The Intersection of Franchising and Secured Lending: Uniform Commercial Code Section 9-408

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Access to capital is critically important for franchisees to succeed and grow. Particularly in recent years, there has been no shortage of lenders willing to provide financing to franchisees. As the loan documentation memorializing franchise finance transactions becomes more complex, franchisees and franchisors need to understand the scope of the lender's proposed collateral and the nuances of applicable secured transactions law. More specifically, the Uniform Commercial Code may alter the effect of certain collateral restrictions set forth in most franchise agreements and limit the lender's remedies related to such collateral.

Collateral Restrictions in Franchise Agreements

Franchisors desire to control the selection of operators of their franchised units. Therefore, franchise agreements typically prohibit at least two collateral protections that are ordinarily available to lenders in a secured lending transaction: (1) a security interest in the equity of the franchisee borrower known as an "equity pledge," and (2) a security interest in the franchise agreement itself. Equity pledges protect lenders by allowing a lender to foreclose on the ownership interests of its borrower upon an event of default, and to sell the borrower's business as a going concern in a foreclosure sale. Security interests in material contracts such as franchise agreements provide lenders with valuable contractual rights in the event of a borrower's default. Franchise finance presents a unique credit risk to lenders because the value of the franchisee's enterprise is dependent upon the rights under the franchise agreement (i.e., the right to use the franchisor's intellectual property and related rights), but the lender is generally unable to obtain a customary "all assets" lien as a result of the restrictions in the franchise agreement.

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Equity Pledge

Many lenders are willing to forego the protections of an equity pledge in a franchise finance transaction. Conversely, some franchisors permit the equity pledge, subject to many restrictions, one of which is a requirement that the equity purchaser is satisfactory to the franchisor. In that circumstance, the equity pledge of a franchisee entity may be of limited utility compared with the equity pledge in a non-franchise finance transaction because the franchisor's consent right significantly limits the pool of potential purchasers.

Security Interest in the Franchise Agreement

The analysis of the lender's security interest in the franchise agreement is more nuanced, and requires an understanding of Section 9-408 of the Uniform Commercial Code, which governs secured transactions. Section 9-408 balances the desire of the franchisor to protect its brand with the need of the franchisee to obtain credit. First, Section 9-408 benefits the franchisee (and its lender) by invalidating the provision in the franchise agreement that prohibits, or requires the franchisor's consent to grant, a security interest in the franchise agreement. *See* U.C.C. § 9-408(a). Specifically, clause (a) states:

> [A] term in . . . an agreement between [a franchisor] and a [franchisee] which relates to a . . . general intangible, including a . . . franchise, and which term prohibits, restricts, or requires the consent of the . . . [franchisor] to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the . . . general intangible, is ineffective to the extent that the term:
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> (1) would impair the creation, attachment, or perfection of a security interest; or
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> (2) provides that the assignment or

> transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the . . . general intangible.

See id. Thus, by itself, the franchisee's grant to a lender of a security interest in the franchise agreement does not establish an enforceable breach under such franchise agreement, notwithstanding any prohibitions to the contrary contained therein.

But, in turn, Section 9-408 also protects the franchisor by providing that the lender's security interest in the franchise agreement:

> (1) is not enforceable against [the franchisor];
> (2) does not impose a duty or obligation on [the franchisor];
> (3) does not require [the franchisor] to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;
> (4) does not entitle the secured party to use or assign [the franchisee's] rights under the . . . general intangible, including any related information or materials furnished to [the franchisee] in the transaction giving rise to the . . . general intangible;
> (5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of [the franchisor]; and
> (6) does not entitle the secured party to enforce the security interest in the . . . general intangible.

See U.C.C. § 9-408(d). As clarified in the comments to Section 9-408, the effect of these provisions is that the lender cannot foreclose upon the rights under the franchise agreement and "step into the shoes" of the franchisee to operate the business (or assign those rights to a third party), *but* the lender will retain a lien on the proceeds of the franchise agreement upon a sale thereof. *See* U.C.C. § 9-408 (cmts. 7-8). Thus, while the lender's ability to enforce unilateral remedies with respect to the franchise agreement is limited, the lender will still maintain a claim to the proceeds of a sale of the franchisee's business that has priority over other creditors of the franchisee and the franchisee itself.

Application to Collateral Documentation

The manner in which the granting clause in the security agreement is drafted is of critical importance to the lender. While a cursory review of the collateral prohibitions set forth in the franchise agreement may lead the franchisee and lender to exclude the franchise agreement from the scope of the security interest in its entirety, Section 9-408 suggests a more nuanced approach. Instead of excluding the franchise agreement entirely from the collateral grant, lenders are well-served by relying on the conventional "excluded collateral" language contained in most security agreements. The excluded collateral definition sets forth a list of assets that are excluded from the scope of the lender's security interest. The following collateral grant exception is a common prong in a definition of "excluded collateral":

> any permit or license or any contractual obligation entered into by any borrower that prohibits or requires the consent of any person other than the borrower and its affiliates that has not been obtained as a condition to the creation by the grantor of a lien on any right, title or interest in such permit, license or contractual obligation or any equity interests related *thereto*, ***but only to the extent, and for as long as, such prohibition or requirement is not terminated, waived or rendered unenforceable or otherwise deemed ineffective by the UCC, any other law or any principle of equity.***

This language has the effect of excluding from the collateral any contract for which the consent of the contract counterparty is required (e.g., the franchisor under the franchise agreement), *but only* to the extent such prohibition or requirement is not deemed ineffective by the Uniform Commercial Code. Thus, such language gives effect to Section 9-408, its related benefits in favor of the franchisee and its lender (including retaining a lien on the proceeds of the sale of the franchise agreement), and its protections for the franchisor, notwithstanding the restrictions in the franchise agreement.

Risk to the Lender

Excluding the franchise agreement from the scope of the lender's security interest entirely may result in adverse consequences for the lender. This risk was highlighted in a recent franchisee bankruptcy case. On May 8, 2018, RMH Franchise Holdings, Inc., one of the largest franchisees in the Applebee's system, and certain of its affiliates, filed for bankruptcy protection. The unsecured creditors committee, which represents the interests of unsecured creditors in a bankruptcy case, realized that the lender acknowledged in the loan documents that the franchise agreements were excluded from the scope of its security interests. Based on that acknowledgment, the unsecured creditors committee argued that the franchise agreements, which comprised a significant portion of the value of the debtors' business, as well as any proceeds of the franchise agreements, were not part of the lender's collateral and any recovery should be shared among the unsecured creditors. *See In re RMH Franchise Holdings, Inc., et al.*, Case No. 18-11092 (Bankr. Del., August 15, 2018) (Doc. 455). While the bankruptcy court did not ultimately rule on the issue (and there is a dearth of case law on the application of Section 9-408 in the franchise context), the case highlights the risk to the lender in entirely excluding the franchise agreement from the scope of its security interest. At the very least, the unsecured creditors committee may use such language to negotiate a payout in the event of a sale of the assets of the franchisee, or a more favorable plan of reorganization.

While the drafting of the security interest to give effect to Section 9-408 may be of critical importance to the lender, this approach should not adversely impact either the franchisee or franchisor. The franchisor is not harmed because the lender cannot enforce the security interest nor use or assign the franchisee's rights under the franchise agreement due to the restrictions set forth in Section 9-408(d). The franchisee is not harmed because the competing drafting approaches likely only impact matters outside the scope of its relationship with the franchisor—that is, the distribution of proceeds among secured and unsecured creditors in a sale. Precise drafting in this regard benefits the franchisee and franchisor by providing greater certainty to the lender regarding potential outcomes, which encourages lenders to continue to provide critical liquidity to the franchise industry.

Tri-Party Agreements

In addition to the security agreement, franchisors, franchisees and lenders should also consider the impact of Section 9-408 on tri-party agreements, if pursued by the lender. The tri-party agreement is an agreement among the franchisor, the franchisee and the lender that clarifies each party's rights to exercise remedies under the loan documents and franchise documents. A lender typically seeks the following rights in a tri-party agreement: (1) an acknowledgment that its security interest attaches to the franchise agreement and related assets; (2) notice and opportunity to cure any default by the franchisee under the franchise agreement; and (3) upon an event of default under the loan documentation, a framework for working with the franchisor to convey the assets of the franchisee to a successor franchisor-approved operator. In drafting such agreements, the parties should clearly state the scope of collateral and remedies available to the lender, and understand the way in which those provisions may be impacted by Section 9-408.

Conclusion

The explosive growth of the number of franchise finance lenders has led to disparate treatment in documentation on a variety of issues, including the scope of the lender's security interests. A proper understanding of Section 9-408 of the Uniform Commercial Code should create greater uniformity in documentation while, at the same time, not exposing lenders, franchisors and franchisees to undue risk.■

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