

PREFACE AND ACKNOWLEDGMENTS

The social and economic impact of franchising is enormous. Hamburger chains seem to be the franchising example imprinted on many people's minds, but the concept has been applied to businesses across the economic spectrum. "One out of every three dollars spent by Americans for goods and services is spent in a franchised business. Homes are bought and sold through franchised real estate companies. The same homes can be cleaned, painted, and carpeted through a franchise. Cars can be purchased, tuned, and washed through franchises. We have our hair cut, clothes cleaned, pets cared for—all in franchised business. We can travel from one area of the world to another through franchised businesses."¹ In fact, franchised businesses have provided nearly 9 million jobs and generated over \$350 billion in payroll.²

At its core, "franchising is primarily a method of distribution of goods or services."³ Franchising involves a series of agreements between the franchisor and franchisee that authorize the franchisee to operate a business using the franchisor's intellectual property and proprietary system. Franchisors license trademarks and/or other intellectual property to franchisees and provide franchisees with support by way of a franchise system to promote common system standards. In exchange, franchisees agree to, among other things, pay the franchisor a royalty and/or some other calculated consideration.

The franchise agreement, discussed at length in this book, is a legally binding contract between a franchisor and franchisee, outlining the franchisor's terms and conditions for the franchisee. Typically, the franchise agreement will include the following provisions: (1) an overview of the relationship and the obligations of both the franchisor and the franchisee; (2) use of the intellectual property, including trademarks and patents; (3) initial and continuing fees; (4) site selection and development; (5) initial and ongoing training and support; (6) duration of the franchise agreement and the franchisee's rights to enter into new agreements; (7) advertising; (8) insurance requirements; and (9) record keeping and the franchisor's rights to inspect the books and records of the franchisee. Utilizing a franchised system can be extremely advantageous because the franchisee immediately has the name recognition of the brand, a business model that has

1. Barbara Beshel and Sidney J. Feltenstein, *An Introduction to Franchising*, IFA EDUC. FOUND. (2001).

2. IFA, *Economic Impact of Franchised Businesses*, Volume IV, E-1 (2017).

3. Briggs and Morgan, P.A., *An Introduction to Franchising*, MINN. DEPART. OF EMPLOYMENT AND ECON. DEV. (2008).

been tested, and detailed guidelines for running and promoting the franchise. The balancing of risks and relatively low barriers to entry have contributed to franchising's impressive contributions to the American economy.

Notwithstanding the massive financial production of franchising in the United States, however, financial troubles and bankruptcy is a reality in some franchisor/franchisee relationships. Even the most famous franchise systems will encounter franchisees in financial distress, and a percentage of struggling franchisees will declare bankruptcy each year in pursuit of varying objectives. Franchisors are not immune from insolvency and franchise systems have (and will) invoke the bankruptcy process. Importantly, "bankruptcy" is a broad term that is not necessarily synonymous with liquidating or going out of business. Rather, bankruptcy is a versatile tool created under title 11, Chapter 11 of the United States Code that may be employed for a number of different purposes, including financial restructuring, effectuating a sale of the business, or liquidating and disappearing from the economic landscape. This book explores bankruptcy issues particular to franchisors and franchisees and the unique challenges that each faces in bankruptcy cases of the other. Bankruptcy is addressed from every angle, including the different scenarios presented when a franchisee files bankruptcy, versus a franchisor bankruptcy filing. However, franchisee bankruptcy filings are much more common than franchisor filings. For that reason, unless otherwise stated, a franchisee filing will be the assumed fact pattern.

The book begins in Chapter 1 with prebankruptcy considerations of the franchisee and franchisor. The chapter explores in depth the franchisor's ability to take actions in an attempt to minimize its risks and the elusive pursuit of a "bankruptcy proof" agreement. The chapter also addresses questions a financially distressed franchisee should be asking itself such as: Is bankruptcy the best option? Would an out-of-court workout to restructure debts work? What steps need to be taken if a filing is imminent?

In Chapter 2, the discussion shifts to the bankruptcy filing and the initial issues that present. The chapter discusses the following issues in detail: (1) where the case may be initiated; (2) eligibility for various types of bankruptcy cases; (3) what bankruptcy chapter will be elected; (4) various emergent and "first day" considerations in Chapter 11 cases; (5) determining if the franchise agreement is property of the bankruptcy estate; (6) the potential "critical vendor" status of the franchisors; and (7) bankruptcy exit strategies.

Chapter 3 discusses the automatic stay, which is the fundamental protection provided to the company filing bankruptcy (the "debtor") under the Bankruptcy Code. Discussion points include the basics of the automatic stay, how a creditor can obtain relief from the automatic stay, and how to avoid the wrath of a bankruptcy court by ensuring that the automatic stay is not violated.

Chapter 4 transitions into cash collateral issues under section 363(a) of the Bankruptcy Code. Debtors need cash to continue operating in bankruptcy. Secured creditors, in turn, are entitled to "adequate protection" for the use of the cash constituting a portion of the secured creditor's collateral. Cash collateral therefore is a critically important issue at the beginning. Chapter 4 discusses an

overview of what cash collateral is, the preliminary considerations that must be addressed, the use of cash collateral, the requirements and forms of adequate protection, and importantly, the relationship to the automatic stay.

Bankruptcy Code section 365 empowers debtors to assume or reject certain contracts and leases, including franchise agreements. A debtor may also attempt to use section 365 to assume and assign the franchise agreement to a third party. “Assumption” and “rejection” are bankruptcy law terms of art and have significant implications for both the debtor and nondebtor parties. Chapter 5 is dedicated to the issues surrounding the potential assumption, assumption and assignment, and rejection of franchise agreements in bankruptcy. These issues have been a hotbed of litigation among franchisees and franchisors in recent years and present litigation risks and opportunities on both sides in a contentious bankruptcy case.

When a franchisee files a bankruptcy petition, an estate is created. The estate consists of substantially all of the property owned by the debtor, including intellectual property and licenses to use intellectual property. Accordingly, Chapter 6 addresses the various types of intellectual property and the effects on intellectual property when a franchisee or franchisor files bankruptcy.

From the perspective of most creditors, the goal in any bankruptcy case is simple: get paid. Whether a claim is paid out of a debtor’s limited resources, and how it is paid, is subject to a complicated set of priorities set forth in the Bankruptcy Code. Chapter 7 discusses claims and claim litigation—specifically, the proof of claim form and what must be included, effects of filing a proof of claim, types of claims, and the treatment of claims under confirmed plans.

Bankruptcy filings do not necessarily result in the eventual reemergence of a reorganized debtor. In fact, bankruptcy is very frequently used as a vehicle for selling a business under Bankruptcy Code section 363. Chapter 8 discusses bankruptcy sales in depth, explaining the legal underpinnings, the mechanics of a bankruptcy sale, and the specific issues that present in a franchisor/franchisee bankruptcy sale.

In both reorganizations and liquidations under Chapter 11, the debtor has an exclusive period to present a plan of reorganization and/or liquidation to creditors and the court. This period can be filled with back-and-forth negotiations as parties jockey for position and attempt to use the numerous plan confirmation requirements to their advantage. Chapter 9 discusses the plan and disclosure statement that are required to be filed with the court and the confirmation process.

A Chapter 7 liquidation bankruptcy will be filed by companies and individuals who carry a large debt load and have no possibility of restructuring. General principles of a Chapter 7 filing, creditor remedies, and Chapter 7 trustee responsibilities, are all explored in depth in Chapter 10 of the book.

Bankruptcy protection is afforded to both businesses and individuals. Chapter 11 of the book explores individual reorganization bankruptcies. This final chapter discusses the process for individuals when they file bankruptcies under either Chapter 13 or Chapter 11. The chapter gives a broad overview of the procedural aspects and all issues that may arise in these types of cases.

The eleven chapters of this book address the intersection of bankruptcy and franchise law from initial stages of contemplating a filing, through the various options presented in a bankruptcy case, and to ultimate conclusion, whether such a conclusion is a reorganization, a sale, or a liquidation. Every participant in the franchising process hopes to avoid becoming entangled in financial restructuring or a bankruptcy filing. The hard fact, however, is that some level of exposure to bankruptcy (whether as a debtor or a creditor) is simply inevitable in any industry. Understanding the process provides such participants with the firmest possible foundation for using bankruptcy for its ultimate purpose: preserving value and maximizing creditor recovery.

The editors thank each of the contributing authors for all of their hard work to make this book a reality. Without the dedication of this talented group of attorneys, this project never would have proceeded past the concept phase.

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This book has been a long time in the making and became a labor of love for the editors. We hope that you will enjoy this book and that it provides useful insight into the fascinating interaction between the worlds of franchise and bankruptcy law.

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