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Bankruptcy Issues in Franchising:

An Overview

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Bankruptcy Issues in Franchising: An Overview

An introduction to the key issues for bankruptcy lawyers, franchisors and franchisees dealing with financial distress.

Franchising Basics for Bankruptcy Professionals

Franchise Structures

The two basic types of franchises are "business format" (also known as a "package format") and "product" franchises. In a business format franchise, the franchisor licenses to the franchisee the use of the business system prescribed by the franchisor and associated with the franchisor's marks. Generally, the franchisor furnishes significant assistance, including a marketing plan and business system, to its franchisees, in turn requiring the franchisee's strict adherence to the controls and method of operation under the franchisor's business system. By contrast, such assistance and controls are usually absent in a product franchise.

A product franchise is where the franchisee sells goods, produced by the franchisor, that bear the franchisor's trademark. The franchisee is typically required to pay the franchisor for the right to distribute the goods. Payment may take the form of a required purchase of trademark goods as well as payment of an initial franchise fee.

There are a variety of ways to structure a franchise system and offering. The franchisor may offer a single-unit franchise, whereby a license is granted by the franchisor to a franchisee to operate a franchise business at or from a single location. Some sort of geographic protection against competition from the franchisor and other franchisees is commonly granted to the franchisee. A franchisor may also grant what is frequently called an "area development franchise," which allows the franchisee the right to establish and operate more than one franchise business within a specified geographic or development area.

Furthermore, a "pure" franchise system is one in which the franchisor obtains revenue through licensing of its mark to its franchisees and collecting a stream of royalty payments. The franchisor may also derive revenue from supplying products sold by the franchisee in connection with the mark. By contrast, a "mixed" system is where the franchisor derives a portion of its revenue from the franchisee fees and product sales and the rest from "corporate" stores owned and operated by the franchisor.

Contractual Relationships

A franchise relationship may be evidenced by a unitary contract or a series of related agreements. These contractual relationships can include the following:

- The basic franchise agreement: The franchise agreement licenses the rights to the franchisee to use the franchisor's trademarks, copyrights, service marks, patent and business systems. In addition to providing for the payment of an ongoing royalty fee, a franchise agreement might contain provisions for the payment of fees for advertising or production costs.
- Development agreements: A development agreement gives a franchisee the right of future development in particular areas.

- Real property leases: In certain instances where a franchisor operates a mixed franchise system, the franchisor may sell off some of its corporate stores to franchisees. If the franchisor was the lessee at that location, the franchisor may enter a sublease with the new franchisee to maintain the location.

- Procurement contracts: One market advantage of franchising is the purchasing power of the franchisor to make purchases for the franchise system as a whole. It is typical for the franchisor to enter into procurement contracts with vendors on behalf of its franchisees to achieve economies of scale. These economies may be passed through to the franchisees, or the franchisor may receive rebates from the vendor, as long as such rebates are disclosed to the franchisees.

Accordingly, when faced with a bankruptcy of a franchisor or a franchisee, courts must determine whether these various contracts will be regarded as a unitary contract or separate obligations. For example, one court has held that a franchise agreement and real property lease were indivisible and that pre-petition termination of the franchise agreement, but not the lease, meant that both the franchise agreement and the lease were property of the estate and assumable by the franchisee-debtor.[1] Further discussion regarding assumption of contracts will be addressed later in this article.

Basics of Business Bankruptcy for Franchise Professionals

Business bankruptcies are filed to preserve assets, distribute assets equitably and/or facilitate orderly liquidation. When a business files for bankruptcy, it may choose to liquidate under Chapter 7 or it may file for reorganization under Chapter 11 of Title 11 of the United States Bankruptcy Code. If the entity chooses to continue operation, generally it will file under Chapter 11, but it always has the opportunity to “convert” to the other chapter.

In a Chapter 7 case, a trustee is appointed to account for the assets and liabilities of the business. The trustee may sell or auction the assets and pursue claims against third parties for the benefit of the creditors. The Chapter 7 trustee administers the assets of the bankruptcy estate and may prosecute fraudulent conveyance and preference actions. The pool of proceeds is then collected and distributed in accordance with the priority scheme established by the Bankruptcy Code. Ongoing business activities generally cease at or before the commencement of a Chapter 7 bankruptcy case, but in limited situations a Chapter 7 trustee may be permitted to continue ongoing operations when necessary and appropriate to maximize sale value for the benefit of creditors.

Many business bankruptcy cases are “no asset cases,” meaning that no proceeds are available for distribution. In the franchise context, this might be the case where the franchise agreement is worthless because it has already been terminated or abandoned and/or all assets are encumbered by liens. An individual franchisee may also file a “wage-earners plan” under Chapter 13, which gives a debtor with regular income an opportunity to repay its debts. Although Chapter 13 rules expedite the procedure, a franchisor should generally treat a Chapter 13 case as if it were filed as a business bankruptcy under Chapter 11.

In a Chapter 11 case, a trustee is typically not appointed. Absent a court order, the debtor, with its pre-existing management, operates as a “debtor-in-possession” and assumes the role of the fiduciary to creditors. The debtor

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[1] *See In re Karfakis*, 162 B.R. 719 (Bankr. E.D. Pa. 1993).

has all of the powers of a trustee to recover preferences, fraudulent conveyances and other assets for the benefit of the creditors. The debtor also has an "exclusive period" to present a plan of reorganization to the court. The process requires court approval of a disclosure statement summarizing the plan and disclosing pertinent financial and operational information. After approval of the disclosure statement, the plan and disclosure statement are circulated and the creditors vote on whether to approve the plan. Once the exclusivity period expires, creditors can file alternative or competing plans.

Today, most Chapter 11 cases are used as tools for liquidation while entrenched management remains in control. In these cases, the plans of reorganization are simply asset sales or auctions, with liquidating dividends. In many other instances, the key assets are sold pursuant to Section 363 of the Bankruptcy Code before the plan process even begins.

A typical Chapter 11 franchise bankruptcy case would follow the timeline set forth below.

Time	Event
Petition Date	Case filed.
Days 2-4	"First day" hearing, where the debtor/franchisee seeks permission from the court to use cash collateral (cash and equivalents subject to security interests), continue to employ and pay personnel in the ordinary course and perhaps obtain interim Debtor-in-Possession (DIP) Financing (usually arranged before the bankruptcy is filed).
Days 22-30	Final cash collateral and financing hearing.
Days 120-210	Deadline for debtor to move to assume or reject leases of commercial real property. May only be extended with landlord consent.
6 months	Plan and disclosure statement filed.
12-18 months	Exit from bankruptcy.

In addition, the players involved in the typical Chapter 11 franchise bankruptcy case include:

- Creditors, which include landlords, suppliers and franchisors with claims.
- A Creditors Committee comprised of three to seven creditors who are selected by the U.S. Trustee (the Committee retains counsel and often a financial adviser paid for by debtor).
- Pre-petition lenders, including secured and unsecured, both before and after bankruptcy is filed.
- A DIP lender, which may provide DIP Financing.
- Taxing authorities and employees with priority wage claims.
- A U.S. Trustee (government representative overseeing the process).

The automatic stay is the most powerful tool granted by the Bankruptcy Code. Section 362 of the Bankruptcy Code provides for an automatic injunction against almost all third parties from continuing or commencing most actions against the debtor or its assets. Such actions include attempts by third parties to enforce liens, take possession, improve a security position or set off a debt. Any action taken in violation of the stay is voidable and willful violations can result in punitive damages, contempt or other sanctions assessed against the offending party. The stay is the mechanism that creates and protects the bankruptcy estate. Once the bankruptcy petition has been filed, events are referred to as occurring "pre-petition" or "post-petition." A creditor can seek relief from the stay from the bankruptcy court for good cause, including "lack of adequate protection," which means that the property at issue is declining in value and the rights of the creditor are diminishing.

Franchise Agreements and the Bankruptcy Estate

As discussed above, the filing of a petition for relief under the Bankruptcy Code creates a bankruptcy "estate."[2] Section 541 of the Bankruptcy Code determines what property of the debtor becomes property of the debtor's estate. The concept of property of the estate is broad in scope, encompassing all kinds of property, including tangible and intangible property, causes of action, real and personal property, certain property held by the debtor in trust for others and certain property of the debtor held by others.[3] The estate includes all legal and equitable interest of the debtor in property as of commencement of the bankruptcy case, including proceeds, profits and similar property.[4]

The federal bankruptcy system in the United States is designed to encourage the rehabilitation of financially troubled entities. To achieve this end, federal bankruptcy law includes the broadest possible definition of "bankruptcy estate property," and it protects that property. In addition, and perhaps even more important for both franchisors and franchisees, bankruptcy procedure creates a situation where the bankrupt entity has a strong advantage in any fight over whether a franchise agreement is property of the estate.

Bankruptcy Estate Includes Franchise Agreements Existing at the Petition Date

Franchise agreements that are in existence at the bankruptcy filing date are property of the franchisee-debtor's bankruptcy estate under Section 541 of the Bankruptcy Code. Applicable federal or state substantive law determines the extent and nature of the parties' property rights in the franchise agreement, as long as such law is not inconsistent with the Bankruptcy Code.[5]

The franchisee-debtor's rights under the franchise agreement are protected by the automatic stay under 11 U.S.C. § 362.[6] A franchisor is prohibited from initiating or continuing any act to terminate a franchisee-debtor's franchise agreement or take any other action that could diminish the franchisee-debtor's rights without first obtaining relief from the automatic stay from the bankruptcy court, pursuant to Section 362 of the Bankruptcy Code.

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[2] Unless otherwise noted, the concepts discussed in this overview apply equally to franchisees and franchisors.

[3] See *U.S. v. Whiting Pools*, 462 U.S. 198, n.9 (1983).

[4] 11 U.S.C. § 541. The bankruptcy court has exclusive jurisdiction over property of the estate, wherever it is located. 28 U.S.C. § 1334(d).

[5] See *Butner v. United States*, 440 U.S. 48 (1979).

[6] *In re Tudor Motor Lodge Assoc. Ltd. P'ship*., 102 B.R. 936, 948 (Bankr. D.N.J. 1989); *In re R.S. Pinellas Motor P'ship*, 2 B.R. 113, 116 (Bankr. M.D. Fla. 1979).

The Bankruptcy Code invalidates so-called ipso facto clauses in contracts purporting to terminate a debtor's interest in property, such as a franchise agreement, solely on the basis of a bankruptcy filing or insolvency.[7] However, the filing of a bankruptcy petition does not expand the franchisee's rights in the franchise agreement.[8]

Franchise Agreements Are Not Estate Property if Properly Terminated Pre-Petition

Generally, if a valid termination notice, which is effective upon receipt, has been delivered before the filing of bankruptcy, then the franchise agreement is not property of the estate.

A franchise agreement that has expired by its own terms or that is properly terminated under state or federal law before a bankruptcy is filed is not protected, because it is not considered in force. A franchise agreement is no longer in existence, it will not be considered property of the estate when the bankruptcy case is filed.[9]

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[7] 11 U.S.C.§ 365(e)(1). Nevertheless, an affirmative, active pre-petition termination of a franchise agreement on the basis of insolvency may be upheld by a court. *See, e.g., Comp III, Inc., v. Computerland Corp. (In re Comp III, Inc.)*, 136 B.R. 636 (Bankr. S.D. N.Y. 1992); *Pat's King of Steaks, Inc., v. Pat's Int'l., Ltd.*, 1986 U.S. Dist. LEXIS 23715 (E.D. Pa., June 25, 1986).

[8] *See, e.g., Moody v. Amoco Oil Co.*, 734 F.2d. 1200, 1213 (7th Cir. 1984) ("Section 541(a) provides that a debtor's estate consists of 'all legal or equitable interests of the debtor in property as of the commencement of the case.' Thus, whatever rights a debtor has in property at the commencement of the case continue in bankruptcy—no more, no less"), *cert. denied*, 469 U.S. 82 (1984); *see also In re R.E.B. & B. Inc.*, 200 B.R. 262 (Bankr. M.D. Fla. 1996) (since underlying agreement provided that telephone number and listing were property of franchisor, and franchisee-debtor was no longer operating as franchisee, franchisor did not violate automatic stay by transferring telephone number and listing to a different location).

[9] *Moody v. Amoco Oil Co.*, 734 F.2d. 1200 (7th Cir.), *cert. denied*, 469 U.S. 982 (1984). *See, e.g., Days Inn v. Gainesville P-H Props., Inc. (In re Gainesville P-H Props., Inc.)*, 77 B.R. 285, 295 (Bankr. M.D. Fla. 1987) ("termination of agreements prior to bankruptcy prevent[s] such agreements from being property of the estate"); *see also, Baskin-Robbins Inc. v. Neiberg (In re Neiberg)*, 161 B.R. 606 (Bankr. W.D. Pa. 1993) (analysis of whether franchisor's pre-petition termination was effective; under applicable law, franchisor did not waive termination rights); cf. *In re Karfakis*, 162 B.R. 719 (Bankr. E.D. Pa. 1993) (court held that franchise agreement and real property lease were indivisible and that pre-petition termination of franchise agreement, but not lease, meant both franchise agreement and lease were property of estate and assumable by franchisee-debtor) (decision vacated by agreement of the parties and the court).

The same reasoning applies to all other executory contracts and leases at issue in a bankruptcy case. Where a franchisor has given notice of termination and the time for the termination pursuant to the contract has passed before the franchisee files for bankruptcy, the termination is deemed to be complete before the bankruptcy filing and the contract is not property of the estate.

Franchise Agreement Termination Is Effective Post-Petition if "Nothing Is Left To Be Done"

If a franchisor has given notice of termination before the bankruptcy was filed but the termination is not effective until a date after the bankruptcy filing date, courts have held that if the franchisor need not take any affirmative act to complete the termination, the termination will be deemed effective once the required time has passed. The courts' rationale for this position is based on the premise that, although the bankruptcy intervened between the notice for termination and the effective date of termination, there is nothing left for the debtor to cure and the termination should become effective. *In re Deppa*, 110 B.R. 898 (Bankr. D. Minn. 1990), provides such an example. In *Deppa*, the franchise relationship was partially regulated by the Petroleum Marketing Practices Act (PMPA), which requires that a franchisee be given a 90-day notice of termination. The franchisor argued that, once it sent its PMPA notice of termination, the franchise agreement was deemed terminated and the intervening bankruptcy did not stop the termination from becoming effective. The court agreed, stating that the 90-day period was not intended as a cure period, but rather provided an opportunity for the franchisee to contest the validity of the termination.

Similarly, in the case of *In re Diversified Washes of Vandalia, Inc.*, 147 B.R. 23 (Bankr. S.D. Ohio 1992), 10 days remained between the notice period and the effective date of termination when the bankruptcy was filed. The court cited the general rule that an automatic stay does not prevent the mere running of time under a termination notice where there was nothing left to be done for the termination to become complete.[10]

Note, however, that in *In re Bronx-Westchester Mack Corp.*, 4 B.R. 730 (Bankr. S.D.N.Y. 1980), the court held that a contract did not terminate even though the notice stated that nothing was left to be done to terminate because the franchisor had falsely assured the franchisee that there would be no termination to keep the franchisee from filing its petition.[11]

A franchisor must make sure that the franchise agreement has been properly terminated. If a franchisee-debtor establishes that a franchise agreement was wrongfully terminated, the contract may become property of the bankruptcy estate and the franchisee-debtor may be entitled to assume the franchise agreement upon compliance with the conditions laid out under Section 365 of the Bankruptcy Code.[12] However, absent collusion or fraud, pre-petition terminations have not been successfully challenged as voidable preferences or fraudulent conveyances.[13]

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[10] *See also Days Inn v. Gainesville P-H Props., Inc. (In re Gainesville P-H Props., Inc.*), 77 B.R. 285 (Bankr. M.D. Fla. 1987); *In re New Media Irjax, Inc.*, 19 B.R. 199, 201 (Bankr. M.D. Fla. 1982); *In re Beck*, 5 B.R. 169, 171 (Bankr. D. Haw. 1980).

[11] Absent collusion or fraud, pre-petition terminations have not been successfully challenged as voidable preferences or fraudulent conveyances. *In re Thompson*, 186 B.R. 301 (Bankr. N.D. Ga 1995); *In re Egyptian Bros. Donuts, Inc*. 190 B.R. 26 (Bankr. N.J. 1995); *In re Coast Cities Truck Sales, Inc.*, 147 B.R. 674 (D.N.J. 1992).

[12] *See Checkers Drive-In Restaurants v. Tampa Checkmate Food Servs. (In re Tampa Checkmate Food Servs.)*, 221 B.R. 541, 548 (Bankr. D. Fla. 1998).

[13] Andrew Selden, Craig Tractenberg, & Dean Waldt, *Tiger by the Tail–Confronting Bankruptcy Issues*, pg. 14 (38th Annual IFA Legal Symposium) (citing *In re Thompson*, 186 B.R. 301 (Bankr. N.D. Ga. 1995); *In re Egyptian Bros. Donuts, Inc.*, 190 B.R. 26 (Bankr. N.J. 1995); *In re Coast Cities Trust Sales, Inc.*, 147 B.R. 674 (D.N.J. 1992)).

Franchise Agreement Is Estate Property if the Franchise Has Opportunity To Cure Before Termination Is Complete

When some action beyond the "mere passage of time" remains to complete a termination that was commenced pre-petition, the automatic stay codified in Section 362 of the Bankruptcy Code will apply to prevent termination post-petition.[14] For example, in *In re ERA Cent. Regional Serv., Inc.*, 39 B.R. 738 (Bankr. C.D. Ill. 1984), the termination notice gave the franchisee the opportunity to cure defaults before the termination was effective. The bankruptcy intervened before the franchisee's time to cure the defaults had expired and the court found that the automatic stay applied and that the franchisor could not terminate the franchise agreement without obtaining permission from the bankruptcy court pursuant to an order modifying or vacating the automatic stay. The court reasoned that there was "something left to be done" before termination occurred.[15]

If the franchisee still has a right to cure, the filing of the bankruptcy before the cure deadline protects that right. Applicable law will decide whether the cure period is:

- The express contractual period.
- Any state law statutory cure period.
- Within 60 days after the filing of bankruptcy.
- In a Chapter 11 case, up until confirmation of a Plan of Reorganization.

Section 108(b) of the Bankruptcy Code extends for 60 days from the bankruptcy filing date, among other things, the opportunity for the debtors to take action to cure a default or perform any other similar act, unless the cure period expires later than 60 days after the date of the order for relief, in which case, the later expiration date applies.

Section 108(a) can extend the time fix by non-bankruptcy law for a franchisee-debtor to commence an action, but may not be used to force an extension of the expiration date of a franchise agreement. In *Lauderdale Motor Corp. v. Rolls-Royce Motors, Inc.* (*In re Lauderdale Motor Corp.*), 35 B.R. 544 (Bankr. S.D. Fla. 1983), the franchisee-debtor attempted to use Section 108(a) to extend its rights as a Rolls-Royce franchisee. Rolls-Royce had sent a notice to the franchisee stating that it would not renew the dealer agreement at its expiration. The franchisee-debtor then filed for bankruptcy protection before the agreement expired. The franchisee-debtor sought a declaration in the bankruptcy court that its dealer agreement with Rolls-Royce was in full effect and also sought relief against Rolls-Royce for a purported violation of the automatic stay.

The franchisee-debtor argued that Section 108(a) of the Bankruptcy Code extended the period provided by state law during which the franchisee-debtor could challenge and reinstate its terminated franchise. The applicable Florida statute gave the debtor 90 days to seek a "determination of unfair discontinuation" of its franchise. The

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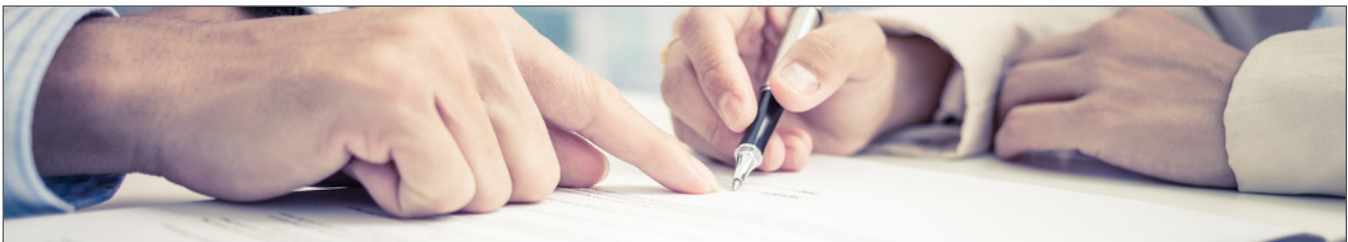
[14] *In re Steaks To Go,* 226 B.R. 32 (Bankr. Mo. 1998).

[15] *See also In re JLS Shamus, Inc.*, 179 B.R. 294 (Bankr. M.D. Fla. 1995) (where bankruptcy was filed on the same day that the previously sent notice of termination had designated as the termination date); *In re Masterworks, Inc.*, 100 B.R. 149 (Bankr. D. Conn. 1989) (franchise agreement was still in place at commencement of franchisee's bankruptcy case, where contractual time to cure default had not expired at bankruptcy filing date).

franchisee-debtor contended that, because Section 108(a) extends the period in which a debtor can "commence an action" to the later of two years after the filing or the end of the period provided by state law, the period proscribed by state law to seek a determination was extended two years after the filing. The court found that the right of a debtor to seek such determination was not the type of litigation or "action" contemplated by Section 108(a). Accordingly, the extra time provided by that subsection was not available to the debtor in its attempt to keep its franchise agreement in force.

The court then stated that Section 108(b) applied in this situation, instead of Section 108(a) of the Bankruptcy Code. Under Section 108(b), the debtor had only the greater of any state-created rights or 60 days after the order for relief to file the protest. Both periods had passed by the time the court entered its order deciding the issue. The court also held that Section 108(b) controls over the automatic stay provided by Section 362 and, therefore, any protest period is not indefinitely stayed by Section 362 but is instead limited by Section 108(b).[16]



Franchise Agreement Is Property of the Estate Where Termination Has Been Enjoined

In *In re Wills Motors, Inc.*, 133 B.R. 297 (Bankr. S.D.N.Y. 1991), a franchisee had obtained a state court injunction to prevent termination by the franchisor before the bankruptcy case was filed. The court held that, when the franchisee-debtor filed its Chapter 11 petition, the franchisor's purported termination of the agreement was not final and complete and that the agreement qualified as an executory contract that could be assumed and assigned under 11 U.S.C. § 365.[17]

Franchise Agreement Is Property of the Estate When Saved By State Law

In *Krystal Cadillac Oldsmobile GMC Truck, Inc., v. GMC* (*In re Krystal Cadillac Oldsmobile GMC Truck, Inc.*), 142 F.3d 631, 636 (3d Cir. 1998), the court held that a franchise agreement was not terminated because state law made it clear that once a dealer (franchisee) has appealed a notice of termination, termination shall not become effective until the state Vehicle Board issues its decision. The franchisee-debtor filed for bankruptcy protection before the Vehicle Board rendered such a decision and, therefore, the franchise agreement was part of the estate. The court further held that any post-petition determinations by the Vehicle Board and the Pennsylvania Commonwealth Court, effectively ordering the termination of the franchise agreement, were made in violation of the automatic stay provisions of 11 U.S.C. § 362(a) and were not binding on the bankruptcy court.

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[16] *See also In re Anne Cara Oil Co.,* 32 B.R. 642 (Bankr. D. Mass. 1983) (Section 108(b) is not applicable where the dealership agreement is terminated pre-petition, even though the termination becomes effective some time post-petition).

[17] *See also City Auto, Inc. v. Exxon Co., U.S.A.,* 806 F.Supp. 567 (E.D. Va. 1992) (although franchisee obtained pre-petition injunction, the franchise held terminated pre-petition when franchisee failed to post bond required by district court as condition for continuing franchise pursuant to preliminary injunction, and thus, franchise was not part of bankruptcy estate).

Franchisors May Obtain Relief From the Automatic Stay To Terminate or Enforce a Franchise Agreement

Bankruptcy courts are generally reluctant to lift the automatic stay, especially in the early stages of a bankruptcy case and will often strictly hold the franchisor to the heavy burden of showing that the requirements for lifting the stay pursuant to Section 362(d) of the Bankruptcy Code have been met.

Section 362(d) of the Bankruptcy Code, which governs requests for relief from the automatic stay, provides:

(d) On request of a party in interest and after notice and hearing, the court shall grant relief from the stay such as by terminating, annulling, modifying or conditioning such stay:

1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

2) with respect to a stay of an act against property ... if:

    a) the debtor does not have an equity in such property; and

    b) such property is not necessary to an effective reorganization.

Franchisors May Have the Automatic Stay Lifted for Cause

Franchisors are most likely to attempt to lift the stay to terminate a franchise agreement after a bankruptcy filing for cause, including lack of adequate protection of an interest in property, under Section 362(d)(1) of the Bankruptcy Code.[18]

In *In re Tudor Motor Lodge Assoc. Ltd.*, 102 B.R. 936 (Bankr. D.N.J. 1989), the court granted a motion for relief from the automatic stay filed by the franchisor, Days Inn of America Franchising, against the franchisee-debtor for cause under Section 362(d)(1). *Tudor Motor* is a significant case because the court lifted the stay in spite of the fact that (1) the court found that the franchisee-debtor could potentially meet the requirements for assumption of the franchise agreement under Section 365 for the Bankruptcy Code and (2) the franchisee-debtor was not in post-petition default to the franchisor.

The *Tudor Motor* court first discussed "adequate protection," which is a concept discussed in bankruptcy cases under Section 361 of the Bankruptcy Code, holding it to be applicable not only for secured creditors but also for other parties, such as franchisors. The court then lifted the stay because it found that the franchisee-debtor (1) failed to perform construction work necessary to bring the premises into compliance with Days Inn standards;

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[18] *See, e.g., Moody v. Amoco Oil* (*In re Moody*), 734 F.2d 1200, 1210 (7th Cir. 1984), cert. denied. 469 U.S. 982 (1984) (debtor's checks did not clear); *In re B-K of Kan.*, 69 B.R. 812 (Bankr. D. Kan. 1987) (court found no adequate protection was provided to the franchisor since the franchisee-debtor continued to use trademarks without paying the franchisor post-petition, arrearages on royalties were accumulating and the franchisor's reputation was at stake because of the franchisee-debtor's quality control problems); *In re Elsan Transmission Corp.*, 55 B.R. 73 (Bankr. E.D.N.Y. 1985) (since franchise agreement was terminated pre-petition, stay lifted to allow the franchisor right to use the franchisee-debtor's telephone number); *In re Beck, 5 B.R.* 169, 170 (D. Haw. 1981) (stay lifted due to irregularities in the debtor's accounting for receipts); *In re JLS Shamus, Inc.*, 179 B.R. 294 (Bankr. M.D. Fla. 1995) (stay lifted due to 15 years of delinquent payments and no possibility of rehabilitation due to size of defaults).

(2) compromised the Days Inn standards of excellence; (3) diminished the value of the Days Inn marks and entitlements; (4) adversely affected patron identification with Days Inn standardized service and consistent quality; and (5) affected Days Inn royalties. The court found that the franchisee-debtor's offer of adequate protection for the franchisor in the form of payment of post-petition obligations under the franchise agreement, with payment on pre-petition liabilities upon the successful completion of the franchisee-debtor's reorganization plan, was insufficient, as the property in the case (the use of trademarks and service marks) was of such a type that money alone could never adequately protect the franchisor.

The Stay May Not Be Lifted if Defaults Have Been or Can Be Cured and the Franchisor Is Adequately Protected

A court will generally not lift the automatic stay to permit the termination of a franchise agreement if the franchisee-debtor demonstrates that defaults have been or can be cured and the franchisor is adequately protected.[19] As discussed below, the Bankruptcy Code allows the franchisee-debtor to cure defaults (at least monetary defaults), in connection with the plan confirmation process.

Strategic Reasons Exist To Move for Relief Even Where Odds of Success Are Slim

As discussed above, franchisors will rarely succeed in efforts to have an automatic stay lifted early in a case. Nonetheless, it is often advisable for the franchisor to file the motion, to focus the debtor and the court on the franchisor's issues early on.

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[19] *In re Indep. Mgmt. Assoc., Inc.,* 108 B.R. 456 (Bankr. D.N.J. 1989) (adequate protection granted proposing a plan of reorganization, based on the assumption and assignment of the franchise agreement, which would necessarily include the curing of all monetary defaults under the franchise and lease agreements).

Assumption, Rejection and Assignment of Franchise Agreements, Licensing Agreements, Service Contracts, Noncompetition Agreements, Unexpired Leases and the Like Under Section 365 of the Bankruptcy Code

Section 365 of the Bankruptcy Code gives a debtor the ability to assume, assume and assign or reject executory contracts and unexpired leases subject to bankruptcy court approval.[20] This authority provides the franchisee-debtor with a very valuable tool in its reorganization efforts, as franchise rights can be transferred for value and burdensome contracts can be rejected.

The term *executory contract* is not defined in the Bankruptcy Code. The legislative history of Section 365 states that executory contracts "generally include contracts on which performance remains due to some extent on both sides."[21] Most courts have adopted the definition of executory contract first articulated by professor Vern Countryman. Countryman's definition is as follows:

> [An executory contract is] a contract under which the obligation of both the bankrupt and other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[22]

Examples of executory contracts routinely at issue in franchise bankruptcy cases include franchise agreements, certain service contracts, equipment leases and real property leases and subleases.[23] License agreements and patent agreements are also typically viewed as executory contracts because of ongoing obligations such as notification of potential infringement and provision of technical assistance or indemnification of the licensee.[24]

In a Chapter 7 case, an executory contract will be deemed rejected if the trustee does not assume or assume and assign it within 60 days after the bankruptcy case commences, unless the court extends that time period "for cause." Trustees almost always seek and obtain additional time to assume or reject executory contracts.

In Chapter 11 cases, the debtor may reject or assume executory contracts (other than unexpired leases of nonresidential real property, i.e., commercial leases) at any time before confirmation of the plan of reorganization. A party in interest may request that the bankruptcy court fix a shorter time period, within which the debtor must reject or assume the contract. This tactic is most effective for franchisors that have a sufficient reason for expediting the decision.

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[20] S11 U.S.C. § 365(a).

[21] H.R. REP. NO. 595 at 340, 347 (1997).

[22] Vern Countryman, *Executory Contracts in Bankruptcy, Part I, 57 Minn. L. Rev*. 439, 460 (1973).

[23] *See, e.g., Moody v. Amoco Oil Co.*, 734 F2d 1200 (7th Cir.) (retail petroleum dealership agreement is executory contract), cert. denied, 469 U.S. 982 (1984); *Burger King Corp. v. Rovine Corp.* (*In re Rovine Corp.*), 6 B.R. 661 (Bankr. W.D. Tenn. 1980) (franchise agreement is executory contract); *White Motor Corp. v. Nashville White Trucks* (*In re Nashville White Trucks*), 5 B.R. 112 (M.D. Tenn. 1980) (automobile dealer sales and service agreement is executory contract).

[24] *See, e.g., In re Gunter Hotel Assoc.*, 96 B.R. 686 (Bankr. W.D. Tex. 1988) (Radisson Hotel license is executory contract); *In re Alltech Plastics, Inc.*, 71 B.R. 686 (Bankr. W.D. Tenn. 1987) (patent license for plastic manufacturing process is executory contract).

Nonresidential real estate leases must be assumed or rejected within 120 to 210 days of the bankruptcy filing unless the court extends this time. As discussed below, in a major concession to landlords, Congress set these firm deadlines when it enacted the 2005 amendment to the Bankruptcy Code.

Assumption of a Contract Under Which Debtor Is Not in Default

Court approval is required for a franchisee-debtor to assume an executory contract such as a franchise agreement or an unexpired lease. To assume an executory contract, a franchisee-debtor must declare its intention by filing a motion with the court. If the executory contract is not in default, the franchisee-debtor is entitled to court approval of the assumption, as long as (a) the contract appears to be in the best interest of the estate; (b) the debtor is able to perform; and (c) the assumption is supported by reasonable business judgment.[25] Assumption and rejection are addressed by Section 365 of the Bankruptcy Code.

Assumption of a Defaulted Contract

Section 365(b)(1) of the Bankruptcy Code contains the requirements for assumption of a contract under which a debtor is in default. Under Section 365(b)(1) of the Bankruptcy Code, a debtor who has defaulted under an executory contract may assume the contract only if the debtor:

A. Cures or provides adequate assurance that the trustee will promptly cure such defaults.

B. Compensates or provides adequate assurance that it will promptly compensate a party other than the debtor to such contract or lease for any actual pecuniary loss to such party resulting from such default.

C. Provides adequate assurance of future performance under such contract or lease.

The Bankruptcy Code requires assurances of "prompt" cure, but courts determine promptness on a case-by-case approach.[26]

Concerning the terms "actual pecuniary loss," some courts have held that such compensation includes attorneys' fees incurred by the non-debtor party. However, the majority of courts have held that, unless the underlying agreement provides for an award of attorneys' fees, the non-debtor party is not entitled to such fees as part of the cure.[27] One court, however, has held that Section 365(b)(1)(B) creates an independent right to attorneys' fees without regard to the terms of the underlying contract.[28] Franchisors seeking to recover attorneys' fees and franchisees seeking to deny franchisors such fees should carefully review the case law and the language included in the franchise agreement.

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[25] *See In re GP Express Airlines, Inc.*, 200 B.R. 222, 230 (Bankr. D. Neb. 1996) (citing cases).

[26] Compare *In re Coors of N. Miss.*, 27 B.R. 918 (Bankr. N.D. Miss. 1983) (three years is prompt, given bad acts by distributor) with *Days Inn v. Gainesville P-H Props., Inc.* (*In re Gainesville P-H Props., Inc.*), 77 B.R. 285 (Bankr. N.D. Fla. 1987) (prompt cure required in five days).

[27] *See, e.g., In re Ryan's Subs, Inc.*, 165 B.R. 465, 468 (Bankr. W.D. Mo. 1994) (citing cases).

[28] *In re Westworld Cmty. Healthcare, Inc.,* 95 B.R. 730, 733 (Bankr. C.D. Cal. 1989).

The amount of the cure cost and whether the default is curable has been the subject of some writings. It is generally required that the cure be a full cure. In *In re JLS Shamus, Inc.*, 179 B.R. 294 (Bankr. M.D. Fla. 1995), the franchisee-debtor had a history of delinquent payments over the life of the franchise. From time to time, the franchisee-debtor had executed notes representing arrearages to date. The franchisor had also lent money to the franchisee-debtor in return for the franchisee-debtor's execution of additional notes.

After filing for Chapter 11 bankruptcy, the franchisee-debtor took the position that the only defaults that needed to be cured were its obligations to the franchisor under a real estate lease and equipment lease. The franchisee-debtor argued that its obligations represented by the promissory notes were merely unsecured obligations, which need not be cured as a condition precedent for assumption of the franchise agreement.

The *Shamus* court agreed with the franchisor that the "package" of payments due to the franchisor, including payments relating to the promissory notes, were "not severable and each is dependent on the other."[29] The court relied on *In re Offices & Serv. of White Plains Plaza, Inc.*, 56 B.R. 607 (Bankr. S.D.N.Y. 1986), which held that defaults that must be cured included those arising under promissory notes for the past arrearages to a landlord.

The court rejected the franchisee-debtor's argument that the *Offices and Services* case was distinguishable. The court found that, although the franchisee-debtor in the *Shamus* case had kept the franchisor current post-petition and proposed to continue furnishing adequate protection by making the regular weekly payments required by the leases and the notes, full cure of defaults to the franchisor, including those memorialized by the notes, was required to assume the contract. Because the franchisee-debtor could not propose a plan to fully cure the defaults, the court lifted the automatic stay.

By contrast, in *In re GP Express Airlines*, 200 B.R. 222 (Bankr. D. Neb. 1996), the court held that a new loan was severable from the conditions of the franchise agreement and need not be assumed as part of assumption of the underlying contract. Additionally, in *In re Twin City Power Equip., Inc.*, 308 B.R. 898 (Bankr. C.D. Ill. 2004), the court found that an agreement with John Deere (a franchisor) to finance a dealer's acquisition of sufficient inventory of John Deere products so the dealer could operate as an authorized dealer was integral, rather than merely incidental, to the dealer agreement. As such, the dealer agreement was considered "a financial accommodation" agreement that is not assumable by the trustee or the debtor-in-possession.[30] The dealer was well in arrears to John Deere, which provided John Deere cause to modify the stay and to allow it to exercise its rights and remedies, including the termination of the agreements.

Cure of Noneconomic Defaults Under Executory Contracts

Before enactment of the 2005 Amendment to the Bankruptcy Code, it was unclear whether a bankrupt company could assume an executory contract (for example, a lease) if there had been a pre-bankruptcy nonmonetary default. Assumption was sometimes barred because certain "historical" defaults (for example, temporary

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[29] *In re JLS Shamus, Inc.,* 179 B.R. 294, 296 (Bankr. M.D. Fla. 1995).

[30] *See* 11 U.S.C. § 365(c)(2).

[31] 11 U.S.C. § 365(b)(3).

closing or "going dark") could not be cured. The 2005 act clarifies that a debtor can cure nonmonetary defaults *in commercial leases* in the event the landlord is compensated for any pecuniary loss. However, the 2005 act expressly applies only to commercial leases, thereby suggesting that nonmonetary defaults in other executory contracts, such as franchise agreements, cannot be cured merely by compensation for pecuniary loss. Whether nonmonetary defaults under the franchise agreements should always be considered "non-curable" defaults will await developing case law, but the 2005 act certainly suggests this outcome is plausible, even if it flies in the face of the policies favoring restructuring.

Adequate Assurance of Future Performance

Section 365 of the Bankruptcy Code states that the franchisee-debtor must also provide adequate assurance of future performance to assume an executory contract. The section provides additional special protections for landlords of shopping center leases concerning adequate assurance of future performance that come into play if the franchisee-debtor leases space in a shopping center.[31]

In *In re Great Northwest Recreation Ctr., Inc.*, 74 B.R. 846 (Bankr. D. Mont. 1987), the court allowed the franchisee-debtor to assume, in conjunction with confirmation of the debtor's plan of reorganization, three motorcycle franchise agreements over the objection of the franchisor. The court stressed that the franchisee-debtor had a very strong historical performance, excellent management and a restructured operation.

The court believed the franchisee-debtor's past difficulties were directly related to market conditions, which were improving.

The assumption was allowed, even though the franchisee did not have the line of credit required by the franchise agreement. Because the franchisor testified that it was willing to accept C.O.D. payment for delivery of motorcycles, the court questioned the need for the credit line, especially since the franchisee-debtor had successfully operated on a C.O.D. basis since the bankruptcy was filed.

The court found that the franchisee-debtor's restructured operation provided adequate assurance to the franchisor that the franchisee-debtor would perform. The court noted that, once the plan was confirmed, the automatic stay would no longer apply and the franchisor could pursue its contractual remedies if the franchisee-debtor defaulted on its obligations under the reorganization plan.

In *In re Memphis-Friday's Assoc.*, 88 B.R. 830 (Bankr. W.D. Tenn. 1988), the franchisee-debtor did not provide adequate assurance of future performance with regard to assumption of a franchise agreement to run a "Friday's" restaurant. The court found that since the franchisee-debtor offered only "generalities," such as stating that the general partner of the debtor possessed "more than sufficient funds to cure defaults" and the debtor's representative "brought no records because he assumed that his testimony would be sufficient," adequate assurance of future performance was not given.[32]

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[31] 11 U.S.C. § 365(b)(3).

[32] *In re Memphis-Friday's Assoc.*, 88 B.R. 830, 841 (Bankr. W.D. Tenn. 1988).

In addition, the franchisee-debtor in *Memphis-Friday's* could offer the franchisor adequate assurance of future performance under the franchise agreement only if the franchisee-debtor could assume the commercial lease for the restaurant. The court concluded that the lease had terminated before the franchisee-debtor's bankruptcy and, therefore, the franchisee-debtor could not assume the lease. The franchisee-debtor's legal inability to assume the lease rendered the assumption of the franchise agreement impossible. There being no assumable lease, the court found there was no assumable franchise agreement.

Assignment of Executory Contracts in a Franchise Setting

An executory contract, such as a franchise agreement, cannot simply be sold to a third party in a bankruptcy case. The franchisee-debtor must first meet the requirements for assumption of the contract and then meet the requirements for assignment. Most notably, the proposed assignee must demonstrate "adequate assurance of future performance" pursuant to 11 U.S.C. § 365(f)(2).

Provisions contained in franchise agreements often provide franchisors with veto power over assignment-of-franchise agreements; however, such provisions are often not enforceable in bankruptcy. Nevertheless, assignments might not be approved if applicable non-bankruptcy law allows the franchisor to withhold consent.

In *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st. Cir. 1984), the bankruptcy court ruled that the franchise agreement for an automobile dealership was assignable despite a clause in the franchise agreement prohibiting assignment and a state statute prohibiting assignment of automobile dealerships without dealer consent. The court reasoned that an automobile franchise is not a personal services contract, holding that the Bankruptcy Code's prohibition on assignment of contracts only applied to personal services contracts. The district court affirmed the decision of the bankruptcy court.

The First Circuit Court of Appeals reversed the district and bankruptcy courts and agreed with the franchisor that the franchise was non-assignable. In its ruling, the First Circuit held that the prohibition on assignment was not limited to cases involving personal services contracts, but applied where the contract is the type that "contract law ordinarily makes non-assignable."[33] The applicable state statute in *Pioneer Ford* stated that dealers could not assign automobile franchises without dealer consent, but that consent could not be "unreasonably withheld." Applying this statute, the First Circuit held that consent had not been unreasonably withheld because the assignee could not meet the working capital requirements of the franchisor.[34]

The Fifth Circuit has also held that the Section 365(c) reference to "applicable law" is not limited to personal service contracts.[35] And, in Illinois, the bankruptcy court found that provisions of that state's Uniform Commercial Code prohibiting assignment where that action would "increase materially the burden or risk imposed on" the non-

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[33] *In re Pioneer Ford Sales, Inc.,* 729 F.2d 27, 28 (1st. Cir. 1984).

[34] *See also In re Van Ness Auto Plaza, Inc.*, 120 B.R. 545 (Bankr. N.D. Cal. 1990) (finding that it was not unreasonable under California law for franchisor Porsche to refuse to consent); *In re CFLC, Inc.*, 174 B.R. 119 (Bankr. N.D. Cal. 1994), aff'd sub nom. *Everex Sys. v. Cadtrak Corp.*, 89 F.3d 673 (9th Cir. 1996) (federal patent law prevented assignment of patent license without patent holder's consent).

[35] *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983). *But see Leonard v. General Motors Corp.* (*In re Headquarters Dodge, Inc.*), 13 F.3d 674, 682-83 (3d Cir. 1993) (remanding to bankruptcy court to determine if the franchisor's right of first refusal was enforceable; case implies, without deciding, that test under § 365(c) is simply whether contract is a personal services contract).

debtor counterparty could be applied to prohibit assignment of an exclusive dealership agreement from the debtor to a competitor of the manufacturer.[36]

In *Ford Motor Co. v. Claremont Acquisition Corp.* (*In re Claremont Acquisition Corp., Inc.*), 186 B.R. 977, 987 (C.D. Cal. 1995), the district court held that it was not clear error for the bankruptcy court to find that Ford Motor Company's refusal to consent to an assignment was unreasonable under the California statute. Note, however, that the same court also ruled that General Motors did not unreasonably withhold its consent to the assignment of its franchise agreement under applicable state law.[37]

One recent case of note is *Wellington Vision, Inc., v. Pearle Vision, Inc.* (*In re Wellington Vision, Inc.*), 364 B.R. 129 (S.D. Fla. 2007). Pearle Vision sought relief from the automatic stay to terminate a franchise agreement with Wellington Vision, the franchisee-debtor, arguing that Wellington could not assume the agreement because it included a nonexclusive license of Pearle Vision trademarks (as do almost all franchise agreements). The district court affirmed the bankruptcy court findings that Pearle Vision had granted Wellington a nonexclusive trademark license, which was, therefore, governed by federal trademark law, which grants a licensor of a nonexclusive trademark license certain protections, including restrictions on assignment.

The *Wellington* court followed the Courts of Appeals for the Third, Fourth and Ninth Circuits, which read the language of Section 365(c)(1) as asking whether a debtor could "hypothetically" assign the license even if it is only proposing to assume the contract. This "hypothetical" test gives most licensors a veto over proposed assumption of the contract by a Chapter 11 debtor. If the contract proposed to be assumed could be "hypothetically" assigned, then the licensor can object at the time of assumption because it does not want to "hypothetically" deal with strangers to the contract as assignees in the future. The "actual" test, used by the courts in the First, Eighth and Ninth Circuits, permits a trustee or debtor-in-possession to assume an executory contract or unexpired lease if the trustee or debtor-in-possession does not actually intend to assign same. Because under the actual test, the licensor will not be forced to deal with new parties, the licensor cannot veto the assumption, as the parties remain the same.

The *Wellington* court also addressed an emerging trend, favored in several decisions in the Bankruptcy Court for the Southern District of New York, that the use of the word *trustee* does not include a debtor or a debtor-in-possession. Under this interpretation, the right of the non-debtor party to object to assignment does not affect the right of a debtor-in-possession to assume an executory contract, although it would affect the right of a trustee to assume the contract.

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[36] *In re Nedwick Steel Co., Inc.*, 289 B.R. 95 (Bankr. N.D. Ill. 2003)

[37] *See also In re Tom Stimus Chrysler-Plymouth, Inc.*, 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991) (holding that automobile franchise agreement was not a "personal service contract based on special trust and confidence and on a special relationship" between franchisee-debtor and Chrysler, and approving assignment); *In re Sunrise Restaurants, Inc.*, 135 B.R. 149 (Bankr. M.D. Fla. 1991) ("[t]o run a Burger King retail establishment does not require special knowledge in the conventional sense ... [if the assignment is permitted the estate] ... will be in no worse position than it is today."); *In re Wills Motors*, 133 B.R. 297 (Bankr. S.D.N.Y. 1991).

Rejection of Executory Contracts in a Franchise Setting

A debtor's other option, besides assuming a contract or assuming it and assigning it, is to reject the contract. The ability to reject executory contracts in bankruptcy provides franchisee-debtors with a potent weapon. If the court allows the rejection, with some limited exceptions discussed below, the non-debtor party cannot require the franchisee-debtor to perform.

Following rejection, the other party to the contract holds an unsecured damages claim for breach of contract. Under Section 365(g)(1) of the Bankruptcy Code, if the contract was not previously assumed in the bankruptcy case, this claim is deemed to have arisen as of the filing date. Accordingly, the claim receives the same treatment in a reorganization plan as other unsecured claims. The amount of the damages is determined by using a breach-of-contract analysis under state law; however, the Bankruptcy Code sets a statutory limit on the size of rejected executory contract claims to avoid dilution of all unsecured claims by one large claimant.[38]

"Business Judgment" Test Determines Whether Rejection Is Allowable

Section 365 of the Bankruptcy Code does not set forth the standards the court should follow in determining whether to allow rejection of executory contracts. In determining whether contracts can be rejected under Section 365, courts typically follow the "business judgment" test.[39] Some courts further qualify this test. For example, in *Jr. Food Mart v. Attebury* (*In re Jr. Food Mart*), 131 B.R. 116 (Bankr. E.D. Ark. 1991), the franchisee-debtor, a corporation that operated a chain of convenience store franchises, sought to reject an employment agreement with the former owner of the franchisee-debtor. The court contrasted the "strict" business judgment analysis, where "the court need only ask if the debtor is saving money by rejecting [the] ... employment contract," with the "liberal" business judgment test analysis, where "courts look to the impact upon the party whose contract is set to be rejected and compare the benefit to be received by the debtor against the harm to the non-debtor party."[40] The court indicated, however, that rejection would not be denied under the later test solely because of unfairness to the non-debtor party.[41]

The *Jr. Food Mart* court found that under either test, the debtor had met its burden of proving that the general unsecured creditors would be benefited by rejection of the employment contract, especially by the dollar savings in salary reduction and the elimination of administrative expense priority payments, which would have to be paid in full under the Bankruptcy Code if the contract were rejected.

Courts sometimes refuse to allow rejection. In *In re Noco*, 76 B.R. 839, 843 (Bankr. N.D. Fla. 1987), a court specifically denied granting a franchisee-debtor's motion to reject contracts with a covenant not to compete. The court in *Noco* granted the franchisor's motion to dismiss the franchisee's bankruptcy petition as a bad faith filing and denied the franchisee-debtor's motion to reject the contract. The only remaining obligations of the franchisee-

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[38] *See, e.g., In re Besade,* 76 B.R. 845 (Bankr. M.D. Fla. 1987); see also 11 U.S.C. § 502(b)(6) (governing landlord claims).

[39] *See e.g., In re JRT, Inc.,* 121 B.R. 314 (Bankr. W.D. Mich. 1990).

[40] *Jr. Food Mart v. Attebury* (*In re Jr. Food Mart*), 131 B.R. 116, 119 (Bankr. E.D. Ark. 1991).

[41] *Id.*

debtor under the franchise agreements were those set forth in the covenants not to compete and the court found that the franchisee-debtors' major reason for filing its bankruptcy petition was to reject the franchise agreements and, more specifically, the covenants not to compete. The franchisee-debtor had transferred the bulk of its assets to a new corporation on the eve of filing and had no unsecured creditors. Based on these facts, the court did not allow the franchisee-debtor to reject the franchise agreements and dismissed the bankruptcy petition on bad faith grounds.

Other cases in which courts would not allow rejection are *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (franchisor-debtor not allowed to reject franchise agreement, given complete lack of benefit to debtor or debtor's creditors) and *In re Reiser Ford, Inc.*, 128 B.R. 234 (Bankr. E.D. Mo. 1991) (rejection not allowed as it only benefited debtor's principal and not bankruptcy estate; case dismissed as bad faith bankruptcy filing).

For a survey of covenants not to compete in rejected franchise agreements, see *Covenants Against Competition in Franchise Agreements, Second Edition* (Klarfel ed., Forum on Franchising, American Bar Association, 2003).

Use of Cash Collateral

Generally, a Chapter 11 debtor is permitted to use virtually all assets during a bankruptcy, even though they may be pledged to a secured creditor.[42] A different rule applies to cash collateral. If collateral is converted to cash in the hands of the franchisee-debtor, such *cash collateral* cannot be used by the franchisee-debtor unless the franchisee-debtor comes forward and establishes that this can be done without prejudice to the secured creditors.[43] Recognizing that cash and cash equivalents are easily dissipated, the Bankruptcy Code places strict limitations on a trustee's ability to use such property.[44]

The franchisee-debtor may use cash collateral only on a showing that the secured creditor's position is already adequately protected. Often, adequate protection includes (1) periodic payments to make up for decline in collateral values; (2) replacement collateral; and (3) other relief that will result in the realization of the "indubitable equivalent" to one's interest in collateral.[45] Since liquidity is an issue for most companies filing for bankruptcy, and almost every company entering bankruptcy has already pledged its assets to a secured creditor, most bankruptcy cases begin with an emergency cash collateral hearing. A franchisor should use the cash collateral hearing to try to persuade the court to mandate payments by the franchisee due under the franchise agreement. This suggestion should be couched in the stipulation that ongoing royalties are to be paid as adequate protection of the trademark rights. Such a stipulation will allow the franchisor to get paid before the assumption or rejection of the agreement. If the franchisee-debtor will not agree to a stipulation to pay royalties, the franchisor can try to force the franchisee-debtor to assume the franchise rights quickly and protect post-assumption royalties as administrative claims.

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[42] 11 U.S.C. § 363(c)(1).

[43] 11 U.S.C. § 363(c)(2).

[44] 3 *Collier on Bankruptcy* 363.03[4][c] (15th ed. 2005) (citing *Freightliner Mkt. Dev. Corp v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368 (9th Cir. 1987)).

[45] 11 U.S.C. § 361.

How the 2005 Amendments to the Bankruptcy Code Alter the Dynamic in Franchise Cases

While most public discussion about the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has emphasized the impact that the reforms will have on the bankruptcy cases of individuals, the impact on business bankruptcies may be even greater, especially in franchise cases.

Time for Assumption and Rejection of Leases Affecting Reorganizations—Issues Affecting All Bankruptcy Cases

Under prior law, a bankrupt company had only 60 days to assume or reject leases. In practice, countless extensions were granted while bankrupt companies developed their game plans. As discussed above, assumption means the debtor accepts the lease and cures all defaults and rejection means the debtor elects to breach the lease and pay the landlord for the breach in diluted bankruptcy dollars.

The 2005 act imposed a firm deadline of 120 days after filing bankruptcy for bankrupt companies to decide whether to assume or reject leases. Thereafter, unless the landlord consents, only one 90-day extension is permitted. Therefore, this amendment firmly limits the time for assumption or rejection to 210 days. This firm deadline for leases allows a franchisor to force a bankrupt franchisee to make crucial decisions early in the bankruptcy process concerning which locations they will keep open. In addition, it provides all creditors, including franchisees with monetary claims against the franchisor, with tremendous leverage in franchisor cases.

Under prior law, bankrupt companies would often “designate” a buyer for the right to exercise the bankrupt company’s power to assume or reject one or more leases in a pool. The designee would then market the leases, sell the profitable ones and “reject” those without value. The 2005 act limits the debtor’s ability to sell “designation rights.” The new, firm 210-day deadline reduces the time for negotiation of such designation rights and the value of these rights. Companies that intend to sell the designation rights must act earlier in the process for these rights to have any real value.

Bankruptcy Warning Signs

Bankruptcy filings rarely occur without warning. Most filings are predictable, based on signs of financial or management difficulties. However, many of the danger signs are not recognized until it is too late for the franchisor to intercede. Listed below are a number of danger signs that call for an intervention.

1. Delinquencies to key vendors required by the franchisor for sourcing.
2. Delinquencies to the franchisor or its affiliates.
3. Delinquencies to the landlord or secured lender.
4. Frequent financial restructuring.
5. Frequent requests for franchisor assistance in financial restructuring or elimination of cash flow problems.
6. Excessive trade debt in relation to other franchisees.
7. Unexplained but frequent change of key vendors or unexplained disloyalty to vendors.
8. Revolving door for financial executives or auditors.
9. Desperate attempts to sell the business on expedited closing terms.
10. Excessive number of lawsuits by or against the franchisee.
11. Wholesale and bulk sale of marginally productive assets.
12. Reported shortages of working capital.
13. Claims of late or unpaid wages.
14. Tax claims.
15. Inventory discrepancies (either too much or too little inventory).
16. Missing or poor accounting records normally maintained by a business operating with these revenues.
17. Unachievable expansion or growth commitments.
18. Loss of irreplaceable customers or relationships.
19. Calamities, labor strife or industry conditions eliminating profitability, such as rising fuel costs, core product prices or shortages.
20. Non-communication with the franchisor where communication would be expected.
21. Rumors of bankruptcy.
22. Unexplained spending unrelated to revenue changes.

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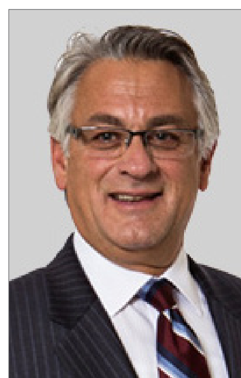
Craig is a skilled international litigator who handles complex business disputes involving intellectual property, licenses, business torts and insolvency issues. He focuses on franchise companies' development and expansion. He has represented individuals, companies and governments in litigation before state and federal courts and in international arbitration forums such as AAA, the International Centre for Dispute Resolution (ICDR) and the International Centre for Settlement of Investment Disputes (ICSID).

His practice centers on developing and protecting the financial and brand equity of franchise companies, real estate projects and energy projects. For franchise companies, he regularly structures new franchise programs, many of which are international. He also defends and enforces franchise agreements. He has also served as special counsel to franchise companies.

Craig has successfully prosecuted several injunctions against unfair competition and trademark infringement in federal courts. He also has more than 30 years of experience defending franchise companies against claims by franchisees for fraud and business torts.



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