

Financial Crisis – Law Firms

Identifying And Dealing With A Financially Troubled Franchisee

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Franchisors dealing with financially distressed franchisees will find that three maxims generally hold true: an out-of-court work-out is usually preferable to a Chapter 11 filing or receivership; if bankruptcy or receivership is unavoidable, a pre-packaged or pre-negotiated restructure plan is usually more beneficial than one imposed by a court; and being prepared is always preferable to being caught by surprise. Even if discussions ultimately fail to produce an agreement, a franchisor can leverage a franchisee default and the ensuing negotiation process to improve its position in a contested Chapter 11 case or receivership proceeding to its benefit by correcting irregularities in default notices and franchise documents, obtaining additional collateral or guaranties and the like.

Of course, in order to take advantage of these opportunities, a franchisor must be aware of a franchisee's financial problems sufficiently in advance of a crisis to avert a precipitous filing and be prepared to engage in dialogue with the franchisee, its primary secured lender(s) and perhaps other key creditors.

Signs Of Economic Distress

Slow Pay (or No Pay): Pay attention to history and stay on top of your receivables. Deviations in a franchisee's historical payment pattern are a pretty good indication that something is amiss. A deviation from the historical norm can also (and often does) indicate liquidity problems. Early inquiry into the nature of any difficulties is advisable. Depending on the severity and persistence of the situation, the franchisor has several options, which can be combined or pursued individually: temporarily deferring or abating rents, royalties or other fees; issuing a notice of default; entering into a work-out agreement for past and future amounts due; and/or evaluating the desirability of closing, transferring or acquiring one or more units.

Nondisclosure/Failure to Report: Failure to timely or accurately report sales or other data can be symptomatic of financial distress. Fundamentally, as cash flow constricts, franchisee management tends to focus more on resolving core issues of survival, rather than on more administrative functions, such as reporting to the franchisor. Again, a franchisor should make a prompt inquiry to ferret out the problem and insist on full compliance with franchise reporting requirements. The options outlined earlier are typically available in the event a franchisee persists in failing to report in accordance with the requirements of its franchise agreement.

Failure to Maintain and Repair Units: Cutting corners is a fact of life for a financially distressed franchisee. When cash is short, a franchisee faced with the not-so-tough choice of buying product or paying for noncritical building and equipment maintenance or repairs will typically choose the former for obvious reasons. Product

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sales generate revenue, while repairs and maintenance deplete scarce cash. Routine inspections can alert a franchisor to the existence of this problem. Franchise agreements typically mandate proper maintenance and repair of a franchised unit. Again, the mechanisms selected to enforce these provisions will depend in large part on the severity of the problem and the existence of other defaults. One early step a franchisor can take, short of declaring a default, is to work with the franchisee to determine the scope of outstanding maintenance and repair items and develop a schedule for completion in accordance with a realistic budget.

Lagging Remodeling Schedules: As with the case of maintenance and repairs, it is not uncommon for franchisees to fall behind on remodeling schedules when cash is tight. Across-the-board extensions are sometimes granted, especially when the failure is pervasive throughout the system. Again, in lieu of issuing a notice of default, or in conjunction with specifying a cure for a previously noticed default, a franchisor can enter into an agreement with a franchisee to extend its remodeling deadline. The scope and cost of remodels together with the franchisor's timetable for completion will guide the length of any extension. A persistent failure to meet even extended schedules, however, usually indicates the presence of serious financial difficulties.

Lack of Quality Control and Increased Customer Complaints: Customer complaints and poor performance on customer surveys are also signs of possible financial distress. Mismanagement may also be a culprit but often is just another symptom of insufficient cash flow. It is incumbent upon a franchisor to enforce the provisions of its franchise agreement. Inspections should be performed, deficiencies noted and, if appropriate, cure periods provided.

Slow Sales: A sustained, noncyclical decline in sales generally points to a problem. A franchisor can learn a great deal about a franchisee's current sales patterns by comparing current sales information with prior-year data during comparable sales periods. There are myriad possible causes for declining sales. Therefore, the condition, while not necessarily a default, probably merits further inquiry and follow-up with the franchisee to determine the cause of the problem and to identify possible solutions. Most franchisees cannot sustain declining sales and lost revenues for protracted periods and still meet their financial obligations.

Preparing For A Franchisee Bankruptcy Or Receivership

Update Files: A franchisor about to embark on workout discussions with a franchisee in default should require from it updated and complete financial and organizational information, and any guarantors or other responsible parties, as a condition to moving forward. Current financial data are necessary for the franchisor to determine whether, and to what extent, to offer concessions, and to assess the collectibility of past due amounts, either from principal or secondary sources. Any reluctance on the part of the franchisee, in these circumstances, to warrant the accuracy, completeness and veracity of any information should raise a red flag.



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Be Organized: All controlling documents should be in proper order, complete and signed by all appropriate parties. If they are not, then a franchisor would be well advised to correct and complete its documents in conjunction with, or as a predicate to, engaging in workout discussions with the franchisee.

Pay Attention to Detail: Any notice of default a franchisor issues to a distressed franchisee must comport in all respects with the requirements set forth in the operative agreement and applicable law. Attention to seemingly minor details, such as addresses, parties' names and capacities, and applicable cure periods, is absolutely critical. Technical deficiencies provide fertile ground for challenging the validity of a default and termination. Usually, a franchisor can get a "do over," but if bankruptcy or receivership intervenes, it may be too late.

Determine Best Course of Action on a Unit-by-Unit Basis: Unlike most creditors, franchisors typically are not concerned solely with recovering past-due accounts receivable from franchisees in default. Rather, a predominant concern for franchisors is protecting the system and stanching future losses. When signs of financial distress arise, one of the first steps a franchisor should take is to evaluate the franchisee's market and operations. Due diligence will enable a franchisor to determine, on a unit-by-unit basis, which problems lie with management, which markets are desirable, which units are salvageable, whether certain units ought to be marketed to a new or existing franchisee, whether it makes sense to acquire any of the units, and whether some units simply must be closed. Once a franchisor has developed an appropriate course of action, or restructure model, it is necessary to evaluate available means of executing the restructure.

Consider Termination and Granting a Temporary License: To both preserve their rights and allow time to negotiate and effectuate a restructure, franchisors often will terminate a defaulted franchise agreement and grant a temporary license to a financially distressed franchisee for a presumably short, and clearly limited, period of time. This gives the franchisee an opportunity to try to turn its business around, while enabling the franchisor to retain close control over the duration of the license in the event of further defaults.

Termination, if done properly and before bankruptcy, has an additional advantage. The federal bankruptcy laws generally allow a debtor to decide whether to assume (retain and perform) executory contracts or assign them to a third party (possibly without the consent of the non-debtor party). If there is no valid franchise agreement when the bankruptcy petition is filed, there is nothing for the debtor to assume or potentially assign. Although a franchisee debtor may continue to operate in Chapter 11 for the term of a temporary license, once the license expires, there is no contract for the franchisee to assume, nor any authorization to operate the franchised business, unless the franchisor grants an extension of the license.

Avoiding a battle over a franchisee debtor's assumption or assignment of its franchise agreement is important, because the law concerning a franchisee's right to assume and assign a franchise agreement varies from jurisdiction to jurisdiction. Some courts prohibit a franchisee from assuming or assigning its franchise agreement without the franchisor's consent. Others may permit a franchisee to assume, but

not assign, a franchise agreement, provided the franchisee meets the statutory criteria for assumption, which include providing adequate assurance that it will promptly cure defaults and comply with the terms of the agreement post-assumption. Still others may permit a franchisee to assign its franchise agreement to a third party, who may not be acceptable to the franchisor, if the assignee provides adequate assurance of future performance.

Pre-Negotiated Chapter 11 Cases

A pre-negotiated Chapter 11 – one in which the provisions of a Chapter 11 plan or less formal restructure vehicle are negotiated and agreed to among the franchisee, the franchisor and, typically, the franchisee's secured lenders before the Chapter 11 case is filed – can take many forms and may provide for rehabilitation of the franchisee's business, or complete or partial liquidation. Often, the plan involves a determination as to which units will be retained and operated by the franchisee, sold to a third party or the franchisor, or closed.

When disagreements or inertia preclude a pre-negotiated arrangement, the parties will be left to their respective rights in Chapter 11 – clearly a less desirable result. A franchisor should take advantage of the pointers outlined above, from correcting and completing documents to terminating franchise agreements, during the period preceding the filing, to ensure that it is in the best position possible in the event of a bankruptcy filing. At the same time, it should also determine its position concerning the viability of the franchised units and the optimal business outcome for the operation. The business solution will drive the actions a franchisor takes in the Chapter 11 case and the aggressiveness with which it pursues them.

Receivership

A secured lender typically prefers a receivership action to a bankruptcy filing, primarily because receivership confers a degree of control upon the secured lender that it does not normally enjoy in a Chapter 11 case. The secured lender typically selects the individual who is appointed receiver (subject to court approval) and drafts all of the important documents in the case, including the critical appointment order, which sets forth the rights, duties, and powers of the receiver. While a secured lender may have a lien on a franchisee's building, equipment, revenue, and every other asset of the franchisee pertaining to the operation of a franchised business, including possibly the franchise agreement itself, it does not have the right to operate the franchised business without the consent of the franchisor. So, unless the secured lender wants to close the business, it must come to terms with the franchisor.

When possible, prior to the filing of the receivership action, the franchisor should attempt to reach agreement with the secured lender concerning the operation of the units post-receivership so those terms can be incorporated into the appointment order. Points of particular concern for a franchisor include operations, reporting, repair and maintenance, remodeling, payment of royalties and fees, and preserving important rights concerning potential sales and other transfers. Each of these matters can be negotiated as a condition for granting the receiver a license to operate. A franchisor should insist that the court be made aware of all agreements with the receiver/ secured lender, and the terms of such agreements should always be incorporated into the order appointing the receiver.

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