Basics of Franchisee Bankruptcies
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Pre-Bankruptcy Workouts

- Credit Limits
- Secured and Unsecured Promissory Notes
- Payment Plans and Operating Plans
- Mediation-Internal vs. External
Pre-Bankruptcy Workouts

- Negotiating a franchise sale
- Receiverships and “ABCs”
- Pre-Negotiated “Pre-Packaged” Bankruptcy
Franchise Agreement Terms to Protect Against Bankruptcy

• Ipso Facto Clauses

• Franchisee will be in default of this Agreement, and all rights granted in this Agreement will immediately and automatically terminate and revert to Franchisor without notice to Franchisee, if: Franchisee is adjudicated as bankrupt or insolvent; all or a substantial part of the assets thereof are assigned to or for the benefit of any creditor; a petition in bankruptcy is filed by or against Franchisee or the franchised business and is not immediately contested and/or dismissed within sixty days from filing.

• Generally unenforceable under Bankruptcy Code §§ 541(c) and 365(e)(1).
Franchise Agreement Terms to Protect Against Bankruptcy

• Letters of Credit to Secure an Otherwise Unsecured Claim
• Generally not an asset of the bankruptcy estate and may be drawn upon after franchisee files bankruptcy
Franchise Agreement Terms to Protect Against Bankruptcy

• 11 U.S.C. § 365 allows a debtor to assume or reject executory contracts and unexpired leases unless applicable law:
  • excuses the non-debtor party to such contract or lease from accepting performance from, or rendering performance to, an entity other than the debtor or the debtor in possession
  • where such non-debtor party does not consent to the assumption or assignment
Franchise Agreement Terms to Protect Against Bankruptcy

• Personal services contracts are often cited as an example of an executory contract that is considered an exception to assignability.
Franchise Agreement Terms to Protect Against Bankruptcy

• To be considered a personal service contract, there must be
  • a special relationship between the parties, or
  • the party to perform must possess special knowledge or a unique skill such that no performance save that of the contracting party could meet the obligations of the contract.

• In most states, the test is whether the contract involves
  • a personal relation of confidence between the parties, or
  • relies on the character and personal ability of a party.
Relief from Automatic Stay

• The automatic stay imposed by § 362 is one of the most fundamental and most important aspects of bankruptcy law.
  • Prevents the commencement or continuation of actions against the debtor, or against any of the debtor’s property, on account of any claim that arose or existed on or at any time prior to the date of the bankruptcy filing.
  • Prevents “the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title” and “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.”
Relief from Automatic Stay

• Franchise Agreement as Property of the Estate and Pre-Petition Termination
  • Even if properly terminated, there may be actions that a franchisor wants to take that are barred by the automatic stay.
Relief from Automatic Stay

• Lack of Adequate Protection under section 362(d)(1)
  • Violation of quality, trademark usage, and other standards under the franchise agreement may establish a lack of “adequate protection” of the franchisor’s interests in intellectual property or other “cause” for relief from the automatic stay under 362(d)(1)
Relief from Automatic Stay

• Cause "is an intentionally broad and flexible concept which must, of necessity, be determined on a case by case analysis."
  • Failure to make post-petition payments under Franchise Agreement
  • Lack of required insurance coverage
Relief from Automatic Stay

• Lack of Equity and Reorganization Not Realistic
• § 362(d)(2) provides that the court may grant relief from the stay “with respect to a stay of an act against property . . . if (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.”
• Franchisor has the burden under §362(g) to show lack of equity
Relief from Automatic Stay

• There must be a reasonable possibility of a successful reorganization within a reasonable time.

• Debtor has burden under §362(g) to establish that reorganization is a "reasonable possibility" within a "reasonable time."
Executory Contract Fundamentals

- Definition of an “Executory Contract”
- Countryman: unperformed obligations on both sides
- Easy definition, right? Not so fast...
Executory Contract Fundamentals

- *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010)

- License:
  - Perpetual
  - Exclusive
  - Royalty Free

- But, *Exide* is the exception. Generally speaking, franchise agreements will be considered executory
Executory Contract Fundamentals

• Why does it matter whether a contract is executory?
• Only executory contracts are subject to assumption or rejection under Bankruptcy Code section 365
• Contracts terminated pre-petition are not executory
Assumption of Executory Contracts

• Cure past defaults
• Adequate assurance of future performance
Assumption of Executory Contracts

• Prior to Assumption/Rejection:
  • Debtor must make payments for value received
  • Non-debtor must continue to perform
  • Adequate protection/motion to compel assumption or rejection
Assumption of Executory Contracts

• Deadlines
  • Chapter 11 – plan confirmation
  • Chapter 7 – 60 days
  • Real property leases – 210 days
Assumption of Executory Contracts

• Assuming “non-assignable” contracts

• Bankruptcy Code section 365(c):

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties if – (1)(A) applicable law excuses a party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.
Assumption of Executory Contracts

• Split in authority
• Actual jurisdictions: 1st Cir, 5th Cir.
• Hypothetical jurisdictions: 3d Cir., 4th Cir., 9th Cir., 11th Cir.
• *N.C.P. Mkt. Group Inc. v. BG Star Prods. Inc.*, 129 S.Ct. 1577 (2009) – U.S. Supreme Court passes on the opportunity to resolve the split
Assumption of Executory Contracts

• Bankruptcy Code section 365(f):

• Except as provided in subjections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection
Assumption of Executory Contracts

• Section 365(f) is the rule, section 365(c) is the exception

• What is “Applicable Law”?
  • Personal service contracts
  • Non-bankruptcy law, such as the Lanham Act
Rejection of Executory Contracts

• Rejection is a deemed breach
• Rejection ≠ Termination
• Rejection damages are general unsecured claims (and capped for real property leases)
Covenants Not to Compete

• Some courts: rejection of a contract including a covenant not to compete rejects everything

• Other courts: rejection is not termination, so covenants not to compete remain enforceable
Section 363 Asset Sales

• To sell property outside of the ordinary course of business, debtor must obtain court approval under section 363(b) of the Bankruptcy Code, which provides in part that a debtor "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate"
Section 363 Asset Sales

• Business judgment rule: courts consider (a) whether the parties have acted in good faith, (b) whether the transaction will produce a fair and reasonable price for the property, (c) whether accurate and reasonable notice of the transaction was given to interested parties, and (d) whether a sound business justification exists for the transaction

• *Sub rosa* plan arguments
Section 363 Asset Sales

• Courts require sufficient exposure of assets to marketplace, either pre-petition or post-petition or both, usually involving a business broker or investment banker
Section 363 Asset Sales

• Multi-step process outlined in bid procedures order: deadline for submission of written bids; qualification of bidders; deposit requirements; date, time, place and rules for auction; deadline for filing objections to sale; sale approval hearing; backup bidder requirements
Section 363 Asset Sales

• Secured claims and Section 363(f): A debtor may "may sell property under subjection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest"

• Statute written in disjunctive: only one requirement must be satisfied to sell free and clear
Section 363 Asset Sales

• Assumption and assignment of executory contracts usually is a part of any Section 363 sale of a business

• Franchisees likely will want to assume and assign the franchise agreement
Section 363 Asset Sales

• List of contracts to be assumed and assigned, and/or debtor's statement of cure amounts, usually is not filed until late in the process

• Timing issues and preemptive objections to assumption and assignment
Section 363 Asset Sales

• Is the auction over when the hammer comes down? Reopening bidding between the auction and the conclusion of the hearing to approve the sale
• Competing policy arguments: finality and enforcing rules of auction vs. maximizing value
• Section 363 auctions in the courtroom
Chapter 11 Plan Confirmation

• Three ways to exit Chapter 11 bankruptcy case: conversion, dismissal or confirmation of Chapter 11 plan

• General process for plan confirmation: grouping creditors with similar claims into classes, obtaining court approval of a disclosure statement that provides information to creditors, sending ballots to creditors to enable them to vote to accept or reject the plan, and evaluating whether a sufficient number and dollar amount of creditors in each class have voted to accept the plan
Chapter 11 Plan Confirmation

- Disclosure statement: like a FDD for the Chapter 11 plan
- "Adequate information" is defined as "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor typical of the relevant class to make an informed judgment about the plan . . . ." 11 U.S.C. § 1125(a).
Chapter 11 Plan Confirmation

• Classification of creditors: claims must be substantially similar to other claims or interest in same class

• Submission of ballots to vote to accept or reject Chapter 11 plan
Chapter 11 Plan Confirmation

• Voting requirements: class of claims has accepted a plan if the plan has been accepted by creditors that hold at least two-thirds in dollar amount and more than one-half in number of the allowed claims in such class that have actually submitted ballot
Chapter 11 Plan Confirmation

• Section 1129(a) of the Bankruptcy Code contains list of requirements for confirmation

• Common objections to confirmation
  - Attempt to release non-debtor personal guarantor
Chapter 11 Plan Confirmation

• Common objections to confirmation
  - Best interests of creditors: recoveries will equal or exceed liquidation value
  - Feasibility: debtor will be able to perform financial and other obligations
  - Plan releases binding on non-debtor third parties
Chapter 11 Plan Confirmation

• Cram down of class that has not accepted the plan under Section 1129(b)
• Plan must not "discriminate unfairly" and must be "fair and equitable" to class that has not accepted the plan
• Absolute priority rule and "new value" plans