FRIENDLY FORECLOSURE

A Non-Bankruptcy Alternative to Resolution of Franchise Defaults

by Daniel Eliades and Caitlin Conklin

Franchising is big business. In the United States, hundreds of thousands of franchised businesses provide nearly 9 million jobs, produce more than $350 billion in annual payroll, and contribute more than $540 billion to the gross domestic product.[1] Notwithstanding the substantial financial production of franchising in the United States, even the most successful franchise systems will encounter franchisees in financial distress.

A franchisee bankruptcy filing is harmful to the public's perception of the franchisor's brand. The shuttering of a franchised location, as a result of a bankruptcy or otherwise, is particularly detrimental to the franchisor and its good-standing franchisees. As a result, astute franchisors are willing to work with franchisees in financial distress[2] before a bankruptcy occurs, in order to, among other things, maintain brand image and reputation.[3] Non-bankruptcy options for troubled franchisees, which may be favored by franchisors, include: 1) an out-of-court workout with the franchisor, which could involve a forbearance agreement and potential modification of the franchise agreement;[4] 2) a pre-bankruptcy asset sale providing for assignment of the franchise agreement to a new operator; 3) termination of the franchise agreement and de-identification of the business from its affiliation with the franchisor; and/or 4) if applicable, the surrender of collateral by the franchisee to the franchisor, as secured creditor, pursuant to Article 9 of the Uniform Commercial Code.[5]

This article explores the surrender of collateral by a franchisee to a franchisor, or its designee, pursuant to Article 9 of the Uniform Commercial Code. This option is available to franchisors whose claims are secured by property of the franchisee.[6] The franchisee surrenders collateral to the franchisor/secured creditor in exchange for full or partial satisfaction of the indebtedness due to the franchisor. Benefits to the franchisor include: 1) lack of disruption in the operations of the franchised business—preserving brand image; 2) continued royalty stream[7] from the collateral of the distressed franchisee by way of operation by a new franchisee; and/or 3) maintenance of value of collateral after surrender for operation as a 'company store' by the franchisor or subsequent sale by the franchisor to a franchisee. The surrender option may be attractive to the franchisee as: 1) the indebtedness credit agreed to by the franchisor may be greater than the fair market value of the collateral; 2) the franchisor or ultimate buyer may pay (handsomely) for unencumbered assets necessary to operate the franchised business; 3) employees are often retained by the new operator; and/or 4) the franchisor or eventual user of collateral may offer a consulting fee to the principals of the defunct franchisee in connection with 'transition assistance.'

Remedies Under Article 9 of the Uniform Commercial Code

In many respects, a franchised location that has adhered to system standards remains an asset to the franchisor's system, even if that franchisee has defaulted in payment obligations. The franchisor is often motivated to see the franchisee's location remain in operation, albeit under new ownership, in order to preserve the value of that franchise location. From the franchisor's perspective, the key to maximizing and preserving the value of a franchisee's location and assets, after default, is to see that the location continues in business with, at most, a minimal disruption in operations.

There are compelling reasons on both sides to part as amicably as possible; therefore, both franchisors and franchisees should be open to expeditious ways to resolve their differences and separate from each other without incurring costs of litigation. However, the franchisor and franchisee do not have unfettered rights to end their relationship on mutually acceptable terms. In winding up the relationship, the parties must consider the claims and interests of the franchisee's other creditors. If other creditors do not get paid, or do not get paid in full, the franchisor and the franchisee potentially face accusation that they colluded or engaged in a fraudulent transfer in ways that negatively affected other creditors.

Fortunately, Article 9 of the Uniform Commercial Code provides a means that allows the franchisor (the secured party) and the franchisee (the debtor) to mutually wind down their relationship in a way that should be insulated from accusations of collusion or fraudulent transfer.

The state law procedures discussed below can result in a franchisor foreclosing on its collateral, and then re-assigning to a new franchisee, without the franchisee location 'going dark.' This tends to preserve the value of the franchisee location and avoids the public perception of failure that can be injurious to both the franchisee and franchisor.

DANIEL ELIADES *is a partner in the Newark office of K&L Gates LLP, and regularly represents various stakeholders in debtor/creditor matters and insolvency issues.*

CAITLIN CONKLIN *is an associate in the Newark office of K&L Gates LLP.*

The Debtor's Voluntary Surrender of Collateral

One method for a franchisor and a struggling franchisee to resolve the franchisee's payment or performance defaults is for the franchisee to consent to a voluntary surrender to the franchisor of the franchisor's collateral. Article 9 of the Uniform Commercial Code sets forth a procedure, at Model Code Sections 9-620 and 9-621, by which a secured party and a debtor can consensually agree to what amounts to a strict foreclosure of the secured party's collateral. If the parties follow the procedures required by Article 9, the transfer of the collateral should be immunized from subsequent attack by junior lienholders or unsecured creditors.

The most significant advantage of Article 9's voluntary strict foreclosure process is that the franchisee's assets can be swiftly transferred from the defaulting franchisee to the franchisor, and then to a new operating franchise, with minimal interruption to the use of those assets in commerce.

A consensual strict foreclosure thus advances the mutual interest of the franchisor and the franchisee to maximize the value of the assets. As an additional benefit, both the franchisor and the franchisee would save on legal expenses, since a judicial foreclosure would prove costlier for both parties.

In order to make the most effective use of Article 9's consensual strict foreclosure process, the franchisor must find a buyer who is willing to pay fair consideration for the franchisee's assets and proceed with the acquisition outside of a bankruptcy, judicial foreclosure, or other insolvency proceeding. In closing on the acquisition of assets, without benefit of a 'protection order' from a court, a buyer will be justifiably concerned about its potential liability, down the road, for the prior franchisee's obligations under theories of successor liability. For these reasons, all parties to a strict voluntary surrender of collateral under Article 9 must demonstrate good faith, fair valuation, and strict compliance with the provisions of Sections 9-620 and 9-621.

Section 9-620(a) provides that a "secured party may accept collateral, in full or partial satisfaction" of an obligation so long as the debtor consents and the secured party does not receive a timely notice of objection from a party-in-interest. As an initial matter, it is vital to examine what the code requires for these initial matters of consent and notice.

The Debtor's Consent

The procedure for obtaining and documenting the debtor's consent is fixed by Section 9-620(c). This subsection provides that, when the secured lender proposes to take the collateral in partial satisfaction of a debt, the debtor *must* consent in an authenticated record executed after the debtor's default. When the secured lender proposes to take the collateral in full satisfaction, the debtor *may* consent in an authenticated record executed after the debtor's default. Alternatively, the secured lender may take in full satisfaction of a debt if it is offered either unconditionally or only subject to the condition that collateral not in the possession of the secured lender be preserved and maintained in an authenticated record, and the debtor either responds affirmatively or does not object within 20 days after the proposal is sent.

In order for the strict foreclosure procedure under Section 9-620 to best preserve the franchisor's and franchisee's joint interests, the debtor/franchisee should cooperate, meaning that the debtor/franchisee should be willing to deliver the authenticated consent immediately. In cases in which the secured lender offers to receive the collateral in full satisfaction of the debt, the debtor's failure to object within 20 days may well be legally enforceable against it. Nonetheless, if the debtor does not want to surrender the collateral, and its failure to object was based on oversight, the secured lender will likely need to enforce its right in court. The secured lender's trip into court means the procedure is no longer a consensual strict foreclosure.

Notice to Parties-in-Interest

Section 9-620(a)(2) provides that, before the secured lender can take the collateral in full or partial satisfaction of a debtor's obligation, the secured lender must not have received a notification of objection "authenticated by" a "person to which the secured party was required to send a proposal under Section 9-621" or "any other person, other than the debtor, holding an interest in the collateral subordinate to the security interest that is the subject of the proposal." The time for receipt of an objecting party's notice is fixed by Section 9-620(d).

The 'Friendly Foreclosure' Process

If the secured lender receives an objection to its offer to accept collateral in satisfaction of debt, the secured lender may still proceed under Section 9-609 to sell or obtain its collateral by conducting a commercially reasonable sale of the collateral. While this is not a voluntary strict foreclosure, the secured lender will still obtain protections under Article 9 so long as it conducts the sale in the manner and with the notice specified by Section 9-610. Proceeding with a sale under Section 9-609 creates additional procedural requirements, but may ultimately land the secured lender in the same position as if a voluntary strict foreclosure had occurred. To gain the utmost protection of Article 9, the secured lender must abide by the terms of the applicable statutes and conduct itself in all respects in a "commercially reasonable" way.

Section 9-610(b) states: "Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms."

Proceeding by way of a commercially reasonable sale is often called the friendly foreclosure because the procedure is frequently used by secured lenders and debtors seeking to avoid the cost of a judicial foreclosure in situations in which the debtor does not dispute its default and the secured lender's right to foreclose. Nonetheless, a secured party who has secured a judgment of foreclosure can also utilize the procedures under Section 9-610 to sell collateral in full or partial satisfaction of the debtor's obligation. Section 9-610(a) makes it clear that its procedures are available as a default remedy for all secured lenders: "After default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing."

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Public or Private Sale?

The first potential issue a franchisor with the status of a secured party may face in its use of the friendly foreclosure process is that Section 9-610(c) may impose a requirement of a public sale. This subsection provides:

> A secured party may purchase collateral:
> (1) at a public disposition; or
> (2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

A franchisor may view the unforeseen bidding by a third-party stranger at a public sale to be a mixed bag, at best, because a franchisor's collateral is frequently imbued with value. From the franchisor's perspective, the collateral is useful, and probably essential, to a franchisee's operation of a franchise in accordance with the franchisor's systems standards.

Frequently, the collateral itself is the product of the franchisor's proprietary know-how. However, a third-party bidding on collateral at a public sale may have other ideas about how to use the collateral, and this may affect the third party's opinion about value. A franchisor has reasons to be suspicious of the motives of a third-party bidder, and its intentions on how to use the collateral.

For example, a quick service restaurant franchisor often develops specialized ovens, refrigerators, freezers, and other items used in a restaurant business, specifically so a franchisee can store, cook, and serve prepared foods in accordance with system standards. This results in a customer in Maine getting the same style and quality of cheeseburger and French fries as a customer in California. At a public sale, a stranger could step forward and bid on a deep fryer—viewing it as a generic deep fryer—while the franchisor believes the deep fryer is highly specialized equipment unique to its system. The franchisor may have developed a deep fryer that includes features that are truly proprietary and that result in a unique or distinctly recognizable French fry.

A third party interested in bidding at a public sale is not likely to view the franchisor's collateral as being as valuable as the franchisor does. A secured party can protect itself against unwanted third-party bidding by noticing the public sale as a sale for all of the franchisee's assets serving as the franchisor's collateral. Under these circumstances, a third-party bidder is not likely to bid to the point that exceeds the partial or full satisfaction of debt being offered by the secured party, so the secured party can usually fix an 'upset price' that ensures it recovers all of its collateral.

Friendly Foreclosure Notice Requirements

Section 9-611 specifies how, and to whom, the secured party gives notice of a disposition under the terms of Section 9-610. The franchisor/secured lender must give to all persons identified in Section 9-611(c) "a reasonable authenticated notification of disposition."[8] Section 9-611(b)(1) and (2) provide that the secured party must notice the debtor and any secondary obligor of the disposition under Section 9-610. Moreover, "if the collateral is other than consumer goods," then Section 9-611(c) requires that notice be given to the same persons identified by Section 9-621(a) and (b).

Section 9-611(e) outlines procedural steps that a secured party/franchisor may follow to assure a finding that its notice process under Section 9-611(c)(3)(B) was reasonable. The secured party complies with that section if "not later than 20 days or earlier than 30 days before the notification date, the secured party requests, in a commercially reasonable manner, information concerning financing statements indexed under the debtor's name in the office indicated in subsection (c)(3)(B)"; and, thereafter "did not receive a response to the request for information"; or "received a response to the request for information and sent an authenticated notification of disposition to each secured party or other lienholder named in that response whose financing statement covered the collateral."

Consequences of a Friendly Foreclosure

The end result of a friendly foreclosure is the same as a judicial foreclosure: The secured party obtains title to the collateral, and may transfer that collateral free and clear to another party. This serves the franchisor's desire to keep the franchise assets in commercial use, without interruption, and to preserve value of the assets. As in a judicial foreclosure, the secured party is entitled to apply proceeds first to costs of the sale, and then to its debt, with any surplus being distributed thereafter in accordance with the priorities fixed by state law, with any equity being returned to the debtor/franchisee. So long as the secured lender/franchisor has acted in a commercially reasonable way, and has followed the procedures of Sections 9-610 and 9-611, the secured lender should be insulated from liability to third persons.

Conclusion

For the reasons outlined above, a secured franchisor and a franchisee have every reason to seek a mutually beneficial resolution of the franchisee's monetary defaults. State law provides tools for their cooperation in protecting their joint interests, even at the point of the dissolution of their relationship. Principals of a defaulting franchisee who consensually resolve their issues with the franchisor sometimes obtain a final benefit: If the franchisor can recover its collateral, and keep it active in commerce, a franchisor may reduce or release principals from personal guaranty exposure as a term of their cooperation agreement. ⚖

Endnotes

1. Price Waterhouse Coopers, *Economic Impact of Franchised Businesses*, Volume IV, E-1 (2016).
2. Reasons for bankruptcy filings unrelated to the franchisor/franchisee relationship are legion. For instance, a business may be undercapitalized or mismanaged; a debtor may be unable to obtain financing or refinance existing debt that has matured; and/or a business may be displaced or disrupted by a natural disaster.
3. *See* Van Elmore and Daniel M. Eliades, *The Financially Distressed Franchisee—Advanced Strategies for Franchisors and Franchisees*, American Bar Association, 30th Annual Forum on Franchising (Oct. 2007).
4. A bilateral restructuring could be broadened via an out-of-court composition agreement with creditors.
5. Non-bankruptcy franchisee insolvency possibilities such as liquidating via a state court assignment for the benefit of creditors, self-liquidation by the franchisee, or a simple cessation of operations would normally be disfavored by franchisors if the franchisee has not already resolved its branding issues.
6. Many franchisors agree to lend money to incoming franchisees to assist with initial costs. Franchisors often receive a security interest in property of the franchisee in connection with such a loan.
7. At its core, a franchise relationship involves a franchisor licensing to a franchisee the right to use the franchisor's trademarks and proprietary system procedures, in exchange for the franchisee's agreement to pay the franchisor a royalty for the use of the franchisor's name and trademarks. The royalty due to the franchisor is typically fixed as a percentage of the franchisee's revenues.
8. §9-611(b).