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At a minimum, every Chapter 11 bankruptcy filing inconveniences the parties with whom the debtor conducts business. In the worst instances, bankruptcy signals the potential demise of the debtor. Despite the negative implications of a bankruptcy filing, bankruptcy is most often an opportunity for a troubled company to solve its operational or financial problems and emerge as a more viable company. Bankruptcy provides a useful business tool for a company to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure.

For example, bankruptcy may assist a franchisor in addressing the following challenging business issues:

- Overexpansion in the market and the need to eliminate units.
- An unworkable equity structure.
- Desire to sell or merge with another entity.
- Threat of franchisee litigation.
- Desire to refinance but the lender has expressed concern about financial or other issues.

The purpose of this presentation is to give an overview of a franchisor bankruptcy, focusing exclusively on Chapter 11, which embodies the reorganization provisions of the Bankruptcy Code. A general knowledge of bankruptcy, and its opportunities, benefits and risks will arm franchisors, franchisees and other interested parties with a repertoire of creative solutions to meet business challenges and attain the parties’ ultimate goals.

I. DARK CLOUDS GATHERING—WARNING SIGNS OF FINANCIAL DISTRESS

While franchisees may have few ways to protect themselves from some of the fallout of a franchisor bankruptcy, an alert creditor or vendor should be able to limit its exposure. Rumors about a company’s difficulties should not be ignored. For public reporting companies, quarterly and annual filings with the Securities and Exchange Commission should provide helpful financial information. The information to look for in the reports is the same information you would like to know about private companies. For example, when a public company has to report that it is uncertain that it can continue to operate as a going concern, bankruptcy is increasingly likely. As to non-reporting companies, one may be able to determine whether the company has defaulted under any of its primary lending arrangements. If so, has the company secured a waiver and what price has it had to pay for that waiver? If the company is being forced to pay a higher interest rate in return for the waiver, it may have simply substituted tomorrow’s problem for today’s. If the company has been required to hire financial advisors, odds are good that the company will need some sort of restructuring. On the other hand, the introduction of a financial advisor or the retention of a CEO with workout experience sufficiently early in the process may enable a company to avoid bankruptcy or, even if a bankruptcy is necessary, to be able to proceed through bankruptcy in an orderly manner.

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1 11 U.S.C §101 et seq. (the “Bankruptcy Code” or “Code”). References to provisions of the Code in this paper will be by citation to Code section number. Chapter 11 of the Code is codified in §§1101 to 1146. Chapter 7, encompassing Code §§701-728, provides for the liquidation of an individual’s or enterprise’s assets and is omitted from the discussion in this paper. It is noted that several provisions of the Bankruptcy Code have been revised pursuant to the Consumer Abuse Protection Act passed in April 2005 and effective October 2005 (referred to as the “Bankruptcy Reform Act.”).
Since the primary revenue source for most franchisors derives from its franchisees, the interested observer should consider how the franchisees in the system are faring. Are franchisees closing at an accelerated rate? Are same store sales declining? Have new concepts been introduced to boost sales? If so, have they been successful? If sales are declining and new products have not been introduced, how is the franchisee going to improve sales? Is there a decline in advertising of the brand? If franchisees are experiencing declining revenues, so is the franchisor.

In addition, a franchisor that has guaranteed certain obligations of franchisees for lease obligations or equipment purchases will lose not only that franchisee’s royalties if a franchise unit closes but may also find itself forced to pay on previously contingent liabilities. This can further exacerbate any cash constraints.

Increased franchisee litigation against the franchisor is another indicator of systemic problems. Pending litigation is reported in the franchisor’s Uniform Franchise Offering Circular. Franchisees are more likely to believe they have claims against the franchisor for breach of the franchise agreement, breach of a duty of good faith and fair dealing, negligent or intentional misrepresentations and the like if their stores are unable to pay for themselves. Even if such claims are meritless, the cost of defending such claims places an additional strain on financial resources.

II. THE PRICE TO PLAY—BANKRUPTCY IS A COSTLY PROCESS

Chapter 11 bankruptcy reorganization cases can be filed to effectuate a well-planned sale of an enterprise or a pre-negotiated restructuring of its debt. More often however, Chapter 11 bankruptcies are filed by companies who have tried to ignore the real severity of their financial difficulties until a precipitating event makes it clear that Chapter 11 is the only alternative to going dark. Potential precipitating events are extensive. If a franchisor has exhausted its borrowing capacity and is losing money, the specter that it will be unable to meet payroll generally provides a wake up call on the severity of its financial difficulties. A successful litigant in a position to execute on a judgment raises a similar risk of an inability to meet critical expenses. If a franchisor’s suppliers and distributors are not protected by deposits, they may threaten to stop stocking and distributing proprietary or perishable goods unless the franchisor provides a sufficient deposit to protect them against the loss they will experience if the enterprise fails. Unfortunately, by the time many companies acknowledge that they desperately need a restructuring, they may have limited their reorganization possibilities by having depleted their financial resources to a level where recovery is difficult. In one of the cruel ironies of bankruptcy, it takes a fair amount of money to be a Chapter 11 debtor.

Having been around this block before, bankruptcy lawyers and financial advisors will generally require retainers as a condition to assisting the debtor. Professionals in the business

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2 Please note that troubled companies often have large outstanding payables to their attorneys. One can only assume that this is because lawyers are not as good at managing their receivables as other service providers. Do not wait until you have successfully defended the client to require them to become current. Require payment while they still need you as much as the next creditor.
of working with debtors can generally assess the risk that a debtor will be unable to pay them. If that risk is high, they are unlikely to be willing to represent the company without a retainer equal to a significant percentage of their projected fees and expenses. Moreover, the debtor’s lead bankruptcy counsel and financial advisors cannot be creditors of the estate on the filing date. In addition to bankruptcy counsel, a franchisor will require continued assistance from many of its existing counsel and advisors. Franchise counsel and franchise consultants can serve key roles in the reorganization. Larger franchisors may also need a service to assist in the preparation of the bankruptcy schedules and to keep track of proofs of claims. All of these professionals will also want retainers, particularly if most of the franchisor’s assets are pledged to lenders or others. Although the debtor will not be required to provide retainers to other parties’ counsel, the debtor will also be responsible for paying the creditors’ committee counsel and financial advisors as well as the lawyers and advisors for any oversecured creditors after the case is filed.

As mentioned above, food and proprietary goods suppliers and distributors may require deposits to offset their risk of being left with product that cannot easily be sold to purchasers outside the franchisor’s system.

A. Claims and Expenses that Must be Paid in Bankruptcy

Once a company files bankruptcy, the debtor will be required to pay substantially all claims that arise after the bankruptcy filing. The Bankruptcy Code grants a first priority among unsecured claims to claims for “the actual, necessary costs and expenses of preserving the estate.” This group includes post-petition obligations to vendors, employees, professionals, and taxing authorities. Post-petition claims entitled to first priority treatment are commonly called administrative priority claims. If a debtor becomes unable to pay administrative priority claims, the bankruptcy estate may be deemed to be administratively insolvent, which is grounds for the court to convert a Chapter 11 bankruptcy case to a Chapter 7 liquidating case.

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3 With the court’s approval, the debtor “may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional person.” 11 U.S.C. § 327(a). A prerequisite to such employment is that the professional persons “do not hold or represent an interest that is adverse to the estate and that are disinterested persons.” 11 U.S.C. § 327(a). A creditor is not “disinterested.” 11 U.S.C. §101(14)(a).

4 Where the debtor has “regularly employed attorneys, accountants, or other professional persons” prior to filing bankruptcy, the debtor may continue to employ such persons in bankruptcy if doing so is necessary to the operation of the debtor’s business. 11 U.S.C. § 327(b). These professionals can be employed for a special purpose even if they are not disinterested. 11 U.S.C. §327(e).

5 Suppliers and distributors may not require deposits for post-petition transactions if they are contractually obligated to perform under a prepetition contract. See 11 U.S.C. § 549(a). Such deposits would constitute postpetition transfers that are subject to the avoidance powers of the trustee, and therefore, the debtor. See 11 U.S.C.§ 549(a).


7 See e.g., 11 U.S.C. § 503(b).

The United States Trustee ("UST") has the responsibility, pursuant to 28 U.S.C. § 586, of supervising the administration of bankruptcy cases. To fulfill this responsibility, the UST has established the Guidelines for Debtors-in-Possession (the “Guidelines”), which impose certain administrative and reporting requirements on Chapter 11 debtors. Among the various responsibilities created by the Guidelines, a debtor is now required to: (i) maintain insurance and make all premium payments thereon when due; (ii) prepare an initial report that includes substantial information regarding the debtor’s business; (iii) prepare and file monthly reports on their operations; and (iv) comply with the rules established by the Bankruptcy Code on who the debtor must pay and who the debtor cannot pay. The debtor must also pay a quarterly fee to the UST’s office to offset the cost to the government of monitoring Chapter 11 cases.

Lessors of non-residential real property (i.e., commercial real estate) must be paid. As discussed more fully on below, lessors of non-residential real property have a number of special rights in bankruptcy which are designed to balance the limitations on a lessor’s damages for rejection of a real property lease.

11 See Guidelines for Debtors-In-Possession, United States Trustees Program, Region 7, available at http://www.usdoj.gov/ust/r07/sanantonio/Guidelines.htm. Other provisions of the Guidelines for Debtors-in-Possession include: (1) general bankruptcy requirements; (2) information regarding bank accounts; (3) lists of creditors, schedules and statement of affairs; (4) initial reports; (5) creditors meetings; (6) operating reports; (7) quarterly fees payable to the Trustee; (8) other regulatory agency reporting; (9) notice requirements on the Trustee; and (10) effect of non-compliance. Id.
14 Section 365(d)(3) was added to address specific problems encountered by lessors of real property. Congress added § 365(d)(3) in order to ease the burden on nonresidential lessors caused by the loss of rental income during the post-filing but pre-rejection period by creating an administrative expense claim governed exclusively by the terms of the lease. In describing the effects of the Amendment, the legislative history provides: [When the trustee has stopped making payments due under the lease] the landlord is forced to provide current services – the use of its property, utilities, security, and other services – without current payment. No other creditor is put in this position. . . . The bill will lessen these problems by requiring the trustee to perform all of the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance will insure that the debtor-tenants pay their rent, common area, and other charges on time pending the trustee’s assumption or rejection of the lease.

In re Amber’s Stores, Inc., 193 B.R. 819, 821-22 (emphasis added). Judge Brozman in In re Wingspread Corp. remarked:

In the legislative history to the 1984 amendments it was recognized that a problem existed during the time the debtor vacated space but had not yet determined whether to assume or reject the lease, because generally the trustee stopped paying rent while the landlord was forced to provide current services. "No other creditor is put in this position. . . . The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance requirement will insure that
Equipment lessors do not need to be paid during the first sixty (60) days following commencement of the case. This provision is designed to give a debtor time to evaluate whether it wants to retain leased equipment or to reject the lease and return the equipment to the lessor, while mandating the performance of the debtor’s duties under unexpired leases beginning sixty days after the filing of the bankruptcy petition. However, the debtor must pay equipment lessors for payments due after the first sixty days following commencement of the case and the lessor can seek payment of the amounts due during the first sixty days if it can show that use of the equipment was an actual, necessary cost of preserving the estate. The Bankruptcy Code does not create a presumption that a debtor benefits from equipment simply because the equipment is in its possession.

A debtor must make payments to parties to ongoing contracts to the extent that the debtor continues to accept the benefits of those contracts. For example, if the debtor has a pre-petition contract with a disposal service to empty its dumpsters, it must continue to pay that service until it rejects or terminates the contract. If the debtor fails to pay, the creditor can file a motion requesting that the debtor be compelled to assume or reject the contract on the grounds that the debtor is not performing its obligations or adequately protecting the non-debtor party’s interests.

As discussed below, a debtor often is required to make partial payments to secured creditors during a case to adequately protect the secured creditor’s interest in its collateral.

The general rule of bankruptcy requires the debtor to pay the claims of post-petition creditors and precludes the debtor from paying pre-petition unsecured creditors. As noted

debtor-tenants pay their rent, common area, and other charges on time pending the trustee’s assumption or rejection of the lease."


See United Sav. Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 369-70 (1988) (citing §§ 361 and 362, which require that adequate protection be given to creditors to compensate them for the continued benefit to the estate of their prepetition contracts with the debtor).

See All Trac Transp., Inc. v. Transp. Alliance Bank (In re All Trac Transp., Inc.), 306 B.R. 859, 876 (Bankr. N.D. Tex. 2004) (where the court held that “[o]utside of a Chapter 11 plan of reorganization confirmed by the bankruptcy court, the Bankruptcy Code does not provide for the pre-plan payment of pre-petition unsecured debt.”) (citing Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003); see also Official Comm. of Equity Sec.
above, the rules are somewhat altered when an executory contract or unexpired lease governs the parties’ relationship.

Debtors often file a motion or motions on the first day of a case asking the court for permission to pay certain pre-petition creditors. These creditors usually include employees and those who are denominated critical vendors. A debtor will typically ask for the authority to continue and honor all pre-petition employee benefits and to pay employees for any unpaid wages earned in the pre-petition period. Unless a debtor’s situation is beyond being saved, this request will typically be granted. More controversial are requests to pay critical vendors. A critical vendor should be a vendor who is (i) a single source provider (ii) of a good or service vital to the debtor’s future operation (iii) who is not contractually bound to provide those services. A critical vendor may also be a vendor who is materially cheaper than alternative

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Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (holding that “[t]he Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved.”). 

21 Numerous courts use their equitable powers, pursuant to § 105(a) of the Bankruptcy Code, to authorize payment of a debtor’s prepetition obligations where such payments are necessary to effectuate the purpose of a Chapter 11 reorganization (i.e., to prevent liquidation of the debtor entity and to preserve the debtor’s potential for rehabilitation). See e.g., Comdisco, Inc., Case No. 01-24795 (RB) (Bankr. N.D. Ill. July 17, 2001); In re UNR Indus., Inc., 143 B.R. 506, 519-20 (Bankr. N.D. Ill. 1992) rev’d on other grounds, In re UNR Indus., Inc., 173 B.R. 149, 158-59 (Bankr. N.D. Ill. 1994); In re Lehigh & N.E. Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981); In re Ionosphere Clubs, Inc., 98 B.R. 174, 176-77 (Bankr. S.D.N.Y. 1989) (citing NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984)). Courts use their equitable powers under either the “Doctrine of Necessity” or the “Necessity of Payment Rule”, both of which were articulated by the Supreme Court in Miltenberger v. Logansprot, C & S.W.R. Co., 106 U.S. 286 (1882). Cf. In re Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004) (where the court held that “[e]ven if § 365(b)(1) allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors.”).


24 See In re Chateaugay Corp., 80 B.R. 279, 281 (S.D.N.Y. 1981); In re Quality Interiors, Inc., 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991) (“This court often permits the payment of prepetition wages so that the debtor in possession may maintain an effective workforce.”); In re Ionosphere Clubs, Inc., 98 B.R. 174, 175-76 (Bankr. S.D.N.Y. 1989) (authorizing the debtor to pay certain prepetition wage claims). Wages up to $4,925 earned by an employee in the 90 days preceding the bankruptcy are entitled to priority treatment and this forms a ground for authorizing their payment. See 11 U.S.C. §§507(a)(3) and (a)(4).


“The debtor must show three elements are present. First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor’s going concern value, which is disproportionate to the amount of the claimant’s prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.”
vendors. The debtor argues that the vendor is so important to its operations that it cannot risk the vendor refusing to provide future services on the grounds that the debtor did not pay the vendor’s prepetition claim. Therefore, the argument goes, the debtor should be allowed to pay the vendor despite the general prohibition on paying pre-petition unsecured creditors. While certain vendors may indeed be critical to a debtor’s operation, the payment of any large amount to critical vendors creates another financial burden on the debtor at the outset of the case. The less liquidity the debtor enjoys on the filing date, the more the debtor may need to risk a temporary business disruption resulting from nonpayment of a “critical vendor” to preserve funds for post-petition operations.

Requests for authority to pay critical vendors are controversial since they favor one group of prepetition creditors over other similarly situated creditors. Creditors may seek to limit or condition the debtor’s right to pay critical vendors. For example, they may negotiate for a cap on the amount payable to critical vendors. Other agreements require the creditor being paid to agree to conduct business with the debtor on the same or better terms than those offered in the pre-petition period. Obviously, interested parties do not want the debtor to experience business interruptions because of a failure to pay critical vendors. On the other hand, they want assurances that the vendors being paid are truly critical vendors.


26 See In re Lehigh & New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981) (stating that payment of prepetition claims may be authorized by the court where there “is the possibility that the creditor will employ an immediate economic sanction, failing such payment.”); In re Penn Central Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972 (allowing the “immediate payment of claims of creditors where those creditors will not supply services or materials essential to the conduct of the business until their pre-reorganization claims have been paid.”)); In re Just for Feet, Inc., 242 B.R. 821, 826 (D. Del. 1999) (where the payment of certain trade creditors’ prepetition claims was necessary to the survival of the debtors during the Chapter 11 reorganization); In re Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (finding that the failure to pay trade creditors would lead to a loss of competitive position in an intensely competitive environment); see also In re Gulf Air, Inc. 112 B.R. 152, 154 (Bankr. W.D. La. 1989) (concluding that “retention of skills, organization, and reputation for performance must be considered valuable assets contributing to going concern value and aiding rehabilitation”).


28 See In re Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004) (holding that “preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors.”); In re FCX, Inc., 60 B.R. 405, 410 (E.D.N.C. 1986) (holding that the prepetition claims of prepetition payroll expenses would improperly subordinate the claims of remaining creditors); In re Coserv, L.L.C., 273 B.R. 487, 495 (Bankr. N.D. Tex. 2002) (citing cases that refused to allow the payment of prepetition claims to “critical” vendors because of inequitable treatment of other creditors by allowing such payments) (citing In re Timberhouse Post & Beam, Ltd., 196 B.R. 547, 550-51 (Bankr. D. Mont. 1996); Chiasson v. J. Louis Matheme & Assoc. (In re Oxford Mgmt., Inc.) 4 F.3d 1329, 1333-34 (5th Cir. 1993)).

29 See In re Just for Feet, Inc., 242 B.R. 821, 826 (D. Del. 1999) (authorizing the debtors to pay prepetition claims of critical vendors in exchange for the vendors’ written agreement to extend credit to the debtors on similar or better terms that the debtors enjoyed in the past).
B. Restrictions on a Debtor’s Use of Cash Collateral Impact its Ability to Pay Administrative Claims

Section 363 of the Bankruptcy Code defines the rights and powers of the debtor with respect to the use, sale or lease of property of the estate.\(^{30}\) The Bankruptcy Code limits the debtor’s rights in a manner designed to balance the interests of non-debtor parties with an interest in property owned or used by the debtor against the debtor’s needs and interests.\(^{31}\) While a debtor is given the right to use, sell or lease property in the ordinary course of its business without court authority, a party with an interest in the property used, sold or leased by the debtor may request that the court condition such use “as is necessary to provide adequate protection of such interest.”\(^{32}\)

In contrast to the debtor’s broad authorization to use property in the ordinary course of its business, the Bankruptcy Code prohibits the debtor from using property that is cash collateral without obtaining either (i) the lender’s consent, or (ii) court authority.\(^{33}\) Cash collateral is the cash proceeds of pledged property.\(^{34}\) For example, if a franchisor has pledged its franchise agreements or licensing agreements to a creditor, the franchisor may not use the royalties or licensing fees that it receives as cash without the creditor’s consent or a court order. The court will grant the debtor’s request to use cash collateral over the lender’s objection only if the debtor adequately protects the lender’s interest in cash collateral. Adequate protection must protect the lender from a decline in the value of its collateral during the case.\(^{35}\)

The value of a lien in franchise agreements or licensing agreements depends on the continuation of the franchise system. The prudent lender will have a lien in all the rights

\(^{32}\) 11 U.S.C. § 363(e). See e.g. In re Cafeteria Operators, L.P., 299 B.R. 400, 410 (Bankr. N.D. Tex. 2003) (providing an example of the adequate protection required by Section 363(e)); In re LNC Invvs., Inc. v. First Fid. Bank, N.A. New Jersey, 173 F.3d 454, 458 (2d Cir. 1999) (section 363(e) “requires a bankruptcy court to prohibit or condition a bankrupt party’s use, sale or lease of property serving as collateral if such action is ‘necessary to provide adequate protection’ of the creditor’s interest in the collateral.”); In re Big Rivers Elec. Corp., 284 B.R. 580, 587 n.8 (W.D. Ky. 2002) (“A debtor may not use cash collateral without either the other entity’s consent or court authorization after notice and hearing . . . conditioned on provision of adequate protection to that entity if it requests it”); In re UAL Corp., 297 B.R. 710, 715 n.3 (Bankr. N.D. Ill. 2003) (noting that a debtor’s use of cash collateral is contingent upon the provision of adequate protection to any lienholder with an interest in the collateral); In re Mach., Inc., 287 B.R. 755, 766 (Bankr. E.D. Mo. 2002) (“the primary function of providing a secured creditor with adequate protection in a cash collateral order . . . is to protect the secured creditor’s interest in the cash collateral when the debtor consumes the cash.”) (citations omitted); In re JKJ Chevrolet, Inc., 190 B.R. 542, 544 (Bankr. E.D. Va. 1995) (“the use of cash collateral . . . requires . . . adequate protection.”).
\(^{33}\) See 11 U.S.C. § 363(c)(2).
\(^{34}\) See 11 U.S.C. § 363(a).
\(^{35}\) See 11 U.S.C. § 361; United Sav. Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 370 (1988) (“It is common ground that . . . [an] interest in property . . . is not adequately protected if the security is depreciating during the term of the stay.”); LNC Invvs., Inc. v. First Fid. Bank, 247 B.R. 38, 45 (S.D.N.Y. 2000) (discussing the manners in which adequate protection may be provided to a secured creditor); In re Suncruz Casinos, LLC, 298 B.R. 833, 844 (Bankr. S.D. Fla. 2003) (“Adequate protection payments are intended, first and foremost, to protect against, and compensate for, a decrease in the value of a creditor’s collateral.”)
necessary to operate the franchise system so that it has the ability to foreclose its liens and operate the system. Of course, the lender would greatly prefer that the franchisor debtor successfully reorganize its business or sell it so that the lender can be repaid without undertaking operation of the franchise. As a result, the creditor should be more likely to consent to the debtor’s use of cash collateral, under the right conditions, than a lender whose collateral is easier to liquidate.

Because Section 552 of the Bankruptcy Code cuts off certain prepetition liens, a debtor’s adequate protection of a lender’s interest in cash collateral frequently includes granting the lender a replacement lien in post-petition collateral of the same types as the lender’s prepetition collateral. If the debtor has unencumbered assets, the lender will request a pledge of that property. The debtor will not agree unless the lender limits its lien so that it does not secure the lender’s entire debt but secures only a diminution in the value of the lender’s original collateral after the petition date. In other words, if the lender’s collateral on the petition date is worth $10 million and the value declines during the bankruptcy case to $8 million, the lender’s lien in the previously unencumbered property would attach to the extent of the $2 million diminution in the value of the collateral.

By statute, a failure of adequate protection gives the secured party a superpriority administrative claim equal to the diminution in value of the secured party’s collateral during the case. For the lender with a blanket lien in all the debtor’s assets, this is fairly meaningless, but for all other secured parties, it is a very important right. In bankruptcy, secured creditors have a right to be paid the value of their collateral as of the petition date. To the extent that the value of the collateral exceeds the lender’s debt, the lender is entitled to post-petition interest and

37 See 11 U.S.C. §§ 361(2), 363 and 364(c)(2); In re Cafeteria Operators, L.P., 299 B.R. 400, 410 (Bankr. N.D. Tex. 2003) (where the court granted a replacement lien on the inventory purchased post-petition to protect the diminution in value of the creditor’s cash collateral); In re Dupell, 235 B.R. 783, 789 n.10 (Bankr. E.D. Pa. 1999) (“Adequate protection may . . . be provided by the creation of a replacement lien on other, unencumbered property.”) (citing In re Ahlers, 794 F.2d 388, 398 (8th Cir. 1986), rev’d on other grounds, 485 U.S. 197 (1988)).
38 See 11 U.S.C. § 364(c)(2); Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089, 1092-93 (2d Cir. 1991) (“Section 364 provides certain incentives that a debtor may offer, with court approval, to induce a potential lender to extend credit post-petition. These incentives include granting the lender . . . a lien on unencumbered estate assets under § 364(c)(2) or (3), on account of post-petition credit extended.”); In re Sun Healthcare Group, Inc., 245 B.R. 779, 781 (Bankr. D. Del. 2000) (where the lender was granted a lien on all unencumbered assets of the debtors, pursuant to § 364(c)(2), in exchange for its loan of up to $25 million); In re Southern Soya Corp., 251 B.R. 302, 306-7 (Bankr. D.S.C. 2000) (stating “that § 364 sets forth an ‘escalating series of inducements’ for those lenders willing to extend credit to debtors, including the granting of a lien on unencumbered assets of the estate.”).
39 See United Sav. Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.), 793 F.2d 1380, 1389 (5th Cir. 1986) (adequate protection is intended to protect secured creditors from a decrease in value of its collateral); Thomas Jefferson Const. Co., Inc. v. Martinez, 1997 WL 375880, *2 (E.D. La. 1997) (adequate protection provisions of the Bankruptcy Code were intended to protect a secured creditor against a decrease in value of its collateral); In re Legedmere Land Corp., 116 B.R. 338, 343 (Bankr. D. Mass. 1990) (creditor should receive adequate protection only where there is a decrease in value of the collateral).
attorneys’ fees until it is repaid. To the extent that the debtor has unencumbered property or equity in property over and above any secured claims, the claimants with the first priority right to payment are generally those with administrative expense claims (i.e., post petition vendors, post-petition taxes, professionals for the estates, etc.). However, a superpriority administrative claim is entitled to payment before administrative claimants. Thus, a superpriority administrative claim is the best kind of claim to hold, other than a fully secured claim.

Lenders with cash collateral often request a superpriority administrative claim for the full amount of their claim as part of the negotiations of a cash collateral order. If a debtor prevails in getting court authority to use cash collateral over the lender’s objection, the court will allow a superpriority administrative claim for diminution in the value of the collateral only.

Additional protections typically required by a lender with cash collateral include providing the lender with periodic financial reports as well as an opportunity to meet with management and review the financial reports. Financial covenants can also be required. The debtor’s right to use cash collateral is limited to amounts set forth in a budget approved by the lender. Slight variances are allowed without lender approval but beyond that, any changes in the budget must be approved by the lender or the court. The debtor must provide the lender with documentation comparing actual to budgeted payments. The budget must include all expenses necessary to maintain the collateral such as insurance and all post petition taxes.

Lenders always demand a finding in a cash collateral order that the lender’s liens are properly perfected, unavoidable and enforceable liens. Since the debtor must have use of cash collateral to survive in most cases, the debtor is not in a position to negotiate such a provision out of a cash collateral agreement/order. Since a cash collateral order is typically entered during the first few days of a case before a creditors’ committee has been formed and has had the opportunity to employ counsel and review the lender’s loan documentation, a court’s agreement to allow such a provision would be highly prejudicial to the interests of unsecured creditors. Not all loan documentation is done as it should have been done and bankruptcy provides the Chapter 11 debtor (in its role as trustee) with tools to set aside liens that have not been properly perfected. Thus, in many jurisdictions, the courts will not enter an interim cash collateral order that binds the debtor to admissions about the enforceability of the lender’s liens and will enter a final order with such provisions subject to the creditors’ committee’s right to challenge the liens within an identified period of time, typically between 60 and 120 days after the formation of the committee.

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45 See 11 U.S.C. § 507(b); Harvis Trien & Beck, P.C. v. Fed. Home Loan Mortgage Corp., 153 F.3d 61, 68 (2d Cir. 1998) (explaining that “[i]n essence, § 507(b) means that a secured creditor has superpriority for a claim in the amount that the debtor’s use of the collateral during the time of the stay diminished the value of the collateral, but only to the extent such diminution is in excess of the adequate protection received.”).
46 Id.
In summary, the Bankruptcy Code conditions the debtor’s use of cash collateral on the lender’s consent or a court order because of the unique characteristics of cash collateral. Cash collateral is liquid and could be used immediately to repay the creditor’s debt. On the other hand, once used, cash collateral is no longer available to satisfy the creditor’s claim. As a general bankruptcy principle, a secured creditor should not be prevented from foreclosing on its collateral if the collateral is declining in value during the case and the debtor has not prevented this decline by otherwise adequately protecting the creditor’s interest with replacement liens, other additional collateral or interim cash payments.

C. Providing Adequate Protection of Non-cash Collateral is an Additional Expense of the Case.

Although the debtor may use its secured creditors’ non-cash collateral without obtaining the creditor’s consent or a court order, all secured creditors are entitled to be protected against a decline in the value of their collateral during the case. A creditor may ask the court to condition the debtor’s use of collateral upon the granting of specific adequate protection or the creditor can ask the court to allow it to foreclose its collateral “for cause, including lack of adequate protection” of its interest in the collateral. Adequate protection of an interest in non-cash collateral could include providing proof of insurance on the property, properly maintaining the property, making periodic payments to offset any declines in value, or offering additional collateral to protect against a decline in value. If the property is declining in value but the property is worth more than the creditors’ claim, the debtor will assert that the creditor is protected by the equity cushion, the difference between the value of the property and the debt encumbering it. While this argument is successful in many instances, the debtor’s concession that the creditor is oversecured has a cost. Oversecured creditors are entitled to interest and attorneys fees allowed under the loan agreement. In contrast, creditors who are undercollateralized on the date of the bankruptcy filing, are not entitled to recover post-petition

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49 See LNC Invs., Inc. v. Nat’l Westminster Bank, N.J., 308 F.3d 169, 179 (2d Cir. 2002) (noting that an equity cushion can provide sufficient adequate protection for a creditor); Mendoza v. Temple-Inland Mortgage Corp., 111 F.3d 1264, 1272 (5th Cir. 1997) (holding that an equity cushion in excess of one thousand percent, which was far in excess of the 20% uniformly acceptable by courts, provided sufficient adequate protection of the creditor’s interest) (citing In re Kost, 102 B.R. 829, 831 (Bankr. D. Wyo. 1989)); Capital Communications Fed. Credit Union v. Boodrow, 126 F.3d 43, 53 (2d Cir. 1997) (“[I]n determining whether a creditor’s interest in a debtor’s property is adequately protected, ‘most courts engage in an analysis of the property’s “equity cushion.”’”) (citing Nantucket Investors Il v. California Fed. Bank (In re Indian Palms Assocs., Ltd.), 61 F.3d 197, 207 (3d Cir. 1995)); Pistole v. Mellor (In re Mellor), 734 F.2d 1396, 1400 (9th Cir. 1984) (“Although the existence of an equity cushion as a method of adequate protection is not specifically mentioned in § 361, it is the classic form of protection for a secured debt justifying the restraint of lien enforcement by a bankruptcy court.”) (citing In re Curtis, 9 B.R. 110, 112 (Bankr. E.D. Pa. 1981)). Cf. In re Shaw Indus., Inc., 300 B.R. 861, 865 (Bankr. W.D. Pa. 2003) (“Where an equity cushion is insufficient in size or likely to erode, it cannot, standing alone, constitute adequate protection.”) (citing In re Sharon Steel Corp., 159 B.R. 165, 169 (Bankr. W.D. Pa. 1993) (citing In re Liona Corp., 68 B.R. 761, 767 (Bankr. E.D. Pa. 1987))); In re King, 305 B.R. 152, 174 (Bankr. S.D.N.Y. 2004) (“Although an equity cushion may by itself provide adequate protection under certain circumstances, this is not so especially when the Debtor does not show a sincere desire to speedily effectuate a reorganization ... it would be a gross abuse of discretion to continue to protect debtor indefinitely just because he has equity in the properties.”) (citing In re Certified Mortgage Corp., 19 B.R. 369 (Bankr. M.D. Fla. 1982)).

interest or attorneys fees. The debtor’s obligation to pay the attorneys fees of the creditors who may be its strongest adversaries in the case can be particularly galling.

D. Management and Board Headaches

With all of the stress of managing the business, one more issue may seem earth shattering. But the issue of proper and legitimate corporate governance must be at the forefront. Under normal circumstances, corporate officers and directors can operate with a certain amount of freedom so long as they exercise good business judgment and act in the best interest of the corporation without self-dealing and with due care. The duty generally is to maximize value for the equity interests. But, there is a dramatic shift when the corporation reaches what is known as the “zone of insolvency.” The focus of officers and directors changes to a strict duty to creditors and extreme caution must ensue to avoid placing the company in further financial demise; or causing a “deepening insolvency.”

As a general matter, officers and directors owe three duties to the corporation: i) to be obedient, i.e. act within the powers granted by the corporate documents; ii) to be diligent, i.e. act in good faith and with the care an ordinary prudent person would use; and, iii) to be loyal, i.e. to avoid conflicts of interest and act with candor in the context of corporate transactions. And, for the most part, an officer or director is usually not liable for mistakes of honest business judgment when the director acts in good faith-- the so-called “business judgment rule.”

When the corporation is solvent, the directors have a fiduciary relationship to the corporation and its shareholders. Typically, this relationship does not extend to creditors absent fraud or the like. However, when the corporation is insolvent, the directors are deemed to be trustees for the corporation and its creditors. Thus, as the corporation becomes insolvent or is on the brink of insolvency, the duties of officers and directors shift from maximizing benefits for the shareholders to preserving the corporate assets as a trust fund for creditors. This fiduciary relationship arises when the corporation enters the zone of insolvency or becomes insolvent in fact. This becomes important as management must act in such a way to protect creditors.

In recent years, management duties have been scrutinized intensely in the bankruptcy arena as creditors struggle for recovery from any source in the wake of liquidating no-asset companies. A new theory has evolved in which officers and directors are sued for acting fraudulently, or even negligently, in prolonging the life of the company and increasing its debt and exposure to creditors. This cause of action is what is referred to as the tort of deepening

51 Wilshire Oil Co. of Tex. V. Riffe, 409 F.2d 1277 (10th Cir. 1969).
53 Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972).
54 See e.g. Aronsun v. Lewis, 473 A.2d 805 (Del. 1984).
insolvency.\textsuperscript{57} It is not a well-defined area; some courts have refuted it and others have expanded it to include accountants, investment brokers and lawyers.\textsuperscript{58} What is important is that management is aware of its duties and responsibilities. The possible consequences become critical as a financially-troubled franchisor moves into the zone of insolvency and constantly must weigh its alternatives. For example, should the franchisor continue with expansion and the sale of new franchises or allow the transfer of existing franchises?. Should the franchisor enter into new or extended financing arrangements which leverage the company further?. Decisions should be made carefully and reasoned and management should be realistic as to its assessment of filing a bankruptcy proceeding.

III. PLOP, PLOP, FIZZ, FIZZ . . . THE CASE FILES!

Once the determination is made that Chapter 11 is the best alternative, the preparation for filing becomes key. The goal is to cause the least amount of disruption to the debtor's business operations as possible as creditors, vendors, and other stakeholders are learning of the bankruptcy and scrambling for position. The filing, which automatically stays creditor actions against the debtor, provides a certain amount of relief in that management finally has breathing room to stop dealing with financial problems on a piece-meal basis and can work on an overall reorganization plan. Still, the first 30-60 days of the case create somewhat of a frenzy merely because of the myriad number of bankruptcy requirements which generate substantial stress.

A. First-day Motions

The bankruptcy petition filing date is a bright-line demarcation. Everything prior to the filing date is referred to as “pre-petition” and after as “post-petition.” This is important because generally, no payments can be made to pre-petition creditors including employees, pre-petition bank accounts must be closed and funds generated by receivables subject to a secured creditor's pre-petition lien cannot be spent without the creditor's consent or court approval. While post-petition operations can continue, these restrictions can be stifling. Thus, a series of motions are created and filed requesting the bankruptcy court to approve certain continued business practices and payments irrespective of the general constrictions. Since these requests are typically emergency in nature, i.e. meeting payroll, they are usually heard the first or second day of the case, hence referred to as “First-day Motions.”

Because first-day motions are heard by the court on an emergency basis, usually one or two days after filing, there has been little time to provide proper notice to all creditors and interested parties. The debtor will attempt to provide notice at least to its lenders, its twenty largest unsecured creditors, specific affected parties (such as utility companies) and the UST for the district where the case is filed. The UST will usually appear at the first-day hearing and essentially represent the interests of creditors until they have a chance to appear and be heard.


or until a committee of creditors is formed. Again, because of the emergency nature of the relief sought, the bankruptcy court will usually only grant the motions on an interim basis and give creditors additional time to object.

1. **Cash Collateral**

As explained previously, once the case is filed the debtor is restricted from spending cash collateral unless the lender consents or the court permits such use after notice and a hearing. In the absence of an agreement with the lender, the debtor must file a motion seeking authority to use cash collateral. Typically, the debtor will include a budget and will describe the means by which it intends to “adequately protect” the lender. Courts are reticent to deny the use of cash collateral which would effectively shut down the debtor’s operation. Instead, they usually will grant at least on an interim basis, the authority for the debtor to pay necessary expenses in the ordinary course so that business can continue uninterrupted.

From a practical standpoint, it is rare in a large case that the debtor and its lender will not have reached some agreement as to the use of cash collateral by the time the case actually files. In most instances, however, in exchange for granting use, the lender has extracted a number of agreements from the debtor, such as an agreement that the lender’s liens are valid and perfected; that the debtor cannot seek a surcharge; that the debtor’s payment to professionals are capped; and that avoidance actions are subject to the lender’s lien. This stipulation between lender and debtor requires court approval, since the debtor is giving up many of its rights to the possible detriment of other creditors.

2. **Debtor-in-possession Financing**

In many instances, the debtor will have obtained financing for its continued operations and specifically to fund the cost of the bankruptcy. The lender will likely insist that the financing be implemented post-petition which requires court approval. The benefit to the lender is that it may have the opportunity to obtain additional collateral or validate its pre-petition liens all of which is “blessed” by the court. If these actions were taken pre-petition, the risk is that they would be set aside in a subsequent bankruptcy filing.

In exchange for providing the financing, the lender will require a number of promises from the debtor much as described above in the section on cash collateral, i.e. liens are valid,

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59 See infra.

60 The debtor is permitted to recover from property securing an allowed secured claim the reasonable and necessary costs and expenses of preserving, or disposing of, such property to the extent it benefits the secured claim. See 11 U.S.C. § 506(c). This is known as a “surcharge” against the collateral.

61 The Bankruptcy Code enables a debtor to recover monies paid or assets transferred prior to the bankruptcy. These include so-called “preference” payments which are made to creditors outside of the ordinary course of business within 90 days of the bankruptcy filing (11 U.S.C. § 547) and assets which were conveyed without due consideration, a so-called “fraudulent transfer” (11 U.S.C. § 548). Collectively, the actions to recover monies or property are known as “avoidance actions” and they are assets of the estate.
use of funds is limited and so forth. The debtor financing requires court approval. If the court approves the financing at the first-day hearing, even if only on an interim basis, it will typically allow the lender to provide funding and will grant it security and other protections for the amount actually loaned.

3. **Pre-Petition Wages and Other Employee Benefits**

Since the debtor is restricted from paying pre-petition debts, employees become creditors for the amount of wages and other benefits which remain due at the time of filing. It is essentially a timing issue in that even on the day payroll is paid, employees have accrued time for the subsequent pay period. Despite the technical requirement that these pre-petition creditors should not be paid, courts recognize the extreme hardship this causes to employees who simply cannot afford to miss a paycheck. There is no provision in the Bankruptcy Code which allows these payments, but it is justified on the basis that ultimately, in a plan or a liquidation wages would be entitled to a priority claim up to $10,000 which would be paid before general unsecured creditors.

The first-day motion will typically seek authority to pay not only the payroll but also all related charges, such as withholding taxes. The debtor will also seek to pay monies related to employee benefits, such as insurance, cafeteria plans, and the like. The goal is to maintain to the greatest extent possible the status quo as it pertains to employees in order to maintain ongoing operations. Obviously, an exodus of employees or a decline in morale would have a detrimental impact on the business and possible reorganization.

4. **Utilities**

The Bankruptcy Reform Act has made significant changes with respect to utilities. A utility cannot discontinue service on the basis of the commencement of a bankruptcy case or a past due debt; however, it may do so unless the debtor, within 20 days of the filing furnishes adequate assurance of payment. In the past, debtors would seek as part of their first day motions, court approval of the form of adequate assurance which might include the granting of an administrative expense claim, the fact that the utility currently holds a security deposit and the fact that payments were timely. The Reform Act expressly prohibits these considerations.

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62 The debtor may obtain unsecured credit and incur unsecured debt in the ordinary course of business which is allowable as an administrative expense. Court approval is required, however, for the debtor to obtain unsecured credit outside the ordinary course of business allowed as an administrative expense or to obtain debt secured by assets of the estate. If the debtor is obtaining secured debt, it may grant an administrative expense claim which has priority over other administrative expenses, a lien on unencumbered property, and/or a junior lien. If the debtor attempts to grant a lien which will be senior to an existing lien it must show it is unable to obtain such credit otherwise and that the existing lienholder will be adequately protected. 11 U.S.C. § 364.


65 11 U.S.C. § 366(c)(1)(B) and (3)(B).
Therefore, the debtor’s first day motions with respect to utilities may reflect more negotiation with its utility creditors and/or a creative approach to providing adequate assurance.

5. **Continuation of Cash Management Systems**

As discussed previously, the UST Guidelines require that the debtor close all of its bank accounts and open new ones with the designation “Debtor-in-possession.” The required accounts include general, payroll and tax accounts. In the case of a large franchisor with multiple accounts and an intricate system of deposits and payments, one can imagine the havoc if this requirement was enforced. Thus, the debtor will seek as part of its first-day motions the ability to maintain its cash systems in place. The UST may require certain controls and reporting. The goal, again is to try to maintain the transition into bankruptcy as seamless as possible.

6. **Honoring Coupon and Gift Certificate Obligations**

From a technical standpoint, a customer who holds a coupon or gift certificate for the debtor’s merchandise is a general unsecured creditor because the debtor is indebted to the customer. Certainly, a failure to honor these obligations would have a devastating affect on customer relations. The debtor will seek authority to honor coupons and gift certificates to avoid these negative consequences.

7. **Payment of Pre-Petition Creditors**

Debtors often have what are often referred to as “critical vendors.” These are trade vendors which supply the debtor with goods or services, the absence of which would severely hinder business operations. After filing, unless the vendor has an actual contract with the debtor, there is no requirement that the vendor continue supplying the debtor. If the vendor is owed money at the time of filing, it may decide to terminate its relationship with the debtor. In order to ameliorate this result, a debtor may seek to pay its critical vendors to ensure they will continue to do business with it. This kind of relief is highly scrutinized because the debtor is thus seeking payment of some unsecured creditors but not others.\(^66\)

8. **Reclamation**

To the extent that a party has sold goods in the ordinary course of its business to the debtor pre-bankruptcy, it may have rights to reclaim the goods if the debtor received the goods

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\(^66\) See *In re KMart Corp.*, 359 F.3d 866, 874 (7th Cir. 2004). The suggestion has been made that with the expansion in the time for reclaiming creditors to exercise their rights (increase from 10 to 45 days), the need for approval of critical vendor payments may be justified.
while insolvent and the reclaiming creditor makes a written demand for reclamation. The reclaiming creditor will be entitled to an administrative expense claim and so for purposes of first-day motions, the debtor will typically ask that such a claim be granted in lieu of returning the goods.

9. Approval of Professionals

All of the debtor’s professionals must be approved by the court and these applications are usually presented as part of the first-day motions. Included are attorneys, financial consultants, appraisers, and investment bankers. Professionals must seek court approval of all fees and costs. The Bankruptcy Code permits fee applications every 120 days; however courts generally will allow professionals in a large case to seek interim compensation on a monthly basis.

B. Management

As a general rule, pre-petition management will remain in control of the debtor and will continue to make day-to-day business decisions. The chief executive officer is typically the designated representative to appear on behalf of the company which is now known as a Debtor-in-Possession or “DIP.” Operations may continue in the ordinary course; that is, inventory can be purchased, products can be sold, employees can be hired and fired. In some instances, the company may have hired a so-called “turn-around” firm either on its own volition or at the insistence of a lender. The continued employment of these managers may have to be approved by the court.

For the most part, compensation of management may continue at the pre-petition level. Only an extraordinary increase in salary immediately prior to filing might draw the scrutiny of creditors and the court. Officers, managers and consultants hired post-bankruptcy must also be paid in the ordinary course of business justified by the facts and circumstances of the case.

In the past, many debtors would seek court approval of various types of severance and retention packages for upper-level management, arguing that such compensation was necessary in order to persuade management to stay with the company through the precarious bankruptcy proceeding. However, the Bankruptcy Reform Act has placed significant limitations on such retention and severance payments. Now, in order to justify a retention bonus to an insider, generally an officer or director, the court must find that the bonus is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation, that the services to be provided are essential to the

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67 11 U.S.C. § 546(c). Certain timing changes were made in the Bankruptcy Reform Act. In addition, reclaiming creditors will be entitled to an administrative claim under 11 U.S.C. § 503(b)(9) even if written notice was not given and this may obviate the need to include reclamation issues as part of the first-day motions.


69 See e.g. 11 U.S.C. § 327.

survival of the debtor’s business, and the amount does not exceed a specific dollar formula based on payments to non-managers or previous payments to insiders. 71 Severance payments to insiders are prohibited unless the payment is part of a program that is generally applicable to all full-time employees and the amount is not greater than 10 times the amount of the mean severance pay given to non-managers during the year in which the payment is made. 72

The bankruptcy does impose additional burdens on management in terms of preparing for and attending hearings and preparing the financial reports and schedules required by the bankruptcy court and the UST. 73 And, bankruptcy is often referred to as a “fish bowl.” Any creditor has the ability to seek financial information from the debtor and to depose management, all of which is time consuming and costly. 74 Although, the debtor can continue its normal business operations, actions which are considered outside the ordinary course require Bankruptcy Court approval. These include sales or purchases of any substantial asset, entering into long-term contracts or leases, and obtaining any type of financing except perhaps short term trade credit. 75

C. The Automatic Stay

One of the significant events triggered by the filing of the case is the immediate imposition of an injunction known as the “automatic stay.” 76 The automatic stay prevents creditors from proceeding with any action against the debtor such as a foreclosure, collections (including letters and phone calls), perfection of a lien, set-off, lawsuits and contract terminations (including notices of termination). 77 The policy behind the automatic stay is that the debtor should be entitled to some “breathing room” while assets are marshaled or while a reorganization plan is being developed. 78 Staying franchisee litigation or even collection actions by trade creditors can save enormous amounts of time and resources. Creditors who

73 The UST’s Office is a division of the Department of Justice and is charged essentially with monitoring Chapter 11 proceedings. The designated representative of the Debtor is required to meet with a representative of the UST, to provide various documents and reports, and to pay a quarterly fee to the UST’s Office based on disbursements.
74 Bankruptcy Rule 2004 allows broad discovery into the Debtor’s financial condition and history. It is often referred to a grant to creditors to engage in an unlimited “fishing expedition.”
78 In re Zinchak, 406 F.3d 214 (3rd Cir. 2005); In re Dawson, 390 F.3d 1139 (9th Cir. 2004); In re National Warranty Ins. Risk Retention Group, 384 F.3d 959 (8th Cir. 2004); In re Perviz, 302 B.R. 357 (Bankr. N.D. Ohio 2003); In re Keen, 301 B.R. 749 (Bankr. S.D.Fla. 2003); In re Seafarer Fiberglass Yachts, 1 C.B.C.2d 209 (Bankr. E.D.N.Y. 1979).
violate the automatic stay by proceeding against the interests of the debtor may be subject to monetary sanctions or other penalties.\textsuperscript{79}

Certain actions are not subject to the automatic stay such as certain governmental proceedings and tax audits and assessments.\textsuperscript{80} Additionally, the automatic stay does not prevent actions against third parties not in bankruptcy\textsuperscript{81}. Thus, for example, a lender can pursue a guarantor who has not filed bankruptcy even though the entity principally obligated on the debt has filed. In addition, the automatic stay does not prevent collection on a letter of credit or the attachment of a mechanics’ lien. A creditor whose action is stayed may file a motion asking the bankruptcy court to lift the stay to allow it to proceed with its remedies.\textsuperscript{82} Various grounds must be shown. For example, a creditor seeking to foreclose on property may be able to obtain relief from the stay by showing the property does not have equity or that it is declining in value and no payments are being made, or that the property is not useful to the debtor’s reorganization.\textsuperscript{83}

D. Working with Constituencies

It seems that the debtor is a lonely soul when the case is first filed. Hopefully, some support prior to filing has been obtained from certain lenders, a group of franchisees or a large unsecured creditor. But that is not always the case, and the debtor must seek its alliances post-filing. This is critical not only because of the disruption to business that the legal disputes can cause, but ultimately the debtor will have to have support of at least one class of creditors in order to obtain confirmation of its plan of reorganization.

1. Creditors’ Committees

Immediately after the case is filed, the UST for the district will solicit from the debtor’s list of twenty largest unsecured creditors persons to serve on a creditors’ committee.\textsuperscript{84} Depending on the responses, the UST will appoint typically three to seven members holding the largest claims, and this so-called “Official Committee” is charged with representing the interests of all unsecured creditors in the case.\textsuperscript{85} The bankruptcy court is usually not involved in this process; however upon request of a party, the court may order the UST to change the membership of a

\textsuperscript{79} Mann v. Chase Manhattan Mortg. Corp., 316 F.3d 1 (1st Cir. 2003); In re Uhrig, 306 B.R. 687 (Bankr.M.D.Fla. 2004); In re Perviz, 302 B.R. 357 (Bankr.N.D.Ohio. 2003); In re Keen, 301 B.R. 749 (Bankr.S.D.Fla. 2003); In re Zartun, 30 B.R.543 (Bankr. 9th Cir. 1983). In re Zartun, 30 B.R.543 (Bankr. 9th Cir. 1983).

\textsuperscript{80} 11 U.S.C. §362(b).

\textsuperscript{81} See In re Deist Forest Products, 850 F.2d 340 (7th Cir. 1988).

\textsuperscript{82} 11 U.S.C. § 362(d).

\textsuperscript{83} Id.

\textsuperscript{84} See generally 11 U.S.C. §§ 1102(a)(1) and (b)(1).

\textsuperscript{85} The UST may appoint the members of a committee organized by creditors before the commencement of the case if the committee was fairly chosen and is representative of the different kinds of claims to be represented. 11 U.S.C. § 1102(b)(1).
The Committee may hire professionals such as attorneys, accountants and appraisers. The fees and costs for professionals are an administrative expense of the debtor and must be paid by the debtor. Clearly, this alleviates the financial burden of a single creditor actively participating in a case. The Committee may investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business and may participate in the formulation of a plan. In the course of its investigation, the debtor may require Committee members to execute a confidentiality agreement since the debtor is often sharing sensitive financial information. The Committee is required to provide access to its information to other unsecured creditors who are not serving on the Committee and solicit and receive comments from those creditors.

The UST may also appoint additional committees of creditors or equity security holders as the UST “deems appropriate.” This is important in a franchisor bankruptcy if franchisees believe their interests are not adequately represented on the Committee. Because franchisees may not have an actual liquidated claim against the franchisor at the time of filing, they may not be included on the list of twenty largest creditors and may not be solicited to serve on the Committee. Yet, they have a large stake in the bankruptcy. Franchisees may urge the UST to appoint a separate committee or petition the court to allow the formation of a franchisee committee.

Committees typically wield a great deal of power in the case because they are viewed by the court as representing the “little guy.” They serve in somewhat of a “watch-dog” capacity to ensure the debtor and the secured creditors are acting appropriately and that the interests of all creditors are being protected with of course, the ultimate goal being the maximization of the estate and creditor recovery. The role of the Committee in this regard creates a certain amount of tension among the players, namely the debtor and its secured lenders who may have entered the bankruptcy arena with a certain strategy only to have it thwarted by an aggressive professional challenge.

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86 11 U.S.C. § 1102(4). This provision was added by the Bankruptcy Reform Act as a means for allowing participation by a smaller unsecured creditor which holds a claims disproportionately large to its own gross revenue.


88 In most cases, the cash which is generated by the debtor’s business is a secured lender’s cash collateral and subject to use only with the lender’s consent or court authority. Thus, a secured creditor may object to payment of fees for Committee professionals. From a practical standpoint however, most secured creditors will permit what is known as a “carve-out” to pay Committee professionals recognizing that support of this constituency will be important in the case. The lender will often place a cap the fees or refuse to allow payment for services incurred in bringing an action against the lender.


90 11 U.S.C. § 1102(b)(3). This provision was added by the Bankruptcy Reform Act so the practicality of providing the required information to unsecured creditors and soliciting their input has not been tested.


Committee. However, given the influence the Committee has on the outcome of the case, this is a faction to which the parties in the case would do well in paying due deference.

2. Appointment of a Trustee or Examiner

As previously discussed, upon filing a Chapter 11, the debtor entity remains in possession of its assets and has broad powers to operate its business. However, a party in interest may petition the court to appoint an independent trustee to take control of the debtor’s assets and business. The basis of the appointment is for “cause” which includes fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor, either before or after the commencement of the case, or that the appointment of the trustee is in the best interests of creditors. There is a presumption in favor of continuing the debtor-in-possession and thus, the moving party must show egregious behavior which would justify a Chapter 11 trustee displacing management. Nonetheless, courts have appointed trustees in less extraordinary circumstances such as where there are internal corporate disputes or conflicts of interest which are negatively impacting the business.

In the alternative, a party may seek the appointment of an examiner to investigate the debtor’s conduct, financial condition, assets, or business operations. This often provides a “middle ground” in that the debtor remains in possession and continues to operate the business, yet the creditors have a greater comfort level that an independent party is exploring any questionable transactions or conduct.

IV. FINDING NEVERLAND

A. Escaping or Embracing Agreements and Leases

The debtor has an extremely powerful tool in its ability to deal with its contracts. It may be able to assign its leases and other agreements (including the franchise agreement) to a third party irrespective of any non-assignment language in the contract. It may by able to reject (essentially terminate) leases and other agreements (including franchise agreements or undesirable real property leases) for which the non-debtor party may have little recourse. And, in certain circumstances, while the debtor is deciding to assume or reject, it may be able to suspend its performance while the non-debtor party is required to perform.

95 Id.
97 See e.g. In re Cajun Elec. Power Coop., Inc, 69 F.3d 746 (5th Cir. 1995).
B. Initial Rules

The threshold question is whether an agreement is part of the bankruptcy estate and therefore subject to the protection of the automatic stay and the debtor’s ability to assume or reject it. If the agreement has been validly and completely terminated prior to the filing of the bankruptcy, it does not become a part of the estate.99 The parties’ contractual relationship ended with the termination and the bankruptcy does not act to revive the agreement.100 However, a critical issue may be whether the contract was validly terminated pre-petition. This issue is determined under applicable state or other non-bankruptcy law.101 Common disputes concerning termination include most often the timeliness or effectiveness of notice. Although notice of termination may have been given, the actual steps to effectuate the termination may not have been implemented or the appropriate time passage may not have occurred.102 Thus, a franchisor which is a party to a valuable lease or license will argue that any purported termination failed pre-petition, that the contract is a part of the estate and that it may treat it appropriately in the course of the bankruptcy. Notably, because the bankruptcy court is a court of equity and “equity abhors a forfeiture,”103 the balance seems to tip in favor of salvaging the contract. For example, the court may consider whether the debtor was granted an opportunity to cure any defaults, or whether any estoppel/clean hand arguments might apply.104 Nonetheless, even if an agreement is important to the debtor’s reorganization efforts, a court will not rely on equitable considerations to revive a contract if in fact it has been validly terminated.

Once it has been determined that the agreement is in existence after filing, it is property of the debtor’s bankruptcy estate. Unless the contract expires by its own terms after filing,105

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100 In re Maxwell, 40 B.R. 231, 236 (N.D. Ill. 1984) (“It has been conclusively established that a bankruptcy court cannot resurrect a lease that has been terminated prior to the filing of bankruptcy”); Moody v. Amoco Oil Co., 734 F.2d 1200, 1214 (7th Cir. 1984).


102 See e.g. In re Karfakis, 162 B.R. 719 (Bankr. E.D. Pa. 1993) (lessor’s failure to effectively terminate lease component of indivisible lease-franchise agreement prior to franchisee’s bankruptcy filing meant that the agreement as a whole survived and was included in the bankruptcy estate).


105 A contract clause which provides for termination upon the filing of a bankruptcy, a so-called “ipso facto” clause is generally unenforceable in bankruptcy. 11 U.S.C. § 365(e)(1). A difficult situation may arise when a termination notice is given pre-filing. If there is no right to cure and the pure passage of time effectuates the termination, the contract will expire on its own terms. The automatic stay does not toll the running of time. In re Margulis, 323 B.R. 130 (Bankr.S.D.N.Y. 2005) (noting automatic stay does not “stop a contract from terminating by its own terms as long as the termination does not depend on a post-petition ‘act.’”) (citing to Moody v. Amoco Oil Co., 734 F.2d 1200, 1213 (7th Cir.1984)); In re Thompson, 309 B.R. 1 (Bankr.N.D.Iowa. 2004); Hazen First State Bank v. Speight, 888 F.2d 574 (8th Cir. 1989).
the non-debtor party must obtain relief from the automatic stay in order to take any action to terminate the contract or demand payment and it must continue to perform under the agreement.\textsuperscript{106} Since the debtor has until plan confirmation to assume or reject contracts and leases (with the exception of real property leases), it may stall its performance. The non-debtor party’s only recourse is to seek relief from stay to allow it to exercise its termination rights and remedies and/or to force the debtor to assume or reject the agreement.

Commercial real property and personal property leases are treated somewhat differently. The lessee of commercial property is required to timely perform its lease obligations after the filing of the bankruptcy.\textsuperscript{107} Payments are required even if the lessee has vacated or is no longer utilizing the premises. Thus, it is important to reject immediately undesired real property leases to avoid incurring the costs which will be deemed administrative expenses of the estate.\textsuperscript{108} In a commercial case, personal property leases typically involve equipment or computer and office-related leases. The debtor must timely perform its obligations under these leases after 60 days after the bankruptcy filing.\textsuperscript{109} Payments are required even if the equipment is not being used. Again, it is important to reject immediately any unwanted leases.

\section*{C. Assumption and Assignment}

A debtor can choose to assume any executory contract or lease provided the agreement is truly executory; that is, it requires future performance by the debtor and the non-debtor parties.\textsuperscript{110} Most franchise agreements and real property leases fall into this category and their characterization as executory is not at issue.\textsuperscript{111}

The remaining requirements are that the debtor must i) cure any default or provide assurance of prompt cure; ii) compensate the non-debtor party for any damages it has incurred; and iii) provide adequate assurances of future performance.\textsuperscript{112} Most contracts are assumable

\begin{footnotesize}
\textsuperscript{106} In re Computer Communications, Inc., 824 F.2d 725 (9th Cir. 1987); In re Gunter Hotel Assocs., 96 B.R. 696 (Bankr. W.D. Tex. 1988) (an executory contract is not enforceable against the debtor, but is enforceable against the non-debtor party during the hiatus period from the filing and prior to assumption or rejection).

\textsuperscript{107} 11 U.S.C. § 365(d)(3).

\textsuperscript{108} See In re Boston Post Road Ltd. Partnership, 21 F.3d 477 (2nd Cir. 1994).

\textsuperscript{109} 11 U.S.C. § 365(d)(5).


\textsuperscript{111} Moody v. Amoco Oil Co., 734 F.2d 1200 (7th Cir. 1984) (franchise agreement treated as executory contract); In re Lauderdale Motorcar Corp., 35 B.R. 544 (Bankr. S.D. Fla. 1983). Examples of non-executory contracts might include an agreement that enabled a creditor to receive stream of monthly alimony payments from debtor's former husband in return for lump-sum payment (See e.g. In re Dean, 317 B.R. 482 (Bankr.W.D.Pa. 2004); debtor has no continuing obligations under the agreement (See e.g., In re Beck, 28 Fed.Appx. 142 (3rd Cir. 2002).

\textsuperscript{112} 11 U.S.C. § 365.
\end{footnotesize}
provided the debtor can show it has exercised “reasonable business judgment,” a standard which is relatively easy to meet. There are exceptions to contracts which can be assumed, such as loan agreements, those for personal services, and non-exclusive intellectual property licenses (described more fully below), but most contracts, including franchise agreements, do not fit into these exceptions and will be assumable so long as the debtor can meet the other criteria regarding cure and future performance.

With the exception of real property leases, the debtor has until confirmation of its plan of reorganization to determine whether it will assume or reject a contract. The non-debtor party may petition the court to require the debtor to assume or reject more quickly on the basis for example that the delay is causing harm particularly if payments are lagging. In most instances, the debtor will want to delay as long as possible for a number of reasons such as using the property without expense or gaining leverage to renegotiate better terms. Most important, once an agreement is assumed, any missed payments or damages become an administrative claim against the estate. The debtor will want to wait as long as possible before incurring this layer of debt. The debtor may choose to make or the court may order adequate protection payments as a middle-ground until the debtor assumes or rejects the agreement.

Commercial real property leases are the exception to the timing requirement described above. The lease is deemed rejected unless the debtor assumes it within 120 days after filing. This period may be extended for an additional 90 days for cause shown, but any further extension must be with the lessor’s written consent.

Although issues may arise over the debtor’s ability to cure defaults in a prompt manner or its viability as an entity which can continue to fulfill its obligations, the main source of controversy is whether the debtor is required to and has the ability to cure non-monetary defaults. In the franchise context, the question is often whether failures to meet quality assurance requirements or to maintain financial covenants can be cured.

One instance in which a default may be incurable is when the default is a so-called “historical fact.” This is an occurrence which cannot be undone such as when a business “goes dark” in violation of a provision in the franchise agreement. The best example of this dilemma

113 In re Food Barn Stores, Inc., 107 F.3d 558 (8th Cir. 1997); In re Klein Sleep Products, Inc., 78 F.3d 18 (2nd Cir. 1996); In re ANC Rental Corp., Inc., 278 B.R. 714, 723 (Bkrcty.D.Del. 2002); In re Wheeling-Pittsburgh Steel Corp. 72 B.R. 845, 849 (Bkrcty.W.D.Pa. 1987).
114 11 U.S.C § 365(d)(2).
115 However, the Bankruptcy Reform Act provides for a cap on these expenses. 11 U.S.C. § 503 (b)(7).
117 11 U.S.C. § 365(d)(4). This timing requirement is new as per the Bankruptcy Reform Act.
was presented in the case of *In re Claremont Acquisition Corp., Inc*, 113 F.3d 1029 (9th Cir. 1997). *Claremont* involved the proposed assumption of an automobile dealership franchise agreement containing a “going dark” restriction by which the franchisor could terminate the franchise agreement for failing to operate for a certain number of days. The debtors failed to operate the dealership for a period of time prior to filing and were in default under this provision. The court held that the debtor was required to cure all non-monetary defaults, and since this default was incurable, the agreement could not be assumed.120

*Claremont* has particular impact on franchisees or franchisors with multiple locations. If excess or bad locations are closed pending assignment or sale, and the agreement has a continuous operation provision, the non-debtor party may argue that the contracts cannot be assigned because the temporary closure is a historical default that cannot be cured. Similarly, if an agreement contains a net worth or other financial covenant, the question becomes whether improved performance remedies this type of default.

Real property leases are treated differently with respect to non-monetary cure. The debtor is not required to cure non-monetary defaults if it is “impossible” to do so at and after the time of assumption, except that if the default arises from a failure to operate in accordance with the terms of a nonresidential lease, the default must be cured by performance at the time of assumption and the lessor compensated for any pecuniary loss resulting from the breach.121

Once a debtor assumes a contract or lease, it has the ability to assign it irrespective of language in the agreement preventing assignment.122 The only additional requirement is a showing of adequate assurance of future performance by the assignee. This may be critical protection for the non-debtor party in that the assignment will relieve the debtor from any liability resulting from a post-assignment breach.123

Whether a franchisee or franchisor can assume and assign a portion of its franchise agreement depends on whether the underlying contract is separate or separable. The general rule is that a debtor cannot assume only a portion of a single contract.124 However, in certain circumstances a single master contract with multiple schedules may be read as having severable, multiple contracts, each subject to assumption separately.125 Generally, defaults

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120 The holding of *Claremont* has been codified in the Bankruptcy Reform Act’s modification of section 365(b)(2)(D).

121 11 U.S.C. § 365(b)(1)(A); added by the Bankruptcy Reform Act.


123 See *In re Richkel HomeCenters, Inc.*, 209 F.3d 291 (3rd Cir. 2000).


under cross-default provisions cannot be used by the non-debtor party to prevent assumption and/or assignment of an executory contract. 126

D. **Rejection**

As in the case of assumption, the decision to reject a contract or lease lies within the debtor’s reasonable business judgment. 127 The rejection constitutes a breach of the agreement, resulting in an unsecured claim for damages. In the case of real property leases and employment contracts, the amount of damages is limited. 128

Many agreements contain liquidated damage clauses providing for a set amount to be paid in the event of breach. 129 These provisions are generally enforceable, so long as they are not, in substance, a penalty over and above the cost of non-performance. Rather, the damages must be in lieu of performance. 130 The bankruptcy court will refer to state law to determine the enforceability although it is likely to view a liquidated damage clause in light of the overall principles of the Bankruptcy Code. The focus is on providing an equitable distribution to creditors, and thus, an agreement which defeats this purpose or provides a preferential status to a party will be heavily scrutinized. 131

The ability to reject contracts and leases (translated into poorly performing locations) is often the principal reason for a Chapter 11 filing. It allows the debtor to rid itself of burdensome obligations and restructure its cash flow. It also allows the debtor to replace unfriendly or unsuccessful franchisees with new operators. Nonetheless, there are obstacles depending on the structure of the agreements. For example, if the franchisor is also the lessor and decides to reject the lease, the lessee/franchisee is permitted to remain in possession for the full term of the lease. 132 The lessor has no liability for failing to perform any further affirmative obligations and the lessee may offset against its rent any damage caused by the lessor’s non-performance of such obligations. 133

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126 *In re Sambo’s Restaurant, Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982); *In re Sanshoe Worldwide Corp*, 139 B.R. 837 (S.D.N.Y. 1992). A question arises under *Claremont* as to whether a default under one contract is a historical and incurable event preventing assumption.


128 11 U.S.C. §§ 502(b)(6) and (7).

129 See e.g. *In re Daily*, 167 B.R. 932, 933 (Bankr. D. Mont. 1994).

130 See *In re United Merchants & Mfrs., Inc.*

131 *Id.*

132 11 U.S.C. § 365(h); *In re Austin Development Co.*, 19 F.3d 1077 (5th Cir. 1994).

133 11 U.S.C. § 365(h); See e.g. *In re Flagstaff Realty Associates*, 60 F.3d 1031 (3d Cir. 1995); see also 11 U.S.C. § 365(n) for similar requirements for intellectual property.
Based on the fact that rejection only effectuates a breach and not a termination of the contract, a franchisee could argue that the franchisor’s rejection does not require it to de-identify, and that it may continue to operate as long as it is able to do so without imposing affirmative obligations on the debtor franchisor. Practically, most types of franchises cannot operate long without a source of authorized supplies or product and the use of unauthorized supplies or product would likely provide grounds for injunctive relief terminating the contract.

To the extent franchisees have claims again the franchisor for defaults under the franchise agreements, i.e. advertising commitments, they may be able to block assumption of their agreements. The debtor may have a Claremont problem in that it cannot cure these historical defaults.

On the other hand, most franchisees will want to work with the franchisor to ensure viability of the system. Thus, a franchisor has the opportunity to renegotiate its agreements. It also provides the chance to implement uniform, updated agreements with the franchisees.

E. Odd Ducks

Certain contracts may not be assumed. These include contracts involving obligations to lend or to provide other financial accommodations, personal service contracts, and contracts which are subject to non-bankruptcy law that prohibits assignment. This last category is particularly important in the intellectual property area. Non-exclusive licenses to use patents, copyrights and trademarks are typically regarded as executory contracts which under most circumstances would be assumable and assignable. However, in a majority of jurisdictions, this is not the case. Because federal patent, copyright and trademark law prohibits the assignment of a non-exclusive license, courts have held that the license cannot be assumed by the debtor unless the non-debtor licensor consents.

Covenants not to compete provide another area of disagreement. One school of thought is that the rejection of a contract, i.e. a franchise agreement, relieves the debtor of all obligations under the contract, including any non-competition clauses. The reasoning is that since the covenant is not a separate agreement and since the debtor cannot reject parts of a contract and assume others, the covenant is rejected along with the remainder of the contract. Other courts have enforced non-competition clauses after rejection arguing that bankruptcy would does not disturb

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non-monetary rights, including the right to seek injunctive relief to prevent a debtor from breaching a non-competition clause.\textsuperscript{138} Because the purpose of a covenant not to compete is to govern the relationship between the parties irrespective of the breach of the underlying contract, it is recognized as severable and hence enforceable.\textsuperscript{139}

V. “THERE MUST BE SOME WAY OUT OF HERE”\textsuperscript{140}…STRATEGIES FOR EXITING BANKRUPTCY

A. Emergence Through Confirmation of a Plan

Chapter 11 contemplates that debtors will exit bankruptcy by confirming a plan of reorganization that provides for payments to creditors in accordance with the distribution priority scheme established by the Bankruptcy Code. The most misunderstood and important concept in the distribution scheme is that a creditor on a lower priority rung cannot be paid unless the creditors on the higher priority rungs are being paid in full.\textsuperscript{141} As a result, unless all creditors are paid in full, equity interest holders like stockholders or partners may not receive any distribution unless the creditors consent to the distribution.\textsuperscript{142}

In stand alone reorganization plans, the debtor typically deleverages by converting debt to equity interests in the reorganized debtor. By eliminating unprofitable business lines and rejecting burdensome contracts, the debtor tries to return to a profitable core business. Under a Chapter 11 plan, the debtor is only required to pay unsecured creditors at least as much as those creditors would receive in a Chapter 7 liquidation of the debtor, which is usually very little.\textsuperscript{143} Of course, if unsecured creditors are not paid in full, equity holders cannot receive a distribution.\textsuperscript{144} Many plans provide little or no cash payments to unsecured creditors.\textsuperscript{145} Instead, the equity interests in the reorganized debtor are distributed to the holders of unsecured claims. Unsecured creditors are given the “up side” of the company.


\textsuperscript{140} Bob Dylan, All Along the Watchtower on John Wesley Harding (Columbia Records 1967).

\textsuperscript{141} This plan confirmation requirement is referred to as the “absolute priority rule” and is codified at 11 U.S.C. §1129(b)(2)(B)(ii). Prior to the enactment of the Bankruptcy Code, the Supreme Court identified an exception to the absolute priority rule under certain circumstances where the old equity holder was allowed to retain an interest in the debtor if the equity holder made a new, substantial, necessary and fair infusion of capital to the debtor. See Case v. Los Angeles Lumber Products, Co., 308 U.S. 106, 60 S.Ct. 1 (1939). For the most recent Supreme Court discussion of the issues see Bank of America Nat. Trust and Sav. Ass’n v. 203 North LaSalle Partnership (“LaSalle”), 526 U.S. 434, 119 S. Ct 1411 (1999).

\textsuperscript{142} Id.

\textsuperscript{143} See 11 U.S.C. § 1129(a)(7), a plan confirmation requirement often referred to as the “best interests” test. LaSalle, 119 S.Ct. at 1416, FN 13.


\textsuperscript{145} In bankruptcy vernacular, with credit to Professor Jay Welborn at the University of Texas, unsecured creditors are paid in “itty bitty bankruptcy dollars” that are not the US Currency that the creditors expected to receive.
Plans can take many forms. In some plans, an investor infuses additional capital in the debtor in exchange for all or a majority of the equity and unsecured creditors receive only the required cash payments. If the debtor is not a viable company, in whole or in part, a plan may provide for an orderly liquidation of the debtor’s assets. A plan may also provide for the sale of the debtor as a going concern with the sale proceeds to be distributed to creditors. Presumably, the acquiror will infuse additional capital into the business and revitalize it. In this scenario, the purchaser generally takes all the “up side.”

All plans divide creditors into classes. Each class contains creditors whose claims have the same priority in payment.146 Since each secured creditor has different collateral and may have different legal rights with respect to that collateral, plans usually classify each secured creditor’s claim separately. While a debtor may separately classify claims of the same priority, the debtor is prohibited from discriminating against one of several classes of creditors who have substantially similar legal rights.147 For example, two groups of unsecured creditors could be separately classified and could be given different types of consideration (e.g. cash or stock) under the plan so long as the value of each package of consideration is the same. A class could also consent to a lesser distribution. But, absent consent, all similarly situated creditors must receive property of equal value on account of their claims.

Franchisees may assert claims against their franchisor for damages arising out of alleged or real breaches of their franchise agreements. For example, a franchissee may assert that the franchisor has failed to meet advertising or other obligations created by the franchise agreement resulting in harm to the franchisee. If the franchisor has rejected franchise agreements,148 the rejection is a breach of the franchise agreement that may result in damages to the franchisee who can no longer operate.

In general, franchisee claims will be prepetition unsecured claims because they arise out of prepetition contracts. Trade and other unsecured creditors are likely to heavily contest efforts by franchisees to grab a disproportionate amount of any distribution to unsecured creditors by inflating their claims. As a practical matter, the average franchisee will not have or want to spend the funds to fully litigate the damages issues. As is true in many bankruptcy situations, it will be in the best interests of all constituencies to resolve the claim issues through negotiation and settlement.

Secured creditors have the right to retain their liens and receive a stream of cash payments with a present value equal to the value of the secured creditor’s collateral on the filing

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146 Section 507 of the Bankruptcy Code is titled “Priorities” and sets forth the relative priority of unsecured claims that are paid before “general” unsecured claims, which are those without a special priority.


148 A franchisor that does not contemplate any significant distribution to unsecured creditors may elect to reject a franchise agreement rather than attempt to terminate the agreement where the franchissee is likely to dispute the grounds for termination. The franchisor removes the franchisee from the system without the litigation expense.
date, or to otherwise realize the indubitable equivalent of their claims. Secured creditors have the highest priority claims to the extent of the value of their collateral.

The first priority of unsecured claims is administrative claims allowed under Section 503(b) of the Code. Generally, administrative claims are claims for the reasonable and necessary costs of preserving the value of the debtor’s estate. As discussed earlier, most claims arising after the bankruptcy filing are entitled to administrative priority. Claims for the fees of professionals retained by the debtor and the creditors’ committee are entitled to administrative claim status to the extent allowed by the court. Some administrative claims are occasionally granted priority over other administrative claims. These are called superpriority administrative claims. As discussed previously, claims for a diminution in the value of a secured creditor’s collateral after the filing date are entitled to superpriority administrative claim status. The same status is sometimes given to creditors who lend money to the debtor post petition on an unsecured basis.

Priority claims are the next category of unsecured claims entitled to payment. Priority claims include all unsecured claims entitled to priority over general unsecured claims. Section 507 of the Code lists all priority claims in their relative priority. In addition to administrative priority claims, the priority claims most commonly occurring in commercial cases are (a) claims for employee wages up to $10,000 for wages earned in the 90 days preceding the filing and claims for contributions to employee benefit plans; (b) claims for deposits for consumer goods not delivered and (c) a wide variety of tax claims including income taxes, property taxes, taxes withheld from others, employment taxes, excise taxes and penalties related to such taxes that are designed to compensate the taxing authority for actual pecuniary loss.

General unsecured creditors follow priority creditors in their right to payment. Finally, as discussed above, if all unsecured creditors are paid in full, equity holders may receive a distribution.

Plans can be confirmed consensually, meaning that each voting class accepts the plan, or by cramdown. A class accepts the plan if a majority in number and two-thirds in

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149 See 11 U.S.C. § 1129(b)(2)(A) setting forth the treatment of secured claims necessary to confirm a plan over the objection of a secured creditor.

150 Much to the dismay of new lawyers, the Bankruptcy Code never really says this clearly although the provisions of 11 U.S.C. §1129(b) are helpful. Nevertheless, all experienced bankruptcy lawyers know that it’s true.

151 See 11 U.S.C. §§ 503(b)(2) and 330(a).


155 A class of creditors or interest holders is entitled to vote if the class is impaired. Section 1124 of the Bankruptcy Code defines impairment by describing situations in which a class is not impaired. In general, a class is not impaired if the plan “leaves unaltered the legal, equitable and contractual rights” of the class of creditors. 11 U.S.C. §1124(1).

156 See 11 U.S.C. §§ 1129(a) (standards for consensual confirmation) and (b) standards for confirmation over the objection of a class of creditors.)
amount of the claims in the class vote in favor of the plan. \[^{157}\] In bankruptcy vernacular, cramdown is the process of confirming a plan over the objection of one or more classes. The Bankruptcy Code establishes the treatment that a class of creditors must receive before the class can be forced to accept the plan over its objection. \[^{158}\] It also establishes general requirements for confirmation, such as plan feasibility. \[^{159}\] If the court concludes that the plan’s treatment of the class is consistent with the required treatment, the court may confirm the plan despite the lack of acceptance by that class.

A debtor has the exclusive right to propose a plan during the first 120 days of the case and if the debtor files a plan within that time, the debtor is given an additional exclusivity period of 60 days to confirm the plan. \[^{160}\] Courts have regularly extended the debtor’s exclusive period, particularly if the debtor seems to be making progress in the case. However, provisions of the Bankruptcy Reform Act Code limit the court’s authority by stating specifically that the 120 day period cannot be extended beyond a date that is eighteen months after the filing date or extend the 180 day period beyond a date that is twenty months after the filing date. \[^{161}\] In addition, if a significant creditor constituency opposes the extension and offers the prospect of proposing a viable alternative plan, the court may open the process. This raises the possibility of different parties proposing and trying to solicit votes on competing plans. A discussion of the dynamics of competing plans is beyond the scope of this discussion. It is probably enough to say that professional fees can be very significant in cases with competing plans.

A plan is not effective until consummated. The plan is essentially a contract between the debtor and its creditors. The plan/contract establishes the terms on which the debtor will satisfy the creditors’ claims. All plans provide for an “effective date.” This is the date that the plan “closes” and becomes binding on all the parties. Often a plan includes conditions to the effective date. For example, the securing of a new financing facility is often a condition to the effective date. Once the debtor has substantially consummated the plan, it can no longer be modified. \[^{162}\]

**B. Emergence Through a Sale of Assets Within or Outside of the Plan Process**

Sales of a company as a going concern are very common in bankruptcy. Often, a company is in financial distress because of industry pressures. The better capitalized players in the industry will have a strong advantage over those in trouble. They can often consolidate and enhance their strength by purchasing a troubled competitor. Alternatively, a strong company with other franchises can expand its product offerings by buying other concepts out of bankruptcy. Investors from within an industry are typically referred to as strategic buyers. In addition to strategic buyers, the large amount of money currently looking for investment

\[^{157}\] See 11 U.S.C. §§ 1126(c) and (d).
\[^{159}\] See 11 U.S.C. §1129(a), as to feasibility specifically, (a)(11).
\[^{161}\] See 11 U.S.C. § 1121(d)(2). This period is shortened even more in a small business case.
\[^{162}\] See 11 U.S.C. § 1127(b).
opportunities has led to increasing numbers of financial players being interested in bankruptcy acquisitions. The financial buyer typically wants control of the company through control of the board or a majority of the stock. In today’s environment, financial buyers are either the traditional private equity firms such as KKR, Texas Pacific Group or the Carlyle Group, or hedge funds such as Cerberus Capital Management, Fortress Investment Group or Farallon Capital.

A sale can be done through a plan of reorganization or, if circumstances warrant, through court approval of a sale outside the ordinary course of business pursuant to 11 U.S.C. §363(b)(1). These sales are initiated by the filing of a motion for authority to sell property of the estate outside the ordinary course. When you hear a reference to a Section 363 motion, it is typically a reference to a motion to sell. However, as described below, Section 363(f) of the Bankruptcy Code is what makes bankruptcy sale so attractive.

A sale of a company through bankruptcy has many advantages over a sale outside of bankruptcy. First, pursuant to section 363(f) of the Bankruptcy Code, a sale of property can be free and clear of the liens, claims and interests in property of third parties. A sale free and clear of liens without the consent of the affected parties is easiest to achieve if the sales price exceeds the liens and interests against the property. The court’s order mandates that the liens in the property being sold are released from the property and attach to the proceeds of the sale. Even if the liens exceed the sales price, the court may still allow the sale if the value being offered is representative of the value of the property being sold.

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163 Pursuant to section 363(f): “The trustee may sell property under subsection (b) or (c) of this section [363] free and clear of any interest in such property of an entity other than the estate, only if – (1) applicable non-bankruptcy 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 sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entities could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. 11 U.S.C. § 363(f)(1)-(5). If any one of the five conditions set forth are met, the trustee has the authority to conduct the sale free and clear of all liens.

164 See 11 U.S.C. § 363(f)(3). Section 363(f)(3) has been interpreted by several courts as meaning that the sales price must exceed the aggregate value of all liens on the property. In re Canonigo, 276 B.R. 257, 261 (Bankr. N.D. Cal. 2002); In re Feinstein, 247 B.R. 502, 508 (Bankr. N.D. Fla. 2000); In re Heine, 141 B.R. 185, 189 (Bankr. D. S.D. 1992); In re Oneida Lake Dev., Inc., 114 B.R. 352, 357 (Bankr. N.D.N.Y. 1990); In re ByGaph, 56 B.R. 596 (Bankr. S.D.N.Y. 1986); Richardson v. Pitt County (In re Stroud Wholesale, Inc.), 47 B.R. 999 (Bankr. E.D.N.C. 1985), aff’d sub nom, Richardson v. Pitt County, No. 85-1422 (4th Cir. Jan. 21, 1986). In Stroud Wholesale, the court rejected a trustee’s argument that the sales price was greater than the value of the property and therefore in excess of the mortgagee’s claims. The court applied the rule that the sales price must exceed the aggregate value of all liens on the property. This rationale was also discussed in In re Riverside Inv. Partnership, 674 F.2d 634 (7th Cir. 1982), which indicated that a court must be “satisfied that the sale proceeds will fully compensate secured lienholders and produce some equity for the bankruptcy’s estate.” Id. at 640.

165 In re WPRV-TV, Inc., 143 B.R. 315, 320 (D. P.R. 1991), aff’d in part and rev’d in part 983 F.2d 336 (1st Cir. Jan. 6, 1993); In re Terrace Gardens Park Partnership, 96 B.R. 707, 712-14 (Bankr. W.D. Tex. 1984) (debtor could sell estate property free of liens, so long as sale price exceeded the value of property even if it did not exceed the aggregate of debts asserted to be secured by liens on property). The analysis that “value” means actual value has been criticized as not being consistent with the statutory language. See Bognanoff, Sale of Assets, pp. 1405-06. See also Morgan v. K.C. Machine & Tool Co. (In re K.C. Machine & Tool Co.), 816 F.2d 238, 243 (6th Cir. 1987); In re General Bearing Corp., 136 B.R. 366-67 (Bankr. S.D.N.Y. 1992). In In re Terrace Chalet Apart., 159 B.R. 821 (N.D. Ill. 1993), the court held that a sale extinguishing a lien may proceed under section 363(f)(3) if the trustee demonstrates
secured creditor’s secured claim in bankruptcy is limited to the value of the property securing the claim.\textsuperscript{166}

A bankruptcy sale allows the debtor to transfer executory contracts and unexpired leases without the consent of the non-debtor parties to such contracts and leases, regardless of whether the contracts include a prohibition on assignment. Requirements for assumption and assignment of contracts were discussed above. The ability to assume and assign executory contracts and unexpired leases in bankruptcy is one of the strongest reasons that a purchaser of a troubled company may require the company to file bankruptcy in connection with the sale. In some older companies, below market leases may be one of the most valuable assets of the company. Because most of these leases will prohibit assignment absent the landlord’s consent, the only way to “sell” the value in the leases is through bankruptcy.

Because a bankruptcy sale can dramatically impact the rights of lienholders and the non-debtor parties to executory contracts and unexpired leases, notice of a bankruptcy sale is critical. While very broad notice is typically given in connection with solicitation of a plan of reorganization, the same breadth of notice is not required for most motions. A Section 363 sale motion must be noticed to all creditors as well as anyone else whose rights may be affected. Without good notice, the purchaser may not get the full benefits of Section 363(f) and the Section 365 provisions for assignment of executory contracts and unexpired leases\textsuperscript{167}.

Chapter 11 contemplates an orderly reorganization or liquidation of the assets and liabilities of a debtor through a plan. As described very generally above, the requirements for confirmation of a plan are designed to reinforce the distribution priority scheme established by the Bankruptcy Code and to balance the interests of various constituencies. Since the sale of substantially all of the assets of the debtor through a Section 363 sale forecloses the reorganization of the debtor’s estate, some courts have been reluctant to approve a sale of substantially all of the debtor’s assets outside of a plan. In contrast to a plan of reorganization,

that the sale proceeds will exceed the amount of the secured debt on the property. In this case, the court referred to the House and Senate report to find that the Congress intended section 363(f) to protect the amount of the secured debt, not the actual value of the security interest. The court further held that even if section 363(f)(3) protects only actual value, it would not apply in this case where the debtor sought to sell her sole asset, an apartment complex.

\textsuperscript{166} See 11 U.S.C. § 506(a).

\textsuperscript{167} Four significant cases dealing with adequate notice and due process are Reliable Elec. Co. v. Olson Constr., 726 F.2d 620 (10th Cir. 1984)(creditor’s claim not discharged by plan where creditor was not scheduled and did not receive notice during case even though creditor had actual notice of case); Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.), 75 B.R. 944 (Bankr. N.D. Ohio 1987)(notice in publications of national circulation were reasonably calculated to inform tort claimants of sale and to bar their claims); In re Karpe, 84 B.R. 926 (Bankr. M.D. Pa. 1988)(after proper notice and no filing of timely objections, court could enter order approving sale without a hearing; challenge by party interested in submitting higher bid overruled since complaining party was not a party in interest in the case); and Magnoni v. Globe Inv. Co., 867 F.2d 556 (9th Cir. 1989)(parties that owned property with the debtor were not entitled to notice of a chapter 7 trustee’s sale of the debtor’s interest in that property since they were not creditors of debtor and had not filed a proof of claim). See also Epstein v. Official Committee of Unsecured Creditors of Estate of Piper Aircraft Corp. (In re Piper Aircraft Corp.), 58 F.3d 1573 (11th Cir. 1995); Waterman Steamship Corp. v. Aguiar (In re Waterman Steamship Corp.), 157 B.R. 220 (S.D.N.Y 1993) (court held that (1) former seamen who were known to be actual or potential asbestosis claimants were entitled to actual personal notice of bar date; (2) those actual or potential claimants who could not be personally identified with reasonable effort were not entitled to actual personal notice of bar date; and (3) potential future claims of those seamen who had not manifested any detectable signs of disease when notice of bar date was given were not discharged).
a sale must not attempt to restructure the rights of creditors. Nevertheless, courts have allowed a sale of substantially all of a debtor's assets through a Section 363 motion where the debtor can demonstrate (i) a strong business reason for proceeding outside of a plan and (ii) an extensive marketing of the assets in a manner designed to bring the best value to the estate under the circumstances. The strong business reason is often a rapid erosion of the value of the business as a going concern due to problems brought on or exacerbated by the debtor's financial constraints.

Regardless of whether a sale is approved through a Section 363 motion or through confirmation of a plan, the debtor must convince the court that it has taken the steps necessary to achieve the highest and best price for the assets being sold. Therefore, the sale process will be substantially similar for a sale whose ultimate highest bidder is approved as the debtor's purchaser through an order on a Section 363 motion or through a plan. The initial stages in the sale of a financially troubled franchisor are not significantly different from those in the sale of healthier companies. The debtor retains a financial advisor or investment banker who prepares an informational memorandum or "book" containing financial information about the company from which a purchaser should be able to determine whether it is interested in undertaking due diligence regarding the opportunity. A book may attempt to identify both the cause of the company's problems and solutions to those problems in hopes of acquainting parties with the opportunity that the investment provides. The advisor and the company determine parties who might be interested in the company or the type of opportunity it presents and solicit their interest. To obtain the book, parties are required to execute confidentiality agreements. Often, a fairly large group has enough interest to execute a confidentiality agreement and receive a book. Interested parties will seek out additional information from the advisor. After a reasonable amount of time under the circumstances, the advisor will ask for indications of interest from those who would like to go to the next step of due diligence with the company. The indications of interest will often include a possible range of values for the company based on a number of assumptions.

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168 Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935 (5th Cir. 1983) (court refused to approve sale of substantially all of debtor's assets outside of plan on grounds that sale terms would restructure rights of creditors outside of a plan and without the protections provided by a disclosure statement).

169 Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983); In re Gulf States Steel, Inc., 285 B.R. 497 (Bankr. N.D. Ala. 2002) (factors for a court to consider in whether to approve a section 363 sale include: (1) any improper or bad faith motive, (2) whether the price is fair and the negotiations or bidding occurred at arm's length, and (3) whether adequate procedure has been followed, including proper exposure to the market and accurate and reasonable notice to all parties in interest); but see Ferrari North America, Inc. v. Sims (In re R.B.B., Inc.), 211 F.3d 475 (9th Cir. 2000) (order approving sale and assignment of franchise reversed because assignee was not purchaser in good faith and appellant did not unreasonably withhold consent to sale and assignment).

170 See In re White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981) (where the debtor was experiencing a significant loss of accounts to competitors, damage to its relationship with dealers, a loss of valued employees, a decrease in profitability due to market conditions, a forecast of continued losses, and difficulty in finding other potential purchasers, a sale of substantially all of the bankruptcy estate's assets could be approved); Stephens Indus., Inc. v. McClung, 789 F.2d 386 (6th Cir. 1986) (trustee was allowed to sell radio station assets and FCC broadcasting licenses where broadcasting licenses could be forfeited in the event the radio station went off the air).
From the indications of interest, the debtor and its advisors (and perhaps representatives of major secured creditors and the Creditors’ Committee) will determine the parties who appear most likely to make an offer within the range of values that the advisor thinks the assets will bring. Based on the operational pressures confronting the debtor and the resources that management can devote to due diligence, the team will decide how many parties will be invited to do due diligence. To assure the court that the highest and best bid has been obtained, a troubled company may allow all interested parties to conduct due diligence with respect to information in a data room, which is usually electronic. Meetings with management may be limited to a smaller group because management has usually been reduced in a troubled company and the sale process has to be balanced with the company’s operational requirements.

The debtor sets a deadline for bids. Upon receiving bids (hopefully!), the debtor again consults with its advisors and key constituencies in the case to select the highest and best bidder with which to negotiate a contract. The bidder must understand that this contract will be subject to higher and better offers. The bidder is the “stalking horse” who sets the floor for other bids. As a result, the stalking horse’s bid may not be the highest amount that party is willing to bid for the assets at the end of the process. Different bidders have different strategies.

Being the stalking horse gives a bidder a number of advantages. First, the stalking horse generally negotiates the form of asset purchase agreement that competing bidders will have to use. Thus, the stalking horse has the best opportunity to negotiate the contractual provisions it requires in connection with the purchase. Because it negotiates this agreement extensively, the stalking horse typically spends more time with management than other bidders and, as a result, may know more about the business and sale assets. Finally, a stalking horse can negotiate the form of auction that will be conducted if other competing, qualified bidders come forward and the types of bidding procedures that will be used.

Sales can be conducted without a stalking horse, although this is generally viewed as less desirable. The debtor establishes a minimum bid and a form asset purchase agreement (which substitute for the stalking horse bid and asset purchase agreement) and all interested parties, subject to the bidding procedures approved by the court, may participate.

Bidding procedures are customary and, for the debtor’s protection, should be approved by the court. Typically, bidders must meet certain requirements to participate in an auction. Additionally, minimum bid increments are set. For example, if the stalking horse bid is $20 million, the initial overbid might be $500,000 with subsequent bid increments of at least $250,000. Bid increments should be designed so that they do not discourage bidding but are significant enough to move the auction forward. The amount of the minimum bid increments depends on the total value of the sale. The larger the total consideration, the larger the minimum overbid in most instances. Other requirements of the procedure might include:

1. A minimum cash deposit, generally a fixed percentage of the proposed purchase price, to be retained by the estate as liquidated damages if the selected purchaser fails to close;

2. Delivery by each bidder of evidence of its ability to close a transaction and to provide adequate assurance of future performance to the non-debtor parties to executory contracts and leases that are to be assumed and assigned to the purchaser;
3. A provision that the overbidder must accept the same terms provided in the proposed purchase agreement or provide a mark-up of its proposed changes.  

Auctions can take place in court or, more commonly, in attorneys’ offices. Courtroom auctions are typically public outcry auctions. However, more time is almost always allowed between bids than in a car or farm auction. In many auctions, bidding parties may be publicly informed of a new higher and better bid but discussions of whether the party will increase its bid as a result are discussed privately between each bidder and the debtors’ counsel and advisors. The debtors may get a bid from a party and then discuss it with the creditors’ committee and major secured creditors before reaching a conclusion on whether it is “higher and better” in terms of total consideration to the estate. When prospective buyers are bidding on substantially all the assets of the company, bids can have different types of consideration that are hard to easily compare. In addition, one constituency may favor a type of bid that is not as beneficial to another constituency as another type of bid. For example, an offer to assume a significant number of contracts helps the parties to those contracts who will end up with the benefit of their bargain. It may also help the general unsecured creditors by eliminating the claims for contract rejection damages. Secured creditors typically favor higher cash bids, although they may be willing to refinance some of the debtors’ debt to get a higher overall recovery. A great deal of behind the scenes negotiating can occur at an auction which can be frustrating to the participants. Some parties are frequent participants in bankruptcy sales and have developed their own strategies for these sales.

Once the purchaser is selected, the terms of the sale must be approved by the court. Approval can be given at a hearing on the Section 363 motion within a day or two of the auction. After the sale closes, the proceeds available to pay unsecured creditors will usually be distributed pursuant to a plan. If the sale is going to occur through a plan of reorganization, the debtor will circulate a plan and disclosure statement describing the sale and how the sale proceeds will be distributed. The creditors will then have an opportunity to vote on whether the sale and plan should go forward. The sale will not close until the debtor completes the plan confirmation process.

As demonstrated in the bankruptcy case of Ground Round Restaurants, Inc.(“GRI”), franchisees can not only become active participants in the bankruptcy sale process, but ultimately become their own franchisor through a purchase of the franchisor’s assets. The

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172 Less commonly, if substantially all of the assets have been sold, the case is converted to a Chapter 7 case and the Chapter 7 trustee distributes the proceeds in accordance with the Bankruptcy Code’s priority scheme.

173 The disclosure statement must be approved by the court before votes on the plan can be solicited. Approval is conditioned upon the disclosure statement including adequate information that would enable a hypothetical reasonable investor typical of claims or interests in the voting class to make an informed judgment about the plan. See 11 U.S.C. §1125(b).

174 Neither of the authors was involved in the Ground Round bankruptcy. The discussion in this article is based on an article published by the franchisee’s counsel (Craig Tractenberg, Franchisees Unite to Purchase Franchisor, Franchising Business & Law Alert, Sept. 2004 at 1) and from articles found on the Ground Round Grill & Bar website.
GRI system included 59 company operated restaurants and 71 franchised restaurants. On February 13, 2004, all the company owned restaurants closed. Many customers assumed all the restaurants had closed and the franchisees quickly saw their sales drop. Additionally, because the franchisees depended on GRI for food and supply distribution, they immediately faced supply problems. Through an existing franchise advisory counsel, the franchisees sought legal assistance. Their ultimate counsel, Nixon Peabody, suggested that forcing GRI into bankruptcy would be more productive than simply filing suit. Inquiries from the advisory counsel demanding certain financial data and reminding the directors of their fiduciary duties in the zone of insolvency apparently provoked a filing.

After the filing, the franchisees stopped paying royalties on the grounds that their claims against GRI for diversion and misuse of advertising fees, development fees, initial franchise fees and other payments to GRI gave them claims against GRI in excess of the amounts owed. Without royalty revenue, GRI quickly proceeded with a sale of its franchise assets.

The franchisees filed claims in the bankruptcy asserting that the damages resulting from GRI’s breaches of their franchise agreements totaled $40 million. As discussed above, a condition to assuming and assigning an executory contract like a franchise agreement is curing existing defaults. Therefore, the franchisees argued that no purchaser could assume the franchise agreements without paying $40 million. The representative of one interested purchaser, Mark Bromberg, reportedly characterized the strategy as “[a] brilliant way of throwing a monkey wrench into the machine.” He followed by characterizing the franchisee’s assertions as “unmitigated bull____. Everyone laughed it was so ridiculous.”\(^{175}\) When the debtor sought approval to sell to a bidder with a cash offer of $6.5 million, the franchisees sought to block the sale on the grounds that the purchase price was insufficient to cure GRI’s defaults under the franchise agreements. Discovery ensued.

As a result of the discovery, all sides developed a better estimate of the value of the franchise agreements (without consideration of the franchisees’ claims) and the range in value of the cure amounts. The debtors also estimated the cost to the estate of litigating the franchisees claims at $1 million. According to the franchisee’s counsel, all of this information helped facilitate realistic settlement parameters. Discovery also revealed $30 million of insurance that could be available to satisfy the franchisee claims. This allowed the franchisees to make a higher cash bid in addition to the value to the estate of a release by the franchisees of their claims. Through a cooperative that they had formed, the Ground Round Independent Owners Cooperative LLC (“IOC”), the franchisees became the successful purchaser of GRI’s franchise assets.

Would this strategy work for other franchisees? Possibly. Several factors that are not present in other franchise systems facilitated their success. First, there were not too many franchisees to bring to a consensus view. Second, the franchisees appear to have had better financial resources than in some systems. Despite rapidly declining sales and the prospect of a failed system the franchisees were able to raise $250,000 to become a qualified bidder. Third,

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many of the franchisees were experienced. The IOC management and board includes people who had either been franchisees or part of corporate management for twenty years. One franchisee who is on the management team served as GRI’s director of franchising before becoming a franchisee. As a result, the franchisees were better able to prepare a realistic business plan and compare their likely results under their own leadership with that of a prospective purchaser. Nevertheless, even if all these factors were present in another situation, it would not necessarily bring a similar result. In reading about what happened and the interested purchaser’s comment above, this author senses that the franchisees may have prevailed in large part by default. What interested purchaser wants to become the franchisor of dissident franchisees in a system where almost half of the restaurants have failed so badly that the company simply shut the doors on 50 restaurants?
VI. BANKRUPTCY TRUISMS

There are a number of truisms and caveats that seem to appear in every case:

- “If you find yourself in a hole, the first thing to do is stop digging.”¹⁷⁶ Bankruptcy does not eliminate management’s brains. Business decisions should go forward as usual; business objectives should be established and followed.

- The business solution is always the best one. Rarely is the so-called “scorched earth” approach successful. Having “your day in court” does not achieve the end goal which is to emerge from bankruptcy with a reorganized structure.

- Bankruptcy courts are courts of equity; seldom does one side prevail on all issues. The inclination is always to reach a middle ground. So, negotiation without court intervention is key.

- Always take the cash. See above.

¹⁷⁶ Will Rogers.
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Sarah B. Foster

Sarah Foster, a partner at Haynes and Boone, LLP, represents all types of parties in business bankruptcy cases, including debtors, creditors and equity committees, secured creditors, and purchasers. Most recently, she represented Schlotzsky’s, Inc. and its affiliates in a Chapter 11 case resulting in the sale of its franchise system. She played an integral role in the successful reorganization of Kitty Hawk, Inc., an air cargo carrier that overcame the economic slowdown of 2000 and the disruption of the entire industry on and after September 11, 2001 to emerge from bankruptcy. Following that engagement, Ms. Foster worked as part of a team of Haynes and Boone lawyers on the successful restructuring, through bankruptcy, of over $2 billion of airline debt for Atlas Air, Inc. and Polar Air Cargo, Inc., both international air cargo carriers. She also represented SpectraVision, the largest provider of in-room video entertainment to the hotel industry, in a reorganization effort complicated by a critical outsourcing contract that no longer made business sense.

On the creditor side, Ms. Foster represented HealthVest, a real estate investment trust, as the largest secured and unsecured creditor of Healthcare International, Inc., a public chain of psychiatric and rehabilitation hospitals. In connection with this representation, she defended litigation seeking to unwind over $200 million in sale-leaseback transactions. Ms. Foster undertook a complicated investigation of the derivatives transactions of three failed hedge funds in connection with representation of a Committee representing the interests of the funds' investors.

Ms. Foster is a past Chair of the Health Care Insolvency Committee of the American Bankruptcy Institute and a contributing editor to Norton Bankruptcy Law and Advisor.
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Ms. Johnsen has been a lawyer representative to the Ninth Circuit Judicial Conference since 2002. She has served on the Ninth Circuit Bankruptcy Panel Rules Committee and the District of Arizona Bankruptcy Pro Bono Committee. She has numerous published decisions and has been a frequent speaker at state and national bankruptcy seminars.

Ms. Johnsen is a founding Director of Valley Commerce Bank and has been recognized as one of the top ten women in Arizona Business. Her booklet *Why You Absolutely Need to Know Something About Bankruptcy, A Guide to the Bankruptcy Process* is a popular desk reference for business owners in every industry.