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Navigating Distressed Franchisee Issues: Understanding Franchisee Bankruptcies and Exploring Alternatives

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These materials focus on franchisee bankruptcy issues and other insolvency proceedings, while providing some grounding basic bankruptcy concepts and alternatives.

I. Bankruptcy Overview

a. Bankruptcy Purpose and Fresh Start

Bankruptcy law has two primary goals. First, it seeks to relieve debtors of certain obligations they are unable to repay by providing them with a "fresh start" and maintain businesses as a going concern when possible. It also seeks to maximize the return to creditors in an efficient manner and avoid the preverbal "race to the courthouse."

b. Bankruptcy Types

Chapter 7 is a liquidation and the type of bankruptcy that most people think of when the term is used. In chapter 7, a trustee takes over the assets of the debtor, reduces them to cash, and makes distributions to creditors from the proceeds in accordance with the priority scheme under the Bankruptcy Code. Because there is usually little or no unencumbered property in chapter 7 cases, as all the assets are subject to liens or exempt, there may not be assets available for liquidation. These cases are referred to as "no-asset cases." Unsecured creditors (typically trade and other creditors with only a contract right to recover) will get a distribution from the bankruptcy estate only if the case is an asset case and the creditor files a proof of claim with the bankruptcy court.

Chapter 11 allows businesses to continue operations and to repay creditors via a court-approved plan of reorganization. Using the plan and provisions of the Bankruptcy Code, the debtor can reduce its debts by restructuring their terms to a serviceable amount. Secured debts still need to be paid at least the value of the collateral under the terms of the plan, but unsecured debts may be paid far less and sometimes receive no payment. The debtor can also reject onerous contracts and leases and right-size its operations. Under chapter 11, the debtor normally goes through a period of consolidation and emerges with a reduced debt load and a reorganized business. Chapter 11 can also be used to facilitate a sale of the debtor's business as a going concern or of pieces of the business, with the proceeds used to pay creditors in accordance with the priority scheme set forth in the Bankruptcy Code.

Subchapter 5 of the Chapter 11 bankruptcy code is newly introduced and specifically designed for small businesses with total debt of less than $2,725,625 (was increased through March 2022 to $7,500,000 under the COVID-19 Bankruptcy Relief Extension Act), which is largely a hybrid of chapter 11 and chapter 13. It is intended to be a faster and less-expensive option (e.g. no fees paid to the US Trustee and no creditors committee allowed) for small business debtors that allows them to retain ownership of their business. The debtor is also the only party that can propose a plan of reorganization. Under subchapter 5, the bankruptcy plan must be proposed within 90 days of case commencement, which makes planning ahead vital for the possible franchisee-debtor and will require prompt attention by the franchisor. Unlike a standard chapter 11 case where the debtor can only retain its equity interest if it pays its unsecured creditors in full or contributes new money, under subchapter 5 the debtor can retain its equity if it pays creditors its disposable income over 3-5 years under the plan.

Chapter 13 is similar to chapter 11, except that it is for use by individuals. In chapter 13, an individual with "regular income" uses their disposable income to make payments on their debts pursuant to a plan over the course of three to five years. Unlike a chapter 7 case, the debtor retains their property and receives a discharge upon completion of the payment plan. The debtor is protected from lawsuits and other claims for the duration of the plan.

c. Automatic Stay

The automatic stay goes into effect upon the filing of the bankruptcy petition. It provides that all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition. The stay prohibits most action against the debtor's property as well. The stay is designed to provide a breathing spell for the debtor, during which negotiations can take place to try to resolve the difficulties in the debtor's financial situation.

There are certain actions that are exempt from the automatic stay. These include the right to perfect a lien in certain circumstances. Guarantors of the debts of the bankrupt entity are typically not protected by the automatic stay and collections actions can continue against them. Thus, if the franchisee's owner has personally guaranteed the obligations of the franchisee, the franchisee's owner can usually still be pursued for their guarantee, unless they file a separate bankruptcy proceeding.

Creditors can seek relief from the automatic stay in certain circumstances so that they continue to pursue the debtor or its assets. Relief from the automatic stay can be granted for "cause." The most common form of cause is a lack of adequate protection for the creditor. Adequate protection is not defined in the Bankruptcy Code but includes cash payments to prevent a decrease in its interest in property, replacement liens, or other relief that allows it to receive the indubitable value of its interest in the debtor's property. Relief can also be granted as to property in which the debtor has no equity and is not necessary to an effective reorganization.

d. Assets of the Bankruptcy Estate

The filing of the bankruptcy petition automatically vests all property of the debtor in the bankruptcy estate. The chapter 7 trustee administers this property and a chapter 11 debtor remains in possession of this property. Estate property includes all legal and equitable interests of the debtor, including contract rights, real and personal property interests.

In a franchisee bankruptcy proceeding, the key assets include any cash or deposit account funds, contracts rights, including under its franchise agreement, leases, equipment, and inventory.

e. Key Players in a Bankruptcy Proceeding

While the franchisee-debtor is the focus in a bankruptcy case, there are other parties that will play an important role in the outcome of the case. Depending on the situation, the franchisor may play a limited role, which will largely be dictated by the extent of its relationship with the franchisee under the franchise agreement and any other contractual relationships. The landlord will also be important to the franchisee's successful restructuring. In some bankruptcy cases, a creditors' committee will be appointed. The committee represents and advocates for the interests of all the unsecured creditors of the franchisee.

f. Benefits to Franchisee Bankruptcy

The franchisee benefits from the filing of the automatic stay in several ways. First, the automatic stay prevents the continuation of any enforcement actions or lawsuits against it, including possibly the termination of its franchise agreement.

The bankruptcy also provides a forum for the franchisee to seek to restructure its debts and reorganize its obligations and its business to form a profitable and viable operation post-bankruptcy. And at the conclusion of the case, the franchisee entity cannot be pursued for pre-bankruptcy debts other than those reaffirmed as part of the bankruptcy proceeding or included as part of its plan.

The reality may be, however, that some franchisees' businesses are not salvageable and that a bankruptcy provides an orderly way for its liquidation and possible transition to a new owner.

g. Downsides/Risks for Franchisee and Franchisor

A bankruptcy filing by a franchisee can have a negative impact on the franchise brand, especially in any instance involving a multi-location franchisee. A bankruptcy filing can have reputational and financial effects beyond the franchisee, as customers may not understand that it is only a single franchisee that has filed for bankruptcy. The brand can be further damaged if the franchisor is not maintaining the location to the standards required under the franchise agreement during the pendency of the case. Further, the franchisor will lose the competitive benefits and financial returns that came from the franchisee if they are not able to reorganize, or that may be reduced even if they can.

h. Sales in Bankruptcy

A struggling franchisee may be interested in selling the franchise to another franchisee or other party, allowing the franchise to continue operating under new ownership. A bankruptcy case also can be a vehicle to sell the franchise to an interested party, and the franchise can potentially be sold free and clear of the debts and other liabilities of the current franchisee. The franchisor may even be able to offer recommendations of parties that may be interested. While the bankruptcy sale process provides certain protections to the buyer, it is slower and more expensive than a transaction outside of a proceeding in most instances. The proceeds of the sale will be distributed to creditors as part of the bankruptcy proceeding and subject to the priorities in the bankruptcy code.

II. Bankruptcy Nuances for Franchisees

a. Executory Contracts

A debtor's executory contracts and unexpired leases often are among the most valuable assets of a bankruptcy estate. Section 365 of the Bankruptcy Code[1] gives a debtor in bankruptcy a considerable amount of flexibility to assume, assume and assign, or reject executory contracts and unexpired leases. In the context of franchising, this flexibility provides the debtor with a valuable tool in its efforts to reorganize its business because it means two key things. First, franchise rights can be transferred for value. Second, a debtor may reject – and be relieved from performing under burdensome contracts.

The Bankruptcy Code does not define the term "executory contract." In determining whether a contract is executory, courts typically consider whether "the obligation of both the bankrupt and the other party [under] 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."[2] In other words, an executory contract is one that has substantial performance remaining on both sides. As set forth below, almost every franchise agreement, with the related license to use the franchisor's intellectual property, will be considered an executory contract.

"Assuming" a contract simply means that its existence is reinstated. The debtor chooses to be bound by its terms, and from the date of assumption forward, both parties must comply with its terms exactly as they would absent bankruptcy. Upon assumption

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[1] 11 U.S.C. §365(a).

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

(and assuming the contract is not then assigned in conjunction with a sale to a third party), the contractual obligations become that of the estate. Therefore, a breach of the contract after the date of assumption will likely result in a post-petition claim for damages (which is treated as a first priority administrative claim, as opposed to a pre-petition unsecured rejection claim).

The Bankruptcy Code also confers on a debtor a valuable right to assign executory contracts and leases in conjunction with their assumption.[3] This allows a debtor, or its purchaser, to monetize valuable contracts and leases. As set forth below, the Bankruptcy Code generally overrides contractual anti-assignment provisions, thereby maximizing the ability to extract value from a debtor's portfolio of contracts and leases – subject to a critical limitation in the context of franchise agreements.

b. Conditions to Assumption and Assignment

A debtor cannot assume an executory contract or unexpired lease unless and until all pre-petition and post-petition defaults have been cured. Specifically, in order to assume the contract or lease, a debtor must (1) cure, or provide adequate assurance that it will promptly cure, the default; (2) compensate, or provide adequate assurance that it will promptly compensate, its counterparty for any actual pecuniary loss resulting from the default; and (3) provide adequate assurance of its ability to perform the contract or lease in the future.[4] Further, in order to assign an executory contract or unexpired lease, a debtor must first assume it and the assignee must provide adequate assurance of its ability to perform in the future.[5]

c. Timing of Assumption or Rejection

Generally, executory contracts and unexpired leases may be assumed or rejected at any time until confirmation of a plan of reorganization. The most significant exception to this rule is for unexpired leases of commercial real estate. As of the 2005 amendments to the Bankruptcy Code, a debtor now is required to assume unexpired commercial real estate

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[3] 11 U.S.C. § 365(f)(2).

[4] 11 U.S.C. § 365(b)(1). This code section was amended in 2005 to provide that a default relating to a debtor's nonmonetary obligations under an unexpired lease of real property must be cured "by performance at and after the time of assumption in accordance with such lease." Thus, while section 365(b)(1)(A) does not prevent a debtor from assuming and assigning a commercial real estate lease under which the debtor previously breached its nonmonetary obligations, it does require that a default arising from a failure to operate in accordance with the terms of the lease must be cured at the time of the assumption, and that any assignee abide by such nonmonetary obligations thereafter. *See* 3 Collier on Bankruptcy ¶ 365.06[3][c](15TH Ed. 2012). Under this amendment, a debtor desiring to assume and/or assign a commercial real estate lease with respect to which it had defaulted under a "go dark" provision should be prepared to turn the lights back on as a condition to assumption and/or assignment.

[5] 11 U.S.C. § 365(f)(2)(A) and (B).

leases within 120 days of the petition date. If a debtor fails to assume a lease within this period, the lease is deemed rejected. A debtor may request the bankruptcy court to extend the 120-day period only once, by an additional 90 days, "for cause".[6] Any extension thereafter requires the lessor's written consent.[7]

The tightened time frame imposed by this amendment requires debtors with substantial commercial leasehold interests to make critical decisions about those leases in the early stages of their bankruptcy cases, sometimes before the long-term prospects for the business can be known or assessed. The pressure of having to decide within 210 days whether to assume or reject long-term leases may deprive a retail debtor (or a franchisee with multiple company operated and leased locations) of the ability to operate through the first post-petition busy season (such as the holiday season) in order to assess which stores might be long-term keepers. Absent a landlord willing to consent to extend that period, debtors may be forced to close locations rather than risk assuming a long-term lease that will result in a substantial administrative expense claim against the chapter 11 estate if the assumption decision turns out to have been ill advised. Thus, the need to act quickly with respect to commercial real property leases is sometimes crucial in a Chapter 11 case.

d. Rejection Issues

Instead of outright assumption or assumption and assignment of a franchise agreement and other related executory contracts, it is also possible that a debtor may choose to reject the agreement. Rejection of executory contracts such as a franchise agreement or an employment contract is treated like a breach of the agreement. Rejection of executory contracts in bankruptcy leads to what are considered to be rejection damages, which generally are breach of contract damages. Under the Bankruptcy Code, such damages give rise to an unsecured claim for the non-debtor party against the assets of debtor. If the contract was not previously assumed in the bankruptcy case, the claim is deemed to have arisen as of the filing date.

The process following rejection of a franchise agreement by a franchisee is relatively straightforward for the franchisor. Generally, after rejection, the franchisor will work with the franchisee to ensure an orderly wind-down of franchisee's business. The franchisor will also file an unsecured claim in the franchisee's bankruptcy case for the

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[6] Factors the court will consider in determining whether "cause" exists include: (i) whether the debtor is current (post-petition) on its lease obligation; (ii) whether the lease is a primary asset of the debtor; (iii) whether the debtor has failed to evaluate the lease and/or propose a plan of reorganization within a reasonable period of time; and (iv) whether the lessor will be damaged beyond compensation available under the Bankruptcy Code due to the debtor's continued occupation of the leased premises. *See South Street Seaport Limited Partnership v. Burger Boys, Inc. (In re Burger Boys, Inc.),* 94 F.3d 755, 761 (2nd Cir.1996).

[7] 11 U.S.C. § 365(d)(4).

damages associated with the rejection of the contract, which generally will include all of the breach damages permitted by the franchise agreement.

Where rejection of a contract involves commercial leases, as may be the case in certain franchisor-franchisee relationships, the Bankruptcy Code applies special rules respecting the calculation of rejection damages. Section 502(b)(6) of the Code provides that lease rejection damages are capped at the greater of one lease year or 15 percent, not to exceed three years, of the remaining lease term. Further, the cap operates from the earlier of the petition filing date or the date on which the lessor repossessed, or the lessee surrendered, the leased property. The cap was instituted by Congress because it was concerned that landlords were obtaining windfalls and an outsized share of the total amount of unsecured claims.

A landlord also retains an unsecured claim for all prepetition unpaid rent. Note that the cap on rejection lease damages generally applies only to damages resulting from the termination of the lease. Some courts have held that a landlord continues to have a separate, uncapped claim for prepetition damages resulting from other harms, such as the disposal of used industrial equipment at the leased property.[8]

Rejection of a franchise agreement by a franchisee also gives rise to considerations respecting non-competition provisions of franchisee agreements. In fact, the use of bankruptcy to reject non-competition agreements is closely scrutinized by the courts. Moreover, there is often a significant struggle over whether the rejection of a franchise agreement means that the entire contract, including non-competition provisions, are rejected - or whether the non-competition provisions survive rejection. Sometimes it depends upon the language of the agreement, which is why it is always a good idea for franchisors to have their franchisees sign a separate, stand-alone non-competition agreement.

e. Franchise Agreement Termination

In some situations, it may become necessary for the franchisor to terminate the franchise agreement of a franchisee that has been continually delinquent and is harming the brand or that has no prospect of restructuring.

As noted above, if the franchisee to be terminated has already filed for bankruptcy, then the franchisor cannot terminate the franchise agreement without first obtaining relief from the automatic stay.

[8] *See, e.g., El Toro Materials Co.*, 504 F.3d. 978 (9th Cir. 2007); *In re Filene's Basement*, 2015 WL 1806347 (Bankr. D. Del. 2015).

In situations where the franchisee has not yet filed a petition, but the threat of bankruptcy exists, the timing of the termination and the contractual provisions for such termination determine whether such a termination will be effective. First, if a franchisor terminates a franchise agreement prior to the commencement of the bankruptcy case and the termination is effective upon receipt, then it does not become property of the bankruptcy estate and cannot be resurrected by the franchisee's bankruptcy filing.

Second, if the franchisor terminates the franchise agreement prior to filing, but it is not immediately effective upon receipt, most courts find the filing of a bankruptcy case will not stop the termination from becoming effective so long as there is nothing left to be done by the franchisor to complete the termination.

Third, however, if the franchisor has terminated the franchise agreement prior to the franchisee filing a bankruptcy petition, but there is an opportunity to cure by the franchisee or something remains to be done by the franchisor, then the franchise agreement becomes estate property and the termination is prevented from taking effect by the automatic stay. The bankruptcy filing also protects the franchisee's right to cure for a period determined by the contract and other applicable law.

f. Ability to Override Anti-Assignment Provisions (the General Rule, but not in the Context of Franchise Agreements)

Provisions in an executory contract or unexpired lease which prohibit, restrict or condition a debtor's ability to assign are rendered unenforceable by section 365(f)(1) of the Bankruptcy Code. Section 365(f)(1) generally covers express anti-assignment provisions which, if enforced, could have the practical effect of precluding assignment. This ability to override contractual provisions is a powerful tool to enhance the value of a debtor's assets.

However, a critical exception in the context of franchise agreements exists in the Bankruptcy Code, found in section 365(c)(1), which provides that a trustee or debtor may not assume or assign a contract if "applicable law" (*i.e.*, non-bankruptcy law) prohibits its assignment.[9] Thus, regardless of whether a contract expressly prohibits assignment, a trustee or debtor may not assume or assign the contract if, for example, it is a license to use certain intellectual property or another type of contract that cannot be freely assigned outside of bankruptcy. This will be discussed in more detail below.

[9] 11 U.S.C. § 365(c)(1)(A).

III. Special Considerations of Franchisee Chapter 11 Proceedings, Including the Franchisor's "Veto Rights"

a. Introduction

Executory contracts, such as franchise agreements, play a vital role in deciding the success or failure of a chapter 11 case. They are often the most valuable assets of a debtor. As discussed above, executory contracts are generally assumable and assignable in bankruptcy provided certain requirements are met. Moreover, provisions in an executory contract or unexpired lease which prohibit, restrict or condition a debtor's ability to assign are rendered unenforceable by section 365(f)(1) of the Bankruptcy Code. Section 365(f)(1) generally covers express anti-assignment provisions, and states that "notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease…"[10]

However, the situation is different in a franchisee bankruptcy. As a general rule, the franchisor can prevent the franchisee from assigning the franchise agreement, along with its intellectual property rights, to a third party without the franchisor's consent. In addition, depending on the jurisdiction, a franchisor may have the ability to determine whether the franchisee can even assume the franchise agreement in the first place, thus affording the franchisor substantial leverage in a franchisee's reorganization proceeding.

b. A Note on the Protection of Trademark Rights under Federal Law

In the typical franchisor/franchisee context, the franchise agreement is the critical operative document. The cornerstone of all franchise agreements is the franchisor's grant of a revocable and non-exclusive license to use certain of its intellectual property and other proprietary information, such as a combination of trademarks, service marks, trade names, copyrights and/or trade secrets.

Federal trademark law provides that a licensor who grants a non-exclusive license for the use of its trademark is entitled to certain protections, including restrictions on assignment.[11] It is commonly recognized that the "substantial weight of authority holds that under federal trademark law, trademark licenses are not assignable in the absence of some express authorization from the licensor, such as a clause in the license agreement

[10] 11 U.S.C. § 365(f).

[11] *In re Rupari Holding Corp.*, 573 B.R. 111, 117 (Bankr. D. Del. 2017).

itself."[12] The purpose of a trademark, after all, is "to identify a good or service to the consumer, and identity implies consistency and a correlative duty to make sure that the good or service really is of consistent quality, i.e., really is the same good or service."[13]

In other words, "federal trademark law generally bans assignment of trademark licenses absent the licensor's consent because, in order to ensure that all products bearing its trademark of uniform quality, the identity of the licensee is crucially important to the licensor."[14]

In particular, the Lanham Trademark Act, codified in Chapter 22 of Title 15 of the United States Code (the "Lanham Act"), provides that a registrant of a mark registered in the Patent and Trademark Office is entitled to nationwide trademark protection.[15] The Lanham Act defines a trademark as "any word, name, symbol, or device, or any combination thereof . . . used by a person . . . to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown."[16] Moreover, the Lanham Act prevents the unauthorized use or transfer of a federally registered trademark. For example, it (a) authorizes a registrant to sue and obtain injunctive relief against the non-consensual use of trademark;[17] (b) provides that "any person who shall, without the consent of the registrant . . . use in commerce any reproduction . . . of a registered mark in connection with the sale . . . of any goods..." shall be liable in a civil action;[18] and (c) provides that "any person who . . . uses in commerce any . . . word . . . symbol . . . which . . . is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services or commercial activities by another person" shall be liable in a civil action.[19]

c. The Franchisor's Veto Rights Regarding Assumption or Assignment of the Franchise Agreement

The Debtor Cannot Assign its Franchise Agreement to a Third Party without the Franchisor's Consent

[12] *Id.* at 117; *In re Trump Entm't Resorts, Inc.,* 526 B.R. 116, 121 (Bankr. D. Del. 2015); *Miller v. Glenn Miller Prods., Inc.,* 454 F.3d 975, 988, 992–93 (9th Cir. 2006); *N.C.P. Mktg. Group, Inc. v. Billy Blanks (In re N.C.P. Mktg. Group, Inc.),* 337 B.R. 230, 235–37 (D. Nev. 2005).
[13] *Trump Entm't,* 526 B.R. at 124.
[14] *Id*.

[15] *The Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002); 15 U.S.C. § 1072, 1111.

[16] 15 U.S.C. § 1127.

[17] 15 U.S.C. § 1116.
[18] 15 U.S.C. § 1114.
[19] 15 U.S.C. § 1125.

As set forth above, the Bankruptcy Code allows a debtor to assume, or assume and assign, an executory contract if it cures all defaults under such contract and provides adequate assurance of future performance thereunder. A debtor is generally granted these rights notwithstanding contractual provisions which restrict the assignment of such agreement.[20]

Nevertheless, the Bankruptcy Code restricts a debtor's right to assign a contract to a third party if applicable law would bar its non-consensual assignment outside of bankruptcy. Specifically, Section 365(c)(1) of the Bankruptcy Code provides in relevant part:

> The trustee *may not assume or assign* any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if –
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> (1) (A) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor . . .; and
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> (2) such party does not consent to such assumption or assignment.[21]

As an initial matter, it should be noted that this section is implicated when applicable (non-bankruptcy) law prevents the non-consensual assignment of a contract. Thus, it is important first to determine whether "applicable law" might excuse the non-debtor party, *i.e.* the franchisor, from accepting performance under the contract in question from a third party. Several courts have concluded that "applicable law" for purposes of section 365(c)(1) includes federal trademark law governed by the Lanham Act.[22]

"Applicable law" under this section has also been held to include (i) the government's right to consent to the assignment of a government contract under the Anti-Assignment Act, 41 U.S.C. section 15,[23] (ii) the right of a municipality to use state law to prohibit the assignment of a contract,[24] (iii) federal patent law wherein non-exclusive patent licenses

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[20] 11 U.S.C. § 365(f)(1).
[21] 11 U.S.C. § 365(c)(1).
[22] *See In re The Travelot Co.*, 286 B.R. 447 (Bankr. S.D. Ga. 2002); *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005); *In re Wellington Vision, Inc.*, 364 B.R. 129 (Bankr. S.D. Fla. 2007).

[23] *In re West Elecs., Inc.*, 852 F.2d 79 (3rd Cir. 1988).

[24] *In re St. James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994), where the Eleventh Circuit adopted the hypothetical test (discussed *infra*) but concluded that the state law in question generally barring assignments without the consent of the municipality did not constitute "applicable law" for purposes of Section 365(c)(1).

are personal and assignable only with the consent of the licensor,[25] and (iv) copyright law prohibiting the assignment of software licenses without the consent of the owner of the copyright.[26]

Since a franchisor can prevent the unauthorized use of its trademarks or other intellectual property under applicable law, the restriction on assignment under section 365(c)(1) will apply to franchise agreements. Therefore, a debtor/franchisee will not be able to assign or otherwise transfer its franchise agreement to a third party without the franchisor's express consent.[27]

May the Franchisor Block the Debtor/Franchisee's Assumption (and use) of its Franchise Agreement, Even if there is No Intent to Assign it to a Third Party?

Section 365(c)(1) is clear that a contract may not be assigned if "applicable law" would bar its assignment to a third party outside of bankruptcy. However, there is disagreement among some circuit courts of appeal as to whether section 365(c) applies to the *assumption* of a contract even if the debtor has not yet decided to, or never will, assign the contract. Thus, reading the words "*may not assume or assign*" in the disjunctive (*i.e.*, the act of assumption is separate from the act of assignment), section 365(c) can be read to bar the assumption of a franchise agreement because applicable law bars the non-consensual assignment of the agreement. The dual interpretations of section 365(c) have resulted in the formation of two different approaches: the hypothetical test and the actual test.

Depending on which circuit the debtor/franchisee is in, the results can vary drastically. Thus, the particular circuit could be the key component to the franchisor's strategy regarding the debtor/franchisee's chapter 11 case. Given the importance of the

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[25] *In re Catapult Entm't, Inc*., 165 F.3d 747 (9th Cir. 1999).

[26] *In re Sunterra Corp.*, 361 F. 3d 257 (4th Cir. 2004).

[27] Franchisors may also argue that because the trademark and intellectual rights are personal, they are likewise not assignable. Similar to non-exclusive patents and copyrights, trademark licenses are personal and cannot be assigned without the licensor's consent. *See Verson Corp. v. Verson Int'l Group PLC*, No. 93 C 2996, 1994 WL 6867 at *5 (N.D.Ill. Jan. 10, 1994) (non-exclusive licensees of patents and trademarks are generally not permitted to assign their rights to third parties unless the license agreement permits assignment); *see also* 4 J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition*, § 25:33 (4th ed. 2001) (general rule is that licensed marks, as well as non-exclusive patents and copyrights, are personal and cannot be assigned unless the license permits assignment); *Dennison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403, 409 (5th Cir. 1962) (licensee acquires only right to a limited use of the mark; licensor retains control, right and title to the trademark); *Tap Publications, Inc. v. Chinese Yellow Pages (New York) Inc.*, 925 F. Supp. 212, 218 (S.D.N.Y. 1996)(license to use trademark is personal and not assignable without licensor's consent because licensor has a duty to control the quality of goods sold under its mark).

Bankruptcy Code provisions to a franchisor who wants to retain control over the approval of franchisees in its system, it is critical for the franchisor's counsel to understand the nuances of sections 365(c)(1) and 365(e)(2) and to evaluate their impact on the jurisdiction in which the debtor/franchisee's chapter 11 bankruptcy case will be heard.

- ***The Hypothetical Test: The Franchisor May Veto Assumption of the Franchise Agreement Irrespective of the Debtor's Intention to Assign***

Courts that apply the hypothetical test base their decisions on a plain reading of the literal language of Section 365(c)(1), and preclude a debtor from *assuming* an intellectual property license where the debtor is prohibited under intellectual property law from *assigning* the license agreement to a hypothetical third party, whether or not the debtor actually intends to assign the agreement to a third party following its assumption.[28]

Applying the hypothetical test, or the disjunctive test, the court will ask: If a debtor would be precluded from hypothetically assigning an agreement under applicable law, then it is also precluded from assuming such agreement in its bankruptcy case.

The principal support for the hypothetical test is a literal reading of the phrase the "trustee may not assume **or** assign" an executory contract.[29] The literal reading of this phrase prohibits the assumption of an executory contract (a franchise agreement) by a debtor/franchisee - even though the debtor/franchisee is not seeking to assign such contract - if applicable law (the Lanham Act) in a *hypothetical assignment* provides that the non-debtor party (the franchisor) to such contract did not have to accept performance from a third party. This scenario is hypothetical because the debtor/franchisee in this example is not seeking to assign (i.e. sell) the contract to anyone – but hypothetically could do so.

A case example of the hypothetical test is *Wellington Vision, Inc. v. Pearle Vision, Inc.*[30] In that case, Pearle Vision, Inc. ("Pearle Vision") sought relief from the automatic stay to terminate its franchise agreement with the debtor, arguing that the debtor could not assume the agreement because applicable law excused Pearle Vision from accepting an assignment of the agreement to a third party. The Bankruptcy Court granted Pearle Vision relief from the automatic stay, which allowed Pearle Vision to terminate the franchise agreement. On appeal, the District Court affirmed the Bankruptcy Court finding that pursuant to section 365(c)(1), the debtor/franchisee could neither assume nor assign the franchise agreement without the consent of Pearle Vision, because the franchisee had a

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[28] Section 365(c)(1) is written in the disjunctive: a debtor "may not assume or assign" a contract if non-bankruptcy law precludes its assignment without consent of the other party.

[29] 11 U.S.C.A. § 365(c)(1) (emphasis added).

[30] *In re Wellington Vision, Inc.*, 364 B.R. 129 (Bankr. S.D. Fla. 2007).

non-exclusive trademark license with Pearle Vision pursuant to the franchise agreement, and thus, the Lanham Act excused Pearle Vision from accepting performance from an entity other than the franchisee.[31] Accordingly, the District Court found that Pearle Vision was entitled to stay relief to terminate the franchise agreement.[32]

To date, the Third, Fourth, Ninth, and Eleventh Circuit Courts of Appeal have adopted the hypothetical test with respect to license agreements or other executory contracts.[33]

Specifically, in the case of *In re Catapult Entertainment, Inc.*, the debtor was formed to create an online gaming network for console video games and was party to two (2) license agreements relating to certain technologies including patents and patent applications. As part of its plan of reorganization, the debtor sought to assume the patent licenses over the licensor's objection. The Ninth Circuit held that, under the plain reading of Section 365(c)(1) of the Bankruptcy Code, the debtor was barred from assuming the patent licenses without the licensor's consent. The Ninth Circuit noted that federal patent law constitutes "applicable law" within the meaning of Section 365(c) and that nonexclusive patent licenses are "personal and assignable only with the consent of the licensor."[34] The Ninth Circuit went on to hold that the debtor was precluded from assuming the patent licenses, on the basis that applicable non-bankruptcy law excused the licensor from accepting performance from any hypothetical third party - even though the debtor did not intend to assign the contract to third party. The Ninth Circuit performed an analysis of the language of Section 365(c)(1), its plain meaning and legislative history, and concluded that if applicable non-bankruptcy law prohibited the non-consensual assignment of an executory contract, then a debtor would be prohibited from assuming such contract - even if the debtor did not intend to assign the contract to a third party. [35]

In addition, in the case of *In re West Electronics, Inc.*,[36] the debtor was a party to a contract with the United States government to provide missile launcher supply units to the Air Force. After the debtor filed for bankruptcy, the government moved for relief from the

[31] *Id*. at 137.

[32] *Id.* at 134.

[33] *In re Sunterra Corp.*, 361 F. 3d at 257; *In re Catapult Entm't, Inc.*, 165 F.3d at 747; *In re St. James Cable Partners, L.P.*, 27 F.3d at 534; *In re West Elecs., Inc.*, 852 F.2d at 79. *See also In re Wellington Vision, Inc.*, 364 B.R. 129 (Bankr. S.D. Fla. 2007); *In re N.C.P. Marketing Group, Inc.*, 337 B.R. at 230.

[34] *Id*. at 750, *citing Everex Systems v. Cadtrak Corp*. (*In re CFLC, Inc*.), 89 F. 3d 673, 680 (9th Cir. 1996).

[35] *Id*. at 747 to 754.

[36] *In re West Elecs., Inc.*, 852 F.2d 79 (3rd Cir. 1988).

automatic stay in order to terminate the contract. The Bankruptcy Court denied the government's motion. After the District Court affirmed, the Third Circuit reversed and held that the government should have been granted stay relief to terminate the contract. In so holding, the Third Circuit analyzed Section 365(c)(1) of the Bankruptcy Code and its legislative history, and concluded that if non-bankruptcy law provided that the debtor could not assign the contract without the government's consent, then the debtor could not assume the contract without the government's consent.[37]

Likewise, the Fourth Circuit adopted the hypothetical approach in the case of *In re Sunterra Corporation*,[38] wherein the court held that a debtor was precluded from assuming a computer software licensing agreement on the basis that applicable copyright law excused the other party to the contract from accepting performance from any hypothetical third party - even though the debtor did not intend to assign the contract to a third party. The Fourth Circuit performed an extensive analysis of the language of Section 365(c)(1), its plain meaning and legislative history, and concluded that if applicable non-bankruptcy law prohibited the non-consensual assignment of an executory contract, then a debtor would be prohibited from assuming such contract -- even if the debtor did not intend to assign the contract to a third party.[39]

These cases provide significant protection to a franchisor (or a licensor of intellectual property) that desires to retain complete control over the identity of its franchisees, including whether the franchisee should be permitted to continue to use the franchisor's intellectual property once it has become a debtor in a Chapter 11 case. If the franchise agreement is essential to the reorganization of the debtor, the franchisor in these circumstances essentially have veto rights over the chapter 11 case.[40]

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[37] *Id*. at 83 (citations omitted).

[38] *In re Sunterra Corporation*, 361 F. 3d 257 (4th Cir. 2004).

[39] *Id*. at 262-271.

[40] In fact, a licensor of intellectual property can prevent the debtor/licensee's assumption of the agreement in these jurisdictions – even if the licensor consented to the assignment of the agreement pre-petition. For example, in *Sunterra*, even though the licensee was permitted pursuant to the terms of the subject software license agreement to assign the license agreement to a successor in interest that acquires substantially all of the licensee's assets, the licensee was precluded from assuming the license agreement pursuant to Section 365(c)(1). The Fourth Circuit reasoned that the consent to assignment did not operate to render the license agreement assumable because the consent made no reference to assumption of the agreement under Section 365. *Sunterra Corp.*, 361 F. 3d at 270-271. Accordingly, in a case in the Fourth Circuit involving application of Section 365(c)(1), even where a license agreement is freely assignable by the licensee in accordance with its terms, the license agreement cannot be assumed by the debtor if the agreement does not include language that expressly authorizes the licensee to assume the agreement under Section 365.

On the other hand, the hypothetical test has been subject of criticism. The draconian reality of the hypothetical test is that even when the debtor indicates no interest in assigning the agreement, assumption is prohibited if assignment is prohibited. While those courts construe the literal language of the Bankruptcy Code, such decisions seemingly jeopardize a debtor's ability to successfully reorganize without the express consent of the franchisor or the owner of the intellectual property rights at issue.[41]

- ***The Actual Test: Assumption Prohibited Under Section 365(c)(1) only if there is an Actual Proposed Assignment***

The actual test provides that if the debtor has no intent to assign the executory contract to a third party, then it can be assumed so long as it meets the other traditional requirements of section 365 (*i.e.*, defaults are cured and adequate assurance of future performance is provided). Under this approach, the courts will make "a case-by-case inquiry into whether the non-debtor party . . . *actually* was being 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'"[42] These courts read the disjunctive "or" in section 365(c)(1) as the word "and".[43] The actual test requires that the debtor actually proposes an assignment before the courts will preclude an assumption in the first instance under in section 365(c)(1).

If the debtor does not intend to assign the contract at issue, then the court does not need to determine whether "applicable law" prevents the non-debtor/franchisor party from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession. Therefore, it is critical at the outset of any chapter 11 case to determine which of the two tests is followed by the applicable circuit.

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[41] For example, the Supreme Court stated in denying the petition for *certiorari* in *N.C.P. Marketing*: "The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under non-assignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to affect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to non-debtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the non-debtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the non-debtor obtains the power to reclaim - and resell at the prevailing, potentially higher market rate - the rights it sold to the debtor." 129 S.Ct. at 1577.

[42] *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997).

[43] *Id*.

The actual test has been adopted by only the First and Fifth Circuit Courts of Appeal.[44] However, a number of lower courts have applied the actual test outside of the hypothetical test circuits.[45]

Of course, the actual test is not without criticism. It may be argued that the actual test aligns Section 365(c) with sound bankruptcy policy only at the cost of departing from at least one interpretation of the plain text of the law.[46]

It is important to note that the First and Fifth Circuits adopted the actual test in the context of issues arising under section 365(e)(2) of the Bankruptcy Code as opposed to section 365(c)(1) of the Bankruptcy Code. While these two Bankruptcy Code sections are effectively corollaries of one another, they are in fact different and address different issues.[47] Section 365(e)(1) contains the *ipso facto* provision that essentially prohibits the termination or modification of an executory contract after the commencement of the case based on (i) the insolvency or financial condition of the debtor, (ii) the commencement of the bankruptcy, or (iii) the appointment of a trustee. Section 365(e)(2) contains the

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[44] *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006). The Fifth Circuit adopted the "actual test" for purposes of construing Code section 365(e)(2)(A)'s exception to the prohibition against enforcement of *ipso facto* clauses. *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 248–249 (5th Cir. 2006) (rejecting the hypothetical approach to Code section 365(c)(1) and holding that "*ipso facto*" clauses are saved and remain enforceable under Code section 365(c)(1) if the non-debtor party is excused from accepting performance from a trustee or assignee). Although the Section 365(e)(2) language at issue in Mirant differs in certain respects from the relevant language of Section 365(c)(1), the reasoning of the Fifth Circuit in *Mirant* suggests that the result would be the same under Section 365(c)(1).

[45] *In re Footstar, Inc.*, 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005) (citations omitted). Lower courts adopting the "actual test" include *In re Cajun Elec. Power Co-op, Inc.*, 230 B.R. 693 (Bankr. M.D. La. 1999); *In re Ontario Locomotive & Indus. Ry. Supplies (U.S.), Inc.*, 126 B.R. 146 (Bankr. W.D.N.Y. 1991); *In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990).

[46] Another variation of the actual test focuses on the use of the term "trustee" in section 365(c). In the case of *In re* Footstar, 323 B.R. 566 (Bankr. S.D.N.Y 2005), the court, unlike other courts that have addressed this issue, applied the plain meaning rule of statutory construction in reaching its conclusion that the "actual test" applies under Section 365(c)(1). The court based its conclusion on the finding that the term "trustee", when used in Section 365(c)(1), could not logically mean the "debtor in possession". *Id*. at 572. The court reasoned that because the Bankruptcy Code does not state that the words "'trustee' are to be construed to mean 'debtor' or 'debtor in possession,"' it makes sense to prevent the trustee from assuming or assigning a contract, but not the party that originally entered into the contract with the non-debtor. *Id*. Thus, "where the debtor in possession seeks to assume, [section] 365(c)(1) does not prohibit assumption of the contract by the debtor in possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract." *Id*. While the rationale is different, the *Footstar* line of cases seems to play out the same as the actual test so long as no trustee has been appointed.

[47] *See In re Mirant*, 440 F.3d at 247, fn. 16.

exceptions to the *ipso facto* provisions of 365(e)(1). Specifically, under section 365(e)(2), the *ipso facto* provisions will not prevent the termination or modification of an executory contract if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance *to the trustee or to an assignee* of such contract or lease ... and ... such party does not consent to such assumption or assignment."[48] Typically, section 365(e)(2) does not arise in the context of the assumption and/or assignment of a contract. Rather, it arises as a basis to seek relief from the automatic stay in order to terminate a contract upon the filing of a bankruptcy. The First and Fifth Circuits adopted the actual test in the context of section 365(e)(2). In fact, in *Mirant*, the Fifth Circuit stated that the cases supporting the hypothetical test under section 365(c)(1) should not be given any particular weight when considering section 365(e)(2), because "they are by no means parallel overall or identical in effect" and are "not sufficiently similar."[49]

Clearly, one of the principal bases for the adoption of the hypothetical test by the Third, Fourth, Ninth and Eleventh Circuits under section 365(c)(1) is the use of the disjunctive term "or" in the lead in phrase to section 365(c)(1) - "the trustee may not assume or assign . . ." However, section 365(e)(2) does not contain this parallel provision, because it does not address circumstances where assumption or rejection are prohibited. Moreover, section 365(e)(2) uses the term " to the trustee or to an assignee", while section 365(c)(1) uses the term "to an entity other than the debtor or debtor in possession." Prior to the 1984 amendments to the Bankruptcy Code, sections 365(c)(1) and 365(e)(2) read exactly the same in this regard. In 1984, Congress elected to modify section 365(c)(1) to replace "to the trustee or to an assignee" with "to an entity other than the debtor or debtor in possession." The Fifth Circuit suggests that Congress' decision to make this change in respect of section 365(c)(1) supports the use of the "actual test" for section 365(e)(2) principally because of the Fifth Circuit's analysis of the plain text of section 365(e)(2). Otherwise, Congress would not have made any changes to the language, or would have made the same change to both provisions. As a result, the logical progression of this analysis is that the change made by Congress to section 365(c)(1) would support the application of the "hypothetical test" to section 365(c)(1).

In addition to the plain text analysis used by the Fifth Circuit to support the use of the actual test, the Fifth Circuit analyzed the Anti-Assignment Act[50] at issue in *Mirant*, which was the "applicable law" relied upon in that case. Under the plain text of the Anti-Assignment Act, the Fifth Circuit concluded that the prohibition on assignment in such "applicable law" required an analysis of the particular facts of the transaction at issue,

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[48] 11 U.S.C.A. § 365(e)(2) (emphasis added).

[49] *Id.* at 247, fn. 16.

[50] 41 U.S.C. § 15.

because certain factual scenarios did not trigger the anti-assignment provisions contained therein. As a result, the Fifth Circuit concluded that the actual test was needed in order to determine whether the Anti-Assignment Act triggered the provisions of section 365(e)(2) in the first instance. An argument can be made, therefore, that the Fifth Circuit's conclusion in regard to the application of the "actual test" vs. the "hypothetical test" depends on which "applicable law" is at issue. As an example, the Lanham Act prohibits the assignment of a license or franchise in all situations without the consent of the licensor/franchisor. Thus, it is unclear whether the Fifth Circuit would apply the "actual test" or "hypothetical test" in connection with the Lanham Act.

As is plain from the above, several Circuit Courts have reviewed and analyzed the same two statutory provisions and have used the same analytical tools in doing so. However, these Courts have come to completely different conclusions concerning the application of such provisions. Based on the above split in the circuits, counsel need to be aware of the potential ramifications associated with these provisions. If you are in the Third, Fourth, Ninth or Eleventh Circuits, and there are executory contracts that consist of franchise agreements, or any contract the assignment of which requires the consent under applicable law of the non-debtor/franchisor party to the proposed assignee, then the franchisee will not be able to assume that contract without the consent of the non-debtor/franchisor third party. As a result, the franchisor will have great bargaining strength in those situations to reach an agreement with the franchisee so that the franchisee has the franchisor's support before the franchisee files for bankruptcy. Otherwise, the outcome of the bankruptcy will be dictated by the franchisor and not the franchisee.

IV. Avoiding and Alternatives to Bankruptcy

a. Consensual Restructuring

It may be possible that the franchisee can negotiate a restructuring of its debts outside of any court proceeding, including with key constituencies like suppliers, landlord, and franchisor. A negotiated arrangement that allows the franchisee to reduce its debt load without court intervention is an efficient option if all parties are able to agree on a compromise. The arrangement can address any number of issues, including those beyond financial. The key is to address the core issues that have created the issues. It may be training, personnel, failure to deliver on brand promise, etc.

b. Receiverships in State Court

Receiverships are similar to bankruptcy proceedings in that they are a court-supervised (in most states) insolvency proceeding. Unlike a bankruptcy, they are typically commenced by the franchisee's lenders rather than the franchisee, or sometimes, by agreement of both. After a request to a state court, usually in the form of a complaint and motion, a receiver is appointed to oversee the franchisee's assets (either with or without consent of the franchisee). The receiver is typically a turnaround professional and must be a neutral party. However, unlike in bankruptcy, the receiver can be selected by the creditors requesting the appointment. Thus, a party with specific experience in the industry and in business restructuring can be selected.

Receiverships are typically used to liquidate the franchisee's assets, but a receiver may operate the business in some instances before selling the business as a going concern. They provide an option to replace an operator who may not be acting in the best interest of the business or who has engaged in self-serving, wasteful, or fraudulent practices. A receivership is usually less expensive and more flexible than a bankruptcy proceeding. It does not, however, provide an effective platform for the franchisee to restructure the business or its debts.

V. Practical Implications for Franchisors

Formal legal analysis of bankruptcy and potential alternative structuring options is simply one piece of the equation for franchisors. Equal consideration must be given to the practical implications of franchisee workouts across the full spectrum of options. Attached as an exhibit is a resource that franchisors may wish to use with their internal teams in an effort to educate them on both the legal and practical nuances of franchisee workouts, including several franchisor support best practices to consider.