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Bankruptcy issues for franchisors and lenders

An introduction to and analysis of the key legal and business issues impacting franchisors and their lenders when a franchisee is in financial distress.

By Rick Pedone and Chris Desiderio

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Introduction

As a result of the current shift in how people live, work, and play, franchisors and franchisees face new challenges to their business model. These pressures, in addition to higher interest rates and the ending of COVID related relief from Federal and State governments, have increased the financial strain on all levels of franchise systems. The linked guide provides an in-depth analysis of the various challenges and tools that may be available to franchisors, franchisees, and lenders to address this new economic environment.

Franchising basics

Overview of Franchise Structures: Business Format and Product Franchise

Generally, there are two basic structures for franchises:

- **"Business format" (or "package format")** - the franchisor licenses to the franchisee the use of the franchisor's business system and trademarks. The franchisor provides significant assistance, including a marketing plan and business system. In turn, the franchisee must strictly adherence to the franchisor's business system. A typical example of a business format system would be a fast food restaurant chain.
- **"Product" franchise** - 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. A typical example of a product franchise would be a tire store. In contrast to a business format, franchisor assistance and controls are usually absent in a product franchise.

There are a variety of ways to structure a franchise system and offering. Often a franchisor will offer a single unit franchise, where a license is granted by the franchisor to a franchisee to operate a franchise business at 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. Franchisors also often 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.

Types of Franchise Contracts

A franchise relationship may be evidenced by a single contract or a series of related agreements. Key common agreements include:

- **The franchise agreement**: The franchise agreement grants a license 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 geographic 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 but maintain control of the location or the franchisor may own the location and lease it to the franchisee.
- **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 savings 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.
- **Credit and intercreditor agreements**: Both a franchisor and franchisee may be subject to several tranches of debt in order to finance the business. Depending on the type of franchise and the amount of credit being extended, lenders may provide financing secured by various collateral packages, which may range from all assets of a borrower (including real property rights and intellectual property) to just the receivables of an entity. As discussed below, at the heart of every franchise restructuring is an evaluation of competing claims of the franchisor, franchisee, suppliers, landlords and lenders. Chaos often results when one or more of these parties fail to understand their rights and, where appropriate, enter into intercreditor agreements.

While an exhaustive analysis of franchise structures and contracts is beyond the scope of this article, it is important to understand that the type of franchise and related contracts will have a significant impact on the options and recovery of franchisors, lenders and other parties in a franchise insolvency. As discussed throughout this article, bankruptcy law may disrupt and alters each of the parties' original expectations.

Business bankruptcy basics

Business bankruptcies are filed to preserve and distribute assets equitably and/or facilitate orderly liquidation. When a business files for bankruptcy, it may choose to liquidate under Chapter 7 of the Bankruptcy Code or to reorganize under Chapter 11. Within Chapter 11, qualifying "small" businesses may elect to proceed under "Subchapter V," which provides streamlined procedures and reduced creditor input.

Chapter 7 Case

In a Chapter 7 case, a trustee is appointed to administer and liquidate 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 causes of action on behalf of the business, including seeking the avoidance of preferences and fraudulent conveyances.[1] The pool of proceeds is then collected and distributed in accordance with the priority scheme established by the Bankruptcy Code.

Because Chapter 7 trustees do not operate businesses, assets are often liquidated for their "scrap" value and any "going concern" value is usually lost. Few Chapter 7 cases result in meaningful recovery for unsecured creditors, as most, if not all, of the debtor's assets are generally pledged as collateral to their secured creditors.

Chapter 11 Case

Alternativley, in a Chapter 11 case, absent a court order, the debtor continues to operate as a "debtor-in-possession" with its pre-existing management at the helm.[2] The debtor has all of the powers of a trustee to recover preferences, fraudulent conveyances and other assets for the benefit of the creditors.

The ultimate goal of a Chapter 11 case is for the debtor to propose and confirm a Chapter 11 plan which dictates the treament of creditor claims and the capital structure of the debtor post-emergence from the bankruptcy case. The debtor has an "exclusive period" to present such a plan of reorganization to creditors and the court. Except in cases under Subchapter V, the process requires court approval of a disclosure statement summarizing the plan which describes pertinent financial and operational information to creditors so that they may cast an

[1] The Bankruptcy Code permits the avoidance of certain transfer (preference payments) made by the debtor-company made within ninety days of the filing of a bankruptcy case. See 11 U.S.C. § 547. In addition, the Bankruptcy Code and state law permits the avoidance of certain transfers of assets (fraudulent conveyances) made prior to the filing for less then reasonably equivalent value while the debtor is insolvent or rendered insolvent as a result of such transfer. 11 U.S.C. § 548.

[2] In circumstances of mismanagement or malfeasance, the court may appoint a trustee to operate the debtor's business, displacing the pre-existing management.

informed vote on whether to accept or reject the plan. After approval of the disclosure statement, the plan and disclosure statement are circulated to creditors so they can vote on whether to approve or reject the plan. If the exclusivity period expires, creditors can file alternative plans.

A Chapter 11 case under Subchapter V substantively resembles a traditional Chapter 11 case, except that creditors' oversight is curtailed, and it is easier a debtor to confirm a reorganization plan over creditor objections. In addition, a Subchapter V plan can permit equity to retain ownership of the company post-emergence even if the plan does not adhere to the "aboslute priorty rule."[3] In exchange, a Subchapter V case must move quickly to confirmation or the case will be dismissed.

Today, many 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 with liquidating dividends or the key assets may be 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 1–4	"First Day" hearing, where the debtor/ franchisee obtains permission to use cash collateral (cash and equivalents subject to security interests) and perhaps approval of 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 nonresidential real property; may only be extended with landlord consent
Within 4 months to 1 year for a typical Chapter 11; no later than 90 days after the Petition Date in a Subchapter V case.	Plan and Disclosure Statement filed
Within approximately 60–90 days after filing of Plan and Disclosure Statement	Solicitation of Votes; Plan Confirmation

[3] The absolute priority rule dictates that senior creditors must be satisfied in full before a more junior class of creditors or equity holders receives any distribution under a plan.

Within 12—18 months of the Petition Date for a typical Chapter 11; approximately 3–6 months in a Subchapter V case.	Plan goes into effect; Exit from bankruptcy

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

- individual creditors, which include landlords, suppliers, and franchisors with claims;
- a Creditors' Committee, comprised of three to seven unsecured creditors who are selected by the U.S. Trustee (the Committee retains counsel and often a financial advisor paid for by debtor);[4]
- pre-petition lenders, which may be secured or unsecured;
- a post-petition lender (also known as a DIP lender);
- taxing authorities and employees with priority wage claims; and
- the U.S. Trustee (government representative overseeing the process).

Benefits of a Bankruptcy Filing

As discussed more fully below, the Bankruptcy Code provides many tools to allow a company to alter or impair the rights of its creditors and contract counterparties over their objections. Among other things, the Bankruptcy Code provides for an automatic injunction against collection efforts or termination of contracts, notwithstanding pre-petition breaches. The Bankruptcy Code also permits the sale of the debtor's assets free and clear of any liens or encumbrances—allowing it to transfer clean title to assets notwithstanding the fact they may be subject to pre-petition liens. Each of these tools are meant to allow the debtor to maximize value for its creditors as well as to preserve the going concern value of the operating business.

The Automatic Stay

The automatic stay is the most powerful tool granted by the Bankruptcy Code. The stay is the mechanism that provides the bankruptcy estate a breathing spell while the restructuring process plays out. Section 362 provides for an automatic injunction against almost all third parties from continuing or commencing most actions against the debtor or its assets as soon as a bankruptcy case is filed.[5] Notably, once a case is filed, absent court ordered relief from the stay, franchisors no longer have the right to terminate franchise agreements. Any action

[4] In a Subchapter V case, there is a presumption against the appointment of a creditors committee.

[5] Once the bankruptcy petition has been filed, events are referred to as occurring "pre-petition or post-petition."

taken against the stay is voidable or void *ab initio*, and willful violations can result in punitive damages, contempt, or other sanctions.

Sales of assets under Section 363 of the Bankruptcy Code

Chapter 11 of the Bankruptcy Code permits a debtor's management to remain in control and continue business operations, including the routine sale of goods or services in the ordinary course of business. Section 363 of the Bankruptcy Code, however, permits a debtor to "after notice and a hearing" use, sell or lease . . . property of the estate" even if such sale would occur outside of the ordinary course of business. For example, a pizzeria may continue to sell pizzas during the pendency of its Chapter 11 case without court approval in the ordinary course of business; however, it can only sell its interests in real property (i.e., something not normally done by a pizzeria) upon notice and hearing.

Section 363 is often used as a powerful tool to expedite the restructuring process because it allows a debtor to transfer all or substantially all of its assets "free and clear" of all claims, liens, and encumbrances (with certain limited exceptions), outside of a Chapter 11 plan of reorganization. In such a scenario, the buyer obtains the assets of the debtor free and clear of any liens, claims, or other encumbrances, and such liens, claims, or other encumbrances simply attach to the proceeds of that sale, which are later distributed pursuant to a plan of liquidation.

Generally, in order to approve a transaction under Section 363 of the Bankruptcy Code, a bankruptcy court will establish sales and auction procedures that will require the debtor to market its assets and set deadlines for interested parties to conduct due diligence, submit bids, and potentially participate in an auction.[6]

In the auction process, a debtor may decide to appoint a "stalking horse," a bidder who sets the floor for the transaction by submitting the opening bid. To encourage stalking horse bids, debtors often offer financial incentives such as "break-up" fees or expense reimbursements, which are paid in the event a stalking horse is not the successful bidder. There are significant benefits to serving as a stalking horse bidder, including early access to diligence, setting the baseline terms of the sale, and input in the drafting of the bidding procedures. Section 363 also provides some protections to lenders. Section 363(k) permits a secured lender to "bid" the value of its claim even if such claim is greater than the value of its collateral.[7] However, a

[6] Although an auction is generally required to establish fair value of assets, bankruptcy courts have allowed private sales if appropriate given the facts and circumstances, including a demonstration of an emergency or threat to asset value. In such cases, additional transparency measures are usually imposed, including the publication of the identity of the buyer, the sale process, and the terms of the asset purchase agreement.

[7] Secured lenders can also serve as stalking horse bidders.

lender can only bid on those assets on which it has a security interest and such rights can be curtailed for "cause."

In order to obtain approval of a transaction under Section 363, a debtor must demonstrate, among other things, that: (1) a sound business purpose exists for the sale; (2) the sale price is fair; (3) the debtor has provided adequate and reasonable notice; and (4) the purchaser has acted in good faith.[8] Courts generally give substantial deference to the debtor's business judgment in evaluating each of these factors.

Franchise agreements and the bankruptcy estate

The filing of a petition for relief under the Bankruptcy Code creates a bankruptcy "estate."[9] Section 541 of the Bankruptcy Code determines what property of the debtor becomes 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, certain property held by the debtor in trust for others and certain property of the debtor held by others.[10] 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. [11]

Bankruptcy estate includes franchise agreements existing at the Petition Date

Franchise agreements in existence on the petition date are property of the debtor's bankruptcy estate under Section 541.[12] As a general rule, the extent and nature of the parties' property rights in the franchise agreement are determined by state law.[13]

Upon the filing of a bankruptcy case, the debtor's rights (whether the debtor is a franchisor or franchisee) under the franchise agreement are protected by the automatic stay under Bankruptcy Code Section 362.[14] For example, a franchisor is prohibited from initiating or

[8] See generally, In re Shubb Hotels Pittsburgh, LLC, 439 B.R. 637, 641 n.4 (Bankr. W.D.Pa. 2010).

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

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

[11] 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).

[12] *See In re Tornado Pizza LLC*, 431 B.R. 503, 510 (Bankr. D. Kansas 2010) ("Of course, if a debtor on the date of filing is a party to a non-terminated franchise agreement, the debtor's right under that agreement becomes property of the estate under § 541.").

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

[14] *In re Tornado Pizza LLC*, 431 B.R. at 510-11; *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).

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 (and vice versa, as applied to a franchisor-debtor).

The Bankruptcy Code also invalidates so-called *ipso facto* clauses in contracts that provide for an event of default or termination solely on the basis of a bankruptcy filing or insolvency.[15]

Franchise agreements are not estate property if properly terminated pre-petition

A franchise agreement that has expired by its own terms or that has been properly terminated under state or federal law before a bankruptcy is filed is not protected by the Bankruptcy Code because the agreement is no longer in force. Since the franchise agreement is no longer in existence, it will not be considered property of the estate when the bankruptcy case is filed.[16]

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 expired 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.

Tactical Issue

The fact that an agreement terminated prior to the petition date is not revived by the Bankruptcy Code has enormous implications for negotiations that take place between franchisors and franchisees. Franchisors need to evaluate the risk of pushing a franchisee into bankruptcy (and the invitation that serves for bringing other creditors to the table) against their increased leverage.

[15] 11 U.S.C. § 365(e)(1). Nevertheless, an affirmative 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).

[16] *Moody v. Amoco Oil Co.*, 734 F.2d. 1200, 1213 (7th Cir. 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).

Franchise agreement termination is effective post-petition if "nothing is left to be done"

Courts have held that if the franchisor does not need to take any affirmative act to complete the termination, the termination will be deemed effective once the required time has passed. The 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 Tornado Pizza LLC* 431 B.R. 503 (Bankr. D. Kansas 2010) provides such an example. In that case, before the debtor filed for bankruptcy, it had defaulted in making monetary payments under certain franchise agreements, and the franchisor had sent notices of default advising of a 10-day cure deadline. The terms of the agreements allowed the franchisor to terminate the agreements effective upon the delivery of the notice of termination, however the franchisor agreed to stay the proceedings to enforce the termination. The debtor then filed for bankruptcy during the stay period, and the franchisor moved for relief from the automatic stay to enforce the post-termination provisions of the allegedly terminated franchise agreements. The court held that the termination notices effectively terminated the franchise agreements, notwithstanding the franchisor's "voluntary stay" to enforce the termination. Because the franchise agreements were terminated prior to the petition date, the franchise agreements were not property of the debtor's estate under Section 541 and were not subject to executory contracts subject to assumption or rejection under Section 365. Notwithstanding the *Tornado Pizza* decision, franchisors and franchisees need to be aware that the decision rests on a narrow set of facts and, in many cases, the termination would be challenged.

Also, 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 that the franchisee-debtor may be entitled to assume under Section 365 of the Bankruptcy Code.[17] However, absent collusion or fraud, pre-petition terminations have not been successfully challenged as voidable preferences or fraudulent conveyances.[18]

Franchise agreement is estate property if the franchisee 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 will apply to prevent termination post-petition.[19] For example, in *In re ERA Cent. Regional Serv., Inc.*, 39 B.R. 738 (Bankr. C.D. Ill. 1984),

[17] 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).

[18] See e.g., In re Egyptian Bros. Donuts, Inc., 190 B.R. 26 (Bankr. D. N.J. 1995); In re Coast Cities Trust Sales, Inc., 147 B.R. 674 (D.N.J. 1992)).

[19] *Tornado Pizza*, 431 B.R. at 516-16, *In re Steaks To Go,* 226 B.R. 32 (Bankr. Mo. 1998).

the termination notice gave the franchisee the opportunity to cure defaults before the termination was effective. The bankruptcy commenced 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 an order to lift the stay. The court reasoned that there was "something left to be done," i.e., cure defaults, before termination occurred.[20]

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 for Chapter 11 bankruptcy protection 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 Section 365.[21]

Franchise agreement is property of 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 under state law, termination of a franchise agreement did not become effective until final determination of the issue by the deciding board (which was required under state law). The franchisee-debtor filed for bankruptcy protection before the board rendered a decision on the agreement. Since the board did not issue its final determination on the appeal of the agreement's purported termination until after the debtor filed for bankruptcy, the subsequent termination of the franchise agreement was a violation of the automatic stay and therefore invalid.

[20] *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).

[21] *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, franchise was 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

Often a franchisor will find itself in a situation where the franchise agreement is in place, but the debtor-franchisee is not performing or other grounds to terminate exist. Unfortunately for franchisors, 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, which 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 for cause under Section 362(d)(1).[22]

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). This case is significant 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 of the Bankruptcy Code, and (2) the franchisee-debtor was not in post-petition default to the franchisor.

The *Tudor Motor* court first discussed how "adequate protection," a concept discussed in bankruptcy cases under Section 361 of the Bankruptcy Code, is applicable not only for secured creditors but also for other parties, such as franchisors. The court then lifted the stay because

[22] *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 franchisor since franchisee-debtor continued to use trademarks without paying franchisor post-petition, arrearages on royalties were accumulating and franchisor's reputation was at stake because of 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 franchisor right to use franchisee-debtor's telephone number); *In re Beck,* 5 B.R. 169, 170 (D. Haw. 1981) (stay lifted due to irregularities in debtor's accounting for receipts); *JLS Shamus,* 179 B.R. 294 (stay lifted due to 15 years of delinquent payments and no possibility of rehabilitation due to size of defaults).

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's standards of excellence, (3) diminished the value of the Days Inn's marks and entitlements, (4) adversely affected patron identification with Days Inn's 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.[23] 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 noted, franchisors 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's and the court's attention on the franchisor's issues early on. In addition, all parties should keep in mind that in bankruptcy a motion for relief from the automatic stay creates a "contested matter" which triggers discovery under the Federal Rules of Bankruptcy Procedure. Thus, it is entirely possible that the franchisee finds itself being deposed days into a case and faced with expedited bankruptcy discovery.

[23] *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, assign, or reject executory contracts and unexpired leases subject to bankruptcy court approval.[24] This authority provides the franchisee-debtor with a valuable tool in its reorganization efforts:

> Section 365(a) enables the debtor . . . to decide whether the contract is a good deal for the estate going forward. If so, the debtor will want to assume the contract, fulfilling its obligations while benefiting from the counterparty's performance. But if not, the debtor will want to reject the contract, repudiating any further performance of its duties. The bankruptcy court will generally approve that choice, under the deferential "business judgment" rule.[25]

A contract is executory if "performance remains due to some extent on both sides."[26] 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.[27] 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.[28]

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 "for cause." Trustees often seek and obtain additional time to assume or reject executory contracts.

In Chapter 11 cases, the debtor may reject or assume executory contracts at any time before confirmation of the plan of reorganization, although, a party in interest may request that the

[24] 11 U.S.C. § 365(a).

[25] Mission Prod. Holdings v. Tempnology, LLC, 139 S. Ct. 1652, 1658 (2019).

[26] *NLRB v. Bildisco & Bildisco*, 465 U.S. 5113, 522 n.6 (1984).

[27] *See, e.g., Moody v. Amoco Oil Co.*, 734 F2d 1200 (7th Cir. 1984) (retail petroleum dealership agreement is executory contract), *cert. denied*, 469 U.S. 982 (1984); *Burger King Corp. v. Rovine Corp.* (*In re Roving 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).

[28] *See, e.g., In re Gunter Hotel Assoc.*, 96 B.R. 696 (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); *In re Chipwich, Inc.*, 54 B.R. 427 (Bankr. S.D.N.Y. 1985) (patent for dairy and eggnog products is executory contract).

bankruptcy court fix a shorter period of time. Franchisors will often want to consider asking for a shortened deadline.

Nonresidential real estate leases under which the debtor is the lessee must be assumed or rejected within the earlier of 120 after the bankruptcy filing or the date of an order confirming a plan of reorganization. The court may extend the 210-day deadline once "for cause," but only before the expiration of the deadline and then only for up to 90 days unless the landlord agrees to a further extension.

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. In order to do so, 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, so long as (a) keeping the contract is in the best interest of the estate, (b) the debtor is able to perform, and (c) the assumption is supported by reasonable business judgment.[29]

Assumption of a contract with existing defaults

Bankruptcy Code Section 365(b)(1) contains the requirements for assumption of a contract under which a debtor is in default. Under Section 365(b)(1), 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;[30]

(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;[31] and

(C) provides adequate assurance of future performance under such contract or lease.

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

[30] The Bankruptcy Code requires assurances of a "prompt" cure, but courts determine promptness on a case-by-case approach. *In re Summit Gas Res.*, Case No. 20-20377, 2021 Bankr. LEXIS 3650, at *8 (Bankr. D. Wyo. May 4, 2021).

[31] Concerning the term "actual pecuniary loss," typically 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. *See, e.g., In re Ryan's Subs, Inc.*, 165 B.R. 465, 468 (Bankr. W.D. Mo. 1994) (citing cases). 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. *In re Westworld Cmty. Healthcare, Inc.*, 95 B.R. 730, 733 (Bankr. C.D. Cal. 1989). Franchisors seeking to recover attorneys' fees and franchisees seeking to deny such fees should carefully review relevant case law and the language included in the franchise agreement.

It is generally required that the cure be a full cure. In *JLS Shamus,* 179 B.R. 294, 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."[32] 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. In doing so, the *Shamus* court found that although the franchisee-debtor in the 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 *GP Express Airlines*, 200 B.R. 222, 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 extension of credit provided by franchisor John Deere to finance a debtor-retail dealer's acquisition of John Deere inventory was an integral component, rather than merely incidental, of the dealer agreement. As such, the dealer agreement was considered "a financial accommodation," and Section 365(c) contains a specific prohibition against assumption or assignment of a contract to make a loan or extend other debt financing or financial accommodations. Therefore, the agreement could not be assumed by the debtor.[33] The dealer-debtor was well in arrears to John Deere, giving John Deere cause to modify the stay and to allow it to exercise its rights and remedies, including the termination of the agreements.[34] These cases illustrate the case that franchisors need to take when restructuring franchisee obligations with a careful edge on how they would be treated in a bankruptcy.

[32] *JLS Shamus*, 179 B.R. at 296.

[33] *See* 11 U.S.C. § 365(c)(2).

[34] *See also In re FPSDA I, LLC*, 450 B.R. 392, 398 (Bankr. E.D.N.Y. 2011) (concluding leases and franchise agreements to be integrated where they were signed contemporaneously, they contained a cross-default

Cure of noneconomic defaults under executory contracts

A debtor can cure nonmonetary defaults *in commercial leases* in the event the landlord is compensated for any pecuniary loss.[35] However, such provision expressly applies only to commercial leases and accordingly the suggestion is 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—for instance, in recent years, some courts have addressed this issue by carving out nonmonetary defaults that are "immaterial."[36]

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 that come into play if the franchisee-debtor leases space in a shopping center.[37]

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.

provision, they only allowed use of the leased property for the operation of the franchise, and the parties would not have entered into the lease without the franchise agreement; debtors could not assume leases until they cured defaults under the leases and respective franchise agreements).

35 Pub. L. No. 109–8, § 328(a)(1)(A) (2005).

36 *See e.g.*, *In re Cumberland Corral, LLC,* Case No. 313-06325, 2014 Bankr. LEXIS 936, at *26 (Bankr. M.D. Tenn. Mar. 11, 2014) ("Where the default is non-monetary and is not curable, the debtor is precluded from assuming an executory contract only if the default was material or if the default caused substantial economic detriment.") (quoting *In re Chapin Revenue Cycle Mgmt., LLC,* 343 B.R. 728, 731 (Bankr. M.D. Fla. 2006)); *In re Clearwater Natural Res., LP,* Case No. 09-70011, 2009 Bankr. LEXIS 2461, at *14 (Bankr. E.D. Ky. July 23, 2009) (materiality and economic significance of default is measure of whether debtor may assume a contract in which a non-curable, non-monetary default has occurred); *In re Empire Equities Capital Corp.*, 405 B.R. 687, 691 (Bankr. S.D.N.Y. 2009) (recognizing that nonmaterial historical defaults can be cured, although holding the default in this case to be material); *see also In re Gretter Autoland, Inc.*, Case No. 14-02832, 2015 Bankr. LEXIS 2734, at *7 (Bankr. S.D. Iowa Aug. 17, 2015) ("No monetary defaults exist under the franchise agreements.... Non-monetary defaults are equally subject to the cure provisions found at [Section 365(b)(1)(A).").

37 11 U.S.C. § 365(b)(3).

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 contrast, 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, among other things, 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.[38]

In *In re Gretter Autoland, Inc.*, 2015 Bankr. LEXIS 2734 (S. D. Iowa Aug. 17, 2015), the court considered whether an auto dealer debtor could assume and assign certain franchise agreements with Ford and GM.[39] Notwithstanding the franchisor-debtor's inability to assume the agreements because it did not demonstrate any intent or ability to cure existing defaults, the court found that the assignee did not provide adequate assurance of future performance. The assignee openly conceded that it planned to operate the franchisor-debtor's dealership in a manner that breached multiple provisions of the franchise agreements. As the court explained, "Although it may be that [the assignee] is successful in its other dealerships, financially stable, and its performance would result in a better business partner for both Ford and GM, these factors do not apply the correct standard. The relevant inquiry is whether adequate assurance of future performance of the terms of the [franchise agreements] … has been demonstrated." *Id.* at *15.

[38] *Memphis-Friday's Assoc.*, 88 B.R. at 841. In addition, the franchisee-debtor 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. Such legal inability to assume the lease rendered the assumption of the franchise agreement impossible. There being no assumable lease, there was no assumable franchise agreement.

[39] As further discussed below, in order to assign an executory contract under Section 365(f), a debtor must first assume the contract, subject to all of the restrictions on assumption under Section 365(b), and adequate assurance of future performance must be provided to the other contracting party. 11 U.S.C. § 365(f).

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."[40]

Provisions contained in franchise agreements often provide franchisors with veto power over assignment-of-franchise agreements. Such provisions are often not enforceable in bankruptcy which is in keeping with the policy goal in bankruptcy of maximizing asset values for creditors.[41] 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.[42] The district court affirmed the decision of the bankruptcy court.

However, 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."[43] 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

[40] 11 U.S.C. § 365(f)(2).

[41] *E.g., In re Gretter,* 2015 Bankr. LEXIS 2734, at *5 ("Even if a [franchise agreement] contains provisions that restrict or prohibit its transfer, a bankruptcy court may authorize the assumption or rejection of an executory contract if such action is based upon sound business judgment and is in the best interests of the estate.").

[42] When an executory contract is based upon the provision of personal services or skills, or upon personal trust or confidence, or otherwise requires performance rather than any substitute performance, the debtor has traditionally been unable to assume or assign the rights of the debtor in such contract.

[43] *Pioneer Ford Sales,* 729 F.2d at 28. The Fifth Circuit has also held that the Section 365(c) reference to "applicable law" is not limited to personal service contracts. *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 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).

withheld because the assignee could not meet the working-capital requirements of the franchisor.[44]

In *Wellington Vision, Inc., v. Pearl 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 non-exclusive 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 non-exclusive trademark license, which was, therefore, governed by federal trademark law, which grants a licensor of a non-exclusive 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 contract 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. However, some courts have deemed such approach "nonsensical," and instead employ the "actual" test, used in the First, Eighth, and Ninth Circuits whereby the court will conduct a case-by-case inquiry into whether the debtor or trustee actually intends to assign the executory contract. If assignment is not contemplated, then applicable law cannot bar assumption.[45] This reasoning has been recently applied by the bankruptcy court in *In re Cumberland Corral, LLC* regarding an attempt by a franchisee-debtor to assume and assign certain franchise agreements with restaurant Golden Corral:

> In the present case, there is no dispute that the Franchise Agreements, by their terms, do not allow assignment without Golden Corral's consent. However, the Debtor has no intention of assigning the Franchise Agreements, and assumption would maintain the parties' relationship under the Franchise Agreements. In other words, allowing the Debtor to assume the Franchise Agreements is not forcing Golden Corral to accept performance from some unknown third party. Instead, assumption would maintain the parties' relationship under the Franchise Agreements.
>
> Under these circumstances, the Court is persuaded by the reasoning of those courts that have adopted the actual test. To allow Golden Corral to block

[44] *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).

[45] *See also In re Kazi Foods of Mich., Inc.*, 473 B.R. 887, 890 (Bankr. E.D. Mich. 2011) (debtor cannot assume franchise agreements with franchisor's consent where applicable law prohibits assignment).

> assumption of the Franchise Agreements because such agreements could not be assigned would allow Golden Corral a windfall while destroying the Debtor's chances at reorganization. Such an outcome would be contrary to the purposes of the Bankruptcy Code.

In re Cumberland Corral, LLC, 2014 Bankr. LEXIS 936, at *23-25.

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, the claim receives the same treatment in a reorganization plan as other unsecured claims. For the purpose of calculating damages, rejection "constitutes a breach [of an executory contract]" deemed to occur "immediately before the date of the filing of the petition."[46] 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.[47]

"Business judgment" test determines whether rejection is allowable

Bankruptcy Code Section 365 does not set forth the standards the court should follow in determining whether to allow rejection of executory contracts. Instead, courts typically follow the "business judgment" test.[48] 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

[46] *See* 11 U.S.C. § 365(g).

[47] *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).

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

party."[49] The court indicated, however, that rejection would not be denied under the later test solely because of unfairness to the non-debtor party.[50]

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), the court specifically denied granting a franchisee-debtor's motion to reject contracts with covenants not to compete. The only remaining obligations of the debtor's under the franchise agreements were those set forth in the covenants not to compete, and the court found that the debtor's major reason for filing its bankruptcy petition was to reject the franchise agreements in order to avoid complying with the covenants not to compete. Thus, the court did not allow the franchisee-debtor to reject the franchise agreements and dismissed the bankruptcy petition on bad faith grounds.[51]

Rejection of intellectual property licenses

Bankruptcy Code Section 365(n) establishes the rights of intellectual property licensees when a debtor-licensor rejects an executory contract. This section is unique to intellectual property agreements insofar as it potentially allows a non-debtor licensee to maintain certain rights with certain exceptions (most notably, trademark licenses had historically not been covered)[52] even after rejection of the license agreement. The licensee is given the option to maintain its rights in the license, even its exclusive rights, for the duration of the contract term. However, it does not have the right to seek specific performance of other obligations of the licensor. If the licensee elects to retain its rights, Section 365(n)(2) requires it to make all royalty payments due under the contract for its term and applicable extensions. By electing to retain its rights under the contract, the licensee is deemed to have waived any right of setoff that it may have with respect to the contract and any claim for administrative expenses. The licensee can, however, assert a claim for rejection damages, but only as an unsecured claim for breach.

The question of what happens to a trademark agreement after rejection in bankruptcy has been the subject of much legal debate in recent years. Because "trademarks" are excluded from the scope of Section 365(n), courts struggled with interpreting whether Congress, by way

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

[50] *Id.*

[51] *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)

[52] Section 365(n) applies expressly to patents, copyrights, and four other types of intellectual property, but not trademarks. 11 U.S.C. § 101(35)(A).

of negative inference, intended to prevent a non-debtor licensee from keeping its trademark rights after rejection of the license agreement. The Supreme Court recently resolved the question in *Mission Prod. Holdings v. Tempnology, LLC,* 139 S. Ct. 1652 (2019). In examining a debtor-licensor's proposed rejection of a trademark licensing agreement, the Court first held that under Section 365(g), the rejection of *any* contract operates as a breach, and if a contract is breached, the non-breaching party is entitled, if it chooses, to retain the benefit of its bargain. Applying this principle to trademark agreements, a breach of a trademark agreement outside of bankruptcy would not result in a termination of the licensee's rights to use the trademark, therefore a breach within bankruptcy should be no different. By allowing the non-debtor licensee to retain its trademark, the decision is consistent with the general rule that the bankruptcy estate cannot possess what the debtor did not possess outside of bankruptcy.

Leases

Perhaps one of the largest obligations of any franchisee are their real estate leases. While "location, location, location" is certainly a mantra that is important to any franchisee and franchisor—as it on its own can lead to the success or demise of a unit—it does not come without a price. Leases are generally long-term obligations that are committed to well in advance of being able to operate. While projections and models may justify a location and a given rent, once operating these assumptions are often challenged. In addition, leases come with additional obligations in addition to just base rent such as utilities, common area charges and maintenance, and sometimes even profit sharing. In addition, most leases contain escalators which kick in regardless of the market at the time such increases take effect. Simply put, addressing real estate leases is a lynchpin in any franchise reorganizations.

While most other executory contracts can be assumed or rejected prior to confirmation of a Chapter 11 plan, the Bankruptcy Code imposes different deadlines for non-residential real estate leases. A debtor-in-possession has 120 days from the filing date to assume or reject non-residential real estate leases. This period can be extended for an additional 90 days with Court approval and further extended only in with the consent of the landlord.

Unlike other executory contracts, the Bankruptcy Code imposes a cap on the damages a landlord can assert for rejection of an unexpired lease. Section 502(b)(6) "caps" a landlord's lease-rejection damages claim against the debtor/tenant at the greater of (1) one year's rent or (2) 15 percent of the unpaid rent for the remaining term, not to exceed three years' rent (the "rent cap"). A landlord's claim for damages in excess of the rent cap is disallowed. This cap gives a tenant (whether a franchisee or franchisor) significant leverage when negotiating with landlords prior to any bankruptcy as a landlord faces double jeopardy when facing rejection of its lease—first, any pre-petition general unsecured claim for damages will be capped and

second, such claim will be paid in "bankruptcy dollars" which could be pennies on the face amount of its claim.[53]

Complications can arise when the franchisor is also the landlord. For example, in *In re FPSDA I, LLC*, 450 B.R. 392 (Bankr. E.D.N.Y. 2011) a debtor-franchisee of several Dunkin' Donuts/Baskin-Robbins franchises were behind on their pre-petition rent and franchise agreement obligations. Because the debtors could not get their landlords to consent to extend the deadlines to assume or reject their leases, the debtors moved for an order to determine that the lease deadlines did not apply or that the debtors could assume the lease without curing the defaults under the franchise agreements. The franchisors/landlords argued that the contracts and leases should be construed as a part of a single transaction and that any assumption of the leases would require the defaults under the franchise agreements to be cured as well.

The court held that the franchise agreements and leases were a single agreement, and that the debtor had to cure any defaults under the lease and franchise agreement before assumption; however, the Court also held that the lease deadlines to assume or reject did not apply. *In re FPSDA I, LLC*, 450 B.R. at 400.

Lender issues in bankruptcy

Franchisors and franchisees are not the only key constituents in a franchise related bankruptcy. The pre-petition lenders are often given a significant seat at the table in a Chapter 11 case. Generally, lenders have a lien on all, or substantially all, of a debtor's assets. In the case of a franchisor this will include a lien on any intellectual property, accounts receivable, contract rights, among other things. In the case of a franchisee, the lender will have a lien on all inventory and FF&E of the operations.

Use of cash collateral

Generally, a debtor is permitted to use virtually all assets during a bankruptcy, even though they may be pledged to a secured creditor.[54] A different rule applies to cash collateral. If a lender's 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.[55] Recognizing that cash and

[53] Complications may also arise if there are any guarantors that are not also debtors in a bankruptcy case or if the landlord has the benefit of a letter of credit or security deposit.

[54] 11 U.S.C. § 363(c)(1).

[55] 11 U.S.C. § 363(c)(2).

cash equivalents are easily dissipated, the Bankruptcy Code places strict limitations on a debtor's ability to use such property.[56]

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.[57] 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. For instance, this suggestion may be couched in a stipulation that ongoing royalties are to be paid as adequate protection of 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.

Intercreditor issues

Often the rights of franchisors and lenders may appear to overlap. For example, a franchise agreement may provide for the compulsory assignment of a franchisee's leases upon termination or expiration of a franchise agreement. Conversely, a lender may assert a lien on all of a debtor's assets, including a franchisee's leasehold interests. These issues can lead to creditors fighting for a limited set of assets based on different rights. Moreover, a debtor may assert that either or both parties failed to perfect such interests or that such claims only give rise to pre-petition claims for which no specific performance is appropriate. Further, in some instances bankruptcy courts will not exercise jurisdiction over issues that it views as purely intercreditor litigation.[58] This can lead to additional uncertainty and litigation for both a franchisor and a lender.

In order to avoid such disputes, lenders and franchisors should enter into clear and concise intercreditor agreements that specifically spell out the disposition of any of the franchisor's assets in the event of a default under the franchise or loan agreement or a bankruptcy. Specific thought should be given to how goodwill, intellectual property rights, real property rights, books and records, and customer information will be treated.

[56] 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)).

[57] 11 U.S.C. § 361.

[58] *See Stern v. Marshall*, 564 U.S. 462, 489, 131 S. Ct. 2594, 2612, 180 L. Ed. 2d 475 (2011).

Conclusion

It is clear that Chapter 11 offers many tools that a skilled professional can use in order to deleverage a balance sheet and shed burdensome contracts and legacy liabilities in order to pave the way to a successful go-forward business. This, however, reqiures careful planning and coordination prior to, and after, a bankruptcy filing. While this article attemps to explore many of these tools and consequences, it only scratches the surface. Other key constituents include the official committee of unsecured creditors, the Office of the United States Trustee, and potentially a privacy ombudsman —all of whom may have divergent interests but all of whom wield sigificant power during the restructuring process. Ultimately, however, the benefits of an orchestrated process far outweigh the risks and complications involved—breathing new life into, and providing a fresh start for, a debtor.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Rick Pedone
617.345.1305
rpedone@nixonpeabody.com

Chris Desiderio
212.940.3085
cdesiderio@nixonpeabody.com

Nixon Peabody Financial Restructuring and Bankruptcy Team

Rick Pedone (Team Leader), Chris Desiderio, Chris Fong, Jack Murray, and Emily Holt

Rick Pedone is the Team Leader of the firm's Financial Restructuring and Bankruptcy Team. Contributing members with Franchise-related insolvency experience include: Chris Desiderio who is of counsel in Nixon Peabody's Financial Restructuring and Bankruptcy group. The team has handled numerous franchise-related insolvency matters in a variety of jurisdictions. Craig Tractenberg, a former partner co-authored an earlier version of this work.

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