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# Food for Thought: Can the Small Business Reorganization Act Be a Path for Restaurant Franchises?

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Both franchisees and franchisors in the restaurant industry have weathered tumultuous times due to the economic consequences of COVID-19. Franchisors faced hurdles such as having to reduce or eliminate royalties for distressed franchises dealing with shutdowns or losing franchised outlets entirely. Similarly, multiunit franchisees have struggled with a drop in sales from the pandemic. Moreover, multiunit franchisees and franchisors may be beyond the reach of certain federal relief programs, like the recently enacted American Rescue Plan Act's Restaurant Revitalization Fund, which excludes entities that, as of March 3, 2020, owned or operated more than 20 locations (together with an affiliated business), regardless of whether those locations do business under the same or multiple names. As a result of ongoing challenges, an increasing number of franchisors and multiunit franchisees may seek relief under Chapter 11 pursuant to the Small Business Reorganization Act. The act originally applied only to small business debtors with business debts below $2,725,625. However, due to the CARES Act and the recently passed COVID-19 Bankruptcy Relief Extension Act, small business debtors with debts up to $7.5 million may now seek relief under the streamlined Small Business Reorganization Act through March 27, 2022. This broadened scope may prompt struggling restaurant systems and their operators to consider whether to file for bankruptcy.

The Small Business Reorganization Act, codified as subchapter V of Chapter 11, was intended to provide qualifying business debtors, such as franchises, a streamlined, less costly, and more efficient Chapter 11 process. Whether bankruptcy may prove beneficial for franchisees or franchisors, including under the Small Business Reorganization Act, depends on a number of factors.

One primary factor is the franchise agreement, the foundation of a franchise relationship. When a franchisor or franchisee files for bankruptcy, the franchise agreement, which is an executory contract, may be assumed or rejected by the debtor. There are many considerations for franchisees and franchisors regarding the impact a bankruptcy may have on their respective franchise agreements. However, the assumption or rejection of executory contracts, such as franchise agreements, generally operates the same in a Subchapter V bankruptcy as in a traditional Chapter 11. Yet, one issue that has arisen is whether a debtor that rejects a contract, and incurs a resulting prepetition debt, can be rendered ineligible for subchapter V relief if that additional debt puts the debtor over the $7.5 million debt limit. In *In re Parking Management Inc.*, a Maryland bankruptcy court determined that the prepetition damages associated with a debtor's rejection of several leases as of the petition date did not render that debtor ineligible because the damages were contingent and subject to the post-petition actions, such as the court granting the debtor's motion to reject those leases. Franchise-debtors can similarly argue that damages arising from the rejection of a franchise agreement should not be considered a noncontingent debt and thus should not be considered for purposes of the debt limit.

There are other considerations for franchisees and franchisors considering relief under subchapter V. In subchapter V, only the debtor may propose a plan, but it has 90 days to do so. This is a shorter period than a traditional Chapter 11, which allows others to propose a competing plan after a certain period of time elapses.

Also, a committee of unsecured creditors is not appointed unless the court orders otherwise. This has the implication of reducing the overall cost of a reorganization because, for example, in a traditional Chapter 11, the attorneys' fees of the creditors' committee are paid by the debtor's estate.

As in a traditional Chapter 11, the debtor remains in possession of its assets and control of its business under a subchapter V bankruptcy. However, a subchapter V trustee is also appointed to oversee and monitor the bankruptcy, to appear on certain matters, such as confirmation or modification of the plan, to help facilitate a consensual plan, and to make distributions under a confirmed nonconsensual plan. The court may remove the debtor as a debtor in possession, in which case the subchapter V trustee will then operate the debtor's business. In the event the subchapter V trustee operates the business of a franchisee, issues may arise as to the trustee's ability to meet the brand's standards, and whether the trustee will be permitted to view proprietary information of the restaurant system, such as the operations manual.

Unlike a traditional Chapter 11, a plan may be confirmed under subchapter V even if all classes reject it. Moreover, the absolute priority rule does not apply. This means that the owners of a franchisee or franchisor may retain their equity interests in the business even if creditors are not paid in full, so long as the plan provides that the debtor's projected disposable income to be received in the three years after the first payment under the plan is due, or in such longer period not to exceed five years as the court may fix, will be applied to make payments under the plan. With regard to business expenses, income is not "disposable income" under the Small Business Reorganization Act if it is "reasonably necessary to be expended" for expenses "necessary for the continuation, preservation, or operation" of the business. Appropriate expenses include payroll, utilities, rent, insurance, taxes, purchase of inventory, and other expenses incurred in the ordinary course of running the business. It is unclear whether reserves for capital expenses or to grow the business are considered "reasonably necessary." A franchisor that seeks to protect its brand may consider including provisions in the franchise agreement setting forth the expenses necessary to the continued operation of the franchise, such as certain marketing expenses or capital improvements over time.

The debtor may employ a professional, such as a lawyer or accountant, even if the debtor owes a prepetition claim to the professional of less than $10,000. This is not the case in a traditional Chapter 11 and may help streamline reorganization by continuing to retain professionals already familiar with the franchise operations.

Administrative expenses can be paid over time through the plan. A franchise system typically requires franchisees to purchase goods from specific vendors, including the franchisor or an affiliate of the franchisor. Claims under section 503(b)(9) for goods received by the debtor in the ordinary course of business within 20 days before filing the bankruptcy petition may be paid over time as opposed to being paid in full on the plan's effective date.

Ultimately, struggling franchises in the restaurant industry may decide to seek relief under the Small Business Reorganization Act. Although the act is intended to provide a streamlined process to reorganization, there remain a number of considerations that franchisees and franchisors will need to consider and evaluate in determining whether to elect to proceed under subchapter V or how to respond to a franchise-debtor who has filed under the act.

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