



# IFA LEGAL SYMPOSIUM

# Navigating Distressed Franchisee Issues: Understanding Franchisee Bankruptcies and Exploring Alternatives

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# Speakers

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# Bankruptcy Purposes

- Breathing spell from litigation
- Powerful restructuring tool: emerge with a clean(er) balance sheet
- Orderly liquidation or reorganization vs. piecemeal dismemberment
- Reject unfavorable contracts; retain or transfer others
- Sale of assets free and clear of liens and claims

# Bankruptcy Types

- Chapter 11: restructuring of debts, which results in a plan to repay debts and keep the business ongoing or effectuate a sale/liquidation
  - Debtor usually remains in control of the business during the bankruptcy case
  - Debtor can propose a plan or can be sale vehicle
- Subchapter V of Chapter 11
  - Small Business Bankruptcy
  - Introduced in 2020, specifically designed for small businesses with total debt of less than \$2,725,625 (increased to \$7,500,000 through March 2022)
  - More efficient than standard Ch. 11 for those who qualify
  - Less third-party involvement and shorter timeline

# Bankruptcy Types

- Chapter 7: franchisee ceases operation and its assets are liquidated to satisfy debts
  - Chapter 7 Trustee is appointed to manage and liquidate the assets
  - Proceeds of liquidation are distributed to creditors
- Chapter 13 (personal): adjustment of debts of an individual with regular income
  - A repayment plan is developed
  - Payments made over 3-5 years based on the debtor's disposable income
  - Debtors retain their assets

# Bankruptcy (Ch 11) is Filed – What Happens?

- Petition/Schedules/Statement of Financial Affairs
- Notice of Bankruptcy Filing
  - Meeting of Creditors (341)
  - Deadline to File Proof of Claim
- Automatic Stay
  - Advise personnel of automatic stay: suspend collection efforts
  - Possible penalties
- First Day Pleadings
- Creditors Committee?

# Bankruptcy (Ch 11) is Filed – What Happens?

- Exit pleadings
  - Disclosure Statement
  - Plan of Reorganization
  - Sale documents
    - Bid Procedures
    - Free and Clear Sale Order



# Assess the Situation

- Get involved early
- Communicate with parties and key constituents
- Is this a franchisee you want to work with?
- What is the exit strategy?

# Executory Contracts/Leases

- Weird name, important concept
- Franchise agreements = executory contracts
- Has the agreement been terminated (fully) before the filing?
- Options:
  - Assume
  - Assign
  - Reject
- Requirements for assumption/assignment
  - Cure defaults
  - Adequate assurance of future performance

# Executory Contracts/Leases (cotd.)

- Franchisor's "Veto Rights"
- General Rule: prohibitions against assignment are unenforceable in bankruptcy
- Exception: Trademark law/Lanham Act + 365(c)(1)
- Result: Franchisee cannot assign franchise agreement to a 3<sup>rd</sup> party without the franchisor's consent
  - Caveat: permissive language in franchise agreement

# Executory Contracts/Leases (cotd.)

- Can franchisor block assumption of franchise agreement, even if franchisee does not intend to assign?
- Yes: In “hypothetical” jurisdictions:
  - 3<sup>rd</sup>, 4<sup>th</sup>, 9<sup>th</sup> and 11<sup>th</sup> Circuits
- No: In “actual” jurisdictions:
  - 1<sup>st</sup> and 5<sup>th</sup> Circuits
- “Know thy jurisdiction”

# Executory Contracts/Leases (cotd.)

- Timing for assumption
  - Chapter 7: 60 days (from petition or conversion)
  - Chapter 11:
    - Most contracts: until confirmation (unless shortened by court order)
    - Commercial real property leases: 120 days + 90 day extension (max 210)
      - Temporarily Extended to 210+90 until the end of 2022
      - Court cannot extend beyond 210 days w/out landlord consent
      - If not assumed w/in that time, lease is rejected and franchisee must vacate

# Distressed Franchisee Practices

- Regular communication will lessen the likelihood of big surprises
  - Stay on top of monitoring and look for trouble signs early
- Emphasize that the same conversations that occur during bankruptcy can occur during restructuring where franchisee still has some control
- Help them understand the importance of finding really good advisors, franchisor is not their bankruptcy advisor

# LIVE Q&A

And now for your questions