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Securitization: An Overlooked Financing Vehicle for Franchisors

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One of the nation's largest quick-serve restaurant franchisors raised $290 million in November 2000 by "securitizing" its royalty stream. But securitization remains an unknown concept to the vast majority of franchisors, their counsel, and their financial advisors. Mature franchisors seeking to raise funds for any of a number of strategic reasons, including acquisitions, system expansion, the development and systemwide incorporation of new product offerings or technology, or the retirement of existing expensive debt, traditionally turn to the standard sources of financing. These include initial or follow-on public offerings, equity private placements, debt offerings, and the establishment of bank credit facilities.

Usually overlooked is a relatively new structured finance technique known as securitization, in which one or more of a franchisor's revenue streams is structurally isolated in a newly created, bankruptcy-remote, special-purpose entity that issues debt instruments, preferred stock, or certificates of beneficial interest secured by that revenue stream. The subject revenue stream could be royalties pursuant to franchise agreements, notes from franchisees whose unit construction the franchisor financed, or, for product-based franchisors, invoice receivables.

This failure to consider securitization is unfortunate, especially when more established, less arcane financing techniques may not be readily available. For example, the IPO market was severely constricted at the time that this article was written in early 2001. In addition, the danger of using a follow-on public offering has become all too apparent—witness Krispy Kreme, the market's 2000 darling, whose share price dropped 10 percent in one day when its follow-on offering was announced. Bank credit facilities are also tightened in the wake of economic and market slowdowns, and the ability to issue new debt is constrained by the franchisor's balance sheet, income statement, and the rating agencies' view of the franchisor's overall financial position.

In a securitization, these obstacles are simply not present. The very essence of a securitization—in which a franchisor's revenue stream is "securitized" (that is, turned into securities)—relies upon the structural isolation of that revenue stream in an entity that is legally independent and bankruptcy remote from the franchisor itself. Thus, the franchisor's overall creditworthiness is no longer of consequence, only the predictability of the revenue stream at issue. Consequently, the ratings that the nation's recognized rating agencies assign to securitization offerings will almost always be superior to those given to a debt or equity offering of the franchisor itself, since these traditional financings require scrutiny of the franchisor's overall creditworthiness (including operating and nonoperating liabilities) and bankruptcy exposure.

Franchisor absence from the securitization arena is particularly ironic given how much franchisee unit construction has been financed using this technique. One company alone, Franchise Finance Corporation of America, Inc. (FFCA), has, since its inception in 1980, financed more than a billion dollars of franchisee construction loans largely through securitizations. Today, FFCA is a New York Stock Exchange-listed company with over $2 billion in capitalization that services more than 5,900 largely franchised properties of some of the biggest systems in the country, including Arby's, Burger King, Chevron, Hardee's, Midas Muffler Shops, Pizza Hut, 7-Eleven, Taco Bell, and Wendy's.[1] FFCA is hardly the only franchisee lender to use securitizations. Yet, despite such enormous securitization activity on the franchisee side of the ledger, franchisors have rarely undertaken securitization financings.

This article will identify the players in a securitization transaction, detail how a securitization is typically structured and accomplished, and address the key issues of law governing securitization activity.

The Players

In securitization terminology, the franchisor whose revenue stream will serve as the basis of the offering is referred to as the originator, contributor, or transferor. The newly created entity that will receive, by means of a true sale, the franchisor's revenue-generating assets and offer securities secured by those assets is referred to as a special-purpose entity, special-purpose vehicle, or, simply, the issuer. A credit enhancer, typically a bank, financial assurance company, or insurance company, may be brought in to enhance the creditworthiness of the securitization offering through letters of credit, surety bonds, guarantees, or some combination of the three. An insurance company may also participate by irrevocably guaranteeing repayment of the principal, interest due on the issuer's asset-backed notes, or both.

Critical to many securitizations is the servicer. Under contract with the issuer, the servicer undertakes to administer the franchisor revenue-generating assets that are the subject of the securitization, ensures that collection of receivables is properly accomplished, oversees the proper distribution of cash once received, and performs its activities so that it at all times remains legally distinct from the franchisor-originator itself. As discussed in detail below, in the franchise setting, the servicer is usually affiliated with the originating franchisor or may be the originating franchisor itself, which would make it a "seller-servicer."

Sometimes, the services of a liquidity provider are required when there is a discrepancy between the timing of the issuer's periodic note repayment or dividend obligations and the dates on which the issuer actually receives cash. The securities sold by the issuer, as secured by the subject franchisor revenue streams, may be publicly offered or privately placed, but under either circumstance almost always involve the services of an investment bank or other underwriter. Those securities will have to be rated by Moody's, Standard & Poor's, or another of the nation's widely recognized credit rating agencies. Of course, most important of all are the investors that acquire the securitization notes, stock, or other ownership interests in the issuer. Under ideal conditions, these investors are qualified institutional buyers or other qualified purchasers, so that the issuer need not register its offering under either the Securities Act of 1933[2] or any applicable state securities laws.

The Securitization Process

The sine qua non of securitization is the isolation of revenue-generating assets, whose cash flow and liquidation value are predictable, into a new entity that is known as the special-purpose entity (SPE), which is wholly independent of, and therefore bankruptcy remote from, the transferor of those assets.

The types of revenue-generating assets that can be the subject of a securitization include franchise agreements (and the attendant right to receive royalties); construction, equipment, or FF&E loan receivables from franchisees whose build-out costs the franchisor finances; and, for product-based franchisors, receivables from product sales to franchisees. The latter will obviously result in a revolving pool of assets.

The key to a successful securitization—and the reason that it may garner a more favorable rating than would a general securities or debt offering of the franchisor—is that the subject assets, once properly isolated, are now distinct from the balance sheet, overall creditworthiness, and bankruptcy possibilities of the transferring franchisor. These revenue-generating assets then secure the notes, stock, or other debt or equity issued by the SPE, to the exclusion of claims from the transferring franchisor's other creditors, including removal of those assets from the possible bankruptcy estate of the transferring franchisor.

To isolate a securitization franchisor's assets even further from the potential bankruptcy creditors of the franchisor itself, two or more SPEs can be utilized. The revenue-generating assets may be contributed to the issuer SPE while a second SPE may receive, by means of sale or contribution, the intellectual property rights of the originating franchisor and license these rights to the issuer SPE, so that the latter can offer and sell franchises and administer the subject franchise network. Under this model, the transferring franchisor's intellectual property, which is critical to the administration of its network and its ability to sell additional franchises, is potentially shielded not just from the bankruptcy claims of the franchisor's creditors, but from those of the issuing SPE's creditors as well.

To achieve this critical goal of isolation, the legal norms governing absolute transfer of assets must be followed. Thus, the originating franchisor must transfer its assets to the SPE so that a true sale will have resulted. The options for accomplishing this are outright sale to the SPE or a capital contribution of the assets to the SPE. This is crucial to ensuring that, upon the bankruptcy of (or other creditor proceeding involving) the originating franchisor, the assets of the SPE are deemed "bankruptcy remote," not affected by the franchisor's bankruptcy and certainly not "substantively consolidated" with the transferring franchisor. "Substantive consolidation" is an equitable judicial doctrine pursuant to which a bankruptcy court has the power to consolidate entities not sufficiently legally distinct, whether under a corporate "alter ego" theory or because the entities' affairs are "hopelessly obscured." (See discussion below.)

In a true sale, the risk of loss associated with the subject assets is wholly transferred, in this case from the originating franchisor to the SPE; the transferring franchisor retains no benefits of ownership with regard to the assets being transferred; the originating franchisor maintains no continuing control over the transferred assets; the originating franchisor's financial statements do not treat the transferred assets as being owned by the franchisor, but rather as sold; and the transfer agreements reflect a true sale.

To achieve the type of legal separation necessary to withstand later judicial inquiry, enjoy "bankruptcy-remote" status, and avoid a substantive consolidation, the SPE (there may be more than one) should be a newly created entity with no prior business activities, no prior creditors, and no actual or potential claims that a third party could assert against it. The SPE's activities must be narrowly confined; its ability to issue debt must be severely restricted and generally limited to the ability to issue the subject asset-backed securities and, perhaps, later subordinated debt; the assets transferred to the SPE must be free of all liens and other security interests; and the SPE's ability to file for voluntary bankruptcy, or to have an involuntary bankruptcy proceeding commenced against it, must be negated to the greatest extent legally possible.

To maintain the "bankruptcy remoteness" of the SPE and avoid substantive consolidation, it is critical that the SPE have a corporate governance structure separate and distinct from the originating franchisor and any other entity, so that no alter ego or other corporate veil-piercing attack upon the SPE could succeed. See the adjacent side bar for the formalities that should be observed.

In other industries, the issuer SPE may—because of the relatively dormant nature of the revenue-generating assets being transferred to it (such as pools of mortgages, credit card receivables, equipment leases, health care receivables, and other commercial trade receivables)—engage its own officers and employees to carry out its responsibilities and affairs. More typically, however, and certainly in franchising, a servicer will be engaged to administer the subject assets, collect receivables, and disburse those receivables to note-holders, either directly or indirectly, through a third-party paying agent.

Thus, in a securitization where franchise agreements and the right to receive royalties are transferred to an SPE, the SPE will need to engage a servicer to administer the franchise network, sell additional franchises, and otherwise fulfill all of the functions of the originating (now former) franchisor. Logic dictates, and the law affirms the propriety of, engaging the

To Avoid Substantive Consolidation

- The SPE must conduct its business solely in its own name or through its own agents (including any servicer).
- The SPE's funds and assets must at all times be maintained separately.
- The SPE must maintain its own set of complete and correct books and records, and, if the SPE, as is permitted, is a wholly owned subsidiary of the originating franchisor, and the franchisor issues consolidated financial statements, notes to those consolidated statements should clearly reveal the SPE's ownership of the transferred assets.
- The SPE must use its own stationery, invoices, checks, and other business forms and instruments, distinct from those of any other entity (including, most certainly, the originating franchisor).
- All of the SPE's liabilities, except its initial organizational expenses, must be paid out of its own funds.
- The SPE may never hold itself out as being liable for, or assume or guarantee, the debts of any other party.
- The SPE must fairly and reasonably allocate overhead expenses shared with a related entity, including payments for office space and employees.
- The SPE must hold itself out as a separate entity, correct any known misunderstandings regarding its separate identity, and not identify itself as a division of any other entity.
- The SPE must maintain adequate capital in light of its contemplated business operations.
- The SPE's organizational documents must forbid it from dissolving, liquidating, merging, consolidating, or selling substantially all of its assets.
- The SPE must at all times maintain bank accounts separate from those of any other entity, and not permit any other entity independent access to those bank accounts.
- The SPE must observe all corporate or trust formalities.
- All SPE transactions with the originating franchisor and other affiliates must be strictly arm's length in nature.
- The SPE must either have its own employees or contract with a "servicer" to conduct its affairs. The servicer may be the originating franchisor itself.

transferring franchisor itself to be the SPE's servicer. The transferring franchisor is then known as a seller-servicer. The franchisor, when acting as a seller-servicer, must deal with the SPE at arm's length; the franchisor should be paid a fee equivalent to what a wholly independent third-party servicer would receive; and the authority of the transferring franchisor to act as servicer should be revocable by the SPE on terms and conditions that normally would attach to an independent third-party servicer.

The servicing agreement between the seller-servicer franchisor and the SPE thus must explicitly delineate the standards to which the servicer must adhere when selling new franchises, administering the franchise network, collecting franchisee payments, and tendering them to the SPE. The agreement must also specify events of termination. In certain circumstances, it may be prudent to engage an industry consultant, paid by the SPE, to monitor the performance of the servicer and, upon the occurrence of certain servicer termination events, to advise and assist the SPE in seeking a replacement.

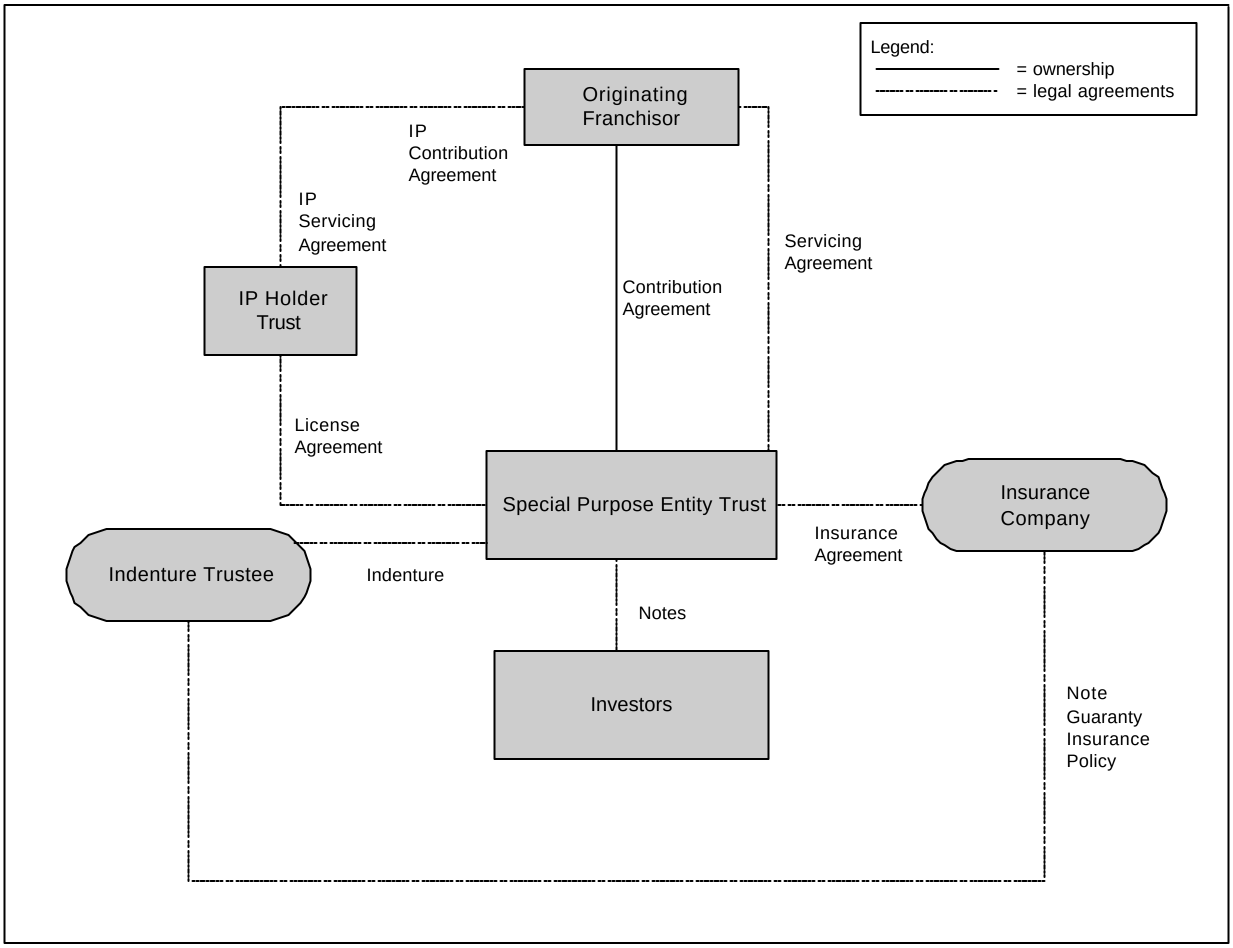
As noted above, internal and/or external credit enhancement facilities may be necessary should the SPE, whether at its inception or later, have insufficient funds to pay noteholders. An internal credit enhancement facility (such as a reserve account) is one that the SPE itself establishes to ensure sufficient liquidity should its revenues be insufficient at any time to satisfy obligations to investors. An external facility is furnished by a third party, such as a bank or insurance company, on behalf of the SPE. In order to obtain a high rating for the SPE's debt or equity offering, the credit enhancement could be an insurance policy guaranteeing to noteholders the timely payment of principal and/or interest on their notes, a form of external credit enhancement. Other credit enhancers include letters of credit, surety bonds, guarantees, subordinated loans, and the SPE's issuance of senior-subordinated debt.

One or more liquidity facilities, typically bank lines or letters of credit, may be required when the timing of receivables collection does not precisely correlate with the timing of payments to noteholders. As opposed to credit enhancement, however, liquidity providers undertake no risk; they are merely fronting cash against receivables certain to be collected.

Finally, desirable ratings from Moody's, Standard & Poor's, or both, are necessary for the SPE to find investors willing to acquire its notes or stock. Moreover, certain categories of institutional investors, financial institutions, and others purchasing asset-backed securities require ratings to satisfy regulatory requirements, investment guidelines, restrictive covenants, or internal policies.[3]

When effecting a securitization, it is vital to involve the rating agencies early in the process, make them comfortable with the transaction and its legal structure, and, if necessary, modify the transaction and its structure to obtain optimal ratings.

A diagram appears below of a securitization involving a franchisor's transfer to one SPE of its existing franchise agreements, the right to sell future franchises and the obligation to administer to the subject network, and the transfer to a separate SPE of the franchisor's intellectual property. The first SPE takes the form of a Delaware business trust in which the SPE appoints the originating-transferring franchisor as its servicer, and the SPE procures an insurance policy guaranteeing repayment of the principal and interest of its notes.



The SPE as Franchisor

Recall that under the securitization model, as delineated in the diagram, the issuer SPE will serve after the transaction in all respects as the "franchisor," not only in administering the franchise network but in selling new franchises as well.

Accordingly, as a brand new entity, the SPE will have to obtain initial franchise registrations in each of the fourteen states requiring registration.[4] Further, should the former franchisor contract as the SPE's servicer, that entity will have to register as a franchise broker (or franchise sales agent) in those jurisdictions requiring the registration of third parties that offer and sell franchises on behalf of a franchisor.[5]

Finally, since the SPE will henceforth be serving as franchisor, all franchise solicitation advertising (defined by applicable state law to include not only advertisements per se but also promotional brochures, letters, videos, websites, and the like) must be filed in the SPE's name in the nine states that require such filings.[6]

Selected Legal Issues

Numerous bodies of law govern and affect a franchisor's securitization. The true sale doctrine in the law of commercial transactions is crucial. Basic precepts of corporate law are also key, including strict adherence to corporate law norms and practices so as to avoid any attempt to pierce the corporate veil of the SPE and achieve a substantive consolidation of the SPE and its franchisor-originator. Trademark law determines whether assignments and registrations of intellectual property are properly accomplished. Securities law governs the SPE's offer and sale of the asset-backed debt and/or securities.

However, perhaps the most critical body of law pertinent to a securitization is bankruptcy law. Two bankruptcy law concepts are highly significant: (1) substantive consolidation, and (2) the exclusion of the originating franchisor's transferred assets from the bankruptcy estate of the franchisor.

Substantive Consolidation

In order to satisfy the policies of reorganization, equality of distribution, and equitable treatment of creditors, bankruptcy courts historically have exercised their equitable powers in appropriate circumstances, subject to appropriate exceptions, to treat separate and distinct entities as one for bankruptcy purposes, i.e., to substantively consolidate them. In doing so, courts have looked to a number of factual indicia of separateness and to the relative fairness of separate versus consolidated treatment of the assets and liabilities of related entities.

The reported decisions under the Bankruptcy Act of 1898 and cases decided shortly after the 1978 enactment of the Bankruptcy Code focus on certain elements that closely track factors relevant to corporate veil-piercing theories.[7] More recent cases take these factors into account in connection with a test that more heavily emphasizes a balancing of the benefits offered by substantive consolidation against the interests of parties objecting to consolidation. These decisions examine the impact of consolidation on creditors of the entities at issue, and the degree of their reasonable reliance on the separate credit of their debtor, instead of cataloguing the mere presence of the substantive consolidation elements.[8]

Although most reported decisions involve attempted substantive consolidation of debtors under the Bankruptcy Code, courts have on occasion consolidated the assets and liabilities of nondebtors with those of debtors. Some, but not all, of those courts have held that proponents of the substantive consolidation of a nondebtor and a debtor have a heavier burden to satisfy due process, among other concerns.[9] At least one court has noted that substantive consolidation of a non-debtor's assets with those of a debtor violates the Bankruptcy Code's strict requirements for the commencement of an involuntary bankruptcy case.[10]

Factors Considered Under Substantive Consolidation

Courts consider two different sets of substantive consolidation elements. In cases depending primarily on the alter ego analogy, the factors often cited as relevant are featured in the sidebar below.

What Counts Under Substantive Consolidation

- Parent corporation owns all or a majority of the capital stock of the subsidiary.
- Parent and subsidiary have common officers and directors.
- Parent finances subsidiary.
- Parent is responsible for incorporation of subsidiary.
- Subsidiary has grossly inadequate capital.
- Parent pays salaries, expenses, or losses of subsidiary.
- Subsidiary has substantially no business except with parent.
- Subsidiary essentially has no assets except for those conveyed by parent.
- Parent refers to subsidiary as a department or a division of parent.
- Directors or officers of subsidiary do not act in interest of subsidiary, but take directions from parent.
- Formal legal requirements of the subsidiary as a separate and independent corporation are not observed.
- Parent assumes contractual obligations of subsidiary.
- Parent shifts people on and off subsidiary's board of directors.
- Parent misuses corporate form and parties engage in nonarm's-length dealings and transfers.
- Parent, its affiliates, and subsidiary act from the same business location.

In re Vecco Construction Industries identified a second set of substantive consolidation elements: the degree of difficulty in segregating and ascertaining individual assets and liabilities, the presence or absence of consolidated financial statements, profitability of consolidation at a single physical location, the commingling of assets and business functions, the unity of interests and ownership among the various corporate entities, the existence of parent or intercorporate guarantees or loans, and the transfer of assets without formal observance of corporate formalities.[11]

The presence or absence of some or all of these elements does not necessarily determine whether substantive consolidation is appropriate.[12] Indeed, many of the elements are present in most bankruptcy cases involving affiliated companies or a holding company structure, but do not necessarily lead to substantive consolidation.

Other factors such as poor or nonexistent recordkeeping of intercompany transactions and of purportedly separate assets (particularly cash and other liquid assets) and liabilities, whether by design or otherwise, are a common reason for imposing substantive consolidation. Courts are more likely to grant substantive consolidation when the assets, liabilities, and business affairs of the affiliate are so hopelessly entangled with those of its parent that segregation is prohibitively expensive or impossible.[13]

The degree of entanglement is important, however, because the potentially prejudicial effect of substantive consolidation is not likely to be justified based on contentions of mere administrative inconvenience.[14] Strict adherence to maintaining corporate or other organizational formalities and separate books and records—and avoiding commingling of assets—should make it more likely that a court would not order substantive consolidation either for reasons of administrative convenience or on equitable grounds.

More recent substantive consolidation decisions continue to rely at least to some degree on the elements described above.[15] However, the balancing test, discussed below, appears to be at least an equally important analysis undertaken in these decisions. For example, in *In re Creditors Service Corp.*,[16] the court cited the *Vecco*[17] factors, but, in determining whether to order the substantive consolidation of a non-debtor individual and several nondebtor entities with the debtor, the court also noted:

> The factors merely provide the framework to assist the Court's inquiry whether harm will result in the absence of consolidation. After a court has decided it has the factual justification to substantively consolidate entities, the ultimate inquiry involves a balancing of the equities based on the bankruptcy court's inherent powers pursuant to §105. [The] Court must be convinced that a harm or prejudice to creditors will occur in the absence of substantive consolidation by weighing the equities favoring consolidation against the equities favoring the debtor remaining separate from the entities and the individual.[18]

Balancing the Benefits of Substantive Consolidation Against Harm to Creditors

Under the balancing analysis appearing in a majority of the decisions, proponents of substantive consolidation must not only demonstrate the existence of substantive consolidation elements, such as the failure to observe corporate formalities, but also establish the harm suffered as a result of this failure, as well as the overall benefits to be derived from substantive consolidation.[19]

Balancing the harm and benefit to creditors that would result from substantive consolidation, the court in *Snider Bros.* stated the following principles: the proponent must demonstrate a "necessity for consolidation, or a harm to be avoided by use of the equitable remedy of consolidation"; supporting evidence must go beyond a mere showing of commingling or unity of interest and must demonstrate the harm caused thereby or prejudice without consolidation; the standard elements are only one factor in the proof of necessity; and even if the proponent can demonstrate the necessity for consolidation, objecting creditors can argue the defense that the benefits of consolidation do not counterbalance the harm to the objectors."[20]

The *Snider Bros.* balancing test has been adopted by many courts, either expressly[21] or impliedly.[22] In another frequently cited decision, *In re Augie/Restivo Baking*, the Second Circuit reduced the considerations pertinent to the balancing test to two "critical factors": "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[23]

The Second Circuit later affirmed the vitality of this test.[24]

A more recent decision from the U.S. District Court for the Southern District of New York, *In re 599 Consumer Electronics, Inc.*, interprets the Second Circuit standard as requiring a court to consider *Augie/Restivo*'s two critical factors as separate bases for substantive consolidation.[25] In particular, the district court noted that "[t]he Second Circuit's use of the conjunction 'or' suggests that the two cited factors are alternatively sufficient criteria."[26] Moreover, in addressing the first of the Second Circuit factors, "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit," the court in *Consumer Electronics* clarified that the test must be applied from the creditors' perspective. "The inquiry is whether creditors treated the debtors as a single entity, not whether the managers of the debtors themselves, or consumers, viewed the four stores as one enterprise."[27] Consistent with its earlier statement, the court there found that creditors knew that they were dealing with separate entities, but then noted:

> A finding that creditors knew they were dealing with separate entities does not necessarily preclude substantive consolidation on the ground that it is impossible or prohibitively expensive to unravel the debtors' commingled finances. Consolidation may still benefit all creditors under those circumstances because "the time and expense necessary even to attempt to unscramble [the debtors' separate finances may be] so substantial as to threaten the realization of any net assets for all the creditors."[28]

The Eighth Circuit has held that "[f]actors to consider when deciding whether substantive consolidation is appropriate include (1) the necessity of consolidation due to the inter-relationship among the debtors; (2) whether the benefits of consolidation outweigh the harm to creditors; and (3) prejudice resulting from not consolidating the debtors."[29]

In *In re Auto-Train Corp., Inc.*, the U.S. Court of Appeals for the District of Columbia Circuit required a proponent of substantive consolidation to show "a substantial identity between the entities to be consolidated . . . ."[30] Even after such a showing under the *Auto-Train* test, however, the proponent must still demonstrate that the benefits of substantive consolidation outweigh any potential harm."[31] The benefits and burdens test perhaps has been applied most clearly and consistently to secured creditors whose rights in specific, clearly identifiable collateral would be impaired or destroyed as a result of substantive consolidation. It is a general rule that, absent a compelling reason, such as fraud, substantive consolidation may not reduce a creditor that is secured by specific, identifiable assets to the status of an unsecured creditor.[32] As a corollary, it is generally agreed that the specific, identifiable collateral of secured creditors should not be enhanced, absent unusual circumstances, as a result of substantive consolidation.[33]

Notwithstanding the widespread acceptance of the *Snider Bros.* balancing test, three issues remain unsettled: (1) the continued importance of the substantive consolidation elements; (2) the appropriate standard for assessing the benefits to creditors of a proposed substantive consolidation; and (3) the appropriate standard for assessing harm to creditors objecting to a proposed substantive consolidation. As courts have noted, substantive consolidation is decided on a case-by-case basis in light of the unique facts as determined by the bankruptcy court in the case at hand.[34]

Excluding Transferred Assets from the Bankruptcy Estate of the Franchisor-Transferor

Subject to certain exceptions, § 541(a)(1) of the Bankruptcy Code provides that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." A bankruptcy trustee of the transferring franchisor, or the franchisor as a debtor in possession, might assert that the franchisor retained an interest in the assigned assets, arguing that they were never sold to the SPE, but were merely pledged to secure an obligation of the franchisor. Under this theory, the trustee or franchisor might seek a court order requiring turnover of the assigned assets to the franchisor, as provided by § 542 of the Bankruptcy Code, or an order enforcing § 362(a) of the Bankruptcy Code (the automatic stay provision) in order to prevent payment to the SPE of proceeds of or revenue generated by the assigned assets.

Whether the assigned assets may be considered property of the bankruptcy estate of the franchisor-transferor depends on whether the transfer of those assets constituted a true sale or other absolute transfer, or only the grant of a security interest to secure a purported obligation of the franchisor to repay money borrowed from the SPE. However, the Bankruptcy Code gives no guidance on whether a debtor has an interest in property, or whether it owes a debt.[35] Generally, state law dealing with property rights determines the nature and extent of a debtor's interest in property.[36] Thus, while bankruptcy law defines what property of the debtor constitutes property of the bankruptcy estate, to determine a debtor's interest in particular property, a bankruptcy court generally will apply state law.[37]

Numerous courts have considered the nature of a transfer of receivables, but judicial analysis in this area has typically proceeded case by case, based on the courts' broad discretion in the exercise of their equitable powers rather than as a result of consistently applied legal doctrines. Generally, in determining whether a sale of accounts receivable constitutes a true sale or a pledge to secure indebtedness, the courts examine "the documentation of the transaction in order to discover whether the alleged buyer of the accounts has assumed the risk of loss."[38] Numerous factors bear on this issue and have been considered by the majority of courts reviewing the nature of transactions involving accounts.

For example, the Second Circuit has said:

> In determining the substance of the transaction, the Court may look to a number of factors, including the right of the creditor to recover from the debtor any deficiency if the assets assigned are not sufficient to satisfy the debt, the effect on the creditor's right to the assets assigned if the debtor were to pay the debt from independent funds, whether the debtor has a right to any funds recovered from the sale of the assets above that necessary to satisfy the debt, and whether the assignment itself reduces the debt. (Citations omitted.) The root of all of these factors is the transfer of risk. Where the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of nonperformance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of nonpayment by the account debtor, while the lender only bears the risk that the account debtor's nonpayment will leave the borrower unable to satisfy the loan.[39]

However, the Tenth Circuit held in *Octagon Gas Systems, Inc.* v. *Rimmer* that a buyer of a company's accounts obtains only a security interest in the accounts, even where the underlying documents expressly and objectively reflect a true sale.[40] In light of the potential impact of the *Octagon Gas* decision on future characterizations of account transactions, we will address that case in detail.

In *Octagon Gas*, the Tenth Circuit held that the assignment of a royalty interest in proceeds of natural gas constituted the transfer of an account, as that term is defined by article 9 of the Uniform Commercial Code (U.C.C.).[41] The court noted that under article 9, the buyer of an account is treated as a secured party, the buyer's interest in the account is treated as a security interest, the seller of the account is treated as a debtor, and the account sold is treated as collateral, regardless of the parties' intent.[42] Therefore, the *Octagon Gas* court concluded that the debtor retained an interest in an account sold by the debtor before bankruptcy, and that this interest constituted property of the debtor's bankruptcy estate.[43]

We believe the *Octagon Gas* decision is wrong to the extent that it implies that the provisions of article 9 should be used to determine the ownership of accounts, including for purposes of determining property of the estate under § 541 of the Bankruptcy Code. While article 9 unquestionably applies to both the sale of accounts and loans secured by accounts,[44] its characterization of an interest in an account as a security interest under the U.C.C. is solely for purposes of perfection and priority, not for determining title or ownership.[45]

In response to *Octagon Gas*, the National Conference of Commissioners on Uniform State Law has adopted the following amendment to Official Comment 2 to U.C.C. section 9–102:

> Neither Section 9–102 nor any other provision of Article 9 is intended to prevent the transfer of ownership of accounts or chattel paper. The determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes (such as in connection with a loan) is not governed by Article 9. Article 9 applies both to sales of accounts or chattel paper and loans secured by accounts or chattel paper primarily to incorporate Article 9's perfection rules. The use of terminology such as "security interest" to include the interest of a buyer of accounts or chattel paper, "secured party" to include a buyer of accounts or chattel paper, "debtor" to include a seller of accounts or chattel paper, and "collateral" to include accounts or chattel paper that have been sold is intended solely as a drafting technique to achieve this end and is not relevant to the sale or secured transaction determination.[46]

Octagon Gas has also received wide criticism from commentators.[47]

Octagon Gas fails to recognize other provisions in article 9 that maintain the distinction between a secured loan and a true sale with respect to accounts. Although *Octagon Gas* currently controls in the Tenth Circuit, we believe that it should not be followed elsewhere. Nevertheless, the *Octagon Gas* case poses some risk that, even absent a recharacterization of the transaction as a financing and even though the transfer of the subject assets to the SPE has the indicia of a true sale, a bankrupt franchisor could be deemed to retain an interest in the assigned assets. Thus, it is possible that the SPE may not be able to defeat treatment of the transaction as a financing with respect to the franchisor.

Although courts typically give effect to the expressed intent of the parties, periodically they have either ignored or given only perfunctory attention to expressed intent where necessary to prevent an inequitable result or where the stated intent is manifestly at variance with the actual purpose of the transaction.[48] However, where the SPE provides value to the transferor and the sale is disclosed as such in the transferor's financial statements or accompanying notes, it would be inequitable to permit creditors of the transferor thereafter to recover the assigned assets (or an interest therein) to the detriment of the SPE when the SPE and the SPE's creditors had only limited recourse to the transferor. Moreover, where the parties are sophisticated business entities that have deliberately structured a transaction to achieve certain legal consequences, the parties' expressed intention should be given effect.[49]

Conclusion

When properly utilized and carefully accomplished, the structured financing technique known as securitization may present an advantageous alternative to franchisors seeking to raise cash for strategic reasons. Ironically, franchisee lenders, most notably Franchise Finance Corporation of America, Inc., have used securitizations in the past two decades to fund billions of dollars of franchisee unit construction and other loans, while franchisors have largely been absent from the securitization arena. The recent $290 million securitization by one of the nation's foremost quick-service restaurant franchisors may, however, be a harbinger that the technique will become an attractive financing alternative for franchisors.

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ENDNOTES

1 *See* Franchise Finance Corporation of America, Inc., *Who We Are—History, available at* <www.ffca.com>.

2 15 U.S.C. §§ 77 *et seq*.

3 *See* Richard Cantor and Frank Packer, *The Credit Rating Industry*, FEDERAL RESERVE BANK OF NEW YORK Q. REV. 1, 10-12 (Summer-Fall 1994).

4 California Franchise Investment Law, CAL. CORP. CODE §§ 31000 *et seq*.; Hawaii Franchise Investment Law, HAW. REV. STAT., §§ 482-E1 *et seq.*; Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. §§ 705/1 *et seq*.; Ind. Code §§ 23-2-2.5-1 *et seq.*; Maryland Franchise Registration and Disclosure Law, MD. CODE ANN., BUS. REG. §§ 14-201 *et seq.*; Michigan Franchise Investment Law, MICH. COMP. LAWS §§ 445.1501 *et seq*.; MINN. STAT. §§ 80C.01 *et seq*.; N.Y. GEN. BUS. LAW §§ 33-680 *et seq*.; North Dakota Franchise Investment Law, N.D. CENT. CODE §§ 51-19-01 *et seq.*; Oregon Franchise Transactions Law, OR. REV. STAT. §§ 650.005 *et seq*.; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. GEN. LAWS §§ 19-28.1-1 *et seq.*; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS §§ 37-5A-1 *et seq*.; Virginia Retail Franchising Act, VA. CODE ANN. §§ 13.1-557 *et seq*.; Washington Franchise Protection Act, WASH. REV. CODE §§ 19.100.010 *et seq.*; Wisconsin Franchise Investment Law, WIS. STAT. ANN. §§ 553.01 *et seq*.

5 California requires that the servicer register as a subfranchisor; California's Franchise Investment Law does not require the registration of franchise sales agents or brokers.

6 California Franchise Investment Law, CAL. CORP. CODE §§ 31156; IND. CODE § 23-2-2.5-4; Maryland Franchise Registration and Disclosure Law, MD. CODE ANN., BUS. REG. § 14-225; MINNESOTA STAT. § 80C.09; N.Y. Comp. Codes R. & Regs. tit. 13, § 200.09; North Dakota Franchise Investment Law, N.D. CENT. CODE § 51-19-10; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. GEN. LAWS § 19-28.1-12; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS § 37-5A-44; Washington Franchise Protection Act, WASH. REV. CODE § 19.100.100.

7 *See, e.g.*, *In re Gulfco Inv. Corp*., 593 F.2d 921, 928 (10th Cir. 1979); *In re Vecco Constr. Indus*., 4 B.R. 407, 409-10 (Bankr. E.D. Va. 1980).

8 *See, e.g.*, *In re Reider*, 31 F.3d 1102, 1106-07 (11th Cir. 1994); *In re Giller*, 962 F.2d 796, 799 (8th Cir. 1992); *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988); *see also In re Eagle-Picher Indus., Inc*., 192 B.R. 903, 905-06 (Bankr. S.D. Ohio 1996); *In re Apex Oil Co*., 118 B.R. 683, 692-93 (Bankr. E.D. Mo. 1990); *In re Snider Bros., Inc.*, 18 B.R. 230, 234, 236-38 (Bankr. D. Mass. 1982); *In re Lewellyn*, 26 B.R. 246, 251-52 (Bankr. S.D. Iowa 1982); *In re DRW Property Co.*, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); *In re Steury*, 94 B.R. 553, 554-55 (Bankr. N.D. Ind. 1988); *In re Crown Mach. & Welding, Inc*.,

100 B.R. 25, 26-28 (Bankr. D. Mont. 1989). *But cf*. *G.M. Mather* v. *G.K. Pipe Corp*. (*In re Moran Pipe & Supply Co*.), 130 B.R. 588, 591-93 (Bankr. E.D. Okla. 1991) (relying entirely on alter ego factors); *In re Gainesville P-H Properties, Inc*., 106 B.R. 304 (Bankr. M.D. Fla. 1989) (relying primarily on alter ego factors).

9 *Compare In re Alpha & Omega Realty, Inc*., 36 B.R. 416, 417 (Bankr. D. Idaho 1984) (fact that general partnership that was related to a debtor corporation was not itself a debtor under the Code precluded substantive consolidation) *with In re New Ctr. Hosp.*, 187 B.R. 560, 567-69 (E.D. Mich. 1995); *In re Tureaud*, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985), *aff'd*, 59 B.R. 973, 977 (N.D. Okla. 1986); and *In re 1438 Meridan Place, N.W., Inc.*, 15 B.R. 89, 95 (Bankr. D.D.C. 1981).

10 *See In re Ira S. Davis, Inc*., No. 92-142595, 1993 WL 384501, at *7 (E.D. Pa. 1993) (citing 11 U.S.C. § 303). *But see In re United Stairs Corp*., 176 B.R. 359, 369-70 (Bankr. D.N.J. 1995) (where the non-debtor entities are alter egos of the debtor, requirements for filing an involuntary case do not apply to prevent substantive consolidation).

11 *In re Vecco Constr. Indus*., 4 B.R. at 410.

12 *See In re Donut Queen, Ltd.*, 41 B.R. 706, 709-10 (Bankr. E.D.N.Y. 1984) (criteria should not be mechanically applied in determining consolidation; rather, factors should be evaluated within the larger context of balancing the prejudice resulting from the proposed order of consolidation with the prejudice alleged by creditor from the debtor's separateness).

13 *See In re Creditors Serv. Corp*., 195 B.R. 680, 690-91 (Bankr. S.D. Ohio 1996); *In re New Ctr. Hosp.*, 187 B.R. at 569.

14 *Compare In re Jeter*, 171 B.R. 1015, 1020 (Bankr. W.D. Mo. 1994), *aff'd*, 178 B.R. 787 (W.D. Mo. 1995), *aff'd*, 73 F.3d 205 (8th Cir. 1996) (evidence of financial commingling sufficient to support substantive consolidation); *In re Standard Brands Paint Co.*, 154 B.R. 563, 572 (Bankr. C.D. Cal. 1993) (although debtors were not entangled in a "records sense," court ordered substantive consolidation finding that "in a functional sense the affairs of all five debtors are so entangled that consolidation will benefit all creditors, because the effect/validity of the intercompany debts and guarantees will not have to be sorted out . . . .); *In re Vecco Constr. Indus.*, 4 B.R. at 410-11 (substantive consolidation granted without opposition when debtors had single operating account and consolidated financials; had made no attempt to segregate receivables, disbursements, or income; had inaccurately allocated affiliate expenses through intercompany accounts; and had filed bankruptcy schedules on a consolidated basis); *In re Baker & Getty Fin. Serv., Inc.*, 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987) (substantive consolidation ordered when corporate funds were extensively commingled and used for principal's personal purposes, segregation of assets could not accurately be accomplished, funds were transferred without adherence to corporate formalities, and corporate entities were alter egos of principal who exercised pervasive control over debtors' financial affairs); *In re Tureaud*, 45 B.R. at 661 (extensive commingling of personal and corporate assets, numerous undocumented intercorporate

transfers, lack of distinction between intercompany transactions despite separateness of books and records, indiscriminate use of different cor-porate names within single transaction, and impossibility of accurately tracing all transfers) *with In re Reider*, 31 F.3d 1102, 1109-11 (11th Cir. 1994) (erroneous listing of both entities' land on debtor's schedules and some evidence of commingling of funds are not sufficient for substantive consolidation where proper allocation of funds can be readily made and harm to creditors resulting from substantive consolidation outweighs benefits) and *In re Ford*, 54 B.R. 145, 147-50 n.6 (Bankr. W.D. Mo. 1984) (evidence of commingled corporate and personal funds, in corporate bank account, common use of funds and common responsibility for loans held insufficient to blur the distinction between the entities and inadequate for substantive consolidation).

15 *See, e.g., In re Creditors Serv. Corp.*, 195 B.R. at 689; *In re Eagle-Picher Indus., Inc.*, 192 B.R. 903, 906-07 (Bankr. S.D. Ohio 1996); *In re New Ctr. Hosp.*, 187 B.R. at 569; *In re Gucci*, 174 B.R. 401, 413 (Bankr. S.D.N.Y. 1994).

16 195 B.R. 680, 690 (Bankr. S.D. Ohio 1996).

17 *In re Vecco Constr. Indus*., 4 B.R. at 407.

18 *In re Creditors Serv. Corp.*, 195 B.R. at 690 (citations omitted).

19 *In re Snider Bros., Inc.*, 18 B.R. 230, 238 (Bankr. D. Mass. 1982).

20 *Id.*

21 *See Drabkin* v. *Midland-Ross Corp.* (*In re Auto-Train Corp., Inc.*), 810 F.2d 270, 276 (D.C. Cir. 1987); *Holywell Corp.* v. *Bank of New York*, 59 B.R. 340, 347 (S.D. Fla. 1986), *appeal dismissed*, 820 F.2d 376 (11th Cir. 1987), *vacated*, 838 F.2d 1547 (11th Cir. 1988), *cert. denied*, 488 U.S. 823 (1988); *In re Creditors Serv. Corp.*, 195 B.R. at 690; *In re Eagle-Picher Indus., Inc.*, 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996); *In re Steury*, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988); *In re Baker & Getty Fin. Serv., Inc.*, 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987); *In re DRW Property Co.*, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); *In re Donut Queen, Ltd.*, 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984); *In re Lewellyn*, 26 B.R. 246, 251 (Bankr. S.D. Iowa 1982); *In re F.A. Potts & Co., Inc.*, 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982).

22 *See Eastgroup Properties* v. *Southern Motel Ass'n, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991); *In re Silver Falls Petroleum Corp.*, 55 B.R. 495, 498 (Bankr. S.D. Ohio 1985); *In re Helms*, 48 B.R. 714, 717 (Bankr. D. Conn. 1985) (balancing of interests is another important factor); *In re N.S. Garrott & Sons*, 48 B.R. 13, 18 (Bankr. E.D. Ark. 1984) (adopting *Snider Bros.* principles as important factors); *In re Luth*, 28 B.R. 564, 567 (Bankr. D. Idaho 1983) (citing *Snider Bros.* test as another element).

23 *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988) (citations omitted).

[24] *See FDIC* v. *Colonial Realty Co.*, 966 F.2d 57, 61 (2d Cir. 1992) (*in dicta*).

[25] *In re 599 Consumer Elec., Inc.*, 195 B.R. 244 (S.D.N.Y. 1996).

[26] *Id.* at 248.

[27] *Id.* at 249.

[28] *Id.* at 250 (quoting *In re Augie/Restivo*, 860 F.2d at 519).

[29] *In re Giller*, 962 F.2d 796, 799 (8th Cir. 1992); *see also In re Apex Oil Co.*, 118 B.R. 683, 692-93 (Bankr. E.D. Mo. 1990) (substantive consolidation supported by analysis of interrelationship among the debtors, basic fairness to creditors, and prejudice to creditors and the debtors resulting from not consolidating the debtors, including the substantial cost of untangling the debtors' affairs).

[30] *In re Auto Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir. 1987). *See also In re Standard Brands Paint Co.*, 154 B.R. 563, 572-73 (Bankr. C.D. Cal. 1993) (discussing the *Auto-Train* test, the court found that a parent and four debtor subsidiaries met the substantial identity test, not in the alter ego/piercing the corporate veil sense, but rather in "functional terms," because they operated as a single consolidated entity and there were multiple interdebtor guarantees and inter-debtor debts).

[31] *In re Standard Brands Paint Co.*, 154 B.R. at 572; *see also In re Reider*, 31 F.3d 1102, 1107-08 (11th Cir. 1994) (reaffirming the adoption of the *Auto-Train* test in the Eleventh Circuit and emphasizing the impact of substantive consolidation on creditors of the entities at issue, and the degree of their reasonable reliance on the separate credit of their debtor, instead of cataloguing the mere presence of the substantive consolidation elements).

[32] *In re Gulfco Inv. Corp.*, 593 F.2d 921, 930 (10th Cir. 1979); *In re Dynaco Corp.*, 184 B.R. 637, 638 n.l (Bankr. D.N.H. 1995).

[33] *In re Cooper*, 147 B.R. 678, 682 (Bankr. D.N.J. 1992) (citations omitted).

[34] *See In re Crown Mach. & Welding, Inc.*, 100 B.R. 25, 27-28 (Bankr. D. Mont. 1989) ("[A]s to substantive consolidation, precedents are of little value, thereby making each analysis on a case-by-case basis."); *In re Tureaud*, 59 B.R. 973, 975 ("[S]ubstantive consolidation cases are to a great degree sui generis.") (quoting 5 COLLIER ON BANKRUPTCY § 1100.06 at 1100-33 (15th ed. 1984).

[35] 4 COLLIER ON BANKRUPTCY § 54107[l] at 541-30 (L. King ed. 15th ed. 1996).

[36] *Chicago Bd. of Trade* v. *Johnson*, 264 U.S. 1, 10 (1924); *In re Ballard*, 238 B.R. 610, 617 (Bankr. M.D. La. 1999); *In re Allnott*, 220 B.R. 871, 892 (Bankr. D. Md. 1998) ("In the absence of any controlling federal law, 'property' and 'interests in property' are creatures of state law."); *Barnhill* v. *Johnson*, 503 U.S. 393, 398 (1992). *See also In re Neponset River*

Paper Co., 213 B.R. 829, 832 (1st Cir. BAP 1999); *In re Altman*, 230 B.R. 6, 11 (Bankr. D. Conn. 1999).

37 *See Butner* v. *United States*, 440 U.S. 48, 54-57 (1979)*; In re Crysen/Montenay Energy Co.*, 902 F.2d 1098, 1101 (2d Cir. 1990); *In re Abruzzo*, 245 B.R. 201, 206 (Bankr. E.D. Pa. 1999); *In re Garten*, 52 B.R. 497, 499 (Bankr. W.D. Mo. 1985).

38 *Grossman* v. *Butcher*, No. 91AP-1023, 1992 Ohio App. LEXIS 3653 (1992).

39 *Endico Potatoes, Inc*. v. *CIT Group/Factoring, Inc*., 67 F.3d 1063, 1068-69 (2d Cir. 1995). In ruling that the transfer of accounts in that case was not an absolute assignment, the court relied on the following factors: the assignee was a preexisting lender to the debtor-assignor, the debtor's accounts receivable were transferred to the lender under a financing agreement that required the lender to "make loans and advances" upon the "security of [the debtor's] accounts receivable," the assignment of the accounts receivable did not discharge or reduce the debtor's obligation to repay the loans, the lender could demand payment directly from the debtor, and upon repayment of all outstanding loans the lender would no longer have an interest in the accounts receivable.

40 *Octagon Gas Systems, Inc*. v. *Rimmer* (*In re Meridian Reserve, Inc*.), 995 F.2d 948 (10th Cir. 1993), *cert. denied*, 510 U.S. 993 (1993).

41 *Octagon Gas Sys.*, 995 F.2d at 954.

42 *Id.* at 955-57 (citing U.C.C. §§ 9–102(1)(b); 1–201(37); 9–105(1)).

43 *Id.* at 955-58.

44 *See* U.C.C. § 9-102.

45 *See* COOGAN, ET AL., SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 28.03[2] at 28-15 (1993) (stating that article 9 is "designed to integrate sale of chattel paper into the Article 9 scheme insofar as the rules dealing with attachment, perfection, and priority are concerned); *see also George W. Ultch Lumber Co*. v. *Hall Plastering, Inc*., 477 F. Supp. 1060, 1069-70 (W.D. Mo. 1979) (*citing United States* v. *Trigg*, 465 F.2d 1264, 1268 (8th Cir. 1972), *cert. denied*, 410 U.S. 909 (1973) (court notes that the U.C.C. does not classify the debtor's interest in the collateral securing a debt as "property" or "rights to property," the terms traditionally used by the U.S. Supreme Court, and that the drafters of the U.C.C. made no attempt to fix location of title to collateral securing a creditor's interest).

46 PEB Commentary No. 14, § 9–102 (1)(b), U.C.C. Rep. Serv. (Callaghan 1994).

47 *See, e.g.*, Lynn M. Lopucki, *The Death of Liability*, 106 YALE L.J. 1, 92 n.127 (1996); Reade H. Ryan, Jr., *Trade Receivables Purchases*, 1996 A.L.I.-A.B.A. BANKING AND COMM. LENDING LAW 507, 569-73.

[48] *See, e.g.*, *Major's Furniture Mart, Inc*., 602 F.2d at 543, and cases cited therein; *Alda Commercial*, 327 F. Supp. at 131617.

[49] *See, e.g.*, *In re Kassuba*, 562 F.2d 511, 515 (7th Cir. 1977); *In re Bevill, Bresler & Schulman Asset Mgmt. Corp*., 67 B.R. 557, 597-98 (D.N.J. 1986); *Granite Partners, L.P.* v. *Bear, Stearns & Co., Inc*., 17 F. Supp. 2d 275, 300 (S.D.N.Y. 1998) (*citing John Hancock Mutual Life Ins. Co*. v. *Amerford Int'l Corp*., 22 F.3d 458, 461 (2d Cir. 1994)).