller-servicer arrangements are structured.[62] First, the SPV should display as many features of being a separate legal entity as possible. This would include having one or two independent directors on the board of the SPV to give it some operational independence as an entity even where it might be a wholly-owned subsidiary of the franchisor. The SPV's accounts and corporate records should be maintained separately and the funds of the franchisor and the SPV should not be commingled. Secondly, the relationship between the franchisor and the SPV should be on a purely arms-length, commercial basis to avoid any claims that the SPV is merely a puppet or agent of the

franchisor, which could lead to a claim by the liquidator that the corporate veil be lifted between the franchisor's company and the SPV. In order to ensure that this commercial relationship is viewed by the court clearly as one between two distinct entities, the fees that the franchisor may charge for its services should be set at market rates. The franchisor's ***J.B.L. 670** authority to act on behalf of the SPV in the specified matters should be laid out in the service contract. That authority should be revocable on terms and conditions that would normally apply to any independent, third party servicer. The standard of service provided to the SPV by the franchisor should be appraised by an independent consultant, and if the performance rendered by the franchisor is deemed to be below standard, the SPV ought to have the right to replace the franchisor-servicer with another, more suitable servicer. These precautions should ensure that the customised securitisation structure will withstand most legal challenges.

Why potential investors might be interested in securitisations by franchisors

There are a number of reasons why potential investors may be particularly interested in securitisations originated by franchisors. The first of these reasons concerns the level of credit risk that may be associated with franchised businesses. Investors (or credit-rating agencies acting in the interests of investors) need to be able to judge the credit risk inherent in the underlying assets of the securitisation (particularly where there is no credit enhancement of the securitisation).63 One key element in this assessment is the availability of reliable data about the franchised business and level of business failures among the franchisees. An attraction for the investor in a franchisor-originated securitisation is that this information may be accessed easily and relatively cheaply. This is because much of the relevant financial and business information that investors may require for the purpose of securitisation will already be readily available. The franchisor is required by contract and by the rules of the British Franchise Association code of practice to produce detailed business plans for the franchisees to show the potential earning power of the franchise.64 Although it is possible that some franchisors may be tempted to present misleading information to the franchisee on matters such as turnover in order to tie the potential franchisee into a franchise agreement (and thereby incur the risk of exposing themselves to potential civil actions by the franchisees on the grounds of misrepresentation or negligent mis-statements, as happened in the case of *Esso Petroleum Co Ltd v Mardon*65 or on grounds of fraud), most franchisors will do an honest job of estimating the market for the franchised products or services based on their careful research and business ***J.B.L. 671** experience.66 Franchisors are usually careful in their assessment of the likely earnings of potential franchisees and will seek to produce a realistic set of figures for these items. These same figures can help the investor to form a view about the reliability of the cash flows of the business and the risks of default in securitisations.

From an investor's point of view, the sources of the cash flow in a franchisor securitisation should not only be reliable, but also diverse, to spread the risk. The main sources of income for franchisors come from the franchisees67 and the more franchisees there are the better, from the investor's point of view. If one franchisee fails this should not have a significant effect on the franchisor's general business and the more franchisees there are, the more revenue there will be for the franchisor. The cash flow from the franchisees comes from a number of sources. The franchisee has to pay an initial franchising fee to join the franchised network.68 The franchisee will then pay an on-going royalty fee (usually based upon a percentage of the franchisee's gross revenues).69 The franchisormay require this royalty fee to be paid on a weekly, bi-weekly, or monthly basis.70 It is often the case in the larger, more established franchises, that the franchisors own the retail premises from which the franchisees do business.71 This can be a positive benefit in attracting franchisees in some cases because it can help to lower the start-up costs for the franchisee (as she does not have to purchase the premises).72 However, ownership of land is beneficial to the franchisor too, not only because it could be used as collateral for the purposes of

conventional borrowing, but also because it can be a source of regular rental income from the franchisees. This rental income may come in the form of a fixed monthly payment or a percentage of the gross revenues of the franchisee's business. The franchisor may also lease equipment to the franchisees and the franchisors may make additional profits from supplying the franchisees with branded products. Other revenue streams from the ***J.B.L. 672*** franchisees may come in the form of fees for management services and training (where that training goes beyond what was originally covered by the initial fee).73

The reliability of the cash flows in a franchisor securitisation may be enhanced by the existence of target clauses and development schedules in the franchise agreement, which is designed to "encourage" franchisees to meet revenue requirements.74 These should provide further comfort for the potential investors. The franchise contract may include provisions and penalties for those franchisees that fail to develop their allocated territories.75 Under the franchise contract there are also likely to be enforcement mechanisms to ensure that the quality of the brand is upheld to maintain customer satisfaction and produce steady, reliable revenues.76 To this end, the franchisor will have the right to send in its inspectors to check on the running of the franchised outlet as well as the condition of the franchised premises. In the event of a dispute with a franchisee over matters concerning quality, the franchisor could, as a final measure, expel the delinquent franchisee from the network. These features of the franchise may help to make the franchisor-originated securitisation more attractive to potential investors.

Another attractive feature of the franchise business is the reduced risk of default owing to the low levels of business failure among franchisees. Part of this success can be attributed to the franchisor's ability to select applicants with sufficient motivation and financial backing to survive those first few years in the business (when the risk of failure is most acute). For example, before granting a franchise, a responsible franchisor will check an applicant's personality, education, background, reputation and business experience as they relate to the type of business operation under consideration.77 The franchisor will also check the amount of capital available to the potential franchisee. This is to ascertain whether there is likely to be sufficient funds available, not only to purchase the franchise and set up the business, but also to keep it functioning through the early years of operations.78 A suitably funded franchisee enjoying the business support of the franchisor in ***J.B.L. 673*** terms of operational methods and business "know-how"79 should mean that the risk of failure among the franchisees is minimised.80 In some cases, if the potential franchisee shows great promise, the franchisor may even assist the franchisee with the cost of setting up the business by offering the franchisee a loan. However, this is not usual practice.81 Franchisors usually prefer to have other parties assuming the risk of lending to the franchisees.82 To assist in this funding process, franchisors often utilise their contacts with the banks. They refer the promising, potential franchisees to the banks' special franchise advisers who may deal with the franchisees' financial requirements in a sympathetic and supportive way, not least because these franchisees could become good, low risk customers of the bank.83

The existing franchisees who prove their ability to meet (and in some case, exceed) their sales targets may be given further incentives by the franchisor to maintain the strength of the company's cash flows. Franchisors are often very keen to sell more franchised outlets to these successful existing franchisees who may wish to expand their own operations from a single outlet to, say, five or twenty outlets.84 The business acumen and experience of these franchisees usually help to keep the failure rate of the franchise low and so help to make the franchisor's business even more attractive to those who would wish to invest in a securitised bond issue.

Investors are, of course, equally interested in the potential return on investment these securitisations may offer. Securitisations typically offer interest rates which are higher than that being paid on gilts, while benefiting from a similar low risk of default where the securitised bond issue enjoys a triple "A" class credit rating.

J.B.L. 674 The potential barriers to the growth of securitisation within

the franchise sector of the United Kingdom

As Firth and Keane pointed out:

"the value of any security (whether equity share or bond) will depend on two main factors: the expected cash flows and the riskiness of the cash flows".85

The cash flows in franchised businesses should be strong (for the reasons stated above), but there may be risks that those cash flows forming the underlying assets may decline. The possible threats to the reliability of these cash flows shall now be considered.

Although no business is risk free, there are some particular problems that may adversely affect the cash flows of the franchisor. Current general economic trends may be moving against those businesses that rely on discretionary consumer spending. With interest rates rising and concerns over pensions encouraging people to save more, consumers may be less keen to spend as much of their discretionary income on the products and services that some business-format franchises provide. Thus, expenditure on franchised hotel accommodation, car hire services, or on frequent nights out in mid-ranged franchised restaurants may fall.86 Even the fast food franchisors may no longer be the secure businesses that they once were. The cash flows to these franchisors may be threatened by changes in consumption patterns, and the intensification in competition.87 Although fast food franchises pride themselves in the quality and uniformity of their products,88 this very advantage could turn out to be a possible disadvantage if consumer tastes start to change.89 Faced with these potential problems, the task of the franchisor is to try to keep the brand fresh and attractive to its customers by adapting its business methods, products and services to meet changes in demand.90 However, this can be difficult. For example, there is a detectable change in consumption patterns of the more affluent, health-conscious consumers away from "fast foods" and "convenience foods" towards foods that contain much less fat, salt and sugar. Health experts have recommended that the government should consider ***J.B.L. 675** introducing a "fat tax" on the advertising of convenience food in an attempt to cut demand for such products.91 If such a tax were to be introduced it could have a negative effect on the level of demand for products such as sweets, sugary drinks, doughnuts, ice-cream and burgers, etc. which are products that are sold through franchised outlets. Even if it seems unlikely that such a tax will be introduced in the near future, the "fat tax" debate may have raised the public's awareness about the potential dangers of consuming too much convenience food. Recent legal actions involving the fast food giant McDonalds have also produced, perhaps unfairly, some unfavourable publicity for the company and, by association, for the fast food sector as a whole. Although the McDonald company was victorious in the so called "McLibel trial",92 the case did raise questions about the health implications of eating too many burger meals.93 The recent American case of young teenagers claiming damages from McDonalds for making them fat94 (*Pelman v McDonalds*) further raised the public's awareness of the risk to health of eating too many burger meals, despite the fact that the McDonald company won that case too.95 The image of the fast food franchise has also been dented by book *exposés* such as *No Logo*96 and *Fast Food Nation*97 as well as by the polemical film *Super-size Me.*98 However, franchisors are attempting to counter this adverse publicity by, amongst other things, promoting healthy eating menus and phasing out extra large portions. The industry is also responding to the public's concerns about the content of food ***J.B.L. 676** products by reducing the fat and sugar contents of the industry's products and by providing nutritional advice on food labels.99

Another risk to the cash flows of the franchised business may arise from the increasingly competitive nature of the sector. Competition in the retail sector of franchising has become very intense because the barriers to entry are often not very high in terms of either costs or skills.100

As a consequence, there is intense competition among franchisors offering similar products (e.g. pizzas can be bought from Pizza Hut or Domino's Pizzas and hamburger meals from Burger King instead of McDonalds). This competition has recently provoked a price war, as rivals cut prices to attract custom. In the medium-term this price competition could lead to a reduction in profitability of the franchisees and a possible increased likelihood of

franchisee failure. For example, the Pizza Express share price fell in 2002 when, according to the *Financial Times,* it suffered, "a rapid decline brought on by increased competition".101 The older, more established fast food brands could also face competition from healthier alternatives, as people respond to the public health messages and eat more wholesome food that contain less fat, salt and sugar.102 Yet even without the threat of competition from similar and substitute products,103 there is the danger that financial returns may decline where franchisors reach a point at which they have almost saturation coverage of the UK market. In late 2002, for example, McDonalds reported its first ever loss.104 The company's earnings subsequently improved when it cut back on the number of new franchised units it planned to open. It also cut its debt, and launched a share buy-back scheme to restore the share price.105 However, other franchisors faced with the threats of market saturation and competition may be tempted to consider what would appear to be an easier, alternative strategy. This entails granting outlets to new franchisees that are within the existing territories of established franchisees. Where this happens it could result in intra-system competition.106 This could occur because there is a basic conflict of interest between the franchisor and the franchisee over the issue of territory.107 Unlike the franchisee, ***J.B.L. 677** the franchisor is primarily interested in the level of sales of an outlet, not its levels of profitability. This is because the royalty payments made to the franchisor come from a percentage of the franchisee's sales, not from the franchisee's profits. The franchisor may, therefore, be tempted to allocate more franchisees to a particular territory than it could profitably accommodate. However, even if a franchisor is able to impose more franchisees upon an existing territorial network,108 this solution may only serve to maintain the franchisor's cash flows in the short-term. Existing franchisees, faced with a declining market share may engage the franchisor in bitter legal disputes, or they may simply abandon the system.109 Where franchisors have imposed extra franchisees into existing franchisees' territories within the United States, the response of at least one state legislature has been to intervene in favour of the franchisees to resolve this conflict of interest.110 Ironically, the business logic of growing to survive in the franchise sector may lead to the large franchisors resorting to securitisation to avoid the prospect of declining revenues, brought about by increased competition and market saturation within the United Kingdom. Those franchisor-companies that are close to saturating the domestic market may find that it is in their strategic interests to expand abroad to keep the business growing and funds that might be obtained through securitisation may be crucial in that process.

However, perhaps one of the biggest obstacles to the growth of securitisation among franchisors in the United Kingdom could be the possible lack of demand from franchisors. This may be the result of the particular profile of the franchise industry in the United Kingdom at the present time. Most franchisors in the United Kingdom are small and medium-sized businesses.111 As has been previously noted, the business-format type of franchised system is fairly easy to set up in the retail sector where there might be relatively few barriers to entry.112 Felstead has noted that 42 per cent of the franchise systems in the United Kingdom have fewer than 11 franchised units, while only 8 per cent had more than 100. The majority of ***J.B.L. 678** franchises have between 12 and 100 units.113 The small franchises tend to operate locally rather than nationally (although many may aspire to grow fast and to become significant national franchises). The majority of the smaller franchisors do not have the ability or even the desire to securitise because of their relatively modest funding requirements (which are often adequately provided for by the traditional lenders). However, for the medium-sized companies that may be listed on AIM114 or OFEX,115 the situation might be different. The "rapid growth imperative" that those ambitious franchisors must follow if they are to be successful in creating larger national businesses may encourage them to consider securitisation as a possible route to cheaper funds for quicker growth. Much may depend upon the availability of an affordable securitisation structure. This is because the costs of setting up a customised structure may be too expensive for franchisors seeking relatively modest sums of a few million pounds. For the medium-sized franchisor, perhaps the only way to utilise securitisation in a cost-effective manner would be to be part of a multi-seller (or multi-party) securitisation. This type of securitisation structure (which was developed in the USA) has allowed

medium-sized businesses the opportunity to access the capital market finance.116 The multi-seller structure could also be used by franchisors whose securities may be unrated, or rated at "less than investment grade", but who, nevertheless, may be able to sell to an SPV some good quality receivables with predictable cash flows.117 The basic idea behind the multi-party structure is simple. It allows many medium-sized originators to pool their receivables within a single entity by selling their receivables to the SPV. The predictability of the stream of revenue flowing into this SPV should be enhanced by the fact that it comes from a large pool of receivables due from many different debtors, and this does much to spread the risks of default. This should make the securities issued by the multi-seller SPV attractive to investors. This multi-seller SPV is also quite likely to be one that is administered by an investment bank with ***J.B.L. 679*** considerable experience in operating securitisations.118 The transaction costs for each seller are, in theory, minimised by using a common SPV, while the securities issued by the SPV may be rated more highly than the securities of the originating franchisors because the insolvency of any particular medium-sized originator is unlikely to affect adversely the aggregate income expected from the receivables. However, as Professor Schwarcz notes, multi-seller SPVs are more likely to fund the purchases of receivables from the various medium-sized originators by issuing short-term commercial paper or medium-term notes rather than long-term bonds to encourage investment.119 This means that the timeliness of payment may become an important issue. The credit-rating agencies will want to see that the SPV has set up liquidity facilities so that the note-holders will receive their payments on time (even if the ultimate debtors are late with their payments). The banks will typically provide such liquidity facilities for a (percentage) fee. The credit-rating agencies will also be keen to see the risk of default on the part of the SPV reduced by means of some form of credit enhancement. External credit enhancements rely on the credit of third parties and can take the form of a letter of credit issued by the banks, or surety bonds issued by insurance companies, or subordinated loans from third parties. Internal credit enhancement can take the form of a "senior-subordinated structure"120 where the SPV issues two tranches of notes to obtain additional funding. The senior tranche (which will usually have a credit rating that virtually guarantees repayment) will be issued to risk-averse investors and the subordinated tranche may be issued to institutional or other sophisticated investors who are able to accept the higher risk of a default on the part of the SPV in exchange for a higher rate of return. "Over-collateralisation" is another form of credit enhancement that is commonly used. It relates to the situation where the pool of assets is of greater value than is needed to support the payments due to the investors, thereby ensuring that if there is a shortfall in the cash from the receivables, there is extra money available to cover that shortfall.121 Unfortunately, the provision of liquidity facilities and credit enhancements and the need to pay fees to the "servicer" bank to collect the receivables on behalf of the SPV can increase significantly the costs of the securitisation for these medium-sized sellers. This direct cost disadvantage coupled with the indirect costs of setting up the securitisation in terms of the time involved in the due diligence investigations, the document drafting and the planning, may make securitisation less attractive to medium-sized franchisor-companies.122

Conclusion

Securitisation may be a serious funding option for the biggest franchisors in the United Kingdom. Indeed, some of them have already used securitisation as a ***J.B.L. 680*** funding method and have duly raised hundreds of millions of pounds to develop their franchised businesses. Large franchisors, as a class, are more likely to be able to afford the relatively high costs of customised securitisation structures. These customised structures offer the large franchisors not only the direct benefit of access to lower cost capital market funding, but also a number of other important indirect benefits, including the ability to retain some control of the brand (despite the transfer of assets to the SPV) as well as the opportunity to obtain additional revenues from "seller-servicer" arrangements. However, these types of securitisations may carry some risks. The assets used in the franchisor's securitisation must be reliable. They need to be able to produce reasonably stable cash

flows that are statistically predictable with verifiable levels of arrears and defaults. In many fields of franchising activity cash flows are indeed predictable, but there are also some areas where the threat of changes in customer demand and the possibility of intra-system competition may pose a significant threat to the reliability of those cash flows. There is also the risk that the SPVs might not be sufficiently "insolvency remote" from the franchisor-originator. This could damage the chances for a successful franchisor securitisation. However, in the British context, the present judicial attitude towards lifting the veil of incorporation may make this particular problem much less of a danger for franchisors in the United Kingdom than for franchisors in the United States.

For the medium-sized franchisor operating through quoted companies on AIM or OFEX, the costs of customised structures are likely to exceed the possible benefits because the sums of money sought through the securitisation are likely to be relatively modest. The alternative to a customised securitisation for these companies is to become part of a multi-seller securitisation, but these also require costly credit enhancements and guarantees to be attractive to investors. In these kinds of structures, franchisors are likely to lose influence over their franchised systems because the "seller-servicer" arrangement is unlikely to be available to them. As a result, it is more likely that medium-sized franchisor companies will focus on other funding options, such as borrowing from traditional lenders, or considering the refinancing of existing loans on a different basis, or considering the renegotiating loan covenants rather than use securitisation as a method of funding. Thus, securitisation may remain a serious funding option only for the largest franchisors in the United Kingdom.

The author would like to thank both Dr Orkun Akseli of the University of Newcastle-upon-Tyne for his help and advice on the section on securitisation and Professor Angleo Forte of the University of Aberdeen for reading and commenting on the earlier draft of this work. The views expressed in this paper are, of course, those of the author.

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1. The majority of franchising activity takes place in the services sector of the economy, but manufacturing franchises also exist and securitisation could be used as a funding method for manufacturing franchises.

2. For a full discussion concerning the definitions of franchising see "The meaning of 'franchise' and 'franchising' " in Ch.I of M. Mendelsohn, *The Guide to Franchising* (6th edn, London: Cassell, 1999), pp.1-17.

3. *ibid.* , Ch.2, "The History and Development of Franchising". The author informs us that "business format franchising" began in the USA in the 1950s and was copied in other countries; however, the explosive growth of franchising in the UK began in the 1980s. See also J. N. Adams and K. V. Prichard-Jones, *Franchising: Practice and Precedents in Business Format Franchising* (4th edn, London: Butterworths, 1997), p.7:"the 1980s was a period of rapid growth in the UK, both of American and other overseas chains, and of indigenous enterprises".

4. J. K. Thompson: *Securitisation: An international Perspective* (OECD, 1995), Ch.2 ("Historical Background"). The market for mortgage-backed securitisations began in the 1980s in the UK. But the market for asset-backed securitisations was slower to take off. The author notes the asset-backed securitisations began in the UK in 1990. The author states: "the main explanation for the slow growth of [ABS] in the UK…[was] apparently slack demand by market participants" (p.32).

5. *ibid.* , p.111:"The United Kingdom represents the largest market in securitised assets outside the United States (with mortgage backed securitisations accounting for some 80% of all securitised assets)".

6. D. Kaufman, J. Yarett, B. Schorr and C. S. Grimson, "Securitisation: An Overlooked Financing Vehicle for Franchisors" (2001) 20 *Franchise Law Journal* 161.

7. M. Mendelsohn, cited above fn.2, at p.32:"the failure rate for new franchised businesses for whatever reason is, so far as one can ascertain, somewhere between one-eighth and one-tenth of the failure rate for non-franchised new businesses".See also the web site of the British Franchising Association ("BFA"). The BFA makes the claim that the failure rate is low for franchisees. See *www.franinfo.co.uk/choosingafranchise3. lasso.* The BFA states:"In relation to any other small business, franchising has proved to be successful, with 94% of units still operating profitable businesses 5 years down the line. It is estimated that more than 40% of small firms cease trading within 3 years (Ganguly 1985). There is other evidence to suggest that franchises are less likely to fail than other types of small

business organisations (Castrogiovanni, Justis and Julian 1993). But remember that franchising is not an easy option and will require investment of a lot of hard work and money, particularly in the early stages".However, there are some authors who are sceptical about how low the failure rate might actually be in practice. They have from time to time questioned the figures periodically issued by the industry. See D. Baillieu, *Streetwise Franchising* (London: Hutchinson Press, 1988), p.3 and S. Price, *The Franchise Paradox* (London: Cassell, 1997), Ch.9. For example, Stuart Price states that:"the popular franchise press and academic literature is replete with the observation that franchisees illustrate superior performance to non-franchised concerns. This observation often derives from uncorroborated franchisor sources and is beset with problems of not being able to compare sectoral statistics" (p.497).Whatever the precise figures might be it would seem fair to assume that a business with a proven track-record, such as a franchise business, may have a greater chance of success in the hands of the franchisee than new businesses enterprise entering the market with an untried concept.

8. In June 1999, The Pubmaster Group's securitisation raised £305 million (which funded the acquisition of 1,277 pubs); see the report in the *Financial Times,* May 22, 1999, p.23. The Unique Pub Company also securitised its revenue streams from its tenanted pubs in 1998. Punch Taverns, another pub chain using tenants, has used securitisation twice (in 1998 and in 2000). See "The Pubmaster Report" in the "Financial Markets driving change at company level". This report can be found at *www.emcc.eurofound.eu.int/publications/2004/ef03117 Pubmaster.pdf.* Punch Taverns' securitisations are outlined in the following report: *www.am bac.com/pdfs*Deals*Punch¨Taverns.pdf.*

9. Business risk in financial management terms has been defined in the following way by E. F. Brigham, *Fundamentals of Financial Management* (6th edn, Orlando, Florida: Dryden Press, 1992), p.483:"Business risk is the uncertainty associated with a firm's projections of its future returns on equity. A firm will tend to have low business risk if the demand for its products is stable, if the prices of its inputs and products remain relatively constant, if it can adjust its prices freely if its costs increase, and if a high percentage of its costs are variable and hence decrease as its output and sales decrease. Other things the same, the lower a firm's business risk, the higher its optimal debt ratio".

10. Mendelsohn, cited above fn.2, Ch.2, "The History and Development of Franchising", pp.18-23.

11. The NatWest Bank survey of franchises found at: *www.natwest.com/smallbusiness/services/franchise/index.asp?navid=sbs/accounts services/franchise/natwest survey.*

12. The British Franchising Association statistics at *www.franinfo.co.uk/franchisinginuk. lasso.*

13. *www.natwest.com/smallbusiness/services/franchise/index.asp?navid=sbs/accounts services/franchise/natwest survey.*

14. M. Mendelsohn, cited above fn.2, pp.42-46. See also *The United Kingdom Franchise Directory,* Norwich, published by the Franchise Development Services Ltd (an annual publication).

15. "Complex economic organisations bound together by ties of ownership, contract and authority may in reality comprise some form of team effort, which could easily be integrated within one capital unit, and may therefore be analysed from the point of view of institutional economics as a quasi-firm. Yet since in fact these groups comprise distinct legal identities which in law are regarded as independent persons, members of the group cannot be held responsible for the acts or omissions of the other members without contradicting the basic principles of legal responsibility".H. Collins, "Ascription of Legal Responsibility to groups in Complex Patterns of Economic Integration" [1990] 53 M.L.R. 731 at 734.

16. J. Phillips and A. Firth, *Introduction to Intellectual Property Law* (3rd edn, London: Butterworths, 1995), p.310.

17. e.g. Coca-Cola and Pepsi-Cola.

18. e.g. Ford Motor Co and Esso Petroleum.

19. e.g. Holiday Inn; Dyno-Rod; Hertz Car Hire; Tie Rack; Prontaprint; Unipart; Burger King, Dunkin Donuts, etc.

20. Source: NatWest/British Franchise Association Survey, April 2003. Found at *www. natwest.com/smallbusiness/services/franchise/index.asp?navid=sbs/accounts services/franchise/natwest survey.*

21. The costs of becoming a manufacturing franchisee or a franchisee of a hotel will be considerably higher than the costs of becoming a franchisee in the retail sector. Because the costs are high, most manufacturing franchisees and hotel franchisees are companies rather than individuals.

22. *ibid.*

23. M. Mendelsohn and R. Bynoe, *Franchising* (London: FT Law & Tax, 1995), p.34.

24. J. A. Brickley and F. H. Dark, "The Choice of Organizational Form: The Case of Franchising" (1987) 18 *Journal of Economics* 401-420. The authors note (in connection with the agency problems of shirking and perquisite taking) the fact that franchisees:"are compensated by residual claims from their particular units. Therefore, the costs and benefits of franchisees' actions that affect the value of their individual units are capitalized onto their own shoulders", at p.406.

25. Franchisors, whose businesses are at an early stage of development, may have to borrow to fund their operations. This level of borrowing may diminish as the franchise system grows and retained profits become a source of finance for the firm.

26. Franchisors and franchisees may use some degree of external financing for any of four general purposes depending on the stage of development that the business has attained at a given point in time. At the outset franchisors may need seed capital to prove a concept or develop a product. Then, when a business plan has been devised and a management team has been appointed, the franchisor may need start-up capital to buy or lease the premises from which the business will operate and to purchase the fixtures and fittings and the start-up inventory to commence trading as a franchised business. Once the business is a going concern, the franchise may need to seek some external funding to maintain its working capital. This type of borrowing is normally used to pay for supplies and workers' wages at times of peak demand for the goods and services offered by the franchised business. This type of funding is invariably short-term funding. The final type of external financing that the franchisor may seek is development or expansion capital. This type of funding may be required to pay for major projects of a mature franchise, such as a market expansion programme (perhaps into neighbouring foreign countries), mergers and acquisitions, or business diversification plans. (D. L. Foster, *The Encyclopaedia of Franchises and Franchising* (New York: Facts on File Inc, 1989), pp.83-85). This type of funding may also be used to re-finance the business.

27. For example, the first securitisation by Pubmaster, the third largest operator of tenanted public houses in the UK, in June 1999, which raised £305 million was used to fund the acquisition of 1,277 existing pubs form other chains. See the report by The European Monitoring Centre on Change, *Financial Markets driving change at company level: Pubmaster* (Dublin: The European Foundation for the Improvement of Living and Working Conditions, 2004), p.3.

28. A. R. Oxenfeldt and A. O. Kelly, "Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?" (Winter 1968-1969) *The Journal of Retailing* 44 at 69-83.

29. *ibid.* See also Adams and Prichard-Jones, cited above fn.3, p.6.

30. For a list of the types of restrictive covenants that may appear on bank loans see R. R. Pennington, *Bank Finance for Companies* (London: Sweet&Maxwell, 1987), pp.20-22.

31. This type of funding may be used to re-finance the business. If there is a significant change in interest rates for example, the franchisor may wish to pay off existing high interest loans with loans at lower interest rates, or if an existing loan has restrictive covenants in the trust deed that the franchisor now finds to be too onerous, the franchisor may liquidate that loan and borrow from another lender where the restrictions placed on the borrower are less onerous. See S. A. Ross, R. W. Westerfield and J. F. Jaffe, *Corporate Finance* (Boston, MA: Irwin 1993), pp.401-402.

32. J.K. Thompson, cited above fn.4, p 111. He notes that asset-backed securitisations for commercial companies were slow to start in the UK. It is only since the 1990s that these types of securitisations have become generally available as an option for commercial companies.

33. External equity tends to be more costly than internal equity and profitable firms tend to use accumulated reserves to finance growth rather than debt, according to the "pecking order theory" described in S. A. Ross, R. W. Westerfield and J. F. Jaffe, cited above fn.31, p.476.

34. For a full list of the pros and cons of using equity finance see p.538-539 in E. F. Brigham, cited above fn.9.

35. *ibid.,* p.477. According to the signalling theory of corporate finance:"the announcement of a stock offering by a mature firm that seems to have financing alternatives is taken as a signal that the firm's prospects as seen by its management are not bright".

36. R. P. Pike and B. Neale, *Corporate Finance and Investment* (Hemel Hempstead: Prentice Hall International (UK) Ltd, 1993), p.343. The advantage of gearing is that it can lower the overall or weighted average cost of capital, and raise the market value of the company. However, this benign effect can only be relied upon at relatively safe gearing levels. Companies can expect the market to react adversely to excessive gearing ratios. Furthermore, as the authors point out:"although debt has its attractions it is potentially lethal. Considerable care should be taken when prescribing the appropriate use of debt that will enhance shareholder wealth without ever threatening corporate collapse".

37. E. F. Brigham, cited above fn.9, Ch.11, s.10 on "Variations in capital structures among firms", at pp.482-483.

38. A significant number of franchises may have the capacity to issue debt because traditionally they do not tend to use much debt. There is also financial accountancy research which has shown that companies which have reasonably certain operating incomes and are profitable tend to use debt less as a source of financing because they can finance developments from retained profits. This research also suggests that this may be particularly true of firms that have a high level of intangible assets and strong growth opportunities. See S. A. Ross, R. W. Westerfield and J. F. Jaffe, cited above fn.31, pp.474-475.

39. Franchisors are not debt-free businesses, but they do not tend to be burdened by very large amounts of existing debt and may have a larger capacity for debt than many other types of business. The franchisor's business is designed to grow largely on the capital/revenues provided by its franchisees. However, franchisors will usually have accumulated some debt when they may have borrowed money to set up the franchise and to operate the franchise through the early, developmental years of business. Some franchisors may also have borrowed to be able to run their own outlets. Some others may have incurred debt to own the premises from which their franchisees operate.

40. D. Baillieu, cited above fn.7; M. Mendelsohn and R. Bynoe, cited above fn.23; R. T. Justis and R. J. Judd, *Franchising* (2nd edn, Cincinnati, Ohio: Dame Publishing, 2002); M. Abell, *The Franchise Option: A Legal Guide* (London: Waterlow Publishers, 1989).

41. J. L. Bradach, *Franchise Organizations* (Boston, Mass.: Harvard Business School Press, 1998), p.61. The author also points out that if rapid growth is not properly managed it can be detrimental to the franchisor. He quotes the CEO of an American franchise as saying "[y]ou can kill a company by growing too fast" (p.66) in order to highlight the problem of the possible lack of managerial capacity to cope with a rapid increase in the network.

42. *ibid.,* pp.63-68.

43. *ibid.*

44. See S. A. Ross, R. W. Westerfield and J. F. Jaffe, cited above fn.31, at pp.578-580 on venture capital. This type of funding is really aimed at "early stage financing of new and young companies seeking to grow rapidly". See also S. E. Pratt, *Overview and Introduction to the Venture Capital Industry, A Guide to Venture Capital Sources* (10th edn, Laurel Avenue, Wellesley Hills, MA: Venture Economics, 1987) and Samuels, Wilkes & Bradshaw, *Management of Company Finance* (5th edn, London: Chapman & Hall, 1990), p.729 on venture capital and pp.723-738 on the problems of small business finance.

45. Adams and Prichard-Jones, cited above fn.3, pp.191-197.

46. J. M. Samuels, F. M. Wilkes and R. E. Brayshaw, *Management of Company Finance* cited above fn.44, pp.326-361.

47. *ibid.,* p.328:"Almost all bond and debenture deeds and an increasing percentage of bank loan agreements contain restrictive 'negative' covenants. These covenants restrict the borrower's right to take certain actions until the debt has been repaid in full".The items covered could include the incurring of any further debt, the disposal of any assets; the payment of cash dividends, redemption of shares, the issuing of options, unless already agreed to in the loan agreement, etc.

48. Transaction costs include accountancy fees, legal fees, the costs of arranging credit enhancements and guarantees and the bond issue costs. See A. Haynes: "Legal Developments in Debt Securitisation" (2000) E.B.L. Rev. 39 at 40.

49. See Schwarcz, "The Alchemy of Asset Securitization" (1994) 1 *Stanford Journal of Law, Business & Finance* 133 at pp.137-140, on "one off" or customised structures.

50. See Adams and Prichard-Jones, cited above fn.3, pp.201-251 on how to manage investment risk by (amongst other things) using off-shore corporate structures and trusts.

51. SPVs are usually corporate entities, but they do not have to be. They could be partnerships, for example.

52. There may be surplus assets owing to over-collateralisation.

53. For example, Schwarcz, cited above fn.49, p.135, Schwarcz, "Securitization, post Enron" (2004) 25 Cardozo L.R. 1539; T. W. Albrecht and S. J. Smith, "Corporate Loan Securitisation: Selected Legal and Regulatory Issues" (1998) *Duke Journal of Comparative & International Law* 411; D. Kaufman, J. Yarett, B. Schorr and C. S. Grimson, "Securitisation: An overlooked Financing Vehicle for Franchisors" (2001) 20 Franchise L.J. 161.

54. [1897] A.C. 22.

55. [1978] S.C. (HL) 90.

56. [1990] Ch. 433.

57. [1998] 1W.L.R. 294.

58. [1998] 1W.L.R. 830.

59. [1998] B.C.C. 607, CA.

60. *Southard & Co, Re* [1979] 3 All E.R. 556 at 557:"English company law possesses some curious features, which may generate curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of the creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary".

61. The established categories include cases where the incorporation is a sham designed to avoid existing contractual obligations, fraud, agency, public policy.

62. D.J. Kaufmann, J. Yarett. B. L. Schorr and C. S. Gimson, "Securitization: an overlooked vehicle for franchisors" (2001) 20 Franchise L.J. 161 at 198.

63. Although the overall credit-worthiness of the franchisor's business is not of prime concern to the investors in a securitisation (as the investors need only be concerned with the revenues coming in to the SPV) the reliability and predictability of those revenues and the risk of default are of great importance.

64. It is usually the case the banks will not supply finance to potential franchisees without a business plan. The franchisor may be asked by the franchisee to assist in this. The franchisor must produce accurate figures to avoid liability. Furthermore, the *Code of Ethics of the British Franchise Association* and the BFA's *Best Practice Guide to Ethical Conduct* require the franchisor to produce accurate information about the franchise to potential franchisees. M. Mendelsohn and R. Bynoe, cited above fn.23, p.105.

65. [1976] Q.B. 801; [1976] 2 All E.R. 5, CA.

66. Danielle Baillieu has pointed out that there are traps for the unwary in franchising and that some franchisors have exploited their franchisees. See D. Baillieu, *Franchising: Fact, Fraud and Fallacy* (London: Streetwise Publications, 1990).

67. R. Justis and R. Judd, cited above fn.40, pp.433-434, and also M. Mendelsohn, cited above fn.2, pp.91-100.

68. M. Mendelsohn, cited above fn.2, pp.92-93. This author estimates that initial fees are between 5 per cent to 10 per cent of the total cost of the franchise package (i.e. the total investment cost to the franchisees of getting into business and opening the outlet)

69. Adams and Prichard-Jones, cited above fn.3, pp.269-70. The authors state that the franchisor could be paid by a straight annual fee or that the franchisor could make his profits from the sale of tied items to the franchisees.

70. R. Justis and R. Judd, cited above fn.40, p.433. See also M. Mendelsohn, cited above fn.2, p.97, where the author estimates that the average amount of continuing franchise fees to be in the region of 5.6 per cent of the gross revenues of the franchisees. Advertising fees which are to be added to the royalties due are, on average 4.2 per cent of the gross revenues of the franchisees.

71. This is a policy of McDonald's. As a result McDonald's is the largest owner of retail property in the world. J.F. Love, *McDonald's Behind the Arches* (London: Bantam Press, 1986).

72. Adams and Prichard-Jones, cited above fn.3, at p.187.

73. Franchisors usually undertake to train the franchisee in the business skills required to run a successful franchise operation (such as accountancy skills, customer services skills, record keeping, job selection skills and interviewing skills to enable the franchisee to recruit a suitable workforce etc). This initial training is usually covered by the initial fee. See Adams and Prichard-Jones, cited above fn.3., at p.301.

74. Felstead, *The Corporate Paradox* (Thomson Learning, 1993) at pp.103-104.

75. *ibid.,* at p.104. The author gives some examples of non-performance clauses such as:"the franchisor may at its sole discretion terminate this agreement in the event that substantial turnover arising form the

business…is not achieved within eighteen months of the date of the agreement, or for a continuous period of six months at any time thereafter…”.

76. M. Mendelsohn, cited above fn.2, p.171.

77. Bradach, cited above fn.41, pp.69-72.

78. S. Price, *The Franchise Paradox* (London: Cassell, 1997). The author examines the causes of franchisee failure in Chapter 9.

79. “Know-how” is practical economic knowledge which enables firms to achieve results. Much of this knowledge may take the form of techniques of organisation, professional standards, or systems of incentives which cannot be privatised by patents. J. Black, *The Oxford Dictionary of Economics* (Oxford, Oxford University Press, 2002).

80. D. Baillieu, *Streetwise Franchising,* cited above fn.7, p.3.

81. R. Justis and R. Judd, cited above fn.40, p.436 notes that some well-established franchisors have sometimes been prepared to help to finance franchisees. M. Mendelsohn, cited above fn.2, p.96 notes “The franchisor could set up its own finance company and make a profit on providing financial facilities to its franchisees”, but he notes that this is rarely done.

82. The franchisor will not want to lose a good potential franchisee because that person does not have the personal funds to buy the franchise and so the franchisor may make arrangements to put the potential franchisee in contact with a range of potential lenders, Adams and Prichard-Jones, cited above fn.3, pp.191-2.

83. M. Mendelsohn, cited above fn.2, pp.100-106. He notes at p.100 that:“as franchising is an inherently safer way of establishing a new business it is not surprising to find that the banking community has appreciated the advantages of lending money to franchisees”.He also notes that:“In June 1981, the National Westminster Bank became the first bank to establish a franchise finance department. It was quickly followed by…Barclays Bank, The Royal Bank of Scotland, the Midlands Bank, Lloyds and the Bank of Scotland…”.

84. Bradach, cited above fn.41, p.72.

85. M. Firth and S. Keane, *Issues in Finance* (Oxford: Philip Allan Publishers, 1986).

86. *Financial Times,* March 11, 2005: “Britons set to hold tight to wallets” (Special Report on Business Recovery), p.4.

87. New restaurant ideas are being developed all the time to meet changing tastes and preferences. Britain's first national curry house chain is soon to be launched, “providing freshly cooked Mumbai cuisine aimed at the smart, casual” customer group. This was reported in the *Financial Times,* November 15, 2004, p.22.

88. “The key to a successful franchise, according to many texts on the subject, can be expressed in one word: “uniformity”. Franchises and chain stores strive to offer the same product or service at numerous locations. Customers are drawn to familiar brands by an instinct to avoid the unknown”, E. Schlosser, *Fast Food Nation* (London: Penguin Books, 2002), p.5.

89. *The Observer,* March 7, 2004: “McDonald's bows to critics and slashes salt ration”.

90. Refurbishing restaurants and introducing healthy eating options. *Financial Times,* July 25, 2002, p.26: “New products help to boost McDonald's data”.

91. *Environmental Health News,* February 28, 2003, p.3: “Call to ban junk food ads” reported that:“a Food Commission report into the health consequences of unhealthy food, marketed to children wants a ban on advertising junk food to children and the introduction of a ‘fat tax’ on advertisers to fund a national programme of promoting healthy diets”.

92. *McDonalds v Steel and Morris* (1997)

93. See McLibel trial web site *www.mcspotlight.org/case/.*

94. *Pelman v McDonalds* United States District Court Southern District of New York Opinion 02 Civ. 7821 (RWS). For the judgment see *www.lawyersweeklyusa.com/opinions/mcdonalds.htm.*

95. *Financial Times,* November 27, 2002, p.20: “Big Food faces grilling over America's obesity ‘epidemic’ “.

96. N. Klein, *No Logo* (London: Flamingo (an imprint of Harper-Collins), 2000).

97. E. Schlosser, cited above fn.88. This book has been described in the publisher's publicity for the book as "a shocking expose…[that] could make a difference to the way we eat. For ever".

98. In this film, the film-maker eats nothing but McDonald's food for one month in an attempt to show that certain types of heavily marketed food may have unhealthy effects if too much of this type of food is consumed. As part of his experiment Spurlock undertakes to accept a "super-size portion of food" (i.e. an extra large portion) every time a McDonald's shop assistant offers it to him. His weight increases, his blood pressure rises and his liver is damaged. Despite the artificial nature of the experiment in so far as very few people live only on a diet of burgers and the fact that McDonalds have never claimed that living mainly on a diet of burgers and French fries is a good thing, the film succeeds in creating a negative image of the fast food franchised sector. See the Morgan Spurlock's film *Super Size Me* web site at *www.supersizeme.com/home.aspx?page=aboutmovie.*

99. See *Financial Times,* March 9, 2004: "Healthier menus at McDonalds" where the newspaper reports that the company has slashed the range of burgers it once offered to make way for salads and has introduced a new labelling system aimed at countering any threat of obesity litigation.

100. It is not cheap to set up as a franchisee as can be seen from the figures presented in the text. However, with banks being willing to lend to potential franchisees, it is still possible for franchisors to recruit franchisees.

101. "Pizza Express runs out of steam", *Financial Times,* November 5, 2002, p.27.

102. For example the rise of gourmet sandwich shops like "Prêt à Manger".

103. For example, one could buy a Kentucky Fried Chicken instead of a hamburger or a pizza.

104. "Weaker sales take their toll on McDonalds", *Financial Times,* September 18, 2002, p.28. See also "McDonalds posts loss and cuts targets", *Financial Times,* January 24, 2003, at p.27.

105. "McDonalds back in the black", *Financial Times,* April 29, 2003, p.30.

106. R. E. Stassen and R. A. Mittelstaedt, "Territory Encroachment in Maturing Franchise Systems" (1995) 4(2) *Journal of Marketing Channels* 27-48.

107. D. Baillieu, *Streetwise Franchising,* cited above fn.7, p.56.

108. The franchisee might have a contractual right to prevent it, because the franchisee has negotiated successfully for an exclusive territory. However, as Bradach (in *Franchise Organizations,* cited above fn.41, p.75) notes, it is uncommon for established franchisors in the fast food business to grant exclusive territories.

109. A. Felstead, cited above fn.74, Ch.5.

110. It reached such a level in the state of Iowa (USA) that the legislature passed a law limiting the ability of the franchisor to do this (1992 Iowa Franchise Law (House file 2362). See R. E. Stassen and R. A. Mittelstaedt, cited above fn.6 (2nd ser.).

111. Felstead, cited above fn.74, p.80.

112. *ibid.* The author states:"Ample capital, national advertising, a well known trade mark and patented processes are all desirable, but not necessary, for a potential franchisor to enter the industry. All that it takes to enter franchising is the desire to do so, and the ability to convince at least one other person (a potential franchisee) that he/she should buy the right to operate the business under the franchisor's trade mark…".The typical costs of buying a franchise have been specified in the text of this article.

113. *ibid.,* cited above fn.74, p.80. Note, this profile has remained fairly consistent in recent years. See *The United Kingdom Franchise Directory* (Norwich), published annually by the Franchise Development Services Ltd. This gives a profile of every known franchisor in the UK.

114. The Alternative Investment Market.

115. OFEX is a share-trading market operated by OFEX Plc to enable OFEX member firms to deal in the securities of unlisted and unquoted companies off- exchange. Securities traded on OFEX are not quoted or dealt in on the London Stock Exchange or subject to its rules. Issuers are subject to continuing obligations or requirements as set out in the OFEX Rule Book. OFEX Plc is authorised and regulated by the Financial Services Authority ("FSA") in order that it can operate the OFEX market in the UK. Issuers and members of the OFEX market must abide by the OFEX Rule Book.

116. Schwarcz, cited above fn.49, p.141.

117. J. Benjamin, *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (Oxford: Oxford University Press, 2000), p.288:"securitisation [allows] institutions whose poor or moderate credit rating would otherwise preclude them from accessing the capital markets, to raise long term, low cost funds by issuing securities on the back of relatively illiquid assets".

118. Schwarcz, cited above fn.49, p.140.

119. *ibid.*

120. Benjamin, cited above fn.17 (2nd ser.), p.289.

121. J. K. Thompson, cited above fn.4, p.25.

122. J. Bresslaw, "Securitisation: Old Dog: New Tricks" (1994) P.L.C. 32-33.

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