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When Franchisors Fail, Franchisees Pay the Price

Jenny Buchan (UNSW Sydney)
Jennifer Gant (University of Derby)

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Franchising is often sold as a safer path to entrepreneurship. But when franchisors collapse or change direction, franchisees can be left with heavy financial risks, little information, and almost no voice.

Fifth in a series about franchising

Franchising is widely promoted as one of the most successful pathways into entrepreneurship. It promises brand recognition, proven systems, and access to shared knowledge. Yet when a franchisor fails, franchisees—many of whom are firstâ€time or small business entrepreneurs—often discover that they carry far greater risk than they anticipated, with little access to information or meaningful participation in decisions that determine their financial future.

Individual entrepreneurs should be asking these key questions before they become part of a franchise: “What risks am I really taking on when I buy into a franchise system, and will I have a voice if the franchisor comes under financial stress or decides to stop franchising?”

People start and run a business primarily to provide a financial return to its owners. For franchisors, this means a return to its shareholders.(Buchan, Frazer, Qu & Nicholls). The franchisor might choose to exit via a public offering. Listing on the stock exchange introduces a group of stakeholders who are primarily motivated by capital gain and regular dividends. This is at odds with the longer-term vision of franchisees, who wants to build the business to secure their family’s future.

In another scenario, the franchisor could decide to change the product mix and to market the most profitable products direct to customers, leaving its franchisees without access to the most lucrative sales.

For policymakers and/or ecosystem leaders the question is, “If franchising is treated as an important pathway into entrepreneurship, what information, consultation, and support structures are needed to make that pathway resilient and fair?”

Franchising as Outsourced Entrepreneurship

Franchising is often described as a hybrid between employment and independent business ownership (Gant & Buchan). In practice, it is a form of outsourcing. Franchisors outsource local ownership, capital investment, staffing, premises, and everyday operational costs to franchisees, while maintaining tight control over branding, systems, products, and strategy. Franchisees fund and operate the local business, but do not control the key strategic decisions that can determine its success or failure.

This structure allows franchisors to grow rapidly with relatively low capital investment. For franchisees, it offers a perceived reduction in entrepreneurial uncertainty — “a business in a box.” Yet the franchise contract is typically a nonâ€negotiable, standard form document that reflects the franchisor’s priorities rather than a balanced allocation of risk.

As franchise systems mature, the gap between perceived and actual risk widens. Franchisors may restructure, expand internationally, borrow heavily, sell their interests to private equity or public investors, or acquire additional brands. These decisions fundamentally affect the risk profile of the network, but franchisees are rarely informed in advance, consulted, or given access to the financial information needed to make informed responses.

Information Asymmetry and Entrepreneurial Vulnerability

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A defining feature of franchising is **information asymmetry**. Franchisors receive continuous information about franchisees through reporting systems, pointâÂ?Â?ofâÂ?Â?sale data, supply chains, and lease arrangements. Franchisees, by contrast, have limited access to information about the franchisor's financial health, governance structure, or strategic priorities (Buchan, J.)

This imbalance matters. In entrepreneurship research, access to timely and relevant information is critical to decisionâÂ?Â?making, risk management, and learning. Franchisees are expected to behave like rational entrepreneurs—conducting due diligence, managing risk, and adapting to change—but they operate in a market where key information is unavailable or delayed.

Before making a commitment to a brand, franchisees can make extensive use of information available through gatekeepers, who "often … know how profitably a business is trading. In franchising gatekeepers include funding bodies making a decision to fund a venture, regulators, accountants authorizing franchisors to confirm they are solvent, lawyers, retail landlords, and industry bodies" (Buchan, Frazer, Qu & Nicholls). Resources available through social media should never be ignored.

When a franchisor encounters financial distress, the consequences of this asymmetry are severe. Warning signs, such as delayed supplier payments or increased costs, are often opaque. Franchisee inquiries can be brushed off by head office staff providing plausible, but incorrect justifications. Franchisees may be locked into longâÂ?Â?term leases, personal guarantees, and sunk investments without any early warning that the franchisor's business model is under strain.

Moral Hazard in the Franchise Model

The franchise structure creates a classic moral hazard problem (Gant, 2022). Franchisors shift significant commercial risk to franchisees while retaining strategic control. Because franchisees bear much of the downside risk—through capital investment, personal guarantees, and operational costs—franchisors may be incentivized to pursue higherâÂ?Â?risk strategies. If those strategies succeed, franchisors and their investors benefit. If they fail, franchisees absorb disproportionate losses.

This is not necessarily deliberate misconduct. Rather, it is a structural feature of the model. Franchisees effectively act as a dispersed insurance pool underwriting franchisor decisions, while lacking the voice, information, or legal standing usually associated with risk bearers.

Optimism bias compounds this effect. Franchisees, like many entrepreneurs, tend to overestimate their chances of success and underestimate the likelihood of failure(Benoliel & Buchan). Disclosure documents and warning statements often fail to correct this bias, particularly where the brand narrative emphasizes rapid growth or historical success (Benoliel, Buchan & Gutentag).

What Happens When a Franchisor Fails?

Franchisor insolvency exposes the weaknesses of the franchise relationship. Unlike employees, who benefit from wellâÂ?Â?developed insolvency protections, franchisees occupy an uncertain position (Gant). They are often not recognized as creditors, but as ongoing operators required to continue trading while administrators attempt to salvage value from the franchise agreements themselves. "The standard form of franchise agreement limits the ability of franchisees to self-protect (Jenvey, 2006) and insolvency legislation, in existence long before franchising became popular, exposes the full extent of the franchisees' vulnerability" (Buchan, Frazer, Qu & Nicholls).

In many insolvencies, registered trademarks, money held in the system marketing account, and franchise agreements are the franchisor's most valuable assets. Trademarks may be sold. There is no guarantee they will not be sold to a competitor who will shelve them or to an entity that does not buy other parts of the business(Buchan, 2013). The franchisor may not own the trademarks (Buchan, 2013).

Marketing funds continue to be payable by franchisees throughout the franchisor's administration. Unless the funds are protected by trusts, the franchisees' contributions will not be returned to franchisees but will be used to repay the franchisor's creditors (*In the matter of Stay in Bed Milk & Bread Pty Ltd (In Liq)* [2019] VSC 181. Buchan & Fernlund).

"Franchise agreements provide rights for franchisors on franchisees' failure, but [they] … rarely provide specific

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rights to franchisees on the failure of the system's linchpin, its franchisor," (Buchan, Frazer, Qu, Nicholls). Administrators may retain or sell them to maximize returns for creditors, while franchisees continue to operate with reduced support, higher costs, and no say in the outcome. Intellectual property may be sold, leases terminated, or supply arrangements disrupted, undermining the viability of franchisee businesses.

During this process, franchisees typically lack access to formal information channels, consultation mechanisms, or collective representation. Decisions affecting their livelihood are made with limited input from those most affected.

Closing the Regulatory Gap

Globally, existing regulatory frameworks have not kept pace with the way modern franchise systems operate, and consequently underestimate the importance of **information exchange, consultation, and participation** in sustaining entrepreneurial outcomes.

For entrepreneurs, a key takeaway is that franchising should be viewed as managed dependence, not just reduced-risk ownership. It's important to ask not only whether a brand is attractive but also what information rights, consultation rights, insolvency protections, and so on exist before trouble begins.

For policymakers, the key takeaway is that franchisee vulnerability isn't just a private contracting issue. Because the law in many countries declares *ipso facto* clauses void (Nicholls & Buchan*)*, franchisees are unable to protect their businesses by signing better designed contracts. They need legislative protection. When franchisors fail the consequences spill over to local businesses, employees, suppliers, communities. Better info exchange, communication during insolvency, and collective representation can be presented as tools for building a resilient community of entrepreneurs and ecosystem health, not just added regulation.

Around the world, franchise regulation focuses primarily on **preâ□Â□contract disclosure and fair dealing**, not on what happens if systems fail. Insolvency law, meanwhile, treats franchisors like any other corporation, without recognizing the unique dependence of franchisees on the franchisor's ongoing viability.

This regulatory separation reflects historical dependence: Franchising evolved under the radar of corporate and insolvency law and has been framed as a matter of contract and competition rather than organizational risk-sharing. Yet modern franchise networks resemble complex organizational ecosystems more than simple contractual chains.

As entrepreneurship policies increasingly emphasize sustainability, resilience, and responsible growth, this gap becomes harder to justify.

Learning from Employment and Corporate Governance

In other areas of economic life, information and participation rights are recognized as essential to fairness and efficiency. Employees facing redundancy typically receive notice, consultation, and representation rights (Gant & Cabrelli). Corporate governance increasingly acknowledges the importance of *stakeholder* interests -- beyond shareholders alone.

Franchisees share many of the vulnerabilities that justify these protections. They make large, sunk investments; depend heavily on one counterparty; lack bargaining power; and face significant barriers to exit. When failure occurs, the social and economic costs extend beyond the individual franchisee to employees, suppliers, and local communities.

Rethinking Information Exchange and Participation

We feel that modest reforms, mandated by regulators and focusing on **information exchange and participation,** could significantly reduce risk and moral hazard in franchising without undermining entrepreneurial flexibility. These include:

- **Early information disclosure** when franchisor decisions may affect network solvency
- **Mandatory communication** between insolvency practitioners and franchisees
- **Consultation rights** during restructuring, administration, or major strategic change
- **Collective representation** of franchisees in insolvency processes
- **Governance reforms** requiring directors to consider franchisee interests
- **Improved transparency** of franchisor financial structures

Such measures would not guarantee business success,

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but they would enable franchisees to respond more effectively to risk, coordinate collective solutions, and make informed decisions.

Implications for the Entrepreneurial Ecosystem

For entrepreneurs, franchising should be understood as a form of **managed dependence**, not reduced risk ownership. For advisers, regulators, and policymakers, the challenge is to ensure that information flows reflect that reality.

Effective information exchange is not just a consumer protection issue; it is an entrepreneurship issue. Markets function best when participants can see and respond to risk. Franchise systems that rely on information opacity and unbalanced risk transfer may grow quickly, but they do so at the expense of resilience and trust.

Conclusion

Franchisees operate at the intersection of entrepreneurship and organizational control. When franchisors fail, franchisees often discover that they are exposed, unheard, and underestimated. This is not an unavoidable feature of entrepreneurship, but the result of contractual, regulatory, and institutional choices that prioritize growth and flexibility over transparency and participation.

ReâÂ□Â□balancing information exchange and decisionâÂ□Â□making rights would help align franchising with contemporary understandings of sustainable entrepreneurship. Giving franchisees a voice when it matters most is not antiâÂ□Â□business regulation—it is a recognition that modern entrepreneurial ecosystems depend on informed, connected, and fairly positioned participants.

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