AMERICAN BANKRUPTCY INSTITUTE

Alexander L. Paskay Memorial Bankruptcy Seminar

Business

Restaurant Chains in Chapter 11

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CONCURRENT SESSION

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Fact Pattern

It's your last day in the office before you head out on vacation to the south of France for two weeks. Your phone rings. It's your old friend from law school, Gil Flynn. He's a local commercial litigation attorney that hates bankruptcy and always refers any bankruptcy-related work to you.

Gil's client is Amy Elliot. She inherited a bunch of money from her late mother, who authored beloved children's novels. Amy still receives regular royalties from her mother's estate via book, TV, and movie rights. Despite having no prior experience, three years ago Amy incorporated Mama's Money, LLC, a Florida limited liability company ("M&M") to purchase the rights to open 35 franchise locations for Phat Burger, Bar and Gym ("PB&G"). PB&G started as a single location in Montana and expanded rapidly across North America and now has 2,500 locations in the U.S. Customers love the ability to chow down on a delicious burger while enjoying a craft cocktail and then go work off the calories all in one convenient location. PB&G owns intellectual property including its trademark insignia, a picture of a thick peanut butter and jelly sandwich in the shape of interlocking dumbbells.

Amy was hands-off with the operation and recently found out that the CFO overseeing the operations embezzled millions of dollars, failed to pay payroll and sales tax, and was last seen boarding a flight to Argentina. M&M operates locations in Alabama, Florida, and Georgia and has an exclusive right in those three states. M&M has 21 subsidiaries - 20 subsidiaries each lease their locations under a lease between the subsidiary and 20 different unaffiliated landlords. The other subsidiary (the 21st one) leases the remaining 10 locations from the franchisor, PB&G, who owns the underlying real property.

There are individual franchise agreements between M&M and PB&G for each location. There is one "Master Lease Agreement" between the M&M subsidiary and PB&G for the 10 of the locations in Georgia, though each of the locations has its own lease "addendum" with its own term, rent provisions, and provision that a default of the related franchise agreement for that location is a default of the lease, but the addendums and the Master Lease Agreement do not have cross default agreements.

In Tampa, Florida, there is a "Multi-Property Lease Agreement" for six locations that are all leased by a single Tampa based subsidiary. This lease lists all properties subject to the lease in one exhibit list, and has a single rent based on a base, plus small percentage rate based on the aggregate sales at the six locations. There are only general default provisions, including the failure to maintain the properties or pay "rent" as calculated under the lease.

Despite her lack of involvement, Amy has always been the CEO of M&M and each of the subsidiaries. When you ask if she signed a personal guarantee, Amy says she doesn't know what that means but that she signs lots of paperwork and legal documents without reviewing them.

M&M has a line of credit with Collings Bank, a mid-size regional bank. The line of credit is fully drawn at $20 million, secured by all assets of M&M. Absent running PB&G franchises, the FFE has been valued by Michael Von Healy Appraisal Services, LLC, as being worth less than the cost to move, store, and sell. The only assets of any value are the franchise agreements. M&M and/or

its subsidiaries owe $4 million in payroll taxes and $900,000 each to the Alabama, Georgia, and Florida departments of revenue.

Most of the locations are profitable, with a few operating at a substantial loss, including two within the Tampa Multi-Property Lease and three within the Franchisor's Master Lease Agreement. Without the embezzlement hiccup, Amy says that M&M would not be considering Chapter 11. M&M is up to date on its liability insurance and has a few minor slip and fall cases pending against that should not impact its bottom line materially. However, it is facing some potentially significant liability from some injuries related to drunk drivers that were served at its stores. Last year, PB&G, the franchisor, rolled out an ill-conceived all you can drink promotion that was heavily advertised for $39.99. The promotion is no longer active. Gil is researching dram shop laws in Alabama, Florida, and Georgia. He is also reviewing the franchise agreement and trying to determine if PB&G is required to indemnify M&M for any losses resulting from these forthcoming suits.

M&M is current on most leases, except one in Florida that it is not paying under protest because the landlord has failed to repair a structural defect and the Franchisor's Master Lease Agreement, which missed one month of payment on all ten locations at the same time it missed a Franchise payment. M&M has a lawyer in Miami that has filed a complaint against the landlord for breach of contract. The structural defect disrupted operations to the point that the store has been temporarily closed, which is also a default under that locations franchise agreement. The landlord says that it is the tenant's obligation under the lease to make the necessary repairs and that the damage was caused by M&M's use of the property.

PB&G began investigating M&M after it missed franchise payments for one month and then caught wind of the failure to pay necessary payroll and sales tax. PB&G provided a notice of default under all franchise agreements due to the payment defaults and because the franchise agreement clearly requires M&M to pay all applicable state and federal taxes.

Amy is expecting to get an extremely large windfall from her mother's estate in the next year or two, but no earlier than nine months from the day you are first meeting with Amy. Negotiations are currently underway to make her mother's books into a series of motion pictures. She's spent the regular royalties on her lavish lifestyle and doesn't have the funds to immediately cure all the monetary issues with M&M. Gil has advised her that Chapter 11 may be able to help her to at least buy some time to fix all the issues until she receives the windfall from the movie deal. Despite her lack of personal involvement in the management of the business, Amy wants to be seen as a "success" and doesn't want to shut down the 35 stores. She is open to shuttering the unprofitable locations if that is a possibility.

M&M has hundreds of employees. It is unclear if their stores closed whether they would be out of work or if PB&G would find new franchisees to operate the locations and potentially retain the employees.

Gil and Amy want to hire Nick Dunne as the new CEO. Nick is a turnaround specialist that has helped other struggling restaurant groups. Amy and her boyfriend Desi have a two-month vacation planned to Europe. They leave in one week and she wants to know how much you would like for a retainer and if the paperwork can be ready for her to sign before they leave on their trip.

Issues to be Discussed

1. Landlord/Tenant Issues

a. Lease assumption/cure –

i. "prompt cure" and "adequate assurance"?

11 U.S.C. §365(b)(1)

Smart Capital Investments I LLC v. Hawkeye Entertainment LLC (In re Hawkeye Entertainment LLC), 49 F.4th 1232 (9th Cir. 2022) (Court held that, even though a default under an unexpired lease already had been remedied prior to assumption or was immaterial, the lessor is still entitled to adequate assurance of future performance). Thoughts?

ii. With the non-franchisor as landlord, does M&M have ability to assign a portion of the locations to a potential buyer?

In re Cafeteria Operators, L.P., 299 B.R. 384 (Bankr .N.D. Tex. 2003) (Debtors could reject master sublease agreement with respect to some, but not all, of the covered facilities).

b. Master leases – Absent landlord consent, can M&M reject only certain stores from the Master Lease Agreement? What about the Multi-Property Lease Agreement? When the franchisor is also the landlord, do courts consider the lease and the franchise agreement as a single agreement?

In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. Del. 2008) (master leases into which restaurant operators entered as part of sales-and-lease-back transactions were, by their plain terms, indivisible agreements under Illinois law, which restaurant operators had to assume or reject in their entirety).

In re Gardinier, Inc., 831 F.2d 974 (11th Cir. 1987) (parties intended that single contract under which Chapter 11 debtor sold land and agreed to pay broker commission form two distinct contracts, and therefore, trustee of liquidating trust established for benefit of debtor's creditors could assume contract for sale of land but reject separate brokerage agreement).

In re FPSDA I, LLC, 450 B.R. 392 (Bankr. E.D.N.Y. 2011) a debtor-franchisee of several Dunkin' Donuts/BaskinRobbins franchises were behind on their pre-petition rent and franchise agreement obligations. Because debtors could not

get their landlords to consent to extend the deadlines to assume or reject their leases, the debtors moved for an order to determine that the lease deadlines did not apply or that the debtors could assume the lease without curing the defaults under the franchise agreements. The franchisors/landlords argued that the contracts and leases should be construed as a part of a single transaction and that any assumption of the leases would require the defaults under the franchise agreements to be cured as well. The court held that the franchise agreements and leases were a single agreement, and that the debtor had to cure any defaults under the lease and franchise agreement before assumption; however, the court also held that the lease deadlines to assume or reject did not apply. *In re FPSDA I, LLC*, 450 B.R. at 400.

c. Deemed rejection – 11 U.S.C. § 365(d)(4)(B)

In re Hyegu Cho, 550 B.R. 152 (Bankr. D. Me. 2016) (A landlord moved for relief from the automatic stay in a chapter 13 case, arguing the commercial lease was deemed rejected because the deadline for assuming the lease had passed. The debtor the applicable provision in section 365 did not apply in a chapter 13 case; however, the court did not agree and granted the landlord's relief, although it did not compel the debtor to surrender the property (since the subsection provides that the trustee, as opposed to the debtor, is required to surrender the premises.)

In re Simbaki, Ltd., 520 B.R. 241 (Bankr. S.D. Tex. 2014) (A chapter 11 debtor sought to assume a restaurant lease. The landlord objected, arguing the lease was not timely assumed and so was deemed rejected. The debtor had filed a motion but the court had not yet issued an order by the deadline. The sole issue addressed by the court was whether a timely motion to assume a lease was sufficient to prevent deemed rejection. The court concluded that it would be reasonable to interpret Section 365(d)(4)(A) as implying that a lease can be unilaterally assumed or rejected. However, Section 355(a) requires that assumption or rejection be approved by the court, so that assumption would not occur until the court issued an order. It found the statute was ambiguous and concluded "that filing a motion to assume satisfies the statutory deadline." The court also noted that "an overwhelming majority of courts" hold that it is sufficient to file a motion to assume before the deadline.

d. Does the timing of Amy's likely windfall impact the timing of her possible plan and exit from bankruptcy? How is this timing impacted by possible deemed rejection of the various leases?

2. Franchisor/Franchisee Issues

a. Did Franchisor terminate pre or post-petition?

Compare *In re Tornado Pizza LLC*, 431 B.R. 503 (Bankr. D. Kansas 2010) (terminated prepetition) with *In re ERA Cent. Regional Serv., Inc*., 39 B.R. 738 (Bankr. C.D. Ill. 1984) (stay prevented termination) and *In re Krystal Cadillac Oldsmobile GMC Truck,* Inc. *v. GMC Oldsmobile GMC Truck, Inc.)*, 142 F.3d 631, 636 (3d Cir. 1998) (same)

b. Can franchise agreements be assumed and assigned to buyer of some of the franchise locations?

i. *Wellington Vision, Inc., v. Pearl Vision, Inc. (In re Wellington Vision, Inc*.), 364 B.R. 129 (S.D. Fla. 2007), franchisor sought relief from the automatic stay to terminate a franchise agreement with the franchisee-debtor, arguing it **could not be assumed** because it included a non-exclusive license of trademarks. The district court affirmed the bankruptcy court findings the debtor had a non-exclusive trademark license, which was governed by federal trademark law, including restrictions on assignment. The *Wellington* court followed the rulings of Courts of Appeals for the Third, Fourth, and Ninth Circuits, which read Section 365(c)(1) as asking whether a debtor could "hypothetically" assign the contract even if it is only proposing to assume the contract.

ii. *In re Cumberland Corral, LLC*, 2014 Bankr. LEXIS 936 (Bankr. M.D. Tenn.), the court applied the "actual test" and explained: "To allow Golden Corral to block assumption of the Franchise Agreements because such agreements could not be assigned would allow Golden Corral a windfall while destroying the Debtor's chances at reorganization. Such an outcome would be contrary to the purposes of the Bankruptcy Code." This court **allowed assumption**.

iii. *In re James Cable Partners, L.P*., 27 F.3d 534 (11th Cir. 1994), the Eleventh Circuit recognizes the "hypothetical test," but applied Tennessee law to the contract rights, and concluded that the § 365(c)(1) exception did not apply and thus **debtor could assume** the cable franchise agreement in that case.

iv. *In re Ajranc Insurance Agency, Inc*. 2021 WL 2774937, 70 Bankr. Ct. Dec. 113 (Bankr. M.D. Fla. 2021) ("the Court concludes that under non-bankruptcy law, Debtor may not assign the Franchise Agreement. And because the Eleventh Circuit Court of Appeals follows the "hypothetical test" under § 365(c)(1), which permits a debtor to assume an executory

contract only if the debtor also has the right to assign the contract, **Debtor may not assume** the Franchise Agreement.").

v. *In re Welcome Group 2, LLC*, 660 B.R. 874 (Bankr. S.D. Ohio 2024). (**debtor could assume franchise agreement** when debtor had no intention of assigning the franchise agreement, **adopting the "actual test.**") The Court explained: "Based on the plain language of § 365(c)(1), the statutory condition that the creditor must be forced to accept performance from or render performance to an entity other than the debtor can only be triggered and thus make the limitation in § 365(c)(1) applicable if the debtor assigns the contract, because the debtor can never be an entity other than itself. Therefore, based on the plain language of the statute, a debtor is not prohibited from assuming an executory contract if it does not intend on assigning it. Interpreting § 365(c)(1) in this manner not only comports with the plain language of the statute, but it also is consistent with the overall objectives of chapter 11 relief and the purposes of the Bankruptcy Code."

In reaching its conclusion, the Court explained:

"In evaluating these approaches, the Court finds that the "actual test" as articulated by *Footstar*, *Adelphia*, and *Aerobox*, is the most faithful interpretation of the language in § 365(c)(1). It also preserves the evident purpose of § 365(c)(1), which is to protect a counterparty from being forced to do business with someone other than the debtor. To be clear, though, the Court does not adopt the "actual test" because it believes that to be the better policy. Rather, the Court believes it is also the most faithful interpretation of the statutory language. The Court also notes that *Footstar* answers the primary criticism leveled at the "actual test" by Justice Kennedy and the courts adopting the "hypothetical test." *Footstar* demonstrates that the charge that the "actual test" rewrites the statute is not accurate. And it further demonstrates that the plain meaning analysis of the "hypothetical test" is itself flawed and leads to a contradictory, if not an oxymoronic, result."

The Court provides a thoughtful explanation as why the Jame Cable line of cases might be decided in error:

"Based on the plain language of § 365(c)(1), the statutory condition that the creditor must be forced to accept performance from or render performance to an entity other than the debtor can only be triggered and thus make the limitation in § 365(c)(1) applicable if the debtor assigns the contract, because the debtor can never be an entity other than itself. Therefore, based on the plain language of the statute, a debtor is not prohibited from assuming an executory contract if it does not intend on assigning it."

c. Does it change your position if M&M seeks to only to assume certain of the franchise agreements as part of a reorganization plan, and is expressly not assigning them, only assuming them?

d. What leverage does the Franchisor have if the franchise agreements were not terminated pre-bankruptcy?

   i. Outstanding cures?
      - Are there cross-defaults under the franchise agreements?
      - Does that matter?
   ii. Buyer approval?
   iii. Prior approval?
   iv. Can the franchisor limit the potential buyers to a predetermined list of only a subset of possible buyers?

e. What leverage does the Debtor have concerning the franchisor?

   i. Close stores vs keep stores open?
   ii. How valuable is store count to this franchisor?
   iii. Will the franchisor waive cure costs to keep more stores open?
   iv. Will the franchisor provide more flexibility in its consent to assumption, or assumption and assignment, in exchange for keeping more stores open?

3. Plan Release Issues

a. For Franchisor – are they responsible for the drunken driver and if so, can it get a release
b. Indemnity provision
c. Releases of Amy if she puts in $ into the plan
d. "Opt in" vs "Opt Out"

   i. *In re Stein Mart, Inc*., 629 B.R. 516 (Bankr. M.D. FL. 2021)-in in *dicta,* pre-*Purdue Pharma*, court allowed "opt out" releases for Ds & Os of liquidating public company retailer, because the process appeared to satisfy the requirements of "offer and acceptance" under Florida contract law.

   ii. Compare. *In re Red Lobster Management LLC*, Case No. 6:24-bk-02486-GER (Bankr. M.D. Fla. 2024) – After objection by the USTO, the Court approved the disclosure statement subject to the removal from the plan docs of the non-debtor opt-out release and implementation of an opt-in

release. The amended plan now provides that the third-party release would be granted by creditors that vote to accept the plan, as opposed to those that did not opt out.

iii. *In re Rite Aid Corp.*, Case No. 23-18993 (MBK) (Bankr. D.N.J.) – the Court confirmed the plan after the opt-out release of non-debtors was changed to an opt-in release.

e. Stay against 3d parties

In re Bird Global Inc., Case No. 23-20514 (CLC) (Bankr. S.D.Fla.) Court overruled objections by the tort claimants that the opt-out release was a nonconsensual discharge in violation of the Supreme Court's decision in *Purdue Pharma*. In distinguishing *Purdue Pharma*, the Court reasoned that the debtors' plan provides for "full satisfaction" of all tort claims, and the channeling injunction and bar order are part of a settlement with the insurers and a section 363 sale of the insurance policies.

f. 363 protections for the buyer of certain locations

Faculty

Hon. Jason A. Burgess is a U.S. Bankruptcy Judge for the Middle District of Florida in Jacksonville, appointed in March 2022. While in private practice, he became a Florida Supreme Court Certified Mediator and the only attorney in North Florida to be Board Certified in both Business Bankruptcy and Consumer Bankruptcy Law. While in law school and for a time following graduation, Judge Burgess practiced in the creditors' rights area, representing many of the nation's largest financial institutions. He later became the managing partner of The Law Offices of Jason A. Burgess, LLC, where he concentrated on chapter 11 bankruptcy cases and complex bankruptcy litigation. He was often called upon as a chapter 11 consultant for complex debtor and creditor bankruptcy cases, and was also appointed as a subchapter V chapter 11 trustee for both the Middle and Northern Districts of Florida. Judge Burgess was honored as a member of ABI's 2021 class of "40 Under 40." He received his LL.M. in business transactions *magna cum laude* from the University of Alabama School of Law.

Lara Roeske Fernandez is a shareholder with Trenam Law in Tampa, Fla. She currently serves on the firm's Executive Board and is a former practice group leader for the firm's Bankruptcy and Creditors' Rights Practice Group. Ms. Fernandez is Board Certified in Business Bankruptcy Law by the American Board of Certification, and her clients include financial institutions, fiduciaries/trustees and private-equity groups in the areas of business reorganizations, trustee representation, bankruptcy litigation, commercial foreclosures and workouts, and loan modifications. Ms. Fernandez has served as a chapter 11 trustee and liquidation trustee. Prior to joining Trenam, she clerked for Hon. Alexander L. Paskay, Chief Bankruptcy Judge Emeritus of the U.S. Bankruptcy Court for the Middle District of Florida, from 2001-04 and for a year after graduating from law school. Ms. Fernandez is AV-rated by Martindale-Hubbell and listed in *Chambers USA*, *The Best Lawyers of America*, *Super Lawyers* and *Florida Super Lawyers*, where she has been consistently listed in the Top 100 Lawyers throughout Florida and Top 50 Women Lawyers throughout Florida and the Tampa Bay area. She received both her B.A. and J.D. from Emory University.

Scott A. Underwood is an attorney with Underwood Murray PA in Tampa, Fla., and has experience in some of the most complex bankruptcy cases and distressed business situations across the state and country. He has represented distressed businesses, chapter 11 debtors, secured and unsecured creditors, bankruptcy trustees, creditors' committees, landlords, liquidating trustees and parties acquiring and selling assets from bankruptcy cases. Mr. Underwood's debtor-side representative experience crosses many industries. He has represented chapter 11 debtors in the health care industry, hospitality, real estate, utilities, waste-management, technology and manufacturing. In addition to representing debtors, he has represented large secured creditors, asset-purchasers, bondholders, debtor-in-possession lenders, trustees, business owners, creditors' committees and professional fiduciaries. His representative and transactional bankruptcy experience measures in the billions of dollars. Beyond core chapter 11 matters, Mr. Underwood represents clients in various high-stakes insolvency related litigation matters. He has been involved in substantial director and officer litigation, bond disputes, technology products liability litigation and other commercial disputes. He also has experience with assignments for the benefit of creditors, having represented assignees, assignors, asset-purchasers and creditors in such proceedings throughout Florida. Mr. Underwood is a member of ABI (for which he served as past chair of its Real Estate Committee) and the Tampa Bay Bankruptcy Bar Association,

Bankruptcy Bar Association for the Southern District of Florida and Business Law Section of the Florida Bar, where he is an active member of its Bankruptcy/UCC Committee and its study groups. A frequent speaker on bankruptcy topics, he has been listed in *Chambers USA* since 2012, in *Florida Super Lawyers* since 2009, as one of the Top 50 Lawyers in Tampa in 2019, and as one of *Florida Trend Magazine*'s Legal Elite since 2013. He was also selected for inclusion in *The Best Lawyers in America* (2018, 2019 and 2020 editions) in Bankruptcy & Creditor Debtor Rights and Insolvency & Reorganization Law, and is rated AV-Preeminent by Martindale-Hubbell. Mr. Underwood received his B.A. in 1998 from the University of Florida and his J.D. *magna cum laude* from the University of Florida Levin College of Law in 2003.

Mark J. Wolfson is a partner with Foley & Lardner LLP's Bankruptcy & Business Reorganizations Practice Group in Tampa, Fla., and has been a practicing commercial litigation and bankruptcy lawyer for more than 40 years. He has advised business clients in a wide variety of complex business bankruptcy reorganization cases and commercial litigation matters. Mr. Wolfson's bankruptcy experience includes representing debtors, secured creditors, official creditors' committees, bondholders, asset-buyers, trade and franchisors, and other groups. He has experience litigating fraudulent-transfer and preference actions, as well as in state assignment for the benefit of creditor proceedings, commercial foreclose cases, and complex post-judgment collection matters. In addition, he has managed out-of-court workouts and litigated disputes under Article 9 of the UCC. In 2020, Mr. Wolfson was the co-lead attorney that represented Stein Mart, Inc., a big-box retailer with 280 stores throughout 30 states, in its chapter 11 case filed in Jacksonville, Fla. In 2020, he was co-counsel to the official committee in FoodFirst Global Restaurants' (d/b/a Brio's) chapter 11 case in Orlando, Fla. More recently, he was committee counsel in the Bertucci's Restaurants chapter 11 case in Orlando and in the Surge Transportation case in Jacksonville, both of which were confirmed and distributed money to unsecured creditors. Mr. Wolfson is a former chair of The Florida Bar's Business Law Section. In addition, he was the primary draftsman of the Florida non-uniform default and remedies provisions. Mr. Wolfson was a member of the advisory board for ABI's Caribbean Insolvency Symposium for more than eight years and has been a member of the advisory board for ABI's Alexander L Paskay Bankruptcy Conference for more than five years. He received his bachelor's degree with high honors from the University of Tennessee in 1979, where he was a member of Phi Beta Kappa and Omicron Delta Kappa, and his J.D. from the University of Florida in 1982, after which he served a judicial clerkship to the Florida Second District Court of Appeals.