

BANKRUPTCY ISSUES IN FRANCHISING: AN OVERVIEW

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We have updated this paper, first presented in a streamlined form on April 3, 1986 before the American Bar Association, Business Law Section meeting, Boston, MA. Since that time many have contributed to the materials to address changes in statutes and case law including those at law firms Buchanan Ingersoll P.C., and Nixon Peabody LLP.

We especially appreciate the contributions of these talented lawyers:
Stephanie Slater, Michael Viscount, John Gotaskie, and Richard Pedone.

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.

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 franchise 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 franchisor 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 the 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 is the lessee at a particular 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, bankruptcy courts

must determine whether these various contracts will be regarded as a unitary contract or separate obligations that must be assumed, assumed and assigned, or rejected *cum onere*. 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.² 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 pending a decision to reorganize or facilitate an orderly sale of some or all of the debtor's assets, to stay litigation and collection efforts, to liquidate claims, and to distribute assets in an equitable manner. When a business files for bankruptcy, it may choose to liquidate under Chapter 7 of title 11 of the United States Code (the "Bankruptcy Code") or to file a plan of reorganization or liquidation under Chapter 11. If a business entity elects to continue operations, generally it will file under Chapter 11, but has the opportunity to "convert" to Chapter 7.

In a Chapter 7 case, a trustee is appointed to administer the debtor's bankruptcy estate for the benefit of creditors. The trustee may sell or auction the assets and pursue claims against third parties for the benefit of creditors and has the exclusive right to prosecute claims that constitute property of the debtor's bankruptcy estate including D&O claims, fraudulent conveyance claims, preference claims, and other avoidance claims under Chapter 5 of the Bankruptcy Code. The pool of proceeds is then collected and disbursed by the trustee 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. However, in limited situations, a Chapter

7 trustee may be permitted to continue ongoing operations when necessary and appropriate to maximize value for the benefit of creditors.

Many business bankruptcy cases are "no asset" cases, meaning that no proceeds are available for distribution to general unsecured creditors. In the franchise context, this might be the case where the franchise agreement is worthless because it has already been terminated or abandoned prior to the bankruptcy filing, and/or all assets are encumbered by liens.

In a Chapter 11 case, a trustee is typically not appointed. Absent an order of the Bankruptcy Court, the debtor, with its pre-existing management, operates as a "debtor-in-possession" and assumes responsibility as a fiduciary to creditors. The debtor has all of the powers and duties of a bankruptcy trustee to recover preferences, fraudulent conveyances and other assets for the benefit of creditors. The debtor also has an "exclusive period" to file a plan of reorganization. The process requires Bankruptcy Court approval of a disclosure statement summarizing the plan and disclosing material financial and operational information necessary to enable a creditor to determine whether to vote to accept or reject the plan. After approval of the disclosure statement, the plan and disclosure statement are circulated along with a ballot soliciting the votes of creditors to approve the plan. Once the exclusivity period expires, creditors and other parties in interest can file alternative or competing plans.

Today, many Chapter 11 cases are used as tools for liquidation while entrenched management remains in control. In some cases, the debtor files a plan of liquidation, pursuant to which the debtor seeks to sell some or all of its assets, and to distribute the proceeds of sale to creditors in accordance with the Bankruptcy Code's priority scheme. In many other instances, the key assets are sold pursuant to Section 363 of the Bankruptcy Code before the plan process even begins.

² See *In re Karfakis*, 162 B.R. 719 (Bankr. E.D. Pa. 1993).

Chapter 11 Timeline

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 Bankruptcy Court to use cash collateral (cash and equivalents subject to security interests), continue to employ and pay personnel in the ordinary course of business, 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 to allow financing during the reorganization...
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.

Constituencies in Chapter 11

The players involved in a typical Chapter 11 franchise bankruptcy case include the following:

- Unsecured Creditors, which include franchisors and distributors, landlords, suppliers, trade vendors and occasionally, tort claimants, with claims.
- An Official Committee of Unsecured Creditors generally comprised of between three to eleven creditors who are selected by the U.S. Trustee (the Committee retains counsel and often a financial advisor paid for by debtor).
- Prepetition lenders.
- In many instances, a debtor-in-possession lender (“DIP lender”), which may provide DIP Financing.
- Taxing authorities and employees with priority wage claims.
- The Office of the United States Trustee (which is part of the United States Department of Justice, and oversees the administration of the bankruptcy case and trustees).

The Automatic Stay

The automatic stay is the most powerful injunction 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.”³ Section 541 of the Bankruptcy Code defines what constitutes property of the debtor’s bankruptcy 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, and certain property of the debtor held by others.⁴ The estate includes all legal and equitable interests of the debtor in property as of commencement of the bankruptcy case, including proceeds, profits and similar property.⁵

The federal bankruptcy system is designed to encourage the rehabilitation of financially troubled entities. To achieve this end, federal bankruptcy law includes the broadest possible definition of “property of the bankruptcy estate” which is protected by the automatic stay. In addition to the Bankruptcy Code’s expansive definition of estate property, perhaps even more important for both franchisors and franchisees, is the Bankruptcy Code’s enactment of certain

procedures which afford a debtor franchisee with significant leverage in litigating the franchisee’s rights under the franchise agreement in bankruptcy.

Bankruptcy Estate Includes Franchise Agreements Existing at the Petition Date

Franchise agreements that have not been terminated or otherwise expired prior to a franchisee’s bankruptcy filing 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.⁶

The franchisee-debtor’s rights under the franchise agreement are protected by the automatic stay under 11 U.S.C. § 362.⁷ A franchisor is prohibited from initiating or continuing any act to terminate a franchisee-debtor’s franchise agreement or taking any other action that could diminish the franchisee-debtor’s rights without first obtaining relief from the automatic stay from the Bankruptcy Court under Section 362 of the Bankruptcy Code.

³ Unless otherwise noted, the concepts discussed in this overview apply equally to franchisees and franchisors.

⁴ See *In re Fulton*, 926 F.3d 916, 923 (7th Cir. 2019), cert. granted sub nom. *City of Chicago, Illinois v. Fulton*, 140 S. Ct. 680, 205 L. Ed. 2d 449 (2019) (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983)); see also 5 Collier on Bankruptcy ¶ 541.01 (16th ed. 2019) (“Congress’s intent to define property of the estate in the broadest possible sense is evident from the language of the statute which, in section 541(a)(1), initially defines the scope of estate property to be all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held.”)

⁵ 11 U.S.C. § 541. Bankruptcy Courts have exclusive jurisdiction over property of the estate, wherever such property is located. 28 U.S.C. § 1334(d).

⁶ See *In re Airadigm Commc’ns, Inc.*, 519 F.3d 640, 654 (7th Cir. 2008). (“The bankruptcy code governs due to the time-honored rule of legislative supremacy.”) (citing *Butner v. United States*, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979)), superseded in part by Bankruptcy Reform Act of 1994, Pub.L. 103–394 (effective Oct. 22, 1994).

⁷ See *In re Motorcycle Excellence Group, Inc.*, 365 B.R. 370, 377 (Bankr. E.D.N.Y. 2006) (citing *In re Tudor Motor Lodge Assoc., Ltd. P’ship.*, 102 B.R. 936, 948 (Bankr. D.N.J. 1989)).

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, insolvency or franchisee debtor’s financial condition.⁸ However, the filing of a bankruptcy petition does not expand the franchisee’s rights under the franchise agreement.⁹

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

Generally, if the franchisor delivers a valid termination notice prior to the petition date, which is effective upon receipt under applicable state law, 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 applicable state or federal law before a bankruptcy petition is filed will not be considered property of the debtor’s bankruptcy estate, and the debtor franchisee cannot revive a validly-terminated franchise agreement upon commencement of a bankruptcy case.¹⁰

It is extremely important that a non-debtor franchisor use “clear and unambiguous” language when attempting to terminate a franchise agreement prior to the franchisee’s bankruptcy filing. A recent case models this point. In *In re*

RMH Franchise Holdings, Inc., RMH Franchise Holdings, Inc. (“RMH” or the “Debtors”) was the second-largest franchisee of Applebee’s restaurants. Prior to bankruptcy, Applebee’s sent a letter to RMH indicating that the Franchise Agreements “would terminate on the 91st day after notice of default.” Applebee’s subsequently extended the deadlines for RMH to cure their defaults, but did not reassert the termination rights they asserted in the original notice of default.¹¹ While Applebee’s argued “that a debtor does not have a property interest in a franchise agreement that has been terminated prepetition” under applicable non-bankruptcy law, the law was not applicable to these facts because Applebee’s did not clearly and unambiguously terminate the franchise agreements prior to the petition date.¹² This resulted in the Debtors’ franchise agreements being property of the estate and subject to the automatic stay.

The same reasoning applies to all other executory contracts and leases at issue in a bankruptcy case. Where a franchisor has given a valid notice of termination under applicable state law 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 agreement is not property of the estate.

⁸ 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).

⁹ *In re Thorpe*, 569 B.R. 310, 316 (C.D. Ill. 2017), aff’d, 881 F.3d 536 (7th Cir. 2018) (“[W]hatever rights a debtor has in property at the commencement of the case continue in bankruptcy—no more, no less. Section 541 ‘is not intended to expand the debtor’s rights against others more than they exist at the commencement of the case.’”) (quoting *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir. 1984) cert. denied, 469 U.S. 982 (1984) (quoting *H.R. Rep. No. 595, 95th Cong., 1st Sess., reprinted in 1978 U.S. Code Cong. & Ad. News 5787*)); see also *In re REB& B. Inc.*, 200 B.R. 262 (Bankr. M.D. Fla. 1996) (holding that because the 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).

¹⁰ *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 the ... agreements prior to ... filing of their Chapter 11 petition prevent those 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).

¹¹ *In re RMH Franchise Holdings, Inc.*, 590 B.R. 655, 661 (Bankr. D. Del. 2018)

¹² *Id.*

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 petition date, several 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. For example, in *In re Deppa*, 110 B.R. 898 (Bankr. D. Minn. 1990), 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 *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 Bankruptcy 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.¹³

However, in *In re Bronx-Westchester Mack Corp.*, 4 B.R. 730 (Bankr. S.D.N.Y. 1980), the Bankruptcy Court held that a franchise agreement did not terminate even though the notice stated that nothing was left to be done to terminate the agreement because the franchisor had falsely assured the franchisee that there would be no termination to keep the franchisee from filing its petition.¹⁴

Bankruptcy Courts, in other jurisdictions, have held that an incomplete termination of an executory contract prior to the bankruptcy filing does not result in forfeiture of the debtor’s contractual rights under the agreement. Rather, the debtor has the opportunity to assume or assume and assign such agreement upon curing all defaults under the agreement. (See below).

In sum, a franchisor must make sure that it has taken all steps necessary to validly terminate a franchise agreement under applicable non-bankruptcy law. If a franchisee-debtor establishes that a franchise agreement was wrongfully terminated, or that all steps necessary to complete the termination under applicable non-bankruptcy law have not yet occurred, 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.¹⁵ However, absent collusion or fraud, pre-petition terminations have generally not been successfully challenged as voidable preferences or fraudulent conveyances.¹⁶

¹³ 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).

¹⁴ Absent collusion or fraud, pre-petition terminations have not been successfully challenged as voidable preferences or fraudulent conveyances. *In re 421 Willow Corp.*, 2003 WL 22318022 (Bankr. E.D.P.A. 2003); *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).

¹⁵ See *In re RMH Franchise Holdings, Inc.*, 590 B.R. 655, 661 (Bankr. D. Del. 2018)

¹⁶ See *In re 421 Willow Corp.*, 2003 WL 22318022 (Bankr. E.D.P.A. Oct. 9, 2003); *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).

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

The presence of an opportunity for a debtor to cure all defaults to avoid forfeiture changes the analysis of whether the existing agreement is terminated or assumed by the debtor's bankruptcy estate.¹⁷ For example, in *In re ERA Cent. Regional Serv., Inc.*, 39 B.R. 738 (Bankr. C.D. Ill. 1984), a franchisor's pre-petition termination notice gave the franchisee the opportunity to cure defaults before the termination became effective. Because the bankruptcy intervened before the franchisee's time to cure the defaults had expired, the Bankruptcy Court held that the automatic stay prevented the franchisor from terminating the franchise agreement without first obtaining an order modifying or vacating the automatic stay.¹⁸

If the debtor franchisee still has a right to cure, the commencement of a bankruptcy proceeding before expiration of the cure deadline will preserve that right. The cure period is determined by applicable law, which may include:

- The express contractual period.
- Any state law statutory cure period.
- Within 60 days after the commencement of a Chapter 7 case.
- In a Chapter 11 case, a debtor may seek to assume, assume and assign, or reject an executory contract through the date of confirmation of a Chapter 11 Plan.

Section 108(b) of the Bankruptcy Code extends for 60 days from the bankruptcy petition 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 fixed 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 requested that the Bankruptcy Court determine that its dealer agreement with Rolls-Royce was in full force and effect, and also sought sanctions against Rolls-Royce for its 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 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 Bankruptcy 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 prevent termination of the franchise agreement.

¹⁷ See *In re C.W. Mining Co.*, 422 B.R. 746, 759 (B.A.P. 10th Cir. 2010), *aff'd*, 641 F.3d 1235 (10th Cir. 2011) (recognizing that "courts appear to focus on a debtor's existing contractual right to cure and revive the contract, thus making termination incomplete and giving the debtor a sufficient interest in the contract to assume.").

¹⁸ 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).

The Bankruptcy 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 Bankruptcy 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).¹⁹

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 was an executory contract that could be assumed and assigned under 11 U.S.C. § 365.²⁰

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 Third Circuit Court of Appeals 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 property of the bankruptcy estate. The Third Circuit 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.

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 satisfied.

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.

¹⁹ See *Lauderdale Motor Corp. v. Rolls-Royce Motors, Inc. (In re Lauderdale Motor Corp.)*, 35 B.R. 544 (Bankr. S.D. Fla. 1983); See also *In re Anne Cara Oil Co.*, 32 B.R. 643 (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).

²⁰ See *Lauderdale Motor Corp. v. Rolls-Royce Motors, Inc. (In re Lauderdale Motor Corp.)*, 35 B.R. 544 (Bankr. S.D. Fla. 1983); See also *In re Anne Cara Oil Co.*, 32 B.R. 643 (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).

Franchisors May Have the Automatic Stay Lifted for Cause

Franchisors are most likely to attempt to lift the automatic 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.²¹

In *In re Tudor Motor Lodge Assoc. Ltd.*, 102 B.R. 936 (Bankr. D.N.J. 1989), the Bankruptcy 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 statutory remedy primarily available to secured parties under Section 361

of the Bankruptcy Code to protect them from the diminution in the value of their collateral after the petition date, but is also available to other parties, such as franchisors. The Bankruptcy Court 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; (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 Bankruptcy 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.



¹⁹ 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) (finding 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 that 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).

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

A Bankruptcy 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.²² 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 consider filing the motion, to focus the debtor and educate the court on the franchisor's issues early in the bankruptcy case.

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.²³ 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.”²⁴ 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.²⁵

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.²⁶ 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.²⁷ However,

²² *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).

²³ 11 U.S.C. § 365(a).

²⁴ H.R. REP. NO. 595 at 340, 347 (1997).

²⁵ “Executory Contracts in Bankruptcy – Introduction, Threshold Issues,” THE UNITED STATES DEPARTMENT OF JUSTICE, <https://www.justice.gov/jm/civil-resource-manual-59-executory-contracts-bankruptcy> (citing Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 *Minn. L. Rev.* 439, 460 (1973)).

²⁶ See e.g. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir. 1984) (retail petroleum dealership agreement is executory contract), cert. denied, 469 U.S. 982 (1984); *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).

²⁷ *In re Alltech Plastics, Inc.*, 71 B.R. 686 (Bankr. W.D. Tenn. 1987) (patent license for plastic manufacturing process is executory contract); see also *In re Golden Books Fam. Entm't, Inc.*, 269 B.R. 300 (Bankr. D. Del. 2001) (license agreement qualified as executory contract).

intellectual property licenses are generally not assignable without the consent of the non-debtor licensor. As discussed below, in some instances, franchisors may frustrate a franchisee debtor's ability to assume and assign a franchise agreement without the franchisor's consent if the franchise agreement also includes a license of intellectual property.



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 assume or reject an executory contract (other than an unexpired lease of nonresidential real property, i.e., commercial lease) 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.

Nonresidential real estate leases must be assumed or rejected within 120 to 210 days of the bankruptcy filing unless the Bankruptcy 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.

Franchisors / Licensors May Challenge the Assumption or Assignment of a Franchise Agreement to the Extent that Applicable Intellectual Property Law Prohibits Assignment without the Consent of the Franchisor / Licensor

Most franchise agreements include the granting of a non-exclusive trademark license. Section 365(c) of the Bankruptcy Code provides that an executory contract cannot be assumed and assigned if applicable non-bankruptcy law restricts the assignability of such contracts. Although trademark licenses are not included in the Bankruptcy Code's definition of intellectual property, most Bankruptcy Courts have held that non-exclusive trademark licenses cannot be assigned without the consent of the licensor.²⁸ This presents a potential problem for franchisees who wish to use the Bankruptcy Code to compel the franchisor to assign its franchise agreement to a third party without the franchisor's consent. The non-debtor franchisor may assert that such agreements are non-assignable because they include trademark licenses that can only be assumed and assigned with their consent.²⁹

Section 365(c) can give an edge to nondebtor-licensors when applicable nonbankruptcy law states that the debtor is not allowed to assign a license to an entity that is not the debtor without consent from the licensor. This concept was articulated in the Fourth Circuit's decision in *In re Sunterra Corp.*³⁰ The Fourth Circuit was asked to decide whether the debtor-licensee may assume a nonexclusive software license over the nondebtor-licensor's objection. The Fourth Circuit concluded that although the software license was an executory contract, the licensee could not assume the license without the licensor's consent. This presents a challenge for debtor-licensees when the nondebtor-licensors are in the driver's seat when making decisions on the treatment of licenses under Section 365(c).

²⁸ See *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 310 (Bankr. D. Del. 2001) (holding that non-exclusive licenses cannot be assigned under Federal Copyright Law); see also *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747 (9th Cir. 1999) (holding nonexclusive licenses do not give rise to ownership rights and are not assignable over the objection of the licensor), *cert dismissed*, 528 U.S. 924 (1999).

²⁹ See *In re Trump Entm't Resorts, Inc.*, 526 B.R. 116, 123 (Bankr. D. Del. 2015) (holding that “trademark licenses are not assignable in the absence of some express authorization from the licensor, such as a clause in the license agreement itself”). See also *In re Wellington Vision, Inc.*, 364 B.R. 129 (S.D. Fla. 2007) affirming relief from stay by bankruptcy court holding franchise agreement not assignable due to trademark holder objection discussed *infra*

³⁰ See *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004).

Certain Jurisdictions Prohibit the Assumption of a Franchise Agreement by a Debtor-in-Possession even if the Debtor-in-Possession Does Not Intend to Assign the Franchise Agreement to a Third Party

For a debtor licensee whose business heavily relies on intellectual property licenses, it is very important to determine the law governing the assumption and assignment of intellectual property licenses in the various venues available to the debtor licensee. While it is generally true that under Section 365(a), executory contracts can be “assigned or assumed”, Section 365(c) houses an exception that prevents such assignment or assumption where applicable nonbankruptcy law would bar the assignment “whether or not such contract ... prohibits or restricts assignment.”³¹ The text of Section 365(c) has caused various circuits to grapple with the word “or.” There is a strong divide as to what the correct interpretation is of Section 365(c) as it relates to the assumption of franchise agreements by a debtor-in-possession.

The first test, applied by the Third, Fourth, and Ninth Circuits is called the “Hypothetical Test,” which interprets 365(c) by concluding that a debtor-in-possession cannot assume and assign an executory contract if applicable non-bankruptcy law would not allow the debtor-in-possession to assign the license to a third party. If non-bankruptcy law does not allow the debtor-in-possession to hypothetically assign the license, regardless of whether the debtor-in-possession has the actual intent to assign the license, then the debtor may neither assume nor assign the agreement.³²

The other test for assignability is the “Actual Test,” applied by the First, Fifth and Eighth Circuits, which makes a case by-case inquiry into allowing assumption of an executory contract depending on whether the debtor-in-possession has an intent to assign the contract. The Actual Test also acknowledges that the debtor-in-possession cannot always be presumed to be a “materially distinct” entity from the entity with whom the nondebtor party originally contracted.³³

Given the ramifications of filing bankruptcy in a jurisdiction that applies the “Hypothetical Test” rather than the “Actual Test”, which may be dispositive on whether a contract can be assumed in bankruptcy as part of a plan of reorganization, a prospective debtor should give careful thought as to whether and when to file bankruptcy in a particular jurisdiction as such a decision could have a material impact on a debtor’s ability to successfully reorganize.

Assumption of a Contract under Which Debtor Is Not in Default

Bankruptcy 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. The court reviews the debtor’s intentions under a “business judgment” standard.³⁴ The Bankruptcy Court determines whether (1) the contract is subject to assumption, and (2) all of the requirements of Section 365 of the Bankruptcy Code have been satisfied.

³¹ See 11 U.S.C. 365(c)

³² See *In re West Electronics, Inc.*, 852 F.2d 79, 83 (3d Cir. 1988)

³³ See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997) (emphasis in original) (quoting *Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F.3d 608, 612 (1st Cir. 1995) (“whether the nondebtor party ... actually was being ‘forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.’”).

³⁴ See *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993).

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 Bankruptcy Courts determine promptness on a case-by-case basis.³⁵

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.³⁶ Until recently, it was unclear whether an unsecured creditor could recover post-petition attorneys’ fees as part of its cure claim.³⁷ In *Travelers Casualty & Surety Co. of Am. v. PG&E*, 549 U.S. 443 (2007), the Supreme Court allowed post-petition attorneys’ fees generated by a contract or a state law because the Bankruptcy Code “says nothing about unsecured claims for contractual attorney’s fees incurred while litigating

issues of bankruptcy law.” *Id.* at 453. 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 applicable franchise agreement.

The amount of the cure cost and whether the default is curable has been the subject of some debate. It is generally required that the cure be a complete 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.”³⁸ 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.

³⁵ See *In re Williams*, No. 10-11108 BLS, 2011 WL 2533046, at *2 (Bankr. D. Del. June 24, 2011) (citing *In re Mako, Inc.*, 102 B.R. 818, 821 (Bankr. E.D. Okla. 1988 (“The period of time that is considered ‘promptly’ may vary in accordance with the circumstances on a case by case basis. Under the appropriate set of facts, a period of time in excess of a year could be prompt.”) (citations omitted) (internal quotation marks omitted)); See also *In re Coors of N. Miss.*, 27 B.R. 918 (Bankr. N.D. Miss. 1983) (allowing cure payments within three years).

³⁶ See *In re Crown Brooks Corp.*, 269 B.R. 12 (Bankr. D. Del. Aug. 1, 2001) (discussing how “courts have held that attorneys’ fees are recoverable as part of a cure claim only if the contract or lease specifically requires their payment”).

³⁷ See *In re SNTL Corp.*, 380 B.R. 204 (9th Cir. BAP 2007) (holding that an unsecured creditor was entitled to contractually agreed upon attorneys’ fees incurred post-petition); See also *In re Electric Machinery Entm’t, Inc.* 371 B.R. 549 (Bankr. N.D. Fla 2007) (holding that unsecured creditor was not entitled to post petition attorneys’ fees).

³⁸ See *In re JLS Shamus, Inc.*, 179 B.R. 294, 296 (Bankr. M.D. Fla. 1995).

The Bankruptcy Court rejected the franchisee-debtor's argument that the *Offices and Services* case was distinguishable. The Bankruptcy 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 Bankruptcy Court lifted the automatic stay.

By contrast, in *In re GP Express Airlines*, 200 B.R. 222 (Bankr. D. Neb. 1996), the Bankruptcy 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 Bankruptcy 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 capable of assumption or assignment by the trustee or the debtor-in-possession.³⁹ 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 Congress's enactment of the Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA"), it was unclear whether a debtor 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 closing or "going dark") could not be cured. The BAPCPA clarifies that a debtor can cure nonmonetary defaults *in commercial leases* in the event the landlord is compensated for any pecuniary loss. However, the BAPCPA 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.

In *In re Escarent Entities, L.P.*, the Fifth Circuit held that a debtor in possession could not assume the pre-petition executory contract because of the existence of an incurable non-monetary default.⁴⁰ In this case, the debtor entered into a pre-petition land sale contract with Quantum Diversified Holdings, Inc. ("Quantum") which had a 90 day feasibility window for Quantum to notify the debtor of its intent to terminate the contract. Quantum ultimately did not terminate the contract, and was bound by the closing date on January 12, 2009. A week before the closing date, the debtor filed for Chapter 11 bankruptcy. As a result of the bankruptcy, the closing date passed without consummation of the land sale contract. The debtor attempted to assume the contract and Quantum objected saying that in order to cure this contract it was impossible because of the passed closing date. The Fifth Circuit ultimately agreed holding that "Escarent's failure to close was thus not only a material default, but effectively an incurable one, as the parties are unable to return to [the closing date], when Escarent's performance was originally due."⁴¹ This case exemplifies the effect that BAPCPA had on historical defaults.

³⁹ See 11 U.S.C. § 365(c)(2).

⁴⁰ See *In re Escarent Entities, L.P.*, 2011 WL 1659512 (5th Cir. April 28, 2011) (unpublished).

⁴¹ See *id.* at *3.

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 or assume and assign 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.⁴²

In *In re Great Northwest Recreation Ctr., Inc.*, 74 B.R. 846 (Bankr. D. Mont. 1987), the Bankruptcy 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 Bankruptcy Court stressed that the franchisee-debtor had a very strong historical performance, excellent management and a restructured operation. The Bankruptcy 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 COD payments for delivery of motorcycles, the Bankruptcy Court questioned the need for the credit line, especially since the franchisee-debtor had successfully operated on a COD basis since the bankruptcy was filed.

The Bankruptcy 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.

⁴² See 11 U.S.C. § 365(b)(3).

⁴³ *In re Memphis-Friday's Assoc.*, 88 B.R. 830, 841 (Bankr. W.D. Tenn. 1988).

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 Bankruptcy 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.⁴³

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 Bankruptcy 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 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 and assignment under the Bankruptcy Code. 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 an assignee's right to assign the franchise agreements without the franchisor's consent; however, anti-assignment clauses are generally unenforceable

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 Bankruptcy 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 reversed the decisions of the Bankruptcy and District Courts, and held that the franchise agreement 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."⁴⁴ 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.⁴⁵

The Fifth Circuit has also held that the Section 365(c) reference to "applicable law" is not limited to personal service contracts.⁴⁶ Similarly, an Illinois Bankruptcy Court found that provisions of Illinois's Uniform Commercial Code prohibiting assignment where that action would "increase materially the burden or risk imposed on" the non-debtor counterparty could be applied to prohibit assignment of an exclusive dealership agreement from the debtor to a competitor of the manufacturer.⁴⁷

In *Ford Motor Co. v. Claremont Acquisition Corp. (In re Claremont Acquisition Corp., Inc.)*, 186 B.R. 977, 987 (C.D. Cal. 1995), *aff'd*, 113 F.3d 1029 (1997), abrogated on other grounds under BAPCPA (related to applicability of penalty rates or provisions), the District Court held that it was not clear error for the Bankruptcy Court to find that Ford'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.⁴⁸

One 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's trademarks (as do almost all franchise agreements). The

⁴⁴ *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 28 (1st. Cir. 1984).

⁴⁵ 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).

⁴⁶ *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).

⁴⁷ *In re Nedwick Steel Co., Inc.*, 289 B.R. 95 (Bankr. N.D. Ill. 2003)

⁴⁸ 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).

District Court affirmed the Bankruptcy Court's finding that Pearle Vision had granted Wellington a nonexclusive trademark license, which was, therefore, governed by federal trademark law, which grants a trademark licensor certain protections, including restrictions on assignment. The Wellington court followed the Third, Fourth and Ninth Circuits, which read the language of Section 365(c)(1) as requiring bankruptcy courts to inquire whether a debtor could "hypothetically" assign the license even if it is only proposing to assume the contract. As previously discussed, 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," which is applied by courts in the First, Fifth and Eighth Circuits, permits a trustee or debtor-in-possession to assume an executory contract or unexpired lease if they do not actually intend to assign the contract. 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, which 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.

Rejection of Executory Contracts in a Franchise Setting

In addition to a trustee or debtor-in-possession's right to assume or assume and assign an executory contract, the trustee or debtor-in-possession

may also reject the contract. The ability to reject executory contracts in bankruptcy provides franchisee-debtors or their bankruptcy trustees 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 non-debtor counterparty 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 as other unsecured claims. The amount of the damages is determined by applying a breach-of-contract analysis under applicable non-bankruptcy law; however, the Bankruptcy Code sets a statutory limit on the size of claims arising from a debtor's rejection of a non-residential real property lease to avoid dilution of all unsecured claims by large landlord claims.⁴⁹

On May 20, 2019, the United States Supreme Court issued its decision in *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology)* ("Tempnology"), which finally resolved an issue that has created confusion and uncertainty for more than 30 years regarding the consequences flowing from a debtor licensor's rejection of a trademark license in bankruptcy.⁵⁰ The Supreme Court considered whether a trademark licensor's rejection of a trademark license terminates the non-debtor licensee's rights to use the trademark or simply constitutes a breach of such agreement, entitling the licensee to assert a claim from damages. The Supreme Court held that rejection of a trademark license under Section 365 of the Bankruptcy Code constitutes a breach of the license agreement entitling the licensee to damages and whatever remedies were negotiated by the licensee under the terms of the license or available under applicable non-bankruptcy law, but does not automatically result in termination of the license.

⁴⁹ See *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003) (discussing cap on damages resulting from the termination of a real property lease furthering Congress's intent to limit landlords from receiving a "windfall" over other creditors).

⁵⁰ See *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology)*, 139 S. Ct. 1652 (U.S. May 20, 2019).

The Court applied a “plain meaning” interpretation of the Bankruptcy Code to reach its conclusion that a debtor licensor’s rejection of a trademark license constitutes a breach of the license rather than a termination. The Court held that no negative inferences arise from the fact that trademark licenses do not fall within the definition of intellectual property governed by Section 365(n) “to alter the natural reading of Section 365(g) ... that rejection and breach have the same results.”⁵¹ The Court further reasoned that this decision is consistent with long-standing case law holding that bankruptcy does not provide a debtor with greater rights than it would otherwise have under non-bankruptcy law: “A debtor’s property does not shrink by happenstance of bankruptcy, but it does not expand, either.”⁵² While the decision in *Tempnology* dealt with the narrow issue of trademark license’s, the Supreme Court made it clear that its “rejection as breach” analysis applies to all executory contracts, including trademark licenses. As a result of this decision, parties must carefully consider what post-rejection remedies exist and what impact this will have on a debtor’s decision to assume or reject a particular executory contract.

“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” rule.⁵³ The “business judgment” rule requires a showing that rejecting the executory contract will benefit the debtor’s estate. When courts review a debtor’s decision to reject an executory contract, the court generally

will not “second-guess a debtor’s business judgment concerning the rejection of an executory contract...”⁵⁴ According to a recent Delaware Bankruptcy decision, “[a] debtor’s decision to reject an executory contract must be summarily affirmed unless it is the product of ‘bad faith, or whim or caprice.’”⁵⁵

In the past, some courts have further qualified 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 Bankruptcy 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.”⁵⁶ The Court indicated, however, that rejection would not be denied under the later test solely because of unfairness to the non-debtor party.⁵⁷

The *Jr. Food Mart* court found that under either test, the debtor had met its burden of proving that the general unsecured creditors would benefit 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), the Bankruptcy Court denied a franchisee-debtor’s

⁵¹ *Id.*

⁵² *Id.*

⁵³ See *In re Extraction Oil & Gas*, 2020 WL 6389252 (Bankr. D. Del. Nov. 2, 2020)

⁵⁴ See *id.* at *2-3.

⁵⁵ See *id.* at *3-4 (citing *In re Trans World Airlines*, 261 B.R. 103, 121 (Bankr. D. Del. 2003) (“A debtor’s decision to reject an executory contract must be summarily affirmed unless it is the product of ‘bad faith, or whim or caprice’”) (quoting *Wheeling-Pittsburgh Steel Corp. v. West Penn Power Co. (In re Wheeling-Pittsburgh Steel Corp.)*, 72 B.R. 845, 849-850 (Bankr. W.D. Pa. 1987)).

⁵⁶ *Jr. Food Mart v. Attebury (In re Jr. Food Mart)*, 131 B.R. 116, 119 (Bankr. E.D. Ark. 1991).

⁵⁷ See *id.*

motion to reject contracts with a covenant not to compete, and granted the franchisor's motion to dismiss the franchisee's bankruptcy petition as a bad faith filing after finding that the franchisee-debtors' primary 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 Bankruptcy Court did not allow the franchisee-debtor to reject the franchise agreements and dismissed the bankruptcy petition on bad faith grounds.⁵⁸

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.⁵⁹ 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 establishes that this can be done without prejudice to the secured creditors.⁶⁰ Recognizing that cash and cash equivalents are easily dissipated, the Bankruptcy Code places strict limitations on a trustee's or debtor-in-possession's ability to use such property.⁶¹

The franchisee-debtor may use cash collateral only on a showing that the secured creditor's position is already adequately protected. Section 363 of the Bankruptcy Code defines adequate protection to include: (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.⁶² 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 attempt to persuade the Bankruptcy 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.



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

While most public discussion about the BAPCPA has emphasized the impact that the reforms have had on the bankruptcy cases of individuals, the impact on business bankruptcies may be even greater, especially in franchise cases.

⁵⁸ See also *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); *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*, Third Edition (Michael R. Gray and Natalma M. McKnew, Forum on Franchising (American Bar Association 2012)).

⁵⁹ 11 U.S.C. § 363(c)(1)

⁶⁰ 11 U.S.C. § 363(c)(2)

⁶¹ 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)).

⁶² 11 U.S.C. § 363

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

Under prior law, a debtor 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. If the debtor prematurely assumed an executory contract or unexpired lease, and subsequently defaults or rejects the lease, the non-debtor counterparty to such contract or lease would be entitled to an administrative claim that would require payment in full prior to any distributions made to unsecured creditors.

The BAPCPA imposed a firm deadline of 120 days after filing bankruptcy for debtors 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, debtors would often “designate” a buyer for the right to exercise the debtor’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 BAPCPA limits the debtor’s ability to sell “designation rights.” The 210-day deadline reduces the time for negotiation of such designation rights and the value of these rights. Debtors 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.

The best defense is a good offense. Franchisors that actively monitor the credit risk of their franchises and take action early in the process to mitigate the risk of a franchisee bankruptcy will be able to eliminate the risk altogether by terminating the franchise agreement prior to a franchisee bankruptcy filing, or to maximize the amount of leverage it may assert in a franchisee bankruptcy.

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