Preparing for Franchisee Bankruptcies in a COVID-19 World

Phillip Bohl
Attorney

James Wahl
Attorney

Robert Haupt
Attorney

Lauren O'Neil Funseth
Attorney

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Lathrop GPM

Warning Signs of Franchisee’s Financial Distress

- Late payments
- Lack of responsiveness
- Observation of market peers
  - Are they similarly struggling?
- Notices from lenders, landlords
- Notices from insurers
- Tax delinquencies
- Quality score decline

Basic Bankruptcy Concepts

- Types of Bankruptcy Cases
  - Chapter 7
    - Business operations cease
    - Bankruptcy trustee liquidates the assets
  - Chapter 11
    - Business operations continue in the ordinary course of business.
    - Existing management team remains in place as the debtor in possession.
  - Chapter 13
    - May be filed by small sole proprietorships
    - Debtor develops a plan to repay a portion of the debts over three to five years.

Basic Bankruptcy Concepts

- Important Terminology
  - Bankruptcy Estate
    - Contains all of the franchisee's legal and equitable interests in property
    - Franchisee's interests and rights under the franchise agreement become property of the estate
  - Automatic Stay
    - Goes into effect the moment bankruptcy case is filed.
    - Broadly protects debtor and the bankruptcy estate from creditor actions.
  - Cash Collateral
    - Upon filing, debtor loses its right to use or spend any cash and cash equivalents in which a creditor claims an interest.

Basic Bankruptcy Concepts

- Business Operations in Bankruptcy
  - Chapter 11 or 13 cases
    - Debtor typically continues to operate its business during the bankruptcy case.
    - May enter into transactions that are in the “ordinary course” of business without approval.
  - Parties of Interest to Franchisor
    - Identity will vary depending on the type, size and complexity of case.
      - May include: landlords, banks, suppliers and distributors, taxing authorities and equipment lessors.

Franchise Agreements In Bankruptcy

- Executory Contracts
  - An executory contract is a contract under which “performance remains due to some extent on both sides.” *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984)
  - Franchise agreements are executory contracts
  - Franchisee’s Options
    - Reject
    - Assume
    - Assume and Assign
  - Effect of Pre-Bankruptcy Termination

Steps to Take Prior to Franchisee's Bankruptcy Filing

- Franchisor must decide if this is a franchisee it desires to retain.
  - The goal is for the franchisor to have maximum control and flexibility.
- There is a risk of over-patience. A franchisee in bankruptcy can only assume a franchise agreement if it has not yet been terminated.
- Forbearance Agreements (get the release).
- Encourage or force sale.
- Consider reducing the size of the franchise operation.

Possible Workout Strategies

- Flexibility in matching the product with the current market demand (temporarily?)

- Pressure on related parties (guarantors? affiliates?)

- Identify your coalition. Who shares your motivations?

Preferential and Fraudulent Transfers

- Preferential Transfer Claims
  - Any payment made on antecedent debts owed by the debtor before the transfer and paid within ninety days of the filing of the bankruptcy petition may be "clawed back."

- Fraudulent Transfer Claims
  - A transfer of assets (including money) made with the actual intent to hinder, delay or defraud a creditor; or
  - A transfer made (including payments) for which the paying party did not receive reasonable equivalent value in exchange for the transfer (or obligation incurred).

Navigating the Bankruptcy Process

- Automatic Stay
- Deadlines
- Sales
- Exit Alternatives

Questions?

Phillip W. Bohl
Minneapolis
phillip.bohl@lathropgpm.com
612.632.3019

Lauren O'Neil Funseth
Minneapolis
lauren.oneilfunseth@lathropgpm.com
612.632.3077

Robert J. Haupt
Kansas City
robert.haupt@lathropgpm.com
816.460.5733

James A. Wahl
Minneapolis
james.wahl@lathropgpm.com
612.632.3425