PREBANKRUPTCY CONSIDERATIONS OF THE FRANCHISEE AND FRANCHISOR

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According to Franchise Direct,[1] in 2015 there were approximately 761,991 U.S. franchise establishments providing direct employment to 8,816,000 people and generating over $889 billion in monetary output. Although these statistics indicate a robust franchise environment overall, some businesses have not been successful in the franchise model. Even in successful franchise operations, individual franchisees may experience financial difficulties that lead them to consider bankruptcy or other forms of financial relief.

A franchisor or franchisee bankruptcy affects all the key players in the business. A franchisee is usually the party to a franchise agreement, one or more nonresidential commercial leases, and vendor contracts. In addition, a franchisee may have both secured and unsecured debt. By the time a franchisee is considering bankruptcy options, it may be in default of its loans or its contracts.

When a franchisee is in distress, key questions are: Could the franchisor have taken steps to minimize its risk? Is bankruptcy the best option for the franchisee? Or should the franchisee avoid the federal bankruptcy laws and seek an out-of-court restructuring of its debts, unwind under state dissolution laws, or simply shut its doors? If bankruptcy is the better option, should the franchisee file a Chapter 11 reorganization, a Chapter 11 liquidation, or a Chapter 7 liquidation?

This chapter will discuss: (1) steps franchisors can take to best protect themselves and the franchise system in the event of a franchisee's financial distress; (2) alternatives to bankruptcy for a distressed franchisee; and (3) prebankruptcy considerations if a franchisee bankruptcy filing is imminent.

1. Franchise Direct Statistics, http://www.franchisedirect.com/information/usfranchiseindustrystatistics/?r=5003 August 22, 2017 (last visited Feb. 7, 2018).

I. DRAFTING FRANCHISE AGREEMENTS TO MINIMIZE RISKS FOR FRANCHISORS

The franchise relationship is one of interdependence between the franchisee and the franchisor and has significant advantages for both parties.[2] Both franchisees and franchisors are interested in the financial success of the venture.[3]

But should the venture become distressed, some prebankruptcy strategies can assist the franchisor in protecting its rights in dealing with a financially troubled franchisee, an insolvent franchisee, or a bankruptcy filing. Although contractual provisions preventing a franchisee from filing bankruptcy are not likely to be enforced, other provisions, such as personal guarantees and noncompete agreements may be effective tools. These tools may be included in the franchise agreement or in ancillary agreements.[4]

In drafting or revising a franchise agreement, the franchisor should consider adding provisions to protect the franchisor and the franchise system in the event of a franchisee default. The default, remedy, and other provisions can be drafted to allow protection in the event of a franchisee insolvency or bankruptcy. Although a franchise agreement clause preventing a franchisee from filing bankruptcy is invalid, and an ipso facto clause is generally unenforceable, franchise agreements may contain other provisions that are enforceable in bankruptcy and that will help protect the franchisor and the franchise system in the event of a franchisee default. Provisions that franchisors should evaluate and consider adding to franchise agreements or ancillary agreements include: personal guarantees, termination provisions upon closing of business, restrictive covenants such as noncompetition, nonsolicitation, and nondisclosure clauses, security interests in franchisee's assets, collateral assignment of leases, business interruption insurance requirements, and limits on use of confidential information, trade secrets, and intellectual property.

A. AGREEMENTS NOT TO FILE BANKRUPTCY ARE INVALID

It is against public policy to prohibit an entity from filing for bankruptcy relief.[5] As a result, no creditor consent is needed to file for bankruptcy, although approval to file bankruptcy must be obtained in accordance with the entity's governing documents and applicable law. Most often, unanimous consent of directors or

2. Kevin J. Smith, *Bankruptcy and the Franchise Agreement: When All, or Only Some, of the Partners of a Franchisee Files Bankruptcy,* 28 Cap. U. L. Rev. 775 (2000).

3. *Id.* (citing Westfield Ctr. Serv., Inc. v. Cities Serv. Oil Co., 432 A.2d 48, 52–53 (N.J. 1981) (internal citations omitted)).

4. Matthew B. Gruenberg, John W. Mills & Suj M. Pandya, *Protecting the System: Ways That Franchisors Can Plan for Franchisee Financial Distress and Navigate Franchisee Receivership and Bankruptcies*, 33 Franchise L.J. 377 (Winter 2014).

5. In re Huang, 275 F.3d 1173, 1177 (9th Cir. 2002); In re Citadel Props., Inc., 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988).

LLC members is required to authorize a bankruptcy filing. In some instances, creditors have tried to prevent a bankruptcy filing by obtaining a position as a director on a company's board and then not approving the bankruptcy filing. Such position, referred to as a "blocking" position or "golden share," has largely been unsuccessful in preventing a bankruptcy filing, as courts have found that all directors must exercise their fiduciary duties of loyalty and due care to the entity, and not act in what is in their best interest as creditor of the entity.[6]

Parties cannot contract to prohibit the filing of a bankruptcy case. "Prohibitions against the filing of a bankruptcy case are unenforceable."[7] Such agreements are void as against public policy.[8] The constitutional and statutory right to file a bankruptcy case cannot be waived even if such waiver is "bargained for and knowing."[9] Thus, any provision in a franchise agreement that would prohibit a franchisee from filing bankruptcy is unenforceable.

B. IPSO FACTO CLAUSES ARE GENERALLY UNENFORCEABLE

An ipso facto clause is a provision in an executory contract or unexpired lease that declares a breach of contract based solely on a party's financial condition or bankruptcy filing.[10] Ipso facto clauses are generally unenforceable in bankruptcy. The Bankruptcy Code specifically invalidates such clauses. Section 365(e)(1), specifically provides:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

A. the insolvency or financial condition of the debtor at any time before the closing of the case;
B. the commencement of a case under this title; or
C. the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

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6. *See* In re Intervention Energy Holdings, LLC, 553 B.R. 258, 265–66 (Bankr. D. Del. 2016); In re Lake Mich. Beach Pottawattamie Resort LLC, 547 B.R. 899, 913 (Bankr. N.D. Ill. 2016).

7. In re Shady Grove Tech Center Associates Ltd. Partnership, 216 B.R. 386, 390, opinion supplemented on remand from district court, 227 B.R. 422 (Bankr. D. Md. 1998); Michael St. Patrick Baxter, *Bankruptcy Proofing: Bankruptcy Provisions in Restructuring Agreements*, 8 J. Bankr. L & Prac. 483, 494 (July/August 1999).

8. Baxter, *Bankruptcy Proofing* (citing In re Peli, 31 B.R. 952, 956 (Bankr. E.D.N.Y. 1983) ("Agreements waiving the right to file a petition in bankruptcy violate public policy and will not be given effect.")).

9. In re Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) ("Even bargained-for and knowing waivers of the right to seek protection in bankruptcy must be deemed void.").

10. In re Peaches Records and Tapes, Inc., 51 B.R. 583, 587 at n. 6 (9th Cir. BAP 1985).

Section 365(e)(1). An exception to this general rule appears in subsection (e)(2)(A), which provides:

> (2) Paragraph (1) of this subsection does *not* apply to an executory contract . . . , if—
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> (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease *from accepting performance from or rendering performance to the trustee or to an assignee* of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.[11]

Courts have held that a party with an interest in an executory contract or lease must come before the bankruptcy court to move for a modification or lift of the automatic stay under section 362(d) to effect the terms of an ipso facto clause under section 365(e)(2)(A).[12]

Many franchise agreements contain a clause stating that the insolvency of the franchisee or the franchisee's filing of a bankruptcy is a default entitling the franchisor to terminate the franchise agreement. Such clauses are considered ipso facto clauses and franchisors cannot rely on such clauses to terminate franchise agreements without court permission. The franchisor must request a modification or lift of the stay to enforce such a clause.

In considering a motion for relief from stay to enforce a termination clause, one issue for the court will be the timing of the bankruptcy filing and whether the franchisee has ceased operations. Issues arise when the franchisor has begun the termination process, but the franchisee files before the process is complete. If a default is not based upon the debtor's financial condition or the filing of bankruptcy, but rather on the closure of the franchisee's operations, the closure provision in the franchise agreement might not be considered an invalid ipso facto clause.[13]

C. PERSONAL GUARANTEES ARE EFFECTIVE TOOLS

Obtaining the franchisee's personal guarantee can be an effective tool for a franchisor. A bankruptcy filing invokes the automatic stay provisions of section 362 and stays all litigation against the debtor. But, except in the case of a Chapter 13 filing (which provides for a codebtor stay), the stay only protects the debtor. As a result, if the franchisor has a claim against a guarantor of its franchise agreement, that action generally will not be subject to the stay and may proceed. Some courts, however, have been willing to extend the protections of the automatic stay to lawsuits against a guarantor under compelling circumstances. Such circumstances typically exist where the guarantor is crucial to the debtor's formulation of a plan,

11. 11 U.S.C. § 365(e)(2)(A) (emphasis added).
12. Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.), 440 F.3d 238, 252 (5th Cir. 2004).
13. In re Lee W. Enters., Inc., 179 B.R. 204, 209 (Bankr. C.D. Cal. 1995).

usually because the guarantor is the likely source of funds to enable the plan to be confirmed.[14] Under such circumstances, some courts have extended the stay to prevent the creditor from pursuing the guarantor, at least temporarily.[15]

A discharge in bankruptcy of the franchisee debtor does not affect the liability of a guarantor.[16] If creditors object to the confirmation of a plan, provisions releasing a guarantor will not affect objecting creditors' claim against the guarantor.[17] In addition, Bankruptcy Code section 524(e) prohibits a plan of reorganization from adjusting the amount of a guarantor's liability for purposes outside the bankruptcy case.[18] In analogous circumstances, courts have held that limitations on a creditor's claim against a debtor (by virtue of particular Bankruptcy Code limitations) do not limit that creditor's claim against nondebtor obligors.[19] However, if the plan contains a properly drafted severance clause, the court may strike the provision that violates section 524(e) and the rest of the plan is unaffected.[20]

D. RESTRICTIVE COVENANTS PROTECT FRANCHISORS

Three types of restrictive covenants, noncompetition agreements, nonsolicitation agreements, and nondisclosure agreements, can be included in franchise agreements or in ancillary agreements to provide protection for franchisors in the event of the insolvency or financial distress of a franchisee. Before including any of these covenants, the language should be analyzed to ensure it is valid and enforceable under the applicable state laws.

1. Noncompetition Agreements Must Be Limited in Time, Area, and Scope to Be Enforceable

A noncompetition agreement or covenant not to compete can be an effective tool for a franchisor both before and after termination of a franchise agreement.[21] A noncompetition agreement restricts a franchisee from entering a business that competes with its franchisor while it is operating its franchise or following termination of its franchise. A valid noncompetition agreement must be limited in time, geographic area, and scope of activity. Covenants not to compete must be "reasonable, narrow in geographic scope, limited in duration, and tailored to the industry" to focus the scope of restricted activities.[22] The scope of the covenants not to compete during both the franchise period and after termination

14. *See* In re Caesars Entm't Operating Co., 808 F.3d 1186, 1189–90 (7th Cir. 2015).
15. *See id.*
16. Sandy Ridge Dev. Corp. v. La. Nat'l Bank (In re Sandy Ridge Dev. Corp.) 881 F.2d 1346, 1351 (5th Cir. 1989).
17. Republic Supply Co. v. Shoaf, 815 F.2d 1046 (5th Cir. 1987).
18. *See* U.S. v. Stribling Flying Serv., Inc., 734 F.2d 221, 223–24 (5th Cir. 1984).
19. *See, e.g.,* Bel-Ken Assoc. Ltd. v. Clark, 83 B.R. 357 (D. Md. 1988).
20. In re Greate Bay Hotel & Casino, Inc., 251 B.R. 213, 221 (Bankr. D. N.J. 2000).
21. Whether a noncompetition agreement is an executory contract subject to rejection in bankruptcy is discussed in Chapter 5.
22. Gruenberg et al., *Protecting the System*.

should be analyzed to ensure protection of the franchise and franchisor and compliance with the applicable state laws.[23]

Some states have been reluctant to enforce noncompetition agreements considering them to be an unreasonable restraint on trade and commerce and have enacted statutes governing noncompetition agreements. For example, California has a strong public policy and a statute prohibiting against such agreements with few exceptions as contained in the statute. California Business and Professional Code section 16600 provides: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."[24] Texas statute provides that a covenant not to compete is enforceable only "if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee."[25]

Similarly, Florida Statute section 542.335 governs the validity of restrictive covenants and makes enforceable restrictive covenants not to compete arising from franchise or license agreements when they are reasonably limited in terms of time and area, and further a legitimate business interest.[26] In the case of a restrictive covenant concerning a former franchisee, the "court shall presume reasonable in time any restraint one year or less in duration."[27] "Legitimate business interests" include "trade secrets, valuable confidential business information, substantial relationships with specific prospective or existing customers, customer goodwill, and extraordinary or specialized training."[28]

A Florida court approved the following sample covenant not to compete provision in a case involving a sporting goods franchise:

FRANCHISEE'S COVENANTS NOT TO COMPETE

A. *During Term.* Franchisee (and all Personal Guarantors and owners of all or part of Franchisee) will not, during the term of this Agreement, on their own account or as an employee, consultant, partner, officer, director, or shareholder of any other person, firm, entity, partnership or corporation, own, operate, lease, franchise, conduct, engage in, be connected with, have any

23. *Id.*
24. CA. BUS. & PROF. CODE § 16600.
25. TEX. BUS. & COMM. CODE § 15.50(a).
26. Winmark Corp. v. Brenoby Sports, Inc., 32 F.Supp. 3d 1206, 1219 (S.D. Fla. 2014) (citing Proudfoot Consulting Co. v. Gordon, 576 F.3d 1223, 1231 (11th Cir. 2009)); FLA. STAT. § 542.335(1)(b).
27. *Id.* (citing FLA. STAT. § 542.335(1)(d)(2); Snelling & Snelling, Inc. v. Reynolds, 140 F.Supp.2d 1314, 1318 (M.D. Fla. 2001)).
28. *Id.* (citing FLA. STAT. § 542.335(1)(b); Autonation, Inc. v. O'Brien, 347 F.Supp.2d 1299, 1304 (S.D. Fla. 2004)).

interest in, or assist any person or entity engaged in any other sporting goods business, except with Franchisor's prior written consent.

B. *After Termination.* Franchisee (and all Personal Guarantors and owners of all or part of Franchisee) will not, for a period of one (1) year after this Agreement expires or is terminated (except for a termination as a result of Franchisor's breach), on their own account or as an employee, consultant, partner, officer, director, or shareholder of any other person, firm, entity, partnership, or corporation, own, operate, lease, franchise, conduct, engage in, be connected with, have any interest in or assist any person or entity engaged in any sporting goods business which is located at the Franchised Location or within an eight (8) mile radius of the Franchised Location or any Play It Again Sports Store. Franchisee expressly agrees that the one (1) year period and the eight (8) mile radius are the reasonable and necessary time and distance needed to protect Franchisor if this Agreement expires or is terminated for any reason.[29]

The court held that the one-year and eight-mile geographic restrictions were reasonable in time and scope as they allowed the franchisor to have the time and ability to relicense the territory and to protect other franchisees in the system.[30] But as these examples show, state laws vary. So, before including any noncompetition provision, such provision should be analyzed under the applicable state law for enforceability.

2. Nonsolicitation Agreements Should Be Limited in Time and Scope

A nonsolicitation agreement restricts an individual (usually a former employee) from soliciting either employees or customers of a business after leaving the business. Nonsolicitation provisions may be included in a separate ancillary agreement or a clause within another document, as found in an employment agreement, independent contractor agreement, or franchise agreement. As with noncompetition agreements, nonsolicitation agreements must be analyzed under the applicable state law.[31]

Here is a sample provision:

<u>NonSolicitation</u>. The [Employee] further agrees that at all times following the date hereof, the [Employee] shall not in any capacity, either separately

29. Winmark Corp. v. Brenoby Sports, Inc., 32 F. Supp. 3d 1206, 1214–15 (S.D. Fla. 2014).
30. *Id.* at 1219.
31. For a chart listing each state and whether it allows noncompetition and nonsolicitation agreements, *see 50 State Desktop Reference: What Employers Need to Know about Non-Compete and Trade Secrets Law* (2016–2017 edition) prepared by Seyfarth Shaw, http://www.seyfarth.com/uploads/siteFiles/practices/141926_ChartofTradeAgreementsbyState_FINAL.pdf (last visited Feb. 7, 2018).

> or in association with others: (i) employ, engage or solicit for employment or engagement, or endeavor in any way to entice away from employment or engagement with the Company or its affiliates, any employee or contractor of the Company or its affiliates, nor (ii) solicit, induce or influence any supplier, customer, agent, client, consultant or other person or entity that has a business relationship with the Company to discontinue, reduce or modify such relationship with the Company.

This provision, or one similar, is likely to raise several issues on enforcement as it is broadly written and unlimited as to time.

Nonsolicitation provisions are generally enforceable if limited to the customers, prospects, and employees of the company at the time such employee terminated his or her service with the company. Generally, the person seeking to enforce the nonsolicitation agreement must have a valid business reason such as protecting a customer list, trade secrets, or other valuable information.[32] A company may also want to prevent the mass departure of valuable employees with specialized skills, knowledge, and access to trade secrets. To enforce the nonsolicitation provisions, the company must show that the information it seeks to protect is valuable. For example, if the company seeks to protect a customer list, it must show that it has spent resources such as time, energy, and money in establishing its client database and that such information is not available to the public.[33]

A nonsolicitation agreement cannot prevent a client, customer, or employee from voluntarily moving to a competitor.[34] Employees and customers can leave voluntarily. Nonsolicitation clauses are more likely to be enforceable if narrow in scope of activity to be curtailed, and if the law governing the contract is consistent with the applicable law in the area in which the provision is to be enforced. If the former employee has improperly solicited employees or used the former employer's information or trade secrets to solicit potential customers, the franchisor may have some recourse depending on the language of the nonsolicitation clause and the applicable state law.

3. Nondisclosure Agreements Are Generally Enforceable

A nondisclosure agreement or confidentiality agreement is a contract that requires one party to protect the confidential information of the other and to refrain from disclosing such information to third parties. Nondisclosure agreements are intended to protect the business' confidential information and trade secrets. In the franchise context, a franchisor may want a nondisclosure

32. Lisa Guerin, *Can Employers Prohibit Employees from Soliciting Coworkers and Customers to a New Employer?,* https://www.nolo.com/legal-encyclopedia/understanding-nonsolicitation-agreements.html (last visited Feb. 7, 2018).

33. *Id.*

34. *Id.*

agreement to protect trade secrets or other confidential information such as recipes, customer lists, and business systems.

A nondisclosure agreement should at least include the definition of "confidential information," the obligations of the receiving party, the period for which the nondisclosure agreement will be valid, and any exclusions. In general, the disclosing party usually wants the confidentiality obligation to last at least as long as the information remains confidential, and the receiving party will want the obligation to be short term.[35]

Nondisclosure agreements are generally enforceable and are not typically analyzed under the same standards as noncompetition or nonsolicitation agreements. The reason is that nondisclosure covenants generally are not considered to be a restraint of trade. Nondisclosure agreements prevent the disclosure of confidential information and trade secrets.[36] Nondisclosure covenants do not necessarily restrict a former employee's ability to compete with the former employer by using the general knowledge, skill, and experience gained from his or her work experience.[37] The U.S. Court of Appeals for the Seventh Circuit considered the issue of nondisclosure agreements and rejected the district court's application of rules applicable to restrictive covenants limiting competition between employers and former employees because "[r]ules limiting the extent of noncompete clauses are based on the fact that they tie up human capital and, if widely adopted, may have the practical effect of preventing horizontal competition."[38] By contrast, the nondisclosure agreement was "vertical in nature and protects intellectual property without affecting competition."[39] The Seventh Circuit's decision reaffirms the general enforceability of nondisclosure agreements, regardless of whether the protected information constitutes a trade secret.

Should a franchisee violate a nondisclosure agreement, the franchisor would have a claim for breach of contract. But such violation could create other claims as well, including trade secret misappropriation, copyright infringement, or unfair competition.[40]

In drafting a nondisclosure agreement, a franchisor should consider the following issues that may arise when seeking to enforce a covenant not to disclose:

a. The provision must be reasonable, specific, and narrowly written. Courts may invalidate or limit the scope of a nondisclosure agreement that is unreasonable or overly burdensome. An ambiguous nondisclosure agreement

35. Neda Dadpey, *Issues Enforcing Nondisclosure Agreements*, Association of Corporate Counsel, April 7, 2017, http://www.acc.com/legalresources/quickcounsel/issues-enforcing-nondisclosure-agreements.cfm?makepdf=1 (last visited Feb. 7, 2018).

36. ZEP Mfg. Co. v. Harthcock, 824 S.W. 2d 654, 663 (Tex. Ct. App. 1992).

37. *Id.*

38. IDX Sys. Corp. v. EPIC Sys. Corp., 285 F.3d 581, 585 (7th Cir. 2002).

39. *Id.*

40. Dadpey, *Issues Enforcing Nondisclosure Agreements*.

may be held to be void for vagueness. The terms must be reasonably limited to serve the employer's legitimate business interest and cannot include things that are obviously not confidential information.

b. The nondisclosure provision must be supported by adequate consideration. Where the nondisclosure agreement is between an employer and employee, the consideration requirement is met if the nondisclosure agreement was executed at the time the employee was hired. If the employer requires execution of a nondisclosure agreement after the employee is hired, courts may require additional consideration. Continued employment alone is not usually considered sufficient consideration.

c. The information sought to be protected must be confidential or valuable. Examples of confidential information include trade secrets and client lists. Examples of information that cannot be subject to a nondisclosure agreement are information that: is in the public domain, is already known by the receiving party, was available prior to entering into the nondisclosure agreement, was received from an unbound third party, or was independently developed without the use of confidential information.[41]

d. To enforce a nondisclosure agreement, the disclosing party must show that it took reasonable steps, based on the circumstances, to keep confidential information secret.[42]

e. A nondisclosure agreement cannot be enforced against third parties. If the party receiving information must disclose it to third parties to fulfill its business obligations, the disclosing party should require the receiving party to enter into a nondisclosure agreement with the third party.[43]

f. General contract principles apply to nondisclosure agreements. Courts will consider whether there was inequitable conduct, unequal bargaining power during negotiations, or overreaching by either party when deciding to enforce a nondisclosure agreement.[44]

E. FRANCHISOR SHOULD CONSIDER TAKING A SECURITY INTEREST IN FRANCHISEE'S ASSETS

When executing the franchise agreement, franchisors should consider requiring the franchisee to grant a security interest in all the assets required for the continued, uninterrupted operation of the franchisee's business should the franchisee become financially distressed.[45] Assets subject to the security interest might include equipment, inventory, furniture, fixtures, or business and customer records. The franchisor should timely and properly perfect its security interest. In the event of a franchisee default, if the parties cannot agree to a

41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.*
45. Gruenberg et al., *Protecting the System*.

settlement, secured franchisors can pursue state law foreclosure over the franchisee's assets and continue to operate (or allow a new buyer to operate) the business as a going concern.[46] It is important that the security interest be taken at the time of executing the franchise agreement. If the franchisor takes a security interest when the franchisee is in distress, it may be subject to preference or fraudulent transfer litigation under the Bankruptcy Code should the franchisee file for bankruptcy.

Franchisors should also consider taking and perfecting security interests in franchisee royalties.[47] Under Article 9 of the Uniform Commercial Code, "account" is defined in part as:

> (2) "Account," except as used in "account for," means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, and (ii) for services rendered or to be rendered.[48]

This definition may allow franchisors to take a security interest in franchisee royalties owed to franchisors and perfect that interest by filing a financing statement in the proper location.[49]

F. USE OF TRADEMARKS SHOULD BE ADDRESSED IN THE FRANCHISE AGREEMENT

The franchise agreement should address the use of the franchisor's trademark. Once a franchisee agreement has terminated, the franchisee must stop using the trademark. If a franchisee continues to use a franchisor's trademark for the benefit of its business after justified termination for breach of the franchise agreement, the franchisor has the right to enjoin the unauthorized use of its trademark pursuant to the Lanham Act.[50]

G. FRANCHISEE SHOULD PROVIDE BUSINESS INTERRUPTION INSURANCE

The franchise agreement can further protect the franchisor from the financial distress of the franchisee by requiring the franchisee to provide insurance coverage that would cover continued royalty payments for a set time following a casualty.[51]

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46. *Id.*
47. *Id.*
48. Uniform Commercial Code § 9-102(a)(2).
49. Gruenberg et al., *Protecting the System* (citing Daniel L. Waddell & Jim Phillips, *How Franchisors Can Benefit from UCC Revised Article 9*, 21 Franchise L.J. 74, 74–76 (Fall 2001)).
50. Lanham Act, § 43(a), 15 U.S.C.A. § 1125(a); 7-Eleven, Inc. v. Grewal, 60 F. Supp. 3d 272 (D. Mass. 2014).
51. Gruenberg et al., *Protecting the System*.

Franchisors should require franchisees and insurance companies to designate the franchise entity as a loss payee under any insurance policies, including as a loss payee or additional insured on any general liability insurance policy.[52] With such designation, the franchisor will receive notice of policy coverage issues or unpaid premiums, and retain the authority to seek force placed insurance over the business, collateral, or other risks associated with the enterprise. "As additional insured parties, franchisors also protect their interests in the event they assume responsibility for management or if they are sued for injuries or damages under theories of vicarious liability."[53]

H. COMFORT LETTERS CAN CREATE ISSUES FOR FRANCHISORS

Issues often arise before bankruptcy with a distressed franchisee when the franchisee's lender has what is commonly known as a comfort letter, which is a tri-party agreement among the franchisor, franchisee, and franchisee's lender that allows the lender to continue to operate under the franchise agreement should the debtor default under its loan and the lender or its designee (or receiver) assume operations under the franchise agreement for its remaining term. The franchisee's lender will want assurance that it can act under the comfort letter, which can become an issue if the comfort letter has not been properly assigned to the lender under the terms of the comfort letter. That situation often happens when the identity of the lender has changed, such as when a commercial mortgage-backed securities (CMBS) loan is transferred to a new trustee. If the comfort letter has not been properly assigned, the franchisor may not want to recognize the new lender as a beneficiary of the comfort letter if it would prefer that the franchisee's location leave the franchise system. The franchisor may also be concerned about granting the new lender rights under the comfort letter if the franchisee has not agreed to it. The franchisor also may want to seek modifications to the comfort letter. These options may be open to the franchisor if the lender has not complied with the terms of assignment of rights set forth in the comfort letter.

I. MEDIATION AND ARBITRATION CLAUSES MAY BE ENFORCEABLE IN BANKRUPTCY CASES

After a bankruptcy petition is filed, the debtor/franchisee usually will want all disputes resolved before the bankruptcy court, which often will be viewed as a more favorable forum to the franchisee debtor than another federal or state court. However, many franchise agreements contain clauses requiring arbitration of disputes under such agreements. Under the Federal Arbitration Act, agreements to arbitrate disputes are to be enforced unless there exist legal or equitable grounds not to

52. *Id.*

53. *Id.* (citing Heather Carson Perkins, Sarah J. Yatchak & Gordon M. Hadfield, *Franchisor Liability for Acts of the Franchisee*, 29 Franchise L.J. 174, 179–81 (Winter 2010)).

enforce such agreements.[54] Bankruptcy courts consistently enforce agreements to arbitrate when the matter raised is a noncore proceeding.[55] Such proceedings are matters related to a bankruptcy proceeding, but not deemed to be a core proceeding.[56] Even core proceedings can be arbitrated if they do not significantly implicate the provisions and policies of the Bankruptcy Code.[57] Thus, matters that typically will proceed in arbitration even after a franchisee bankruptcy case is filed include a dispute over whether the franchise agreement was breached and the extent of the damages to be awarded to either party.[58] The party seeking arbitration must diligently pursue such rights or may find that such rights will be deemed waived by the bankruptcy court. Courts have found the filing of a proof of claim against a franchisee's bankruptcy estate to constitute a waiver of the right to have the claim amount arbitrated under the franchise agreement.[59]

J. FORUM SELECTION CLAUSES MAY BE ENFORCEABLE IN BANKRUPTCY CASES

In addition to agreements to arbitrate, a franchise agreement may contain a forum selection clause setting forth the venue of a future bankruptcy filing. Through such a clause, the franchisor can attempt to restrict a bankruptcy filing to a favorable forum or avoid an unfavorable forum.[60] In the maritime context, the U.S. Supreme Court has held that forum selection clauses "are *prima facie* valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances."[61] To overcome the presumption of validity, the objecting party must show that: (1) the forum selection clause is the result of fraud or overreaching, (2) enforcement would violate a strong public policy of the forum, or (3) enforcement would so seriously inconvenience the moving party as to be unreasonable.[62] Such clauses may be very important to a franchisor or franchise system that has franchisees throughout the United States or over a wide-ranging geographic area and wants to restrict disputes to a convenient court. In objecting to such a clause as a debtor, the franchisee may argue that enforcement of the clause will violate the public policy of fairness in that the designated forum may not be as easily accessible to the debtor, its creditors, its employees, and other parties-in-interest in the case.

54. *See* 9 U.S.C. § 2.

55. *See* In re Elec. Mach. Enters. Inc., 479 F.3d 791, 796 (11th Cir. 2007).

56. Title 28 provides a nonexclusive list of core proceedings. *See* 28 U.S.C. § 157(b)(2)(A)–(P).

57. *See* In re Slipped Disc Inc., 245 B.R. 342, 345 (Bankr. N.D. Iowa 2000); *see also* In re Williams, 564 B.R. 770, 778–79 (Bankr. S.D. Fla. 2017) (finding core proceedings subject to arbitration if it would not present an inherent conflict with the underlying purposes of the Bankruptcy Code).

58. *See id; see also* In re Roasters Corp., No. 98-8074C-11D, 2000 WL 33673775, at *4–5 (Bankr. M.D. N.C. Oct. 6, 2000).

59. *See* In re Brooke Corp., No. 08-22786, 2013 WL 3214687 (Bankr. D. Kan. June 24, 2013).

60. Baxter, *Bankruptcy Proofing*.

61. M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10 (1972).

62. Baxter, *Bankruptcy Proofing* (citing M/S Bremen v. Zapata Off-Shore Co. 407 U.S. at 15–16).

The franchisee may also argue that denying the debtor its chosen court will unreasonably increase the debtor's administrative expenses, deplete the bankruptcy estate, and diminish the return to creditors.[63]

A forum selection clause may be enforced by a motion to transfer under 28 U.S.C. § 1404(a), which provides "[f]or the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought or to any district or division to which all parties have consented."[64]

II. ALTERNATIVES TO BANKRUPTCY FOR A DISTRESSED FRANCHISEE

Bankruptcy affects both the rights of the franchisee and the franchisor. A franchisee bankruptcy filing may limit the ability of the franchisor to terminate the franchise agreement, affect the franchisor's right to control the use of trademarks, copyrights, and trade secrets, and curtail collection of prepetition royalties. Thus, a franchisor who has a franchisee in distress and contemplating bankruptcy may consider working with the franchisee to restructure the terms and conditions of the franchise agreement to avoid a bankruptcy filing. The franchisor's options could include offering a short term or permanent reduction in royalties, assisting with operational issues to increase efficiency, and/or providing targeted advertising or marketing to help increase sales.

A. ADVANTAGES OF NONBANKRUPTCY ALTERNATIVES

The Bankruptcy Code provides many tools, some available only in bankruptcy, that may aid a franchisee in distress. These tools include, among others, the automatic stay, the ability to assume favorable contracts and leases and reject underperforming or unprofitable contracts and leases, the ability to sell assets free and clear of liens, and the ability to restructure debt. But the use of these tools comes with a cost to the franchisee and to the other parties in interest.

Bankruptcy can be an expensive, time-consuming, and stressful process. Bankruptcy requires transparency, compliance with the Bankruptcy Code, and the fair and equitable treatment of creditors. Complying with all the bankruptcy requirements can be very time-consuming and take the franchisee and its management away from day-to-day business operations at critical times.

Bankruptcy requires full and open disclosure. The debtor has a duty to notify all creditors of its bankruptcy filing and to make full disclosure of its assets,

63. Baxter, *Bankruptcy Proofing*.

64. Atl. Marine Constr. Co., Inc. v. U.S. Dist. Ct. for the W. Dist. of Tex., 134 S.Ct. 568, 576–81 (2013).

liabilities, and financial affairs in public filings, thus losing its ability to keep certain information confidential. The debtor submits itself to the bankruptcy court's jurisdiction and must seek bankruptcy court approval for many actions that the debtor would be allowed to take without court approval outside of bankruptcy, a process which adds time and expense to the restructuring.

Bankruptcy requirements may limit the ability of the distressed franchisee to reach creative solutions with its creditors. In a bankruptcy restructuring, the debtor has an obligation to classify and treat similarly situated creditors fairly, which limits the debtor's ability to work out resolutions with some creditors. In addition, in Chapter 11, the Bankruptcy Code allows for the formation of an official unsecured creditors' committee that may pursue preference or fraudulent transfer litigation against creditors or insiders of the debtor. In that case, the debtor no longer has the discretion to determine which, if any, creditors it should pursue for bankruptcy causes of action. Vendors upon whom the reorganized debtor may rely to continue its business may be subject to litigation from the creditors' committee.

Bankruptcy can also be expensive. The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 determined in its 2012–2014 Final Report and Recommendations that a Chapter 11 bankruptcy can often be too expensive, especially for small and medium-sized companies.[65] Administrative expenses, including professional fees, create substantial costs for the estate. For example, the bankruptcy estate must pay not only for the debtor's professionals, but also for the professionals of official committees as well. Without adequate funds to reorganize, those companies liquidate or shut down without trying to reorganize under the Bankruptcy Code or wait too late to avail themselves of the federal bankruptcy laws. Such delay limits a company's restructuring options and can lead to sales or liquidations before the company has a chance to reorganize.

In a franchisee bankruptcy, franchisors are prevented from collecting prepetition past due royalties or advertising fees and may have a delay in collecting postpetition fees. Franchisors may be subject to confusion in the marketplace and adverse publicity due to public notice of the bankruptcy filing. The brand may be damaged if the franchisee fails to maintain quality during the pendency of the bankruptcy, closes stores, or debrands but continues operating as an independent.[66] A franchisee bankruptcy may come to the notice of other marginal franchisees who may also consider a bankruptcy filing potentially destabilizing the franchisor. Landlords may be affected as well. Thus, before deciding on a bankruptcy, a

65. American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012–2014 Final Report and Recommendations (citing Harvey R. Miller and Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129, 181 (2005) (quoting H.R. Rep. No. 95-595, at 220 (1978) *reprinted in*, 1978 U.S.C.C.A.N., 5963, 6179).

66. *See* Sharyn B. Zuch, *Alternatives to Franchisee Bankruptcy: Workouts, Compositions of Creditors, Assignments for the Benefit of Creditors, and Receiverships*, 33 Franchise L.J. 359 (2014).

distressed franchisor or franchisee should consider all opportunities for relief, including nonbankruptcy alternatives, and weigh the advantages and disadvantages. A franchisor should consider working with the franchisee on an alternative to bankruptcy to avoid a franchisee feeling "forced" into bankruptcy.

Given these disadvantages to bankruptcy, before filing, both franchisors and franchisees should explore alternatives to bankruptcy and evaluate if and how bankruptcy would be the best remedy for their legal and financial issues.

Potential alternatives to bankruptcy may include an out-of-court restructuring, unwinding under state law, composition of creditors, assignments for the benefit of creditors, or receivership. These alternatives to bankruptcy may offer a more confidential, less expensive, quicker, and more flexible way to resolve a franchisee's financial issues. A franchisor may be more likely to cooperate in a nonbankruptcy solution as it allows the franchisor to have more control over the process, allows for more confidentiality, and reduces the likelihood of adverse publicity due to the public nature of court filings.

B. OUT-OF-COURT RESTRUCTURING

An out-of-court restructuring is a nonjudicial, consensual restructure of a distressed company's financial difficulties. Because there is no statutory scheme such as the Bankruptcy Code governing the process and imposing rules on priority, amount, or timing of payments, the debtor and its creditors are free to negotiate deals that may not comply with the Bankruptcy Code but work for the continuation of the business. With this approach, there is the opportunity for creativity and flexibility.

A small franchisee with a simple capital structure and few creditors may be well-suited to an out-of-court restructuring rather than a bankruptcy. "The optimal conditions to undertake an out-of-court restructuring is when there is a fairly simplified capital structure with few classes of equity and debt and a limited number of constituents involved in the negotiation and approving the transaction."[67] Favorable preconditions for an out-of-court restructuring include:

- Knowledge of current loan default and the potential defaults that are likely to occur during the workout period;
- Sufficient cash, liquidity, or available financing to operate during the workout period;
- Understanding of the franchisee's short and long-term cash requirements;
- Creditor group is small, willing to negotiate, and motivated to do an out-of-court restructuring;
- Stakeholders are of a manageable number and willing to negotiate; and

67. *Out-of-Court Restructuring Alternatives*, TalkingPoint, Bankruptcy & Restructuring, Financier Worldwide, June 2016 (quoting panelist Jeff Zappone), https://www.financierworldwide.com/out-of-court-restructuring-alternatives/ (last visited Feb. 7, 2018).

- Parties share the common goal of minimizing the potential costs of bankruptcy and disruption of the business.[68]

An out-of-court restructuring involves several constituents of the franchisee and it may take time and patience to reach a consensual resolution. Therefore, the out-of-court restructuring process should begin before the franchisee's situation is desperate. If the franchisee has no cash, has multiple judgments against it, its bank accounts have been garnished or setoff, or it is facing eviction proceedings, it may be too late for an out-of-court workout and bankruptcy may be the only option.[69]

The debtor or a major creditor may initiate an out-of-court restructuring.[70] In the case of a distressed franchisee, the franchisee may reach out to its franchisor and its largest financial creditors to initiate workout negotiations. It is often better and less disruptive to the franchisee's business if the secured lender and franchisor allow the franchisee to pay its trade creditors, employees, landlords, and other operating debts in the ordinary course of business. If the franchisee can stay current on these obligations, there is no need to involve those parties in the workout discussions and the pool of negotiating parties is more manageable.

At the beginning of an out-of-court restructuring, the participating creditors should agree to a forbearance that prohibits the creditor from exercising its default remedies or taking other actions against the debtor during the restructuring process.[71] For example, franchisors should consider forbearing on immediately exercising remedies, such as terminating the franchise agreement, during the negotiations. There may also be confidentiality agreements between the debtor and the creditors or among the creditors to protect their information during the negotiation.[72]

The goal of the out-of-court restructuring should be to improve the financial condition of the debtor and to allow it to service its restructured debt. Generally, to achieve that goal, creditors may have to make concessions, such as reducing the amount of their debt, reducing the interest rate charged, forgoing penalties, extending the term of the loan, or reducing the amount of periodic payments. In the case of a franchisee bankruptcy, the franchisor may also have to make concessions such as reducing the amount of past due franchise fees, allowing the franchisee to convert some of its current payables to long-term debt, allowing a reasonable payout of past due fees, reducing royalties, increasing advertising and marketing, or providing further training or support to a struggling franchisee.

Another benefit to an out-of-court restructuring as opposed to a bankruptcy is the ability for the parties to negotiate releases without court oversight. As

68. *Id.* (panelists James Feltman, James Sprayregen, and Jeff Zappone).
69. Zuch, *Alternatives to Franchisee Bankruptcy*.
70. Rick Antonoff, *Out-of-Court Debt Restructuring and the Problem of Holdouts and Free Riders*, The Metropolitan Corporate Counsel at 17 (Oct. 2013).
71. *Id.*
72. *Id.*

discussed later in this chapter, the bankruptcy courts often restrict attempts to obtain broad releases of nondebtor parties. A franchisee may be less likely to eventually file a bankruptcy.

A restructuring agreement should be in writing. Typical secured lender agreements will include a forbearance agreement, general release of claims against the lender, franchisee's acknowledgment that the loan is in default, and reaffirmation of the franchisee's personal guarantees.[73] Franchisors may also have a standard work-out agreement. Terms may include a cross-default provision that provides that a default of the workout agreement constitutes a default of the franchise agreement, releases, and reaffirmations, among other terms.[74]

C. STATE LAW DISSOLUTION AND WINDING UP

A franchisee may choose to dissolve and wind up its company under the applicable state law. The applicable state law will depend upon the entity form, that is whether the franchisee is organized as a corporation, partnership, limited liability company, or sole proprietorship, and the state of formation of the entity. Laws governing dissolution and winding up may vary from state to state.

Many franchisees are organized as limited liability companies to take advantage of that form's limited liability and lack of double taxation. All fifty states and the District of Columbia have authorized the formation of limited liability companies (LLCs) in their jurisdictions.[75] Many, but not all states, have adopted the 2006 Revised Uniform Limited Liability Company Act (Re-ULLCA). Re-ULLCA, as amended, section 702 provides for the winding up of an LLC after dissolution.[76] ULLCA section 702 provides:

> (a) A dissolved limited liability company shall wind up its activities and affairs and, except as otherwise provided in Section 703, the company continues after dissolution only for the purpose of winding up.
> (b) In winding up its activities and affairs, a limited liability company:
> (1) shall discharge the company's debts, obligations, and other liabilities, settle and close the company's activities and affairs, and marshal and distribute the assets of the company; and
> (2) may:
> (A) deliver to the [Secretary of State] for filing a statement of dissolution stating the name of the company and that the company is dissolved;
> (B) preserve the company activities, affairs, and property as a going concern for a reasonable time;

73. Zuch, *Alternatives to Franchisee Bankruptcy*.
74. *Id.*
75. Nevada Corporate Planners, Q&A, http://www.nvinc.com/llcqa.htm (last visited Feb. 7, 2018).
76. Uniform Limited Liability Company Act § 702.

(C) prosecute and defend actions and proceedings, whether civil, criminal, or administrative;
(D) transfer the company's property;
(E) settle disputes by mediation or arbitration;
(F) deliver to the [Secretary of State] for filing a statement of termination stating the name of the company and that the company is terminated; and
(G) perform other acts necessary or appropriate to the winding up.[77]

The ULLCA also provides for the winding up of the LLC in the event the LLC has no members.[78]

Franchisees organized as corporations may also wind up under applicable state law. Most states have adopted the Model Business Corporation Act (MBCA) as the basis of their own state laws although each state has implemented its own modifications. The MBCA governs the voluntary dissolutions of corporations and provides for dissolution by incorporators or initial directors if the corporation has not issued shares or commenced business or otherwise a dissolution by board of directors and shareholders.[79] The MBCA provides specific rules for drafting the proper articles of dissolution, continuing the corporate existence to wind up and liquidate business affairs, notifying potential claimants (both known and unknown), paying claims, and distributing assets.[80] The MBCA provides for protection for directors of a dissolved corporation so long as the rules are followed.[81]

Dissolution and winding up under state law may be less expensive and quicker than a Chapter 11 bankruptcy case, but as there is no court supervision or authority for the action taken, it is very important that all the rules provided by statute are followed.

D. COMPOSITION OF CREDITORS

A composition of creditors is a formal contract between a debtor and two or more creditors wherein the parties agree that the debtor will pay the creditors less than the full amount of their claims in satisfaction of those claims.[82] The agreement is like a Chapter 11 plan of reorganization in that it provides for the classification of creditors, the treatment of their claims, and the terms of repayment. In the franchise context, the composition should also provide for the treatment of any franchisor's claims. A composition process may also provide for notice to all creditors, a form for submitting claims, and a method for resolving disputes over the amounts of claims. The creditors agree to discharge the balance of their claims

77. *Id.*
78. Re-ULLCA § 702.
79. MBCA §§ 14.01, 14.02.
80. MBCA §§ 14.03–14.08.
81. MBCA § 14.09(b).
82. Zuch, *Alternatives to Franchisee Bankruptcy*.

and to forbear from exercise their collection rights so long as the debtor performs under the agreement. The agreement of creditors to forbear is important because there is no automatic stay of collection or other actions against the debtor or property as there would be in a bankruptcy proceeding.

Compositions of creditors are governed by the applicable state law. Franchisees considering this bankruptcy alternative should determine if this alternative is available and enforceable in its state.

E. ASSIGNMENT FOR THE BENEFIT OF CREDITORS

An assignment for the benefit of creditors is a procedure under state law in which the debtor, as assignor, transfers all its rights, title, and interest in its assets to an independent third-party fiduciary (the assignee).[83] Lawyers, accountants, and turnaround specialists may serve as assignees. The assignee then generally liquidates the assets and distributes the net proceeds to the assignor's creditors on a pro rata basis. In some cases, the assignee may operate the business for a short time to maximize the value of assets, complete work in progress, or sell the business as a going concern. The assignee generally charges an initial fee as well as a percentage fee based on the assets liquidated.

The debtor may commence an assignment for the benefit of creditors in accordance with its formation documents and the applicable state corporation law or assignment for the benefit of creditors' statute. A corporation seeking to use the bankruptcy alternative usually will need both board and shareholder approval because it involves the transfer to the assignee of substantially all the assets of the corporation. Depending on the applicable state law, an assignment for the benefit of creditors may or may not require a public court filing.

An assignment for the benefit of creditors may have some procedures in common with a bankruptcy case. As in a bankruptcy case, an assignment for the benefit of creditors generally requires claimants to submit a proof of claim form to the assignee by a specific date. Employee and other claimants may have priority of payment in certain amounts under state law. Assignees may be able to pursue preferences and fraudulent transfers if provided by state law, and not found to be preempted by the Bankruptcy Code in that applicable federal jurisdiction.[84]

But some benefits available in bankruptcy are not available in an assignment for the benefit of creditors. For example: (1) there is no automatic stay; (2) vendors who delivered in the twenty days prior to the bankruptcy filing do not receive an administrative priority claim; (3) lease rejection damages are not capped; and (4) asset sales are not free and clear of liens, claims, and

83. *Id.* at 368.

84. *See* Bob Eisenbach, *Assignments for the Benefit of Creditors: Simple as ABC?*, In the (Red) The Business Bankruptcy Blog, https://bankruptcy.cooley.com/2008/03/articles/business-bankruptcy-issues/assignments-for-the-benefit-of-creditors-simple-as-abc/ (discussing avoidance actions under assignments for the benefit of creditors) (last visited Feb. 8, 2018).