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A Franchisor's Guide to Surviving Franchisee Bankruptcies

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When a franchisee files for bankruptcy, the franchise agreement generally constitutes property of the franchisee's estate, to the extent such agreement was in effect as of the date of the petition.[1] Therefore, the automatic stay under 11 U.S.C. §362 prohibits a franchisor from taking any action against the bankrupt franchisee without first obtaining relief from stay, including, without limitation, collection efforts, termination of the franchise agreements and compelling the franchisee to discontinue its use of certain trademarks, service marks and the like. Since a franchisor may end up in a situation where the franchisee is able to continue with its business operations despite its prepetition and/or postpetition defaults, the franchisor should play a significant role in the franchisee's bankruptcy case in an effort to protect its reputation and its interest in the good will of the business.

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In the event a franchise agreement has been properly terminated prior to the petition date, the franchise agreement will not be considered property of the bankruptcy estate. Moreover, a franchisee's bank-ruptcy filing will not reinstate franchise agreements that were properly terminated prepetition, nor will it restore contractual rights or privileges that the franchisee lost prior to the petition date.

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Section 365 of the Bankrutpcy Code authorizes the trustee[2] to assume, assume and assign, or reject an "executory contract," subject to court approval. The right of the debtor-in-possession (DIP) to assume or otherwise reject a franchise agreement permits debtor franchisees to assume successful and profitable franchises while rejecting franchises that are underperforming or unprofitable. Although the Bankruptcy Code does not define an executory contract, it is generally defined as "a contract under which the obligation of both the bankrupt and the 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."[3] Thus, a franchise agreement is considered an executory contract for bankruptcy purposes if, on the petition date, there are material obligations outstanding on both sides.

As a general matter, the DIP must assume the entire contract.[4] Unfortunately, there is no specific timeframe within which a chapter 11 DIP must assume or reject an executory contract, and such contracts may be assumed by a DIP at any time before confirmation of a plan of reorganization. 11 U.S.C. §365(d)(2). In a chapter 7 case, the franchise agreement is deemed rejected if it is not assumed within 60 days after the order for relief. 11 U.S.C. §365(d)(1). Upon a showing of "cause," however, the court, in a chapter 7 case, may extend the time for the debtor to assume or reject a franchise agreement. *Id.*

When a defaulting franchisee files for bankruptcy and subsequently attempts to "assume" the franchise agreement in bankruptcy, the Bankruptcy Code provides certain protection to franchisors. Under 11 U.S.C. §365(b)(1), assumption is prohibited unless three specific requirements are met at the time of assumption. First, the franchisee must cure any defaults or provide adequate assurance that the DIP will promptly cure such default. Second, the franchisee is required to compensate, or provide adequate assurance, that the franchisee will promptly compensate the franchisor for any "actual pecuniary loss" resulting from such default. Lastly, the franchisee must provide adequate assurance of future performance under the franchise agreement.

Often, a franchisor is confronted with the DIP's attempt to "assume" the franchise agreement in bankruptcy, without the franchisor's prior consent. Under §365(c) of the Code, a DIP may not assume an executory contract if "applicable law" excuses the nonconsenting party from accepting performance from (or rendering performance to) an entity

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1 *See Vylene Enters. Inc. v. Naugles Inc. (In re Vylene Enters. Inc.)*, 90 F.3d 1472, 1476 (9th Cir. 1996).

2 Pursuant to 11 U.S.C. §1107(a), a DIP in a chapter 11 case has all of the rights and powers of a trustee with respect to §365. More often than not, assumption, assignment or rejection of a franchise agreements is dealt with in the context of a reorganization in chapter 11 rather than a liquidation in chapter 7, the term "debtor-in-possession" or "DIP" are used throughout this article (recognizing that it is generally interchangeable with the word trustee).

3 *See* Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973).

4 *See Cinicola v. Scharffenberger (In re Cinicola)*, 248 F.3d 110, 119 (3d Cir. 2001).

other than the debtor. Section 365(c) provides in material part, as follows:

> The Trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
>
> > "(1)(A) *applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor-in-possession*, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
> >
> > (B) *such party does not consent to such assumption or assignment....*"[5]

Moreover, the Ninth Circuit in *In re Catapult Entertainment Inc.*[6] has determined that the literal language of §365(c)(1) is thus said to establish a "hypothetical test," and that "a debtor-in-possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor-in-possession has no intention of assigning the contract in question to any such third party."[7]

In *Catapult*, the DIP sought to assume a patent license over the objection of the licensor. The Ninth Circuit first determined that federal patent law constitutes "applicable law" within the meaning of §365(c), and that nonexclusive patent licenses are personal and assignable only with the consent of the licensor. Accordingly, the court held that the DIP could not assume the patent license over the licensor's objection and lack of consent and that the license had granted the debtor a personal, nonexclusive license to use the patents.[8] Since the *Catapult* decision, other courts have similarly held that the Lanham Act[9] is an "applicable law" within the meaning of §365(c), and that pursuant to the Lanham Act, a contract granting the debtor a nonexclusive license to use a nondebtor licensor's trademarks and/or service marks may not be assumed (or assigned) without the licensor's consent.[10]

In *In re Wellington Vision Inc.*, 364 B.R. 129, 131-32 (Bankr. S.D. Fla. 2007), the debtor entered into a prepetition franchise agreement with Pearl Vision Inc., pursuant to which Pearl Vision granted the debtor, among other things, a limited, nonexclusive license to use its trademarks, trade names and service marks. The bankruptcy court granted Pearl Vision's motion for relief from stay to terminate the franchise agreement. On appeal, the district court affirmed the bankruptcy court's holding that Pearl Vision had granted the debtor a nonexclusive trademark license protected by the Lanham Act, which "provides that a licensor who grants a nonexclusive license for the use of its trademark is entitled to certain protections, including restrictions on assignment."[11] Thus, the district court ultimately held that because the DIP could not, as a matter of law, assume or assign the franchise agreement, and because Pearl Vision would not consent to such assumption and assignment, relief from stay was appropriate in the circumstances of the case to allow Pearl Vision to terminate the franchise agreement.[12]

A franchisee in bankruptcy is also given the option to "assume and assign" a franchise agreement for value to a third party. However, not only must the DIP meet all three of the above-referenced requirements for assumption, the DIP must also show "adequate assurance of future performance" by the assignee, regardless of whether or not there is an existing default under the franchise agreement.[13] A bankruptcy court may authorize the rejection of the debtor's franchise agreement if, in the business judgment of the DIP, rejection will benefit the estate and creditors.[14] In addition, a rejection of an executory contract constitutes a breach immediately before the date of the filing of the petition, arising in a prepetition unsecured claim as a result of such breach.[15]

Franchisees are typically parties to unexpired leases of nonresidential properties, and thus, they also have the ability to assume, assign or reject those unexpired leases during the relevant time periods set forth in §365. The DIP has 120 days after the order for relief to make this determination, unless the DIP successfully obtains a 90-day extension for "cause" prior to the expiration of the 120-day period.[16]

In a chapter 11 case, the DIP will often postpone making a decision to assume or reject a franchise agreement until the debtor proposes a plan. A franchisor may determine during the pendency of the bankruptcy proceeding and prior to plan confirmation that it requires relief from the automatic stay to terminate a franchise agreement for "cause."[17] The term "cause" is a "broad and flexible" concept that permits a bankruptcy court, as a court of equity, to respond to inherently fact-sensitive situations.[18] In fact, "cause" has no clear definition and is determined on a case-by-case basis.[19] In some cases, a franchisor may seek relief from stay to terminate the franchise agreement based on the debtor's unpaid postpetition royalties, lapse of insurance coverage, material post-petition defaults under the franchise agreements, lack of adequate protection, deterioration of the franchisor's interest in the good will of the business and, as set forth above in greater detail, the DIP's inability to assume the franchise agreements under "applicable law." Indeed, it is a "long-standing rule" that failure to make post-petition payments constitutes "cause" under §362(d)(1).[20] Furthermore, it is well settled that the Bankruptcy Code neither enlarges the rights of a debtor under a contract, nor does it prevent the termination of a contract by its own terms.[21]

Several jurisdictions have consistently held that a debtor's ongoing defaults under a franchise agreement diminish the value of the franchisor's trademark and service marks. Accordingly, the franchisor's interest is not adequately protected.[22] In *B-K of Kansas*, 69 B.R. 812 (Bankr. D. Kan. 1987), the bankruptcy court analyzed the adequate-protection issue in the context of a franchise agreement between the debtor and Burger King Corp. As a result of the debtor's substantial defaults, the franchise agreement termi-

5 *See* 11 U.S.C. §365(c)(1)(A) (emphasis added).

6 *See Perlman v. Catapult Entm't. Inc. (In re Catapult Entm't. Inc.)*, 165 F.3d 747 (9th Cir. 1999).

7 *See Catapult Entm't. Inc.*, 165 F.3d at 750.

8 *Id.* at 750-51.

9 *See* 15 U.S.C. §1051, *et seq.*

10 *See Wellington Vision Inc. v. Pearle Vision Inc. (In re Wellington Vision Inc.)*, 364 B.R. 129, 134 (S.D. Fla. 2007). Courts have also held that §365(c)(1) prohibits the assumption of contracts that grant a nonexclusive copyright license. *See In re Golden Books Family Enm't. Inc.*, 269 B.R. 300, 310 (Bankr. D. Del. 2001).

11 *Id.* at 134.

12 *Id.* at 134-37.

13 *See* 11 U.S.C. §365(f)(2).

14 *See Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.)*, 756 F.2d 1043 (4th Cir. 1985), *cert. denied sub nom.*

15 *See* 11 U.S.C. §365(g)(1).

16 *See* 11 U.S.C. §365(d)(4)(A).

17 *See* 11 U.S.C. §362(d)(1).

18 *See Scripps GSB I LLC v. A Partners LLC (In re Partners LLC)*, 344 B.R. 114, 127 (Bankr. E.D. Cal. 2006).

19 *See Benedor Corp. v. Conejo Enters. Inc. (In re Conejo Enters. Inc.)*, 96 F.3d 346, 352 (9th Cir. 1996) (*quoting Christensen v. Tucson Estates Inc. (In re Tucson Estates Inc.*), 912 F.2d 1162, 1166 (9th Cir. 1990)).

20 *See Matter of Indep. Mgmt. Assocs. Inc.*, 108 B.R. 456, 464 (Bankr. D. N.J. 1989).

21 *See In re Carrol*, 903 F.2d 1266, 1271 (9th Cir. 1990).

22 *See, e.g., In re B-K of Kansas Inc.*, 69 B.R. 812, 815 (Bankr. D. Kan. 1987); *In re Tudor Motor Lodge Assocs. LP*, 102 B.R. 936, 952 (Bankr. D. N.J. 1989).

nated pre-petition pursuant to the terms of the franchise agreement.[23] Burger King sought relief from the automatic stay to purse its franchise rights for "cause" under 11 U.S.C. §362(d)(1) and for lack of equity under §362(d)(2).[24]

First, the bankruptcy court found that the franchisee did not have equity in the franchise rights because the franchise agreement had been terminated automatically. More importantly, the court found that the franchisor was not adequately protected because the franchisee had continued to use the franchise trademarks and service marks without making payments, causing arrearages to accumulate at an enormous rate.[25] Thus, despite the DIP's objections, the court granted relief from stay and acknowledged that "the use of trademarks and service marks, is of such a type that money may never adequately protect the movant" and that the "[franchisor's] reputation to the general is at stake."[26] Accordingly, a franchisor may seek and ultimately obtain relief from stay to terminate an existing franchise agreement that is the subject of the franchisee's bankruptcy based on the franchisee's ongoing defaults under the franchise agreement and for lack of adequate protection of the franchisor's property interest, including, without limitation, its valuable trademarks and other intangible rights relating to the franchise, reputation and business.

In an effort to protect the franchisor's post-termination rights under the franchise agreements and to continue to enforce the franchisee's obligations upon termination of the franchise agreement, counsel should include specific language in any proposed order granting stay relief, which should include, among other things, a provision stating that all post-termination rights expressly survive termination of the franchise agreements in accordance with the terms and conditions set forth in the franchise agreements. A franchisor may benefit by working closely with the franchisee to restructure the terms and conditions set forth in the franchise for a reduction in royalties and to assist with operational issues in connection with the franchise prior to a bankruptcy filing. If a bankruptcy filing is inevitable, it is prudent for any franchisor to obtain competent counsel with the ability to enforce and protect its rights and interest in bankruptcy. ■

23 *See B-K of Kansas*, 69 B.R. at 813.
24 *Id.* at 814.
25 *Id.* at 815.
26 *Id.*

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