Alternatives to Franchisee Bankruptcy: Workouts, Compositions of Creditors, Assignments for the Benefit of Creditors, and Receiverships

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When a franchisee files for bankruptcy, its franchisor, landlord, suppliers, and customers are all affected. In the short term, the franchisor usually experiences a delay in receiving post-petition royalties and advertising fees.[1] In the long run, the franchisor may lose a valued location or see it transferred by the bankruptcy judge to an operator that the franchisor has not approved, despite an anti-assignment provision in the franchise agreement.[2] Worse yet, the franchisor's brand may be damaged if the system's quality standards are not maintained during the bankruptcy or if the franchisee rejects the franchise agreement,[3] de-brands, and continues operating as an independent in violation of its noncompetition covenants. Even a single franchisee bankruptcy can disrupt and demoralize the entire system, tempting other marginal operators to file based on the perceived success of one franchisee in publicly escaping its financial obligations.

Landlords suffer too. While the franchisee takes advantage of the Bankruptcy Code's generous window of opportunity to decide whether to assume

1. Franchise agreements are subject to special treatment under the Bankruptcy Code as "executory contracts." *See* 11 U.S.C. § 365. Once a franchisee files for bankruptcy protection, a franchisor's ability to enforce the termination provisions of a franchise agreement is severely limited by § 365's emasculation of *ipso facto* clauses contained in most franchise agreements that would otherwise allow for termination based on the financial condition, insolvency, or bankruptcy of the franchisee. *See* 11 U.S.C. § 365(e).

2. *See* Jason B. Binford, *Assigning a Franchise Agreement over the Franchisor's Objection: Bankruptcy May Make It Possible*, 32 Franchise L.J. 71 (2012).

3. In a Chapter 11 case, the franchisee does not have to determine whether to assume or reject the franchise agreement until confirmation of the plan of reorganization. *See* 11 U.S.C. § 365(d)(2).

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or reject the lease,[4] landlords are forced to sit on the sidelines, prevented from evicting the franchisee by the automatic stay.[5] If the franchisee ultimately rejects the lease and gives up the location, the landlord will find its claim for future rent subject to a cap under the Bankruptcy Code.[6]

Suppliers are also hurt. They may incur large losses for goods delivered to the debtor more than twenty days before the bankruptcy filing,[7] possibly recovering just pennies on the dollar from the bankruptcy estate. On the other hand, if those suppliers were lucky enough to be paid during the ninety days before the bankruptcy filing, they will likely be the targets of preference litigation—those nasty "claw back" actions in which creditors are forced to disgorge payments received during the three-month run-up to the bankruptcy filing.[8]

Customers may encounter a dark, dingy unit with dirty floors and empty shelves or a restaurant with stale rolls and slow service because there is not enough waitstaff. Parents whose children attend a preschool that has filed a Chapter 11 may find that their kids' favorite teachers or playmates have suddenly left and that there are not enough toys and art supplies.

The franchisee will not escape unscathed. Although the bankruptcy system is designed to give a troubled business breathing room to reorganize while protected from aggressive creditors trying to seize its assets, bankruptcy is not the free ride that a failing franchisee may think it is. Once its bankruptcy case has commenced, the franchisee becomes a debtor[9] under the Bankruptcy Code. The debtor and its principals lose all sense of privacy about their business affairs because virtually everything in a bankruptcy is a matter of public record. Bankruptcy is a stressful, time-consuming process that takes management away from the day-to-day operations of the franchise for unproductive activities like court appearances, meetings with attorneys and creditors' committees, and preparation of special financial schedules and reports for the bankruptcy case.

Bankruptcy is also expensive. Lawyers and financial professionals assisting the debtor demand large retainers before the bankruptcy is filed. After the filing, professionals are paid, often millions of dollars in big cases, before general unsecured creditors.[10] Indeed, the feeding frenzy for fees in large

4. *See* 11 U.S.C. § 365(d)(4) (2013) (providing that the debtor in a Chapter 11 case has at least 120 days to decide whether to assume or reject a lease of nonresidential real property). This deadline is routinely extended by the court.

5. 11 U.S.C. § 362(a) (2013).

6. 11 U.S.C. § 502(b)(6) (2013).

7. Under 11 U.S.C. § 503(b)(9) (2013), suppliers are generally entitled to an administrative expense claim for goods received by the debtor within twenty days before the bankruptcy filing. Administrative claims are paid before general unsecured claims.

8. 11 U.S.C. § 547 (2013).

9. 11 U.S.C. § 101(13) (2013).

10. *See, e.g.*, Maria Chutchian, *New Bankruptcy Fee Guidelines Won't Hurt Attys' Paydays*, LAW360 (Oct. 28, 2013, 6:46 PM), http://www.law360.com/articles/483261/new-bankruptcy-fee-guidelines-won-t-hurt-attys-paydays (discussing professional fees in high-profile Chapter 11

Chapter 11 cases has drawn so much scrutiny that effective November 1, 2013, the U.S. Trustee Program (UST), the Justice Department's watchdog agency charged with keeping the process of bankruptcy honest, implemented new guidelines for professional compensation in big cases.[11] Even the government has its hand out, requiring debtors to pay the Justice Department a quarterly user fee for the services of the UST, based on the amount of the debtor's disbursements in its Chapter 11 case.[12]

When a franchisee bankruptcy is filed, everyone loses something. Is there a better way? Fortunately, a number of state court and nonjudicial strategies can and should be used to restructure or liquidate the assets of a struggling franchisee outside of bankruptcy court. In fact, troubled businesses may already be turning to these alternatives because bankruptcy filings are trending downward from their high water mark in 2009. The American Bankruptcy Institute reports that there were a total of 37,917 business bankruptcy filings during the first three quarters of 2013, representing a 53 percent decrease from the high point of 80,923 business filings during the same time period in 2009.[13] Of course, some of the decrease is a function of lower interest rates and the recovery in the national economy, but it is not hard to imagine that some of the decline in commercial bankruptcy filings is attributable to businesses finding a less painful way to restructure or wind down. This article will address several of these nonbankruptcy alternatives and discuss how they can be used to save time and money for all the major players.[14]

I. Advantages of Bankruptcy Alternatives

Except in those instances where a bankruptcy filing can truly add value to a franchisee's business, such as when its assets are pledged to secure substantially more debt than the assets are worth and the secured creditors will not negotiate a reduction of their loans outside of bankruptcy, alternatives to bankruptcy often present a quicker, less expensive, more flexible, more private and collaborative way to achieve a restructuring or liquidation of a distressed franchise unit. For the purposes of this discussion, we assume that the

cases, which can be enormous—over $300 million in the American Airlines bankruptcy and in excess of $2 billion in the Lehman Brothers case).

11. Fee Guidelines, U.S. Dep't of Justice (Nov. 4, 2013, 3:47 PM), *available at* http://www.justice.gov/ust/eo/rules_regulations/guidelines/index.htm.

12. 28 U.S.C. § 1930(a)(6) (2013).

13. *See* Statistics, Am. Bankr. Inst., *available at* http://news.abi.org/statistics (last visited Dec. 8, 2013).

14. Disclosure issues under the FTC Franchise Rule, 16 CFR § 436, may arise if a franchisee files for bankruptcy and the franchisor initiates an adversary proceeding to protect its rights under the franchise agreement (Item 3) or seeks permission from the bankruptcy court to terminate the agreement (Item 20). An in-depth discussion of these issues is beyond the scope of this article. The franchisor, however, should be aware that nonbankruptcy alternatives, especially nonjudicial alternatives, may allow for more favorable reporting of the outcome of a franchisee failure, such as a sale to an assignee rather than a termination.

failing franchisee is either a limited liability company or a closely held corporation, operated by a husband and wife who are personally liable for the business debts, either as guarantors or as the initial franchisees. The principals may have used their life savings to invest in the franchise and therefore have very limited assets other than the franchise and their personal residence, making both the financial and the emotional stakes high if the business fails.

Given this scenario, it is important for all the key players to develop an understanding of why the franchise is in distress and whether it can survive. Was it too thinly capitalized to begin with and in need an infusion of additional equity or a refinancing? Has there been a drop in demand due to the overall economy or the appearance of an attractive new competitor in the local market? Is management absent, inefficient, inexperienced, and in need of additional training, or are the owners distracted by personal problems that require medical or other nonbusiness professional intervention? These questions should be answered before undertaking any type of financial restructuring, whether in a bankruptcy or outside of it. Some of these causes of business failure can be remedied, but other types of problems may be so serious that the only reasonable solution may be an orderly liquidation.

If liquidation is inevitable, everyone needs to be onboard, including the principals of the franchisee. The franchisor may need to take a giant step back and analyze the big picture. Perhaps it should refrain from immediately enforcing all of its rights under the franchise agreement, such as sending a notice of termination, which may leave the franchisee feeling as though it has no choice other than to run into bankruptcy court. Exercising such restraint might be a prudent business decision because a nonbankruptcy liquidation of a failing franchisee can benefit the franchisor in many ways, including more control over the process, less notoriety, and reduced legal fees.

If there is a consensus that the business may be viable, the franchisee will need to generate realistic short-term and long-term projections of its future revenues and expenses and develop a strategy for a nonbankruptcy restructuring. To be successful, the franchisee must persuade its creditors that future cash flow from operations, plus any equity infusion, refinancing, or both, will be sufficient on a going forward basis to pay the future expenses of the business and retire a meaningful portion of its accumulated debts over a reasonable period of time. The franchisor should consider making financial concessions such as royalty reductions, deferrals, or waivers to assist the franchisee in attempting to restructure outside of bankruptcy. This will demonstrate that the franchise system is supporting the troubled unit and will help the franchisee persuade its other creditors to work with it outside of a Chapter 11.

The beauty of nonbankruptcy alternatives is that they have less of a public stigma, can be more creative, are usually quicker to implement, and incur fewer professional fees than a bankruptcy. However, even outside of bankruptcy, the franchisee will need to make a fair and complete disclosure of its financial condition if it hopes to induce creditors to accept less than what they are owed. While bankruptcy substitutes do not typically require a formal disclosure statement and plan of reorganization as mandated by the Bankruptcy Code, the franchisee should prepare accurate and up-to-date balance sheets, income statements, cash flow projections, and a liquidation analysis to demonstrate to creditors what they would receive if the business closes. In short, any consensual restructuring or nonbankruptcy liquidation should include candid financial disclosures and some sort of a plan—for which the franchisee will need professional assistance from an accountant, attorney, turnaround specialist, or other financial advisor.

II. Disadvantages of Nonbankruptcy Alternatives

The biggest disadvantage of using a nonbankruptcy alternative to ease an insolvent franchisee out of its financial woes is the risk that, despite the best efforts of the franchisee and its collaborating creditors to restructure or to liquidate in an orderly fashion, other disgruntled creditors may file an involuntary bankruptcy petition against the franchisee.[15] If the franchisee ends up in bankruptcy anyway, the financial arrangements made as part of the nonbankruptcy alternative could be unwound and any prebankruptcy payments or security received under those arrangements will be vulnerable to attack as preferences or fraudulent transfers in avoidance actions brought by the bankruptcy trustee.[16] Related to this risk is the possibility that major creditors and the franchisee could invest significantly in professional fees for a nonbankruptcy alternative, only to find themselves starting from scratch once an involuntary bankruptcy is filed.

It should be kept in mind that the risk of an involuntary filing can be minimized by good communications and by making sure that all creditors are invited to participate in the process of planning for a nonbankruptcy alternative. Creditors that file involuntary bankruptcy petitions usually do so because they are frustrated by the debtor's lack of transparency coupled with the belief that insiders are dissipating the debtor's limited assets. Few creditors will be motivated to invest the time and money to initiate an involuntary bankruptcy if the franchisee has been candid about its financial condition and has included all creditors in the attempt to resolve its financial problems.

Another disadvantage of pursuing nonbankruptcy alternatives is the lack of the automatic stay,[17] which, immediately upon a voluntary bankruptcy filing, operates as an injunction to prevent creditors from pursuing collection efforts against a struggling franchisee while it attempts to reorganize or its assets are liquidated. Outside of bankruptcy, no such universal, automatic protection is available to stop a creditor from seizing a bank account or

15. 11 U.S.C. § 303 (2013).
16. 11 U.S.C. §§ 547, 548, 550 (2013).
17. 11 U.S.C. § 362(a) (2013).

levying on tangible personal property, so it is important for those creditors that wish to work with a financially fragile franchisee to get a handle on what is going on with other creditors that may become spoilers.

A final disadvantage of nonbankruptcy alternatives can arise when a failing franchisee's assets are being sold to a third party. Potential buyers may be concerned about the quality of the title to the assets they are purchasing from a seller that is in financial distress. In a sale under § 363 of the Bankruptcy Code (a 363 Sale), there is no doubt that the buyer takes title to the assets free and clear of all liens, claims, interests, and encumbrances.[18] Any liens attach to the proceeds of the sale and the buyer is assured of pristine title. However, if an asset sale occurs outside of bankruptcy, the buyer will not always get the same blanket protections and may insist that it will only go forward with the purchase if the franchisee files for bankruptcy.

These potential disadvantages of nonbankruptcy alternatives can usually be minimized through careful drafting of pleadings and other relevant documents used in state court insolvency proceedings, open communications between the debtor's insolvency professionals and the creditor body, and credible assurances that insiders are not looting the debtor's assets.

III. Out of Court Workouts

An out of court workout is, by definition, a nonjudicial consensual approach to solving a failing franchisee's financial problems. Using this technique, because no Bankruptcy Code or other statutory scheme imposes rules about who gets what and when they get it, the relative bargaining positions of the parties, their personalities, and the creativity of the people attempting to achieve the workout will govern the outcome, including whether the franchisee stays out of bankruptcy. Time and patience is required for a successful workout to be implemented. Accordingly, it is important for the workout process to begin before the franchisee is in desperate straits and a bankruptcy is inevitable. It may be too late for anything but a bankruptcy if multiple judgments have been entered against a franchise, a creditor has levied on a bank account, or a landlord has filed an eviction action. In a perfect world, the franchisee would approach its key creditors as soon as it senses that it is in serious financial trouble, but that simply does not happen very often.

The franchisor, among all creditors, is in a unique position to learn about a franchisee's financial difficulties in the earliest stages because the franchisee is often required to provide monthly financial reports. The franchisor should identify franchisee financial problems at their inception and encourage troubled franchisees to seek professional financial assistance sooner rather than later, when the lure of bankruptcy as an easy way out will seem more attractive.

18. 11 U.S.C. § 363(f) (2013).

Franchisors should look for these red flags of financial distress: late submission or failure to file monthly reports (including incomplete reports), late payment, failure to pay or partial payment of franchise and advertising fees, failed onsite inspections, high employee turnover (especially in-house accounting personnel), frequent changes in suppliers, growing accounts receivable or payable balances, unusually high or low inventories relative to other franchisees, customer complaints and loss of significant customers, employee complaints (especially claims for unpaid wages), landlord default notices, notices of tax claims or liens, and the initiation of collection actions by lenders or suppliers.

The secured lender (or lenders) is typically the 800-pound gorilla in the room. The lender will ordinarily have a first priority lien on all of the franchisee's tangible and intangible assets, including the franchise agreement, and a personal guaranty from the principals of the franchisee. Even though the secured lender has the most leverage in a workout scenario, it may also have the most to lose. In most instances, the secured lender does not want its collateral back because the collateral has little resale value and is probably worth less than the amount of the loan. Further, the guaranties held by the secured lender may be worthless because the principals of the franchisee are often judgment proof and may file bankruptcies themselves if their franchise unit fails. As a result, even though the secured lender probably has the most leverage in the workout negotiations, it may be willing to make concessions, such as reducing the interest rate, waiving fees and penalties, permitting interest only payments during a moratorium period, extending the maturity date of the loan, or expanding a line of credit.

Sometimes lenders insist that a troubled borrower engage a turnaround professional to attempt to stabilize the business by providing management assistance, developing realistic financial projections, and negotiating accommodations with suppliers, landlords, and other creditors. However, lenders, especially large national banks, may insist that franchisees hire expensive national turnaround firms that the lenders have worked with before. It may be more advantageous for the franchisee and the other creditors involved in the workout to employ a local turnaround manager that is likely to charge less and that may have an easier time negotiating deals with local landlords and suppliers based on personal relationships developed during prior assignments. The Turnaround Management Association (TMA) is a national organization comprised of such professionals, including attorneys, accountants, lenders, equity investors, and management consultants.[19]

Franchise systems may have formal or informal financial counseling or workout programs for their troubled franchisees or may even pay for outside financial professionals to mentor failing franchisees. These programs can include help with cash management and budgeting, restructuring unpaid

19. *See* Turnaround Management Association, Membership Directory, *available at* http://www.turnaround.org (last visited Dec. 8, 2013).

franchise and advertising fees into long-term debt, and even teaching unsophisticated franchisees how to approach landlords to renegotiate an above-market lease or request a rent reduction during the slow season. In a workout scenario, sometimes the franchisor will guaranty the franchisee's obligations to key suppliers in order to gain concessions on the amount to be paid for past due accounts and ensure future deliveries. The franchisor may also consider taking over the franchisee's lease to gain control over the location as a hedge against a possible future bankruptcy where the lease might be transferred.

All in all, franchisors can and often do assume a leadership role in helping a troubled franchisee work through its financial problems to avoid a bankruptcy. This can benefit the entire creditor body and franchise system if things go well and the franchisee is rehabilitated outside of bankruptcy. However, because the franchisor can exert so much power by using the threat of terminating the franchise agreement or pursuing the principals on their personal guaranties, if the franchisee ultimately fails, the franchisor could be subject to lender liability type claims, such as breach of fiduciary duty, breach of the duty of good faith and fair dealing, or wrongful interference with the franchisee's day-to-day management. Accordingly, the franchisor should be reasonable in its demands during workout negotiations, and it should always leave something on the table for both the franchisee and its suppliers to minimize both this risk and the incentive for trade creditors to get together to pursue an involuntary bankruptcy.

Any workout arrangement between the franchisee and a creditor should be memorialized in writing. Secured lenders usually have their own forbearance agreement, which typically includes a general release of claims against the lender and requires the borrower to acknowledge that the loan is in default and reaffirm any personal guaranties in exchange for the lender's indulgences. Payment of a fee to the lender may be required to enter into a forbearance agreement, and this should be factored into the workout negotiations. Secured lenders may ask for some other type of credit enhancement, like personal guaranties, if they do not already have them in place; they may also set financial benchmarks for the franchisee.

The franchisor may also use a standard workout agreement, which should include a cross-default provision that makes a default under the workout agreement also a default under the franchise agreement. The franchisor may have a term promissory note template or other forms such as a release, reaffirmation, and cure agreement that it uses system-wide, especially for workouts which involve allowing the franchisee to convert some of its current payables into long-term debt. Although it seems counterintuitive, the franchisor might even want to consider releasing the franchisee's principals from their personal guaranties in exchange for their agreement to sell the franchise back to the franchisor on favorable terms after a short period of time if a turnaround does not appear to be working. This approach creates a strong disincentive for the owners of the franchisee to file for bankruptcy if the workout is unsuccessful.

Because suppliers may not be as sophisticated, the other players in the restructuring should ensure that the franchisee's trade vendors have agreed in writing to accept less than the full amount they are owed and/or payments over time or whatever other concessions they are willing to make as part of a workout. Entering into a writing is a powerful tool for building a consensus and keeping everyone committed to it.

IV. Composition of Creditors

One highly formalized workout strategy is called a composition or arrangement of creditors. A composition is

> [a]n agreement between a debtor and two or more creditors for the adjustment or discharge of an obligation for some lesser amount; an agreement among the debtor and two or more creditors that the debtor will pay the creditors less than their full claims in satisfaction of their claims.[20]

In the composition agreement, the creditors agree to discharge or forgive the balance of the debt owed to them and forbear from collection activities so long as the debtor performs under the terms of the composition. Compositions of creditors typically require a very high percentage of creditor participation to become effective because many creditors are unwilling to take a big hit unless they feel that everyone else is making an equivalent sacrifice.

The document memorializing the composition agreement can resemble a short version of a Chapter 11 reorganization plan, specifying classes of creditors and terms of repayment for each class.[21] The composition process may even include a claim form for creditors to submit and a mechanism for resolving any disputes about the size of claims. Unlike a Chapter 11 plan, in the composition of creditors, the creditors will need to agree not to undertake litigation against the debtor and forgo other collection efforts because there is no automatic stay barring such activities outside of a bankruptcy.

For a composition of creditors to be successful in the franchise world, the franchisee would need to involve the franchisor and any secured lenders at the inception. The franchisee could then work with the franchisor and the secured lenders to develop a plan to propose to suppliers and the landlord. The restructuring strategy under the composition could take many forms: the continued operation of the franchise with periodic payments to creditors, a single payment to creditors funded by a refinancing or capital infusion to retire old debt, or pro rata payments from the proceeds of an orderly liquidation or sale. The proposed composition of creditors could be communicated in a number of ways, such as by circulating the proposed plan with a persuasive cover letter, inviting creditors to a joint meeting, or through one-on-one negotiations. As in a Chapter 11, the franchisee will need to ac-

20. Black's Law Dictionary 304 (8th ed. 2004).

21. *See* Thomas Lindahl, *Alternatives to Bankruptcy: A Primer on Composition Agreements*, 28 Mich. Bus. L.J. 43 (Fall 2008) (discussing the use of compositions of creditors and providing a sample Michigan form).

tively solicit support from creditors to gain the votes needed to make the composition effective.

Since compositions of creditors are fundamentally contracts, they may be enforceable in state court and a state's corporation act may even offer an avenue to bind dissenting creditors.[22] However, the parties should not count on judicial enforcement of a composition of creditors, as its overlap with the Bankruptcy Code and other federal law may create preemption issues.[23] Although compositions of creditors have been used with success in certain states, they are not seen in all parts of the country, so it is best to check the local practice in the franchisee's jurisdiction before undertaking a composition of creditors.

V. Assignments for the Benefit of Creditors

While a composition of creditors may be considered a state court analog to a Chapter 11 reorganization under federal bankruptcy law, an assignment for the benefit of creditors (ABC) is in many ways comparable to Chapter 7 liquidation under the Bankruptcy Code. An ABC is a creature of state law in which the debtor (the assignor) transfers all of its right, title, and interest in its assets to an independent third party fiduciary (the assignee), which is hired by the assignor to sell its business and to equitably distribute the net proceeds to the assignor's creditors, typically on a pro rata basis. The assignee, who may be an accountant, attorney, or turnaround specialist, takes title to the assets in a fiduciary capacity and usually undertakes an immediate orderly liquidation. However, in some instances, an assignee may operate the assignor's business for a short period of time, if necessary, to complete work in progress or to maximize the value of the assets at sale, where there is the prospect of selling the business as a going concern.

ABCs originated in the English common law, and currently over thirty states have ABC statutes,[24] while others, such as Connecticut, have not codified this common law practice. ABCs are initiated voluntarily in accordance with the state's corporate law as well as any applicable ABC statute, and the assignment should comply with a company's articles of incorporation and bylaws, which ordinarily require both board and shareholder consent. The assignee often has its own standard trust agreement and will require a retainer with the balance of the fees and expenses paid from the proceeds of the asset sale. Once engaged, the assignee is typically required to record the assignment in the assignor's county of residence and serve all known creditors with a notice of the assignment, notice of a bar date for claims, and information about how to submit a claim.[25] Some ABC statutes also re-

22. *Id.* at 49, n.7.

23. *Id.* at 49, n.8.

24. *See* Robert Richards & Nancy Ross, *Practical Issues in Assignments for the Benefit of Creditors*, 17 Am. Bankr. Inst. L. Rev. 5, 6 n.2 (Spring 2009) (providing a state-by-state list of ABC statutes).

25. *See, e. g.*, N.J. Gen. Stat. §§ 2A:19-7, 19-8 (2013); Mass. Gen. Laws ch. 203 § 41 (2013).

quire the assignee to post a surety bond and file an inventory of the assignor's assets.[26]

The assignee takes the assets subject to the claims of fully perfected secured creditors, who are sometimes the impetus for an ABC because of its speed and efficiency. Even though there is no automatic stay in an ABC, unsecured creditors (and any unperfected secured creditors) are generally deterred from going after the assignor's assets once they are in the hands of the assignee. This is because the assignee is treated as a lien creditor under the Uniform Commercial Code[27] from the time of the assignment. Because the assignee's interest in the assets is automatically perfected upon execution of the assignment without the need to file a financing statement, the assignee is senior to any unperfected secured creditors and to all unsecured creditors.[28] In addition, under the ABC laws of some states, the assignee may be able to void existing writs of attachment on the assets which predate the assignment.[29]

ABC practices vary widely across the country. In some states, for example, New Jersey and Florida, there is substantial court supervision of the ABC process, which is run like a baby bankruptcy with court approval of assignee sales, while in states like Massachusetts, there is virtually no court supervision.[30] Nonetheless, even in states with minimal judicial involvement, creditors may be protected by certain statutory requirements, like Massachusetts' rule that a majority of creditors "in number and value" must assent to the assignment.[31]

Some state statutory schemes, such as New Jersey's, give the assignee avoidance powers, similar to those given to a bankruptcy trustee, under which the assignee can seek to claw back payments made to creditors prior to the assignment that allowed them to get more than their fair share of the assignor's assets.[32] California developed sophisticated ABC practices for liquidating the assets of technology firms during the dot.com era. A number of turnaround firms became the darlings of venture capital and private equity companies as they gained experience in selling intellectual property quickly and quietly in ABCs.[33] Yet other states, notably New York, have lagged behind and failed to develop modern ABC practices.[34] Accordingly,

26. *See*, *e. g*., N.J. GEN. STAT. §§ 2A:19-7, 19-10 (2013); 10 DEL. CODE ANN. §§ 7381, 7383 (2013).

27. UCC § 9-102(a)(52)(B) (2013).

28. UCC § 9-309(12) (2013).

29. GEOFFREY L. BERMAN, GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: A PRACTICAL GUIDE 2 (Am. Bankr. Inst. 2000).

30. *See generally* Richards & Ross, *supra* note 24.

31. MASS. GEN. LAWS ch. 203 § 41 (2013).

32. N.J. GEN. STAT. § 2A:19-3 (2013).

33. Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 WASH. U. L.Q. 1375, 1417-18 (2004).

34. *See* New York City Bar Ass'n Comm. on Bankruptcy & Corp. Reorganization, *Non-Bankruptcy Alternatives to Restructuring and Asset Sales*, Nov. 2010, at 13, *available at* http://www.nycbar.org/pdf/report/uploads/20072001-NonBankruptcyAlternativestoRestructuringsandAssetSales.pdf (suggesting that the ABC law in New York is "antiquated" and infrequently used).

local practices in the state where a failing franchisee operates should be investigated to determine whether an ABC might be a good exit strategy.

An ABC offers many advantages for liquidating a failing franchise. The process is less expensive than bankruptcy and involves less notoriety. An asset sale can be conducted quickly by an experienced assignee, who may be able to achieve a higher price for the assets than a Chapter 7 trustee. The assignee is an independent professional who will inspire more trust during the wind down process than the franchisee would. Significantly, in the sale of a franchise unit, the assignee will not become emotionally attached to the franchise operation or motivated to delay the process or sabotage a potential sale in the hope of getting a chance to resuscitate the business.

Another advantage of an ABC as compared to bankruptcy is the franchisee's ability to select the person or firm who is going to liquidate its assets. This could be a tremendous advantage for the franchisor, which might be able to induce the franchisee to select an assignee familiar with the franchise system to liquidate the unit. In a Chapter 7 bankruptcy, the UST selects a trustee at random from a standing panel comprised of bankruptcy attorneys (and accountants in some jurisdictions). The appointed trustee may not have any experience with franchising in general or with the particular franchise system to which the franchisee belongs.

There are, however, several disadvantages to an ABC compared to a bankruptcy. As mentioned earlier, there is no automatic stay, so an ABC can be impractical when a number of the troubled franchisee's creditors have already initiated collection actions or when eviction or foreclosure proceedings are underway. ABCs are sometimes attacked as fraudulent transfers under state law, particularly if the purchase price for the assets is low or the assets are bought by insiders of the assignor. The exercise of certain avoidance powers by assignees under state ABC laws has also been successfully challenged in federal court on grounds of preemption by federal bankruptcy law.[35]

Because an ABC, unlike a composition of creditors, typically does not depend on the consent of a large percentage of the franchisee's unsecured creditors, using an ABC always comes with the risk that unhappy creditors could thwart the process by filing an involuntary bankruptcy. Three creditors with unsecured claims totaling $15,325,[36] which are not contingent or disputed, can file an involuntary case against the assignee and drag it into bankruptcy court; if there are less than a dozen creditors in total, excluding employees and insiders, all it takes is one creditor.[37] Bankruptcy courts tend to be de-

35. *See, e.g.*, Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198 (9th Cir. 2005) (holding assignee's exercise of state preference law avoidance powers was preempted by federal bankruptcy law). *But see* Spector v. Melee Entm't LLC, 2008 Del. Super. LEXIS 48, at *27 (Del. Super. Ct. 2008) (holding that the assignee's state preference law avoidance powers were not preempted by federal bankruptcy law).

36. 11 U.S.C. § 303(b)(1) (2013). The minimum aggregate of claims needed to commence an involuntary bankruptcy is adjusted every three years based on the Consumer Price Index. *See* 11 U.S.C. § 104(a) (2013).

37. 11 U.S.C. § 303(b)(2) (2013).

ferential to ABCs initiated in good faith and may abstain from exercising jurisdiction if it is found that "the interests of the creditors and the debtor would be better served" by dismissing the case and allowing the debtor's assets to be sold through an ABC that would yield a better return for the creditors.[38] Indeed, if a bankruptcy is filed more than 120 days after an assignee takes possession of a debtor's assets, the Bankruptcy Code excuses the assignee from the duty to turn the property over to the bankruptcy trustee unless doing so "is necessary to prevent fraud or injustice."[39]

However, even if the assignee ultimately prevails, it is costly and time consuming to fend off an involuntary bankruptcy petition. The author recently represented the buyer of perishable goods from an ABC. The jurisdiction required the assignee to obtain state court approval for the sale. The proposed sale was noticed to all known creditors and a hearing was set as well as the deadline for creditors to object to the sale. No creditor filed an objection to the sale, but on the afternoon preceding the sale hearing, three creditors filed an involuntary bankruptcy petition. The bankruptcy filing had nothing to do with the proposed asset sale. Rather, it was a preemptive strike against the assignee, who had substantial avoidance rights against these creditors under the state's ABC law, for preference payments they had received during the four months prior to the assignment. The reach-back period for preference payments made to noninsiders is only ninety days[40] under the Bankruptcy Code. By waiting until the last possible minute to file the involuntary petition, these creditors had effectively manipulated their preference window thereby reducing their exposure by hundreds of thousands of dollars. The assignee immediately filed a motion to dismiss the involuntary bankruptcy as a bad faith filing, massive litigation ensued, and a settlement was eventually reached with the petitioning creditors, under which the bankruptcy was dismissed and the state court approved the asset sale.

In the meantime, the perishable goods had physically deteriorated, the buyer lost some of its opportunities to resell these assets, and under the purchase and sale agreement, the price ultimately paid was adjusted downward to the detriment of all creditors. All nonpetitioning creditors would have been better off if the matter had been resolved without the involvement of the bankruptcy court. This case serves as a good example of what can go wrong in an ABC if there are rogue creditors, so every effort should be made to determine whether an involuntary filing is likely before an ABC is initiated.

VI. Receiverships

Receiverships are an ancient equitable remedy that gained popularity in England during the Elizabethan period as a method of preserving and

38. 11 U.S.C. § 305(a)(1) (2013).
39. 11 U.S.C. § 543(d)(2) (2013).
40. 11 U.S.C. § 547(b)(4)(A) (2013).

managing property in situations where the owner could not be trusted to care for it.[41] In modern times, receiverships are considered an extraordinary remedy. Absent consent, a receiver will only be appointed by a court upon a showing of waste, fraud, gross mismanagement, or other special circumstances, such as risk of loss to the property during protracted litigation.[42]

A receiver is formally defined as one "who by such appointment becomes an officer of the court to receive, collect, care for, administer and dispose of the property or the fruits of the property of another."[43] Receivers can be attorneys, accountants, or other professionals, such as property managers. Receivers may specialize in the management of troubled regulated businesses, such as skilled nursing facilities, which can only be operated by licensed administrators; certain states, like Connecticut, have highly detailed receivership statutes that govern these types of special receiverships.[44] At its best, a receivership is a quick way to insert an experienced manager into a failing company to stabilize the business, stem losses, and prevent a decline in asset values.

General receivership proceedings are typically initiated in state court in the state where the company operates or where the property is located, in accordance with state statutes, rules of civil procedure, general equitable principals, or all three. If there is diversity or another basis for federal jurisdiction, a receivership may also be sought in federal court. A federal receivership could be useful in instances where a failing franchisee has units in more than one state because federal receivers are permitted to reach across state lines to recover property.[45] For a receivership to be a cost-effective strategy, the best practice would be to obtain the franchisee's consent before heading to court; otherwise, the franchisee will have an opportunity to oppose the appointment of a receiver at a hearing, unless an emergency situation exists, in which case the court may appoint a receiver ex parte.[46]

A receivership is not an independent cause of action; rather, it is a form of relief that is ancillary to civil litigation, such as a collection action or a foreclosure case. While an assignee in an ABC may operate as an independent agent, largely outside of the supervision and control of the court, a receiver is often referred to as "an arm of the court."[47] As an officer and representative of the court, receivers may only act within the scope of the authority and discretion granted to them in the order of appointment. A receiver will usu-

41. Ralph Clark, Clark on Receivers § 4 (3d ed. 1959).

42. Hartford Fed. Sav. & Loan Ass'n v. Tucker, 491 A.2d 1084, 1087 (Conn. 1985).

43. *See* Clark, *supra* note 41, at § 11(a).

44. Conn. Gen. Stat. § 19a-541 *et seq*. (2013).

45. 28 U.S.C. § 754 (2013).

46. *See, e.g.*, Conn. Gen. Stat. § 52-504 *et seq.*; *see also* Connecticut Practice Book §§ 21-1, 21-2, 21-3 (2013). The author was involved in a Connecticut foreclosure case in which a receiver was appointed ex parte on the lender's affidavit showing that the debtor had abandoned the premises and an emergency existed. The emergency was an uncontrolled water leak that threatened an entire office building and required immediate attention.

47. *See* Clark, *supra* note 41, at § 11(a).

ally be required to post a bond, prepare an inventory of assets in the receivership estate, and file periodic financial reports with the court. In most states, receivers must seek formal court approval, after notice and hearing, before undertaking any major act with respect to property under their control, such as spending estate funds, borrowing money, or selling assets.

Although unsecured creditors can petition to put an insolvent corporation into a receivership, receiverships are most often sought by secured creditors, particularly mortgage lenders, who do not want to take physical possession or ownership of a troubled property. Nonetheless, these lenders do want to have the rents collected by someone they can trust to pay the mortgage rather than by the borrower who may divert funds and fail to keep the premises in good repair. Such lenders may have relationships with management companies that can be relied on to operate the property economically during an ongoing foreclosure case. Receivers' fees and expenses are usually paid from the income generated from the assets they are managing with any shortfall made up by the lender.

The party seeking the receivership files a motion for appointment of a receiver either at the time an action to collect a debt is commenced or later in the case, when it becomes apparent that the debtor is mismanaging the property, such as by failing to pay bills or neglecting to make needed repairs. The moving party submits a proposed order of appointment of receiver to the court, containing a broad grant of powers that allow the receiver to take possession of the debtor's physical property, books and records, and bank accounts and to manage and control them during the pendency of the receivership. The order typically requires the debtor to surrender all keys to the receiver and vacate the premises without delay. The receiver will also be given the power to collect debts owed to the debtor, initiate lawsuits on behalf of the debtor, and defend in the debtor's name. The order may contain an injunction preventing the debtor from interfering with the receiver and may even enjoin creditors from pursuing collection actions against the debtor while the receiver is in place. The order will usually require the receiver to promptly give written notice to all known creditors of the receivership and provide a means by which creditors can file a claim for payment.[48]

The order of appointment may also direct the receiver to solicit the debtor's property for either a private or a public sale, but ordinarily no sale may be finalized without court approval, after giving all parties in interest notice and an opportunity to object to the sale at a hearing. In this regard, a receivership may resemble a Chapter 7 bankruptcy much more than an ABC, where sales are often conducted in private. However, even when a hearing is required, a receiver can usually get a sale of assets approved by a state

48. Receivers may supply creditors with a standard proof of claim form similar to the one-page claim forms used in a bankruptcy. However, receivers usually do not require that a particular form be used and will accept informal claims embodied in letters with copies of unpaid invoices attached.

court judge within just a few weeks while even a fast-track 363 Sale usually takes several months in a bankruptcy.

Because a receiver's sale is not governed by the Bankruptcy Code, the question of whether the buyer gets title free and all clear of all claims, liens, and interests varies from state to state. For instance, in New Jersey, any court-approved sale of assets by a "liquidator," which by statute includes both assignees and receivers,[49] passes title to the purchaser "free and clear of all liens of the secured creditor" with the liens attaching to the proceeds.[50] Rhode Island's receivership statute contains no similar provision, but it is standard practice for sale orders in that state to direct that the assets are being sold free and clear of liens, claims, and encumbrances, and receiver sale orders customarily direct mortgage holders and other claimants to deliver a release of their encumbrances to the receiver.[51] Similarly, although Connecticut's receivership statute does not contain a 363 Sale analog,[52] savvy buyers insist that the sale order expressly state that the sale is free and clear of liens, claims, and encumbrances, and the courts routinely honor that request.

Receivership practices, like ABCs, vary widely across the country and are used routinely in some states in lieu of bankruptcy. For example, Rhode Island has evolved a highly sophisticated and nimble receivership practice, where for many years experienced receivers have worked with receptive state courts to quickly and efficiently liquidate failed concerns outside of federal bankruptcy court. Receiverships thrive in this state because of three factors: (1) Rhode Island's Business Corporation Act[53] codified the equitable practices of receiverships under the common law; (2) the state has specialized business courts with experienced judges who handle all receiverships; and (3) the state's bankruptcy bar association has developed a standard set of receivership protocols, pleadings, and forms that are widely used and accepted.[54]

Receiverships have not been used frequently for franchisees although sometimes they are initiated by mortgage lenders against hotel franchisees. If a franchisor had to pick a nonbankruptcy alternative as a way to transition a failing unit, an ABC might be a better choice because they are largely extrajudicial and operate out of the public eye in most states. Also, even though receivers are often permitted to run a business for a short period of time before it is sold, they ordinarily do not have to honor prereceivership contracts, so the status of a franchise agreement may be in limbo during a receivership

49. N.J. GEN. STAT. §§ 46-1(a)–(b) (2013).

50. N.J. GEN. STAT. § 2A:46-6(3) (2013).

51. *See* Diane Finkle, *Rhode Island Receivership Proceedings*, Am. Bankr. Inst., 17th Annual Northeast Bankruptcy Conference 104 (2010) (discussing receivership practices in Rhode Island).

52. CONN. GEN. STAT. § 52-504 *et seq.*

53. R.I. GEN. LAWS § 7-1.2-1301 *et seq.*

54. *See generally* Finkle, *supra* note 51, at 101–06.

and the franchisor may not receive its royalties and advertising fees during the receivership without a fight.

Accordingly, if a franchisor finds itself a party to a franchisee receivership initiated by a secured lender, it will be in the franchisor's best interests to be proactive from the outset, especially in situations where a sale of the real estate is anticipated. If a franchisor suspects that a receivership may be in the works, it should reach out to the lender before the receiver is in place to make sure that its rights will be protected during the receivership. Such protections might include: authorization for the receiver to perform all of the franchisee's duties under the franchise agreement, authorization for the receiver to cure any prereceivership monetary and nonmonetary defaults under the franchise agreement, or even permission to terminate the franchise agreement, if all parties agree, coupled with authorization for the receiver to enter into a short-term franchise agreement as a bridge to selling the unit to a new operator. The franchisor should insist that the order appointing the receiver expressly preserve whichever of these concessions the secured party will agree to; otherwise, the franchisor should be prepared to object to the appointment of a receiver and the form of order presented to the court.

VII. Conclusion

As compared with bankruptcy, which is governed by a complex federal statutory scheme, bankruptcy alternatives such as workouts, compositions of creditors, assignments for the benefit of creditors, and receiverships are governed by state law and traditional equity principles, which can be narrowly tailored to fit the situation at hand. These flexible practices can be quickly implemented, often with minimal court oversight, to maximize the value of a failing franchisee's assets while minimizing the stigma, cost, and delay of restructuring or liquidating a failing unit in a bankruptcy. Local practices should be investigated to determine what type of bankruptcy alternatives are generally employed in the jurisdiction where a struggling franchisee operates because of tremendous variation across the country.