STRUCTURED WORKOUTS: FRANCHISOR STRATEGIES
FOR DEALING WITH THE
FINANCIALLY-CHALLENGED FRANCHISEE

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I. OVERVIEW

Regardless of whether a party represents franchisors or franchisees, it's likely they have faced the situation of a franchisee struggling with financial difficulties. A franchisee’s finances can fluctuate after signing the franchise agreement for many reasons, such as franchisor problems, market conditions, credit and banking changes, poor initial capitalization, ownership changes, health issues and a host of other occurrences that may, or may not, be beyond the franchisee’s control.

This paper will identify, from the franchisor and franchisee perspective, innovative approaches to crafting a structured workout designed to minimize financial loss, and if applicable, keep the franchise open by:

- How to identify if trouble is coming and identify the root cause of the trouble (short and long term issues, as well as operational and financial);
- How to protect against trouble through candidate vetting and franchise agreement drafting;
- Franchise agreement drafting tips for asset collateralization, franchisor management ("step-in") rights, personal guarantees, standby letters of credit, escrow accounts and collateral assignments of lease, as well as franchisee concerns regarding these provisions;
- Establishing clear policies regarding credit limits;
- Utilizing structured workout strategies such as secured and unsecured promissory notes, confessions of judgment, payment plans and operating plans, mediation (internal and external), negotiated sales, and terminations, negotiated settlements and "compositions," receiverships, assignments and state law remedies; and
- Comparing alternatives to Chapter 11 filings, including automatic stays, court-enforced alterations of creditor’s rights and bankruptcy sales.

While this paper discusses a number of the non-bankruptcy workout options that may be available in an applicable jurisdiction along with their respective advantages and disadvantages, a comprehensive analysis of each option under all states’ laws, however, is outside the scope of this paper. Parties considering one of the options discussed should carefully review the applicable state statutes and common law.

II. STRUCTURED WORKOUTS

A "structured workout" is a definitive, short or long-term plan to reduce financial stress prior to filing for bankruptcy protection. It is a more formal way of documenting the franchisor’s and franchisee’s commitment to do or cause to be done certain actions in order to attain financial comfort. A structured workout can be initiated by the franchisor or franchisee, but also can result from informal or formal mediation as well as litigation.
Bankruptcy, on the other hand, is governed by federal law (in the United States), in formal court proceedings, and can be voluntary or involuntary. Generally speaking, the federal bankruptcy statute is designed to provide for a uniform system throughout the United States. Non-bankruptcy workout options, in contrast, are based largely in state law. For that reason, the non-bankruptcy options available to parties can vary substantially from state to state.

Voluntary bankruptcy means the franchisee - debtor files a petition requesting protection under the federal bankruptcy laws, whereas involuntary bankruptcy means the franchisor or the franchisee’s creditors "force" the franchisee into bankruptcy. An involuntary bankruptcy case may be filed against a franchisee – debtor that is not generally paying bona fide debts as they come due by three or more creditors holding undisputed, non-contingent claims in the aggregate of at least $15,325. However, while it is not a complicated matter to place a franchisee into an involuntary bankruptcy case (mechanically, it involves completing and filing a simple form), the franchisee – debtor has the right to contest whether the involuntary filing was proper. This can lead to a potentially expensive mini-trial on that particular matter.

III. IDENTIFYING TROUBLE IS COMING

How can trouble be identified on the horizon before it hits? Knowing the warning signs will help to craft a workout that leads to a good outcome, hopefully for all parties. Some warning signs are:

- The franchisee is not returning calls, correspondence or appearing at meetings;
- The franchisee’s location, if applicable, is not well-maintained;
- The franchisee receives an inordinate volume of complaints from the franchisee’s employees, vendors, franchisees and/or customers;
- The franchisee fails to timely pay rent or honor lease obligations;
- The franchisee’s insurance lapses;
- The franchisee defaults on loans or other payment obligations to the Franchisor or other creditors;
- The franchisee’s credit rating falls;
- The franchisee liquidates personal assets;
- The franchisee has receivables more than 30 days past due, or longer if typical in the specific franchise system;

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3 11 U.S.C. § 303(b)(1). An involuntary bankruptcy case may be filed by one creditor if the debtor has less than 12 total creditors.
• The franchisee must pay for items on a C.O.D. basis;

• The franchisee has a large volume of litigation;

• The franchisee has tax liens or judgments that are unsatisfied;

• The franchisee has high employee or owner turnover; and

• The franchisee is unable to produce financial statements or other accounting records. \(^5\)

Although the list above may be used as a checklist to identify potential warning signs, it’s important to delve a little deeper into each one to determine whether distress really exists. This part of the analysis is more art than science, but in general, if a franchisee that is initially communicative, pays timely, has good operations and customer ratings, then suddenly or over time no longer communicates with the franchisor, is behind on making payments, starts failing or receiving low scores on inspections, or starts receiving an inordinate number of customer complaints, something is likely amiss. Without truly understanding these circumstances, it is unlikely that a long-term viable solution can be achieved for the benefit of both the franchisor and franchisee.

IV. ROOT CAUSES OF THE FINANCIAL TROUBLE

There are a variety of reasons why a franchisee may experience financial trouble sometime during the course of the franchise relationship.

A. Short-Term vs. Long-Term Issues

A franchisee’s financial stress in many instances is not caused by the acts of the franchisee itself, but instead, by forces outside the franchisee’s control. For example, those instances when a franchisor places additional units near an existing business can often cause profound financial distress. Franchisees are sometimes faced with unique issues, often times unknown to the franchisor, that result in financial stress, including:

• The arrival of new competitors to the local market;

• Temporary or permanent changes in traffic patterns, on/off ramps, etc.;

• Road construction outside or near the franchised unit;

• A new destination that has begun to draw customers away from the existing franchised unit and the area in which the franchised unit is located;

• Temporary scaffolding constructed around the building where the franchised unit is located, blocking signage, easy ingress/egress to and from the franchised unit, causing pedestrians to relocate across the street; and

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• Subway stops that have been temporary or permanently closed, including for relocation.

B. Operational/Financial Inabilities of Franchisee

The financial stress of a franchisee is sometimes a result of a franchisee’s inability to properly manage the franchised unit or its own finances. A franchisor must ask itself whether it permitted an undercapitalized entity to become a franchisee? Alternatively, is the issue prompting the franchisee's financial stress caused by the inability or inexperience of the franchisee itself or its managers? Would additional required training, the infusion of additional capital, or a new manager be sufficient to address the financial issue? Or, have the principals of the franchisee overextended themselves in their personal lives by purchasing large homes, boats or planes? And, a franchisor must realize that sometimes, a franchisee simply does not have the ability or desire to operate its franchised unit, which is the root cause of the problem.

V. BEFORE TROUBLE COMES – CANDIDATE VETTING AND FRANCHISE AGREEMENT DRAFTING

Laying a foundation in the franchisor's vetting process and franchise agreements is critical to giving it options to resolve issues if they arise later. Franchisors need to seek a balance between achieving business goals, such as selling franchises, and creating a good legal framework to protect against future loss. Some franchisors are more willing to absorb risks for a variety of reasons: having a candidate that is promising operationally, but financially less qualified, the franchisor’s need to sell businesses, or other factors. Thus, it is important to understand the franchisor’s priorities and how much risk the franchisor is willing to take in the areas of payment, performance, reputation and growth. If the franchisor's risk tolerance is high, it may not need as much protection in its agreements.

A. Candidate Vetting

If the franchisor determines it does not have a high risk tolerance, it should make sure to vet the candidate according to the franchisor’s highest priorities. Generally franchisors are most concerned about the franchisee’s financial stability. A franchisor should look to the franchisee’s company assets if the franchisee is a business entity, or personal assets if the franchisee is an individual or provides a personal guarantee. Accordingly, the franchisor’s vetting process should include an application or other method of gathering information regarding the franchisee’s assets, including permission to run an initial credit or background check (as well as to periodically run those checks if the franchisee must maintain a specific level of assets).

Operational qualifications may be important to certain franchisors with franchise operations targeting a specific skill set or licensure. In that case, the franchisor may need to balance the need for the franchisee to have the qualifications with the need to franchise a unit. If the franchisee does not have the required skill set, the franchisor can include a provision in the contract that the franchisee acquire the needed skills by a date certain by completing a training program or employing or partnering with another individual or business having the required skill set. When including this type of requirement, also consider what to do if the franchisee never acquires the skills or licensure – does it trigger a default of the franchise agreement or some other action?
B. Franchise Agreement Drafting

1. Collateralization

Franchisors may need to leverage company or personal assets in order to obtain payment or performance of the franchisee’s obligations to the franchisor. The franchisor can ensure payment by entering into a security agreement that enables the franchisor to file a lien against the assets.6 The Uniform Commercial Code7 and existing bankruptcy law8 offer benefits to a secured party who holds a first priority lien. However, whether it would be appropriate and necessary for a franchisor to secure the amounts due from a franchisee through a security interest depends upon circumstances specific to each case. For instance, a franchisor must ask itself what, if any, benefit would be realized by being granted a security interest in assets that are already secured by a first lender who will not agree to subordinate its debt. In some instances, further encumbering the franchisee's assets could breach the covenants of the loan agreement between the franchisee and its lender.9 And, in the event of a default, does the franchisor actually want the right to possess and control assets whose value is often far less than the original purchase price? In addition to obtaining a security interest in typical assets, franchisors may also obtain a security interest in royalty payments, which constitute a promise to pay, thus creating a typical debtor/creditor relationship.10 In either situation, the franchisor must draft the franchise agreement to clearly state that it has the right to take a security interest in the franchisee’s assets and the asset that will be collateralized, and obtain the franchisee’s authorization to file a financing statement.11

If the assets are outside of the United States, the franchisor may need to file an instrument similar to a financing statement in the country where the assets are located. Some countries limit the type of asset that can be collateralized and who can file the financing statement.12 If the debtor is located outside of the United States, the franchisor may register the

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6 To collateralize assets, the franchisor must first create the security interest by creation of an obligation to pay or perform. In a franchise agreement, the obligation to pay royalties is sufficient to create the obligation to pay. Second, the security agreement must "attach," meaning the moment in time when the security interest is enforceable against the debtor. After attaching, the security agreement must be "perfected" by filing a public financing statement with the appropriate governmental body. The first to file is generally the party that has "priority" in the collateral. Daniel L. Waddell and Jim Phipps, How Franchisor Can Benefit From UCC Revised Article 9, 21 Franchise L.J. 74, Fall 2001, p. 74-77.


8 See e.g., 11 U.S.C. § 506

9 Lenders prefer to be in a first position, otherwise the loan is riskier. Kassar describes a specific situation where a client needed a small loan and discovered a prior equipment purchase that included a blanket lien on all assets of the business, creating difficulty with obtaining the loan. Ami Kassar, In Small Business Lending the Devil Is Often In The Lien, The New York Times, October 21, 2013, 1:00 p.m.

10 Waddell and Phipps suggest that franchisors may also be able to take a security interest in trademark rights and other intellectual property licensed to the franchisee during the term of the franchise agreement, comparing it to a leasing arrangement where the lessor wishes to obtain its equipment back at the end of the lease term. Daniel L. Waddell and Jim Phipps, supra note 6 at p. 76.

11 Id. at p. 77.

12 Countries have adopted laws influenced by Article 9 of the Uniform Commercial Code, the Canadian Property Security Act, and models from the United Nations Commission on International Trade Law (UNCITRAL) and the Organization of American States (OAS). Arnold S. Rosenberg, Michael Daigle, Philip F. Zeidman, Michael E.
security interest in their non-U.S. jurisdiction or the District of Columbia. For example, in Dayka & Hackett v. Del Monte Fresh Produce, the court considered whether Dayka & Hackett had a perfected security interest over the assets of an insolvent produce distributor located in Mexico because Dayka & Hackett filed their security interest in the District of Columbia. The court held that Dayka & Hackett satisfied the requirements of Article 9 of the Uniform Commercial Code.\textsuperscript{13}

Further, the franchisor will also want to restrict the franchisee from granting third parties the right to lien the same assets or dispose of the assets.\textsuperscript{14} As previously stated, a restriction on the right to lien the assets will impact the franchisee’s ability to secure financing, unless the franchisor is willing to take a second position. A subordination agreement between the franchisor and the lender can be utilized to document the franchisor’s willingness to subordinate its security interest in favor of the lender, and most importantly, set forth the rights of the parties in the event of a default, including the potential repurchase of assets.\textsuperscript{15} For SBA loans, especially, the franchisor will need to subordinate.\textsuperscript{16}

The franchisor may also wish to monitor to ensure the collateral is still owned by the franchisee and maintains its value. For example, in 2000 assessment of a franchisee’s net worth might have been based on real estate holdings. After the real estate downturn,\textsuperscript{17} those holdings might have significantly less value than the franchisor requires. In anticipation of this issue, the franchise agreement should address the specific asset, how the franchisor will monitor the asset to determine value, the value the asset must maintain, and what occurs if the asset value falls below the threshold, such as additional collateral, substitute collateral, cash-in-advance for items, additional guarantors or even place the franchisee in default of the agreement.

\textsuperscript{13} The court adopted a “comprehensive test,” rather than a “collateral-specific test” to determine whether the filing satisfied § 9-307(c) of Article 9 of the Uniform Commercial Code, because a comprehensive approach “has the advantage of clarity and might reduce transaction costs” whereas the collateral-specific approach would require secured parties to retain foreign counsel, consult foreign law and “file in the limited-purpose registry to perfect as to some security interests or collateral, while having to file in the District of Columbia to perfect as to others.” Dayka & Hackett, LLC v. Del Monte Fresh Produce N.A., 269 P.3d 709, 713-14 (Ariz. Ct. App. 2012); See Rosenberg et. al, supra note 12 at p. 201.

\textsuperscript{14} Gary R. Batenhorst, Breaking Up Is Hard To Do: Challenges and Opportunities in Franchisor Buyback Rights and Obligations, American Bar Association, Franchise Law Journal, 30 Franchise L.J. 97, Fall 2010, p. 102.

\textsuperscript{15} In his article, Batenhorst notes that a release of the security interest before repurchase is advantageous so that disposition is free of the security interest, and the secured party can only obtain proceeds from the collateral.

\textsuperscript{16} The Small Business Administration wants its lenders to have a primary interest in the franchisee’s assets if the franchisee obtains a section 504 loan given the “limited collateral taken to secure [the] 504 loan.” SBA Policy Notice, Control No. 5000-863, Effective April 9, 2003, p. 2. The SBA generally requires that any franchisor taking a security interest in the franchisee’s collateral include the following statement: “Notwithstanding anything to the contrary in section [include citation] of the Franchise Agreement, Franchisor will agree to subordinate its interest in any lien required by the lender or the SBA under the loan authorization.” Seamus Ryan, SBA Liaison, Email, July 14, 2015.

\textsuperscript{17} U.S. News & World Report, Thinking Outside The Housing Bubble: Finding a Better Way To Avoid Economic Catastrophes, John Vogel, June 14, 2013.
2. **Franchisor Management Rights**

If a franchisee is troubled, the franchisor may want a right to "step-in" and assume operations of the franchise for a limited period of time. For example, if the franchisee dies suddenly or becomes incapacitated and does not have a business plan to handle the ongoing operations, the franchisor may manage the business in the interim. In order to have those "step-in" rights, the franchisor should include a provision in the franchise agreement that outlines when the right is triggered, how the franchisor will assume operations and for how long, and whether the franchisor is entitled to any payments while operating (royalties, advertising fees or management fees).

Step-in rights can create liability for issues occurring on the premises, claims by the franchisee of mismanagement, and claims for defects or maintenance of the property. Franchisors also many not anticipate the costs and difficulty of assuming operations of a unit that it doesn’t own, such as hiring additional staff temporarily, making payments to critical vendors, handling disputes and other unanticipated issues. Another issue to be considered is whether the franchisor would then become a joint employer of the franchisee’s employees during this period, thus assuming liability for the franchisee’s missteps. A possible solution to these liability issues is for the franchisor to become an employee of the franchisee through an employment agreement. Before incorporating step-in rights, franchisors should carefully consider how exercising such rights will impact the franchisor and franchisee and then create provisions that address those concerns.

Because of the risks associated with the franchisor’s operations, as well as the possible effect on the assets of the franchisee, lenders often object to step-in rights. Step-in rights also violate the Small Business Administration’s bank covenants. At a minimum, the franchisor should consider restricting its right to operate the business to a shorter period of time or only handle certain aspects of the business in order to overcome these third-party concerns.

Franchisees, on the other hand, generally do not want a franchisor to step-in and run their business, not only because of the loss of control, but also due to the possible negative effect of the franchisor’s operation and, if the franchisor is entitled to additional fees for its operation, the additional cost. Franchisees should consider, first, whether the franchisor’s operation of the business causes a violation of their loan covenants. Additionally, franchisees can try to negotiate removal of the step-in rights, a reduction of the duration of the step-in, or additional requirements that must be met before the step-in rights are triggered. Further, and most importantly, franchisees can avoid step-in by having a written succession or business interruption plan in place that key employees or partners can implement.

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3. Personal Guarantees

As previously discussed, franchisors use personal guarantees as a means to obtain comfort that the franchisee is financially qualified. Without careful valuation methodology and monitoring of the personal assets of the franchisee, personal guarantees may not, at the end of the day, provide the comfort that the franchisor seeks. Additionally, the franchisor should consider who will provide the personal guarantee, especially in the case of a business entity or a married couple. The franchisor should evaluate who has the assets that the franchisor wishes to leverage, and then include a provision that enables the franchisor to obtain a personal guarantee from those individuals.

A relatively new development in the arena of personal guarantees is private equity. In that instance, the private equity firm may not be willing to provide a personal guarantee because, to a private equity firm, easy exit from the relationship and return on investment is paramount.\(^\text{21}\) Large corporations also will not provide personal guarantees of its shareholders, members or partners. In those situations, the franchisor will need to use alternative means to gain financial comfort, such as collateralizing business assets or requiring the business to maintain a specific level of investment.\(^\text{22}\)

4. Standby Letter of Credit

Another alternative when franchising to a private equity firm is obtaining a standby letter of credit in lieu of a personal guarantee. A standby letter of credit is an amount guaranteed by a bank that a franchisor can obtain if certain events occur. Standby letters of credit are very different from lines of credit, which are credit-based, and thus may disappear if the franchisee’s or lender’s situation changes.\(^\text{23}\) In order to obtain a standby letter of credit ("SLOC"), the franchisor will not only need to provide for it in the franchise agreement, but also must have an agreement with the franchisor’s bank stipulating when and how the franchisor is able to draw upon the SLOC.\(^\text{24}\) SLOCs require the franchisee to put a certain amount on deposit with the issuer based upon the franchisee’s creditworthiness. Franchisors should stipulate that the SLOC cannot serve as collateral for any loan. Franchisees may object to the SLOC, because it ties up the franchisee’s capital, which could be put to other use.


\(^\text{22}\) Financial stability is one of the concerns a franchisor may have when franchising to a private equity firm. Gilbert and Cannon also suggest the franchisor consider: (1) good controls of brand standards and confidentiality of specifications; (2) protecting intellectual property, especially if non-compete provisions are eliminated; (3) strict confidentiality of non-public financial information; and (4) controls for supply arrangements, especially if the private equity firm has multiple interests. Gilbert & Cannon, supra note 21.

\(^\text{23}\) Lines of Credit are used in situations where expenses are variable. Banks evaluate the amount of the line of credit and fees charged based on the borrower’s credit. Stephen D. Simpson, CFA, The Basics of Lines of Credit, Forbes, http://www.forbes.com/sites/investopedia/2013/08/06/the-basics-of-lines-of-credit/ (last visited Aug. 6, 2015).

\(^\text{24}\) SLOCs are especially advantageous for franchisors in the context of a franchisee bankruptcy, because it is generally accepted that a letter of credit issued by a third party bank is not property of a debtor’s bankruptcy case. See, e.g., In re Compton Corp., 831 F.2d 586, 589 (5th Cir. 1987); In re Kmart Corp., 297 B.R. 525, 529 (N.D. Ill. 2013). In practice, however, SLOC beneficiaries, out of an abundance of caution, frequently request permission from the bankruptcy court to draw down on a SLOC.
5. **Escrow Accounts**

Franchisors may also insist that the franchisee place a certain amount of money in an escrow account\(^\text{25}\) as security in case of a breach of the agreement. In this situation, the franchisee either allows the franchisor or another party to hold the escrowed amount in an account, interest or non-interest bearing, for a specific period of time. The escrow agent then releases some or all of the escrowed amount upon the occurrence of certain events. The franchisor should carefully evaluate how much should be held in escrow and for how long in order to address its concerns.\(^\text{26}\) Franchisees, on the other hand, may strenuously object to escrow funds, because it ties up a significant amount of the franchisee’s capital. The franchisee can object to or try to limit the escrow amount, and should pay strict attention to the events triggering release of the escrowed funds. Similar to the SLOC, the franchisor should stipulate that the escrow fund cannot be collateralized.\(^\text{27}\)

6. **Collateral Assignments of Lease**

Another creative use of collateral is for the franchisor to obtain a right to assume the franchisee’s lease if the franchisee breaches the franchise agreement or if certain other events occur.\(^\text{28}\) Typically this right is incorporated into a rider to lease, but the right to obtain the collateral assignment should tie to the franchisor’s rights in the franchise agreement. The lease rider should provide the franchisor a right of assignment but not a duty to assume, to provide the franchisor the flexibility to assume the lease.\(^\text{29}\) Additionally, the lease rider should contain the landlord’s consent to the franchisor exercising this option as well as to recognize the franchisor or its new franchisee as tenants pursuant to the lease.\(^\text{30}\) If the business is located in a critical area for the franchisor, the franchisor will want to be able to preserve operations at that location by assuming the lease. The franchisor may also want the option to assign the lease to another qualified franchisee or a third party. Landlords may object to any right of assignment, but key factors are to give the landlord a right to approve the assignee, payment of an assignment fee, payment of all amounts owed to the landlord, continuing liability of the assignee, and rent increases. Franchisees and lenders, on the other hand, may seek to prevent a franchisor from obtaining a right to assume the lease, because it decreases their ability of the franchisee to...

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25 Escrow accounts are bank accounts held in the depositor’s name and an escrow agent, that can be returned to the depositor or paid to a third party upon the occurrence of a certain condition. Black’s Law Dictionary (10th ed. 2014).

26 Additionally, franchisors should consider that payment into escrow will be considered a franchise fee. William L. Killion and Sarah J. Yatchak, *But It Doesn’t Walk Or Talk Like a Duck: The Perils Of The Hidden Franchise*, Business and Commercial Law, 25 GP Solo 10, March 2008.

27 In the case of a franchisee bankruptcy whether escrow agreements will be property of the estate (and therefore protected by the automatic stay) will be subject to a factual analysis including whether: “(1) the funds were placed in escrow under an escrow agreement for the benefit or protection of another party; (2) the funds were in the possession and control of an escrow agent on the [bankruptcy filing date]; and (3) the debtor is entitled to receive the funds (or some portion thereof) only after fulfilling certain conditions.” *In re Expert South Tulsa, LLC*, 522 B.R. 634, 647 (B.A.P. 10th Cir. 2014). If each of the foregoing conditions are met, the escrow will not be considered property of the estate and the beneficiary will be able to recover the funds. Given the factual nature of the conditions – and that facts are often contested – parties almost always seek recognition from the bankruptcy court that escrow funds are not property of the estate before taking possession of such funds.


30 Batenhorst, *supra* note 14 at p. 98.
continue to lease the space after the franchise relationship ends, or for the lender to sell the
leasing rights to another party.

VI. ESTABLISHING CLEAR POLICIES

The British economist John Maynard Keynes once said "[i]f you owe your bank a
hundred pounds, you have a problem. But if you owe a million, it has." Stated differently in
the context of a franchise relationship, a franchisor that is owed a significant amount of money from
a financially stressed franchisee has a significant problem. A variety of solutions exist to
address the financial distress of a franchisee depending on the particular situation.

A. Credit Limits

To avoid the situation upon which Keynes commented, a franchisor must establish and
adhere to credit limits that set the maximum amount of credit that it will agree to extend to a
franchisee. In establishing a credit limit, "a one size fits all" scenario as compared to the
establishment of different credit limits for each individual franchisee's own circumstances, is
within the province of the franchisor (subject to any specific state regulations). It is critical
however, for a franchisor to establish and articulate its credit limit policies clearly and
unequivocally to its franchisees early on in the franchise relationship. Waiting until the
franchisee finds itself in a financially difficult position may subject a franchisor to a variety of
claims—whether or not supported in law, including bad faith termination.31

B. Additional Workout Strategies

As previously discussed, franchise agreement drafting, including establishing clear
policies regarding financial wherewithal and credit policy can provide the means for a franchisor
and a franchisee to weather a franchisee's financial difficulty. Once difficulties arise, other
strategies can be utilized through other agreements as further explained below.

C. Secured and Unsecured Promissory Notes

The debt owed by a franchisee to a franchisor may also be addressed and memorialized
by a promissory note from the franchisee to the franchisor. Before this option is considered, a
franchisor must conclude that the franchisee has sufficiently addressed the circumstances that
caused the default, and that the franchisee is otherwise able to comply with the repayment
terms of the promissory note while at the same time being able to support the operation of the
franchised unit. In most circumstances, a promissory note is part of a broader forbearance or
settlement agreement between the franchisor and the franchisee that addresses not only the
outstanding debt but the conditions the franchisee must meet to avoid default and termination.32

31 See e.g., Harara v. ConocoPhillips Co., 377 F. Supp. 2d 779 (N.D. Cal. 2005) (finding franchisor did not
constructively terminate the franchise by terminating franchisee's credit privileges pursuant to company policy);
Wright-Moore Corp. v. Ricoh Corp., 794 F. Supp. 844 (N.D. Ind. 1991) aff'd, 980 F.2d 432 (7th Cir. 1992) (copier
manufacturer's change in credit terms did not constitute a "substantial modification" in violation of Indiana Deceptive
(withdrawal of credit threatened to destroy franchisee's business); Gruver v. Midas Int'l Corp., 925 F.2d 280 (9th Cir.
1991) (franchisor's termination of franchisee's credit line did not constitute wrongful act for purpose of franchisee's
claim that it signed termination agreement under economic duress).

32 Franchisors should consider the potential impact a promissory note and corresponding agreement that addresses
the franchisee's outstanding defaults would have on any personal guarantees. See e.g., Inter-Sport, Inc. v. Wilson,
661 S.W.2d 367 (Ark. 1983) (subsequent execution of a promissory note from franchisor to franchisee in satisfaction
In most circumstances, any agreement entered into by a franchisor to address a franchisee’s outstanding debt would include a requirement that the franchisee execute a general release in favor of the franchisor. A franchisor should also consider whether to insist that all amounts due under a promissory note be secured by the franchisee’s assets for the reasons previously addressed in this paper.33

D. Confessions of Judgment

A confession of judgment, also known as a confessed judgment, a statement of confession, a warrant of confession or a judgment by confession, is a judgment taken against a debtor by the creditor, based on the debtor’s written consent,34 and is enforced in the event of a subsequent default by the franchisee. Franchisors often utilize a confession of judgment in connection with a promissory note, and require a franchisee to consent to the entry of a judgment against it in the event of a default under the applicable loan agreements. With a confession of judgment, a franchisor is much more likely to obtain a judgment in its favor in a much shorter period of time, sometime even on an *ex parte* basis. And, with a confession of judgment in hand, a franchisor is likely to incur much less attorneys’ fees and costs pursuing its remedies against a defaulting franchisee. Yet, a few potential pitfalls could impact the viability or strength of a consent judgment.

It is critical that the consent judgment be accompanied by findings of fact and conclusion of law to avoid a collateral attack by the franchisee,35 or to prevent the franchisee from asserting baseless claims and defenses.36 A franchisor also must ensure that all of the relevant parties, including any guarantors, are bound by the confession of judgment. Otherwise, a franchisor will find itself litigating the matter in any event, thus eviscerating the reason for having first obtained the confessed judgment.37

E. Payment Plans and Operating Plans

Depending on the severity of the financial default, a franchisor should consider offering its franchisee a payment plan or operating plan to address the underlying default and its cause. A payment plan, setting out the amount due and terms upon which payment is due, will allow the franchisee to “catch up” while staying current on its continuing financial obligations under the franchise agreement. If the franchisee’s financial problems are caused by operational deficiencies, the franchisor can require the franchisee to implement a plan to address the

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33 See “Collateralization,” supra at section V.B.1.


35 *Martino v. McDonald’s Sys., Inc.*, 598 F.2d 1079 (7th Cir. 1979) (franchisee was barred by the doctrine of res judicata from claiming that franchisor violated the Sherman Act where consent judgment included findings of fact and conclusions of law).

36 *Greenwood v. Kadoich*, 357 A.2d 604, 606 (1976) (a judgment debtor must act promptly and demonstrate through admissible evidence a meritorious defense in order to open a confessed judgment).

operational defects, including hiring a new manager, undergoing additional training, or requiring the purchase of equipment deemed necessary to improve the franchised unit’s financial performance. When determining whether to extend a franchisee a payment plan, a wise franchisor should also consider the “optics” in the event the franchisor later finds itself in litigation against its franchisee. Offering financial assistance could make it more difficult for the franchisee to argue that it was mistreated, or that the franchisor wrongfully terminated the franchise agreement or acted in bad faith.

VII. MEDIATION

In a near-perfect world, a franchisor and its franchisee have each sought to maintain open lines of communication in their continuing effort to resolve the outstanding monetary default. Despite the cooperation of both parties in this process, often neither the franchisor nor the franchisee is willing to recognize the weakness in each side's case. In these instances, non-binding mediation may be a reasonable alternative.

Mediation is a non-binding process in which the franchisor and the franchisee meet (with or without their respective legal counsel) in order to try and resolve the particular issue at hand. The mediation is conducted by a mutually selected, neutral party who uses his or her legal and business expertise to facilitate the negotiated resolution of the dispute. During the mediation process, the neutral mediator attempts to explore the strength and weaknesses of each parties’ position in an attempt to assist them to reach an agreement. In this process, the parties are not bound by the mediation proceedings unless a formal agreement is reached.

Like all other dispute resolution vehicles, mediation has both its strengths and weaknesses. Often, the parties are entrenched in their respective views, given that the dispute is in its infancy, it is hard to change minds when all of the facts are unknown. Further, if the franchisor's representative has a poor relationship with the franchisee, such dynamic may hinder any effective solution.

A. Internal Mediation

It is not uncommon for a franchisor to require in the franchise agreement that the franchisor and franchisee meet face to face in an attempt to resolve a particular dispute as a condition precedent to either party filing an action against the other. Often, the participants in this internal mediation are limited to the business people for both the franchisor and the franchisee, and lawyers are excluded.

B. External Mediation

External mediation is more formal than internal mediation, and is frequently administered by an independent mediation company. JAMS and the American Arbitration Association are two of the more recognized players in this field. Here, legal and business representatives of the franchisor and the franchisee meet with a mutually acceptable, third-party mediator in an attempt to resolve the outstanding dispute. Although the cost of mediating a dispute through an outside firm is greater than internal mediation, it can be helpful by providing more formality to the process, and allowing both parties to hear from someone other than their counsel about the risks of pursuing their respective claims and defenses, as well as the potential weaknesses in the parties’ respective case.38

38 Franchisors and franchisees might consider, for example, the American Arbitration Association’s Early Neutral
VIII. NEGOTIATING A SALE

Yet another creative solution to resolving the financial default of a franchisee is to convince the franchisee that its best option is to sell its franchised business. However, convincing a franchisee that a sale of its business is in its best interest often presents challenges. At this stage, the franchisee might be significantly delinquent in its obligations owing to both the franchisor and likely its secured lender. And, given the financial difficulties of the franchisee, the value of the franchised unit may have diminished because of ongoing operational deficiencies.

This situation requires compromise from all parties. The franchisor and the lender must be willing to consider accepting an amount less than what is actually owed. Recognizing that this is a hard pill to swallow, a franchisor and lender likely will at some point realize that the assets of the business (and those of the franchisee and its principals) are insufficient to satisfy the amounts due. Often, franchisees, have invested their life savings into the franchised business, and may be relying on the franchised business as the sole source of income for themselves and their families. The franchisee is also likely invested psychologically in the business and doesn’t want to simply walk away; it does not want to be seen as a failure. Finally, in almost all circumstances, the franchisor and franchisee have very different opinions about the value of the franchised business. As such, it is crucial to understand these dynamics before the discussion begins.

IX. TERMINATION

Where a franchisor has exhausted all other avenues in an attempt to resolve the issue surrounding a financially defaulting franchisee without success, terminating the franchise agreement might be the only logical next step. In terminating a franchise agreement, a franchisor gains significant leverage against its defaulting franchisee, who is no longer able to lawfully use the franchisor’s trademarks and operating system. Among other things, the termination of a franchise agreement in a franchise system where the franchisee relies significantly on the franchisor for such things as proprietary supplies or services, reservation systems, etc. could prompt a franchisee and its counsel to quickly become more realistic in negotiations.

A termination also affords a franchisor significant benefits in any subsequent bankruptcy filed by the franchisee (as further discussed below). If the franchise agreement has been terminated pre-petition, and the termination process is complete with no right to cure when the bankruptcy petition is filed, the debtor/franchisee does not have a property interest in the Evaluation Program (ENE). According to the AAA, a neutral evaluator is chosen by the parties to prepare an unbiased non-binding report, which consists of an unbiased opinion of the issued presented. The ENE process is considered confidential, and is intended to encourage direct communication between adversarial parties about possible claims and supporting evidence-particularly important in situations where the disputants are far apart in their views on how the law applies to the case in question or what the case is worth. In these instances, an evaluation of the dispute that seeks to determine best and worst case alternatives can point the way to a negotiated agreement. The non-binding report can serve as a catalyst for settlement negotiations, can enhance communication between the parties and can be employed to dispose of specific issues prior to proceeding with other dispute resolution options. See www.adr.org/aaa/faces/services/disputeavoidanceservices/earlyneutralevaluation (last visited Aug. 7, 2015).
franchise and there is no executory contract to assume. "The bankruptcy filing does not resuscitate the terminated rights." 39

Yet, a franchisor that terminates a franchise agreement could hasten a franchisee and its counsel into filing a legal preceding that may have otherwise been avoided. In an attempt to overcome that result, and the inevitable entrenchment of the positions of the respective parties, negotiations post termination remain a viable option. 40 Among other things, a franchisor could offer the terminated franchisee a limited license agreement that allows the franchisee to continue operating its stores for a limited amount of time, pending either a sale or a reinstatement upon certain conditions being met. A limited license agreement is a powerful tool used by a franchisor, especially when the limited license agreement includes a general release and acknowledgments by the franchisee of the event of default, the fact that there are no affirmative defenses against the franchisor, and that the franchise agreement was properly terminated.

X. ALTERNATIVES TO CHAPTER 11 BANKRUPTCY

Despite the myriad alternatives available to a franchisor to address a franchisee’s financial default, there are a variety of potential obstacles and roadblocks that could hinder any negotiations. Among others, the franchisee could file bankruptcy.

If a franchisee files for bankruptcy prior to a franchisor terminating the franchise agreement or the termination becoming perfected, 11 U.S.C. § 362 serves to stay any lawsuits against the franchisee, any acts to obtain or control property of the bankruptcy estate, or any termination of the franchise agreement without the express permission of the bankruptcy court. Simply stated, a bankruptcy by the franchisee creates much greater obstacles to a franchisor that seeks to enforce its rights against a franchisee under the franchise agreement.

In addition to a preemptive bankruptcy filing by the franchisee, a franchisor also faces the obstacle of a franchisee who simply doesn’t want to “play ball” in the negotiations. Clearly, there will be instances when a franchisee, for an endless variety of reasons, simply doesn’t want to try and reach an amicable resolution and may simply file a preemptive suit against the franchisor. Fortunately, the warning signs of a recalcitrant franchisee or its counsel are often demonstrated early on in the negotiation process, allowing a franchisor to take its own preemptive measures to protect its own interests.

A. Negotiated Settlements and "Compositions"

The simplest solution to avoiding the cost and expense of a bankruptcy filing is to negotiate a settlement among the parties. This solution involves merely discussions in an attempt to resolve the issues that led to a possible bankruptcy filing in the first place. A

39 In re Tornado Pizza, LLC, 431 B.R. 503, 510-11 (Bankr. D. Kan. 2010); see also In re Seven Hills, Inc., 403 B.R. 327, 334 (Bankr. D.N.J. 2009)("where the underlying contract or lease has been validly terminated prior to the institution of the bankruptcy proceedings, such contract or lease is not resurrected by the filing of the petition in bankruptcy and cannot therefore be included among the debtor in possession’s assets.").

40 Barring some affirmative conduct on the franchisor’s part, post-termination negotiations attempting to resolve the issue will not been deemed a waiver of the termination or the franchisor’s post-termination rights under the franchise agreement. See i.e., In re 717 Grand St. Corp., 259 B.R. 1, 4 (Bankr. E.D.N.Y. 2000)(franchisor’s willingness to negotiate after termination of franchise agreement does not amount to waiver where franchisee could point to no act by franchisor that could be construed as a waiver of the termination notices, express or implied).
negotiated settlement may be an ideal resolution in a situation where there are very few parties and the financial problem is easily identified – for example, negotiations between a borrower and the bank where the borrower defaulted on a loan payment after incurring expenses that were not contemplated by either party. In contrast, a negotiated settlement may not be a viable option when there are multiple parties with disparate interests or where the source of the financial stress is not easily identified or resolved. In those situations, the parties will be free to pursue their collection remedies under state law, potentially eviscerating the debtor's assets before a negotiation can even be scheduled.

A debtor may attempt to use a "composition" to address the issue of multiple creditors with different rights and motivations. Generally speaking, a composition is a written agreement among all the creditors to pursue their collection rights only as set forth in the agreement. Compositions can be either formal or informal. A formal composition is a court-supervised process and is rarely used in the United States. An informal composition does not involve a court. Rather, informal compositions involve negotiations among all creditors where the creditors agree to stay their collection efforts during the negotiations and with the intention of reaching a commitment binding on all creditors. The principal advantage of an informal composition is that the costs can be dramatically lower than a bankruptcy filing or even other non-bankruptcy options. The obvious disadvantage to an informal composition is that, to be completely effective, it requires unanimous participation among creditors. If there are a significant number of creditors, the option of having them voluntarily agree to anything may not be worth discussing. Even with a small number of creditors, the voluntary nature and the unanimity requirement can be problematic. If every creditor must agree to a particular solution, it provides a great incentive for one or more creditors to hold out, and therefore to "hold up" the debtor and the other creditors. Because informal compositions are not supervised by a court, there is little that the debtor or other creditors can do to prevent such a situation.

B. Receiverships

Creditors have the option of seeking the appointment of a receiver under both state and federal law. Federal law recognizes the appointment of a receiver both under federal statutory law and in the Federal Rules of Civil Procedure. In federal court, the parties are required to invoke the jurisdiction of the court, which is typically accomplished under diversity jurisdiction. Federal diversity jurisdiction requires the parties to demonstrate that at least $75,000 is in

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42 J. Bradley Johnston, The Bankruptcy Concept, 65 Am. Bankr. L.J. 213, 233-35 (1991) (discussing non-bankruptcy options in the context of the "prisoner dilemma" describing the situation where parties can be expected to pursue solutions that maximize their individual recovery, even where their individual solution harms both the debtor and other creditors).

43 While creditors cannot be compelled to participate in a composition agreement, the agreement may still be useful without unanimous participation. Non-participating creditors simply reserve all of their rights. If a debtor is able to bind substantially all creditors under a composition agreement, it could then turn its time and resources to dealing with a hold out-creditor.


controversy. State courts also may appoint a receiver either under general equitable principles or specific state statutes. Both federal and state law recognize that the appointment of a receiver is a drastic remedy, and generally require a showing that the relief requested is necessary and that more narrowly tailored relief would not be effective. Grounds for appointment of a receiver include fraud, mismanagement, insolvency, waste, and material injury to property.

Once a receiver is appointed, he or she immediately takes the place of the debtor's management and takes legal possession of the debtor's property. While statutory law may provide some guidance, the specific powers of the receiver will typically be set forth in the court order appointing the receiver. The receiver will be tasked with managing and operating the debtor's business for the purposes of orderly selling assets and winding down the business. There are no hard and fast rules for how a receiver is compensated. Compensation will be determined by the court and may take the form of an hourly fee, a lump sum, or a percentage of the assets distributed to creditors.

Receiverships have several advantages over a bankruptcy filing. A receivership case likely will be less costly than a Chapter 11 bankruptcy filing, although the costs in receiverships of complicated business can add up quickly. In addition, the order appointing the receiver can be very specifically tailored to the circumstances of the case. Moreover, a receivership case has less oversight (and therefore less cost) because the United States Trustee is not involved and because creditor committees are not appointed in a receivership case.

Like any other option, receiverships also come with disadvantages. Bankruptcy law is a well-developed area with a great deal of case law. Receiverships, on the other hand, are not guided by the same scope of statutory or case law. As a result, it is more difficult to predict outcomes of particular situations in receivership cases. In addition, while receivership orders can be specially tailored to the facts of the case, the downside is that unique orders can lend to ambiguity and disagreements on how the provisions should be applied. Another disadvantage to a receivership is that there is no automatic stay. Thus, parties are not prohibited from seeking non-judicial remedies or seeking relief in a different court from the pending receivership. Some receivership orders impose injunctions that act similarly to the automatic stay. Such injunctions can prove useful and effective in federal receivership cases. In state cases, however, the parties may run into problems with enforcing the injunction outside of the state.

C. Assignments for the Benefit of Creditors

An assignment for the benefit of creditors ("ABC") is a creditor remedy usually available under state statutory and/or common law. A company may use an ABC to wind down its affairs, in a manner similar to a Chapter 7 bankruptcy filing. However, ABCs are also used to effectuate an assignment of a going-concern business to another party. An ABC involves the legal

47 Id. at § 1332(a).
49 Id.; see also N.Y. C.P.L.R. § 6401 (McKinney 2015).
50 "The order of appointment of a receiver is the measure of his power." Zeligman v. Juergens, 762 P.2d 783, 784 (Colo. Ct. App. 1988); see also Perry Center, Inc. v. Heitkamp, 576 N.W.2d 505, 511 (N.D. 1998) ("while a receiver's powers may be broad in scope, a receiver has only such powers as are conferred by statute and the court order appointing him.").
assignment of title to all of the company's property to either a designated party tasked with liquidating the company or to an assignee (in the case of a going concern assignment). The assigning company is required to provide the assignee with detailed information on the known creditors. The assignee then provides written notice to the creditors advising of the ABC and advising that creditors with claims are required to file written proofs of claim with the assignee. The assignee then distributes the assets to creditors under the priorities set forth under applicable ABC state law. Depending on the state, ABCs may either be supervised by a court or administered non-judicially under a state statute.51 The popularity of ABCs varies widely from state to state and based on macroeconomic circumstances. For example, ABCs rose in popularity in California in the 1990s during the dot-com boom as a vehicle for expeditiously selling and assigning a tech company to another entity.52

The two principal advantages of an ABC are that, under the right circumstances, ABCs can be faster and less expensive than a bankruptcy filing. While a bankruptcy case involves many different parties including the U.S. Trustee, a creditors' committee, and even the court itself, an ABC assignment typically involves only the active participation of the assignor, the assignee, and their related professionals. This cuts down on cost (fewer professionals, less billing). It also allows the process to be conducted with less oversight, and thus the task is accomplished more quickly. In addition, an ABC can involve less time and effort on the part of the assigning company's management. Rather than deal with the responsibilities as a debtor-in-possession leading up to a Bankruptcy Code section 363 asset sale, the management of an ABC assigning company effectively "hands the keys" to the assigning party and walks away.

ABCs also come with disadvantages. First and foremost, because there is no automatic stay, creditors are free to jockey for advantage through other means. This is especially problematic if the creditors are located outside the state where the ABC is being administered. In addition, the outcome of ABC litigation can be unpredictable. While bankruptcy law issues are frequently litigated and courts issue published opinions, there is very little case law providing guidance on ABC issues.

Moreover, ABCs do not provide the same level of protection for asset buyers as a section 363 sale in bankruptcy. For example, bankruptcy law clearly permits the assignment of executory contracts (even over the objection of the non-debtor party) and the sale of assets free of liens, claims, and encumbrances. While state law governing an ABC may purport to free an assignee of claims following an assignment, there are no similar provisions allowing for assignment of executory contracts or the assignment of assets free and clear of liens. In addition, the specific nature of an ABC gives rise to issues when the company has assets and creditors across state lines. Parties may attempt to enforce ABC provisions in other states by asking the other state court to recognize an assignment and its effects under the principal of comity. However, the cost of such an approach rises by each different state involved. And, whether out of state courts will accept a comity argument is not assured.

51 See Geoffrey L. Berman, General Assignments for the Benefit of Creditors at 18 n.78 (American Bankruptcy Institute 2d ed. 2006) (discussing the difference between court supervised and non-court supervised ABCs and noting that "Massachusetts is one example of a state where no accounting requirement [to be filed with a court] exists.").

Finally, there is a disagreement across jurisdictions on whether an assignee has standing to bring fraudulent transfer lawsuits in the case of a liquidating ABC. If the assignee does not have standing, that precludes what may have been a significant source of recovery to creditors. In a Chapter 7 liquidation, the Chapter 7 trustee unquestionably has the power to bring fraudulent transfer lawsuits on behalf of the estate in order to claw back funds for the ultimate benefit of all creditors. In ABC cases, assignees have attempted to use state fraudulent transfer laws for the same purpose. However, some courts have held that because assignees are not the entity that originally made the transfer, state law prohibits them from bringing a fraudulent transfer lawsuit against the recipient of the transfer. If the assignee is denied such standing, it may mean much less recovery for creditors.

D. Additional State Law Remedies

In addition to ABCs, there are other state law remedies to effectuate the liquidation of a financially troubled business. The owners of a company may simply determine to wind down the business and cease operations. In a wind down, the company sells its assets and distributes the proceeds to creditors in a manner the company determines is appropriate. The company may thereafter cease to exist voluntarily under the provisions of state law for terminating the particular type of business (i.e., whether it is a corporation or a limited liability company). Alternatively, the company may eventually be dissolved by the state for failure to continue the necessary filings (franchise tax returns, for example) to remain a viable entity.

The disadvantages of such an approach are readily apparent. No notice to unsecured creditors is required in a wind down. As a result, creditors who are not aware that the entity no longer has assets may continue to file lawsuits against the entity. Moreover, creditors may file suits against transferees (including, for example, LLC member recipients of distributions) under state fraudulent transfer statutes. Ultimately, while a wind down is inexpensive and relatively easily accomplished, the uncertainty created is frequently more trouble than it is worth.

Companies also may make use of the Uniform Commercial Code to dispose of assets in the context of liquidating a business. Prior to approximately 1990, most states had enacted UCC article 6-102, permitting bulk transfers of assets. A bulk transfer sale puts into place a process whereby the company provides the proposed assignee with a list of creditors and the proposed assignee notifies the creditors of the assets to be sold. If the creditors are provided proper notice, the assets are then sold to the assignee free of any claim of the creditors. However, if creditors are not properly notified, they have remedies up to and including voiding the entire sale. In 1988, the National Conference of Commissioners on Uniform State Laws recommended the repeal of bulk sale provisions, on the grounds that revised article 9 provided sufficient protection to creditors and the risk of liability to purchasers in a bulk transfer transaction was too great. The vast majority of states thereafter repealed their bulk transfer statutes. With the exception of one state, however, the remedy is no longer a viable option.


54 Georgia joined the repealing states effective July 1, 2015. See Ga. Code Ann. § 11-6-102. As of the publication of this paper, Maryland appears to be the sole remaining jurisdiction with UCC 6-102 still on the books. See Md. Code Ann., Com. Law § 6-102.
Finally, UCC article 9 provides remedies for the non-judicial foreclosure of assets. Generally speaking, such remedies require the secured creditor to follow strict requirements including notice and a prohibition from breaching the peace.\textsuperscript{55} Practically speaking, the remedies are best utilized by agreement between the secured party and the borrower as part of a consensual liquidation of assets. If the disposition is not consensual, the secured party must be very cautious and conscientious in following the relevant statutes.\textsuperscript{56} Moreover, Article 9 remedies are not available for real estate assets. The remedies also suffer from the same state law limitations discussed above with respect to ABCs.

XI. COMPARISON OF ALTERNATIVES TO CHAPTER 11

The non-bankruptcy workout options discussed above refer generally to bankruptcy in the context of the advantages and disadvantages of each choice over a bankruptcy filing. While a bankruptcy filing is discussed briefly in those sections, a more complete understanding of the bankruptcy concepts mentioned above will assist decision makers in selecting the option that truly works best in a particular circumstance. As such, this section discusses the bankruptcy concepts in greater detail, to allow for a full comparison between a bankruptcy filing and other non-bankruptcy options.

A. Automatic Stay

The automatic stay is a powerful tool available only in a bankruptcy filing. As the name makes clear, the stay automatically goes into place the moment an entity files for bankruptcy protection. The stay is a broad-reaching injunction that prohibits all parties from commencing or continuing any collection efforts against the debtor.\textsuperscript{57} This includes freezing all litigation against the debtor. In addition, the stay has even been interpreted to require a secured party to return collateral repossessed shortly before a bankruptcy filing.\textsuperscript{58}

The automatic stay provides a debtor with a number of protections and advantages. The stay applies nation-wide and requires no action on the part of the debtor to seek or to recognize the stay. The concept of the automatic stay is well-recognized and understood by parties with any experience in litigation or collection matters. With rare exceptions, the debtor does not need to explain why it is in a party's best interest not to violate the automatic stay. Most parties

\textsuperscript{55} UCC section 9-609(a)(2) permits a secured party to take possession of collateral after default "without judicial process, if it proceeds without breach of the peace."). See Ronald V. Odette Family Ltd. P'ship v. AGCO Finance, LLC, 129 P.3d 95, 101 (Kan. Ct. App. 2005) (citing to K.S.A. 2004 Supp. 84-9-609(a)(2) and noting: "To foreclose, the secured party may even take possession of the collateral without judicial process, so long as they commit no breach of peace.").

\textsuperscript{56} See 11 U.C.C. §9-609:16 [Rev] (3d ed. 2014) (citing case law holding that a secured party wrongfully repossessing collateral may be liable for trespass and conversion).

\textsuperscript{57} In re Abacus Broadcasting Corp., 150 B.R. 925, 926 (Bankr. W.D. Tex. 1993) ("This automatic stay is broad and all encompassing.").

\textsuperscript{58} In re Leverette, 2013 WL 5350902, at *6 (Bankr. S.D. Miss. Sept. 25, 2013) (holding that a bank’s failure to return collateral after receiving notice of the bankruptcy supports a finding of contempt for willful violation of the automatic stay); In re Herbst, 469 B.R. 299 (Bankr. W.D. Wisc. 2012) (same); In re Johnson, 501 F.3d 1163 (10th Cir. 2007) (same); but see In re Carter, 502 B.R. 333 (B.A.P. 8th Cir. 2013) (holding that a bank in possession of repossessed collateral was not in contempt for holding the collateral until an order of the bankruptcy court was entered requiring it to return the collateral).
understand a bankruptcy court's power to issue contempt orders for a willful violation of the automatic stay and therefore err on the side of caution.

There are exceptions to the automatic stay, set forth in Bankruptcy Code section 362. Section 362 was included as an original part of the Bankruptcy Code, first enacted in 1978. The section has been amended several times since then. As it is currently written, section 362 is an extremely long statute where special interest exceptions have been tacked on with little organizational structure. It can be very difficult to determine whether an exception set forth in the statute truly governs the facts at issue. Moreover, even where parties believe in good faith that an exception applies, they can be held in contempt, fined, or both if that belief turns out to be incorrect.\(^59\) Therefore, it is very common for parties to seek "protective orders" from a bankruptcy court making it clear that an exception to the automatic stay applies.\(^60\) Obtaining such orders requires time and expense and the debtor is provided with an opportunity to object and argue that the stay, in fact, applies.

The automatic stay remains in place for an entire bankruptcy case. Moreover, plans of reorganization often include broad injunctions that, in many ways, mimic the automatic stay upon plan confirmation.

B. Bankruptcy Expense and Risks

A bankruptcy case can be very expensive. The debtor is required to have attorneys and often needs to retain other professionals such as financial advisors, accountants, auctioneers, and investment bankers. In addition, in many Chapter 11 cases a committee of unsecured creditors is appointed. The committee also hires counsel and sometimes other professionals as well. All of the fees and expenses incurred by a committee are paid by the debtor's estate. Moreover, there are fees associated with filing (which can add up when there are multiple related debtor entities) and a debtor is required to make quarterly payments to the United States Trustee.

From time to time, news stories are published with breath-taking fees paid to bankruptcy professionals in large Chapter 11 cases. For example, the fees paid to debtor’s counsel and financial advisors in the General Motors and American Airlines cases exceeded ten million dollars a month during the pendency of the case.\(^61\) However, these bottom-line numbers often fail to account for the fact that bankruptcy advisors and professionals provide the same kind of services to these large complicated companies that would have been provided even if a bankruptcy case had never been filed. In addition, the Bankruptcy Code has been interpreted to permit solutions that allow for the minimization of fees through an expedited bankruptcy process. For example, it is fairly common for parties to negotiate a bankruptcy solution prior to


\(^{60}\) It is fair to say that most knowledgeable practitioners, when asked whether an act contemplated by a creditor might violate the automatic stay, are likely to advise their clients – out of an abundance of caution – that it is safer to ask permission than forgiveness, and recommend they simply file the appropriate motion for relief from stay in a court of competent jurisdiction. To do otherwise risks injury to the client and to the attorney who might otherwise give dangerously erroneous advice. In re Durango Georgia Paper Co., 297 B.R. 316, 321 (Bankr. S.D. Ga. 2003).

\(^{61}\) Mark Curridden, Law Firms Feast on EFH Case, Dallas Morning News, July 6, 2015, at D1 (discussing fees in the EFH bankruptcy case and other recent large Chapter 11 filings).
filing a bankruptcy case, and then to file the case simply to approve a pre-negotiated plan. These are known as "pre-pack" cases and can dramatically shorten the length of time a company is in bankruptcy. Also, rapid section 363 sales are routinely approved by bankruptcy courts (see the bankruptcy sales discussion in Section XI.D. below).

C. Court Enforced Alteration of Creditors' Rights

In addition to the automatic stay, the potential ability to alter the rights of creditors is among the most powerful and useful tool in a bankruptcy case. The United States Constitution prohibits state laws that alter the contractual rights of parties. As such, there are very few solutions that allow a debtor to compel a creditor to accept less than the amount they are lawfully owed under a contract or lease. Bankruptcy, however, is a federal solution that explicitly permits the alteration of contract and lease rights under certain circumstances. As an example, section 365 of the Bankruptcy Code permits a debtor to reject executory contracts or leases. In effect, the debtor is permitted to walk away from its obligations under the agreements, leaving the non-debtor party with a mere unsecured claim for damages. Moreover, in the case of a non-residential real property lease, a landlord's unsecured claim is subject to a cap on damages. The power to reject unprofitable contracts and leases allows a debtor to shed itself of burdensome obligations, and to concentrate on the profitable side of its business through the assumption of other contracts and leases. Simply stated, there is no state law remedy providing a debtor with such a powerful and potentially useful restructuring tool.

The plan process also allows for the alteration of creditor rights for the benefit of a reorganized debtor. The specific mechanics of plan confirmation are complicated and outside the scope of this paper. In brief summary, a debtor is required to obtain approval from different classes of creditors to confirm a plan. As long as a debtor obtains the requisite approval from one class of creditors, the debtor is permitted to "cram down" the plan on other objecting creditors. This power is well understood by sophisticated creditors (such as banks and other secured creditors) and provides a debtor with significant negotiation leverage to craft a viable reorganization solution.

D. Bankruptcy Sales

While the bankruptcy plan process is a powerful tool, bankruptcy sales (known as "363 sales" in reference to the applicable Bankruptcy Code provision) have become a very common alternative to a plan of reorganization. Bankruptcy courts routinely permit Chapter 11 debtors to put into place a process where substantially all assets are sold in a short period of time. Often, the process will involve detailed bidding procedures, a "stalking horse" bidder, and an auction for the sale of the assets. Once the sale occurs, the debtor thereafter will convert the case to Chapter 7 to deal with the remaining assets and to wrap up the case, or will seek to confirm a liquidating plan in the Chapter 11 case.

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62 U.S. Const. art. 1, § 10 (prohibiting states from enacting laws "impairing the Obligations of Contracts . . . .").

63 11 U.S.C. § 1126(c) (providing that a class of creditors is deemed to accept a plan if at least two-thirds in amount of claims and one half in number of claims in the class votes in favor of the plan).

64 A Chapter 11 plan is organizes different types of creditors into various classes and if one class with "impaired" claims (meaning claims that are altered by the terms of the plan) votes in favor of the plan, the plan can be confirmed. 11 U.S.C. § 1129(b)(1).
Section 363 sales are less expensive than Chapter 11 reorganizations because they take less time. A plan process involves drafting the plan and disclosure statement and seeking approval from various creditor constituencies. Even under the best circumstances, the process takes approximately two months from the time the plan is filed until it is confirmed. A 363 sale can often be accomplished in less than half that time. In addition, section 363 sales are very attractive to asset purchasers because the Bankruptcy Code allows a debtor to sell the assets free and clear of liens, claims, and encumbrances. The buyer takes the assets free and clear, leaving the creditors to fight over the priority of their claims in the proceeds. Because a section 363 sale order provides clean title to assets, asset purchasers frequently insist that a financially troubled debtor file bankruptcy and put into place a 363 sale process as a condition to the purchase of the assets.

XII. FRANCHISEE CONCERNS

This paper has discussed at length the franchisor’s rights regarding the franchisee’s assets, but what are the franchisee’s rights, or issues that should concern the franchisee? Franchise candidates willing to take the leap into owning their own business may be concerned about the possible effects on their family or themselves if the franchise is not successful. A franchisor that require a franchisee to sign a personal guarantee, essentially using the franchisee’s personal assets as collateral, should concern a franchise candidate. In that situation, if a franchisee wishes to protect certain personal assets, it can request the franchisor "carve-out" specific assets, and a franchisor may be willing to do so provided that the remaining assets are sufficient to address the franchisor’s concerns regarding financial stability.

A franchisee should also address the valuation method used if the assets are required to maintain a certain value. There are many valuation methods that can be used, and each can impact asset value. Franchisees may agree to the specific valuation method with the franchisor, or that the franchisor and franchisee must agree on the asset value or have the asset valued by a third party before triggering any of the franchisor’s options previously discussed. That being said, there is a downside to a fixed value of an asset because the value of the asset in the future may not be the same as its present value. Using the previous example of real estate value, a contract stipulating real estate valuation at a multiple of the original purchase price, might create a value higher than the market value of the real estate today. If the franchisee were to try to sell that real estate, the franchisee would not obtain the cash amount the franchisor originally projected.

65 Batenhorst discusses the case *Coast to Coast Stores v. Gruschus*, 667 P.2d 619 (Wash. 1983), in which the franchisor was entitled to repurchase inventory at fair market value. But, under the Uniform Commercial Code, inventory was required to be sold at a commercially reasonable sale. The court ruled the UCC safeguards were "a better basis for valuation than a hypothetical fair market price." Batenhorst, *supra* note 14 at p. 101-102.

XIII. CONCLUSION

Every financially distressed situation has its own unique facts and different parties with different priorities and motivations. A workout solution that may be perfect for one situation may be an absolute disaster for another. Reaching a favorable outcome is greatly enhanced by dealing with professionals and advisors who are aware of, and have experience with, different and varied solutions to financially challenging circumstances discussed in this paper. Having access to a diverse solution "toolbox" is a tried and true method for navigating through the significant potential advantages and disadvantages associated with either filing bankruptcy or pursuing a non-bankruptcy workout.
BIOGRAPHIES

JASON B. BINFORD

Jason Binford practices in the Insolvency, Bankruptcy & Creditor Rights Section of the Dallas-based law firm Kane Russell Coleman & Logan PC. His experience includes representation of debtors, official committees of unsecured creditors, and secured and unsecured creditors in large to mid-size Chapter 11 and Chapter 7 cases. He has significant familiarity and expertise in issues unique to vendor creditors and has developed several niche areas of experience including hospitality/franchise, agri-business, intellectual property, 363 sales, executory contracts and landlord/tenant issues. Jason is a frequent speaker and writer on cutting edge business bankruptcy topics. Jason has extensive experience in representations dealing with the complicated interaction between bankruptcy and other areas of the law, including intellectual property, franchise, and agri-business issues. He is an editor and contributor to the Franchise Law Journal. He has also published and spoken on the topic of statues protecting agricultural commodity producers and on issues unique to agricultural cooperatives whose members have filed bankruptcy. Jason has been selected by his peers for the Texas Super Lawyers list of Rising Stars published by Thomson Reuters (2011-2015), designation given to lawyers under 40 who are viewed by the colleagues as preeminent in their respective practice area. He is also actively involved in various legal and civil organizations in the Dallas/Fort Worth area.

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Robert F. Salkowski is a partner with the law firm of Zarco, Einhorn, Salkowski & Brito, P.A., located in Miami, Florida. Robert has practiced franchise, dealership and distribution law for over 20 years, and regularly represents franchisees, automobile dealers and hotel owners throughout the United States. Robert also frequently lectures about franchise and distribution matters, has authored numerous articles on these subjects in industry and legal publications, and has received a number of awards and recognitions from national publications, including The Best Lawyers in America for Franchise Law.

ANDRA J. TERRELL

Andra Terrell has been Assistant General Counsel for Luxottica Retail at their corporate headquarters in Mason, Ohio since May 2005. From August 1999 through May 2005 she was Assistant General Counsel for General Nutrition Centers, Inc., a Pittsburgh, Pennsylvania based franchisor of nutritional supplement retailers with over 4,200 locations worldwide. From September 1995 through March 1998 she was the General Counsel of Decorating Den Systems, Inc., an Easton, Maryland based franchisor of home decorating services with more than 500 franchises in the United States and Canada. From March 1998 through November 1988 she was Franchise Counsel for Precision Tune Auto Care, Inc., a Leesburg, Virginia based franchisor of auto care centers with 410 stores worldwide. She is a graduate of Johns Hopkins University (B.S. Natural Sciences and History of Science, 1992) and Howard University School of Law (J.D., 1995). Andra is a member of the Maryland Bar. Additionally, Andra is a member of the American Bar Association (Forum on Franchising), and has been active in the Corporate Counsel Steering Committee and Diversity Caucus, which recently appointed has as the Liaison to the Disabilities Rights Commission. Further, she is also a member of the International Franchise Association, and is serving her second term on the IFA Task Force.