Published on *The National Law Review* https://natlawreview.com

What to do When Your Franchisee Files for Bankruptcy

Article By:

Joseph H. Lemkin

With the economic downturn caused by COVID-19, many expected a tidal wave of commercial bankruptcy filings. After an initial spike of retail bankruptcy cases at the outset of the pandemic, the onslaught of bankruptcy has not yet materialized. Whether due to PPP loans, other available credit, modification and forbearance agreements, or government moratoriums on foreclosure and eviction proceedings, many businesses have been able to temporarily avoid debt obligations without the need to file for bankruptcy protection. As moratoriums terminate and debt obligations become due, franchisors would be mindful to prepare for an uptick in franchisee bankruptcy filings.

Bankruptcy cases are filed for two primary purposes. Most franchisees wish to use the bankruptcy process to reorganize their financial affairs and remain in business under chapter 11 of the Bankruptcy Code. Other franchisees file for bankruptcy protection to liquidate assets through an orderly process whereby assets are marshaled to make distributions to creditors. In either scenario, without preparation and active participation in a bankruptcy case, a franchisor risks having its franchise agreement transferred to an unqualified operator or retained by the debtor-franchisee under unacceptable terms.

Franchise Agreement Becomes Property of Bankruptcy Estate

Upon the filing of a bankruptcy case, a franchise agreement becomes property of the debtor/franchisee's bankruptcy estate. This means the franchisee's rights in the franchise agreement are protected by the Automatic Stay, an injunction imposed by Section 362(a) of the Bankruptcy Code. Unless relief is obtained from the Bankruptcy Court, the Automatic Stay prevents any action to terminate or otherwise impact the franchisee's rights in the Franchise Agreement, without permission from the Bankruptcy Court. Even though a franchise agreement may include provisions that purport to default and terminate a franchisee's interests based upon a bankruptcy filing, such "ipso facto" clauses are not valid in bankruptcy cases. Once the franchise agreement is part of the bankruptcy, subject to curing monetary and other defaults, the debtor/franchisee will have the opportunity to assume or reject the franchise agreement, notwithstanding such ipso facto clauses. However, there are steps that a franchisor can take to avoid its franchise agreement from being assumed and/or assigned in its franchisee's bankruptcy case.

Pre-Bankruptcy Termination

To avoid a franchise agreement from becoming tied up in a bankruptcy proceeding, a franchisor's best option is to unambiguously terminate the agreement prior to the bankruptcy filing. The importance of unambiguous termination language has been made clear by several bankruptcy courts. The importance of this issue was crystallized in *In RMH Franchise Holdings, Inc. (RMH)*, 590 B.R. 655, 661 (Bankr. Del. 2018), which involved one of the largest franchisees of Applebee's restaurants. RMH defaulted under its franchise agreement and owed Applebee's approximately $12 million at the time of the bankruptcy filing. If the Applebee's contracts had been terminated pre-bankruptcy, they would not have been of RMH's bankruptcy estate and could not be assumed and/or assigned by RMH.

Before the bankruptcy filing, Applebee's notified RMH that the agreements would terminate on the 91st day if its defaults remained uncured. The cure deadline was extended several times, and Applebee's even agreed to forbear from enforcing its rights through a date certain. On that date, RMH filed its bankruptcy case. The Bankruptcy Court addressed the issue of whether the franchise agreements were terminated pre-bankruptcy, and hence not property of the bankruptcy estate. The Court ruled that through the cure extension letters, Applebee's did not clearly and unambiguously terminate the franchise agreements, as required under state law. This case reveals the critical importance of providing valid unambiguous termination notices before a bankruptcy is filed. Otherwise, the franchise agreement will be subject to assumption and assignment in a franchisee bankruptcy case.

Notably, even when termination notices are clear, their effectiveness may be subject to other state court rights which holds termination in abeyance. For example, in *Krystal Cadillac Oldsmobile GMC Truck,*142 F.3d. 631, 636 (3d. Cir. 1998), the Third Circuit Court of Appeals held that a franchise agreement termination was not effective as of the bankruptcy case filing date, because the termination notice remained subject to an undecided appeal pending before the state Vehicle Board. Because state law provided that termination was not effective during the pendency of the appeal, the franchise agreement was held to be part of the bankruptcy case.

Franchisor Can Object to Assignment of Franchise Agreements

If a franchise agreement is not terminated pre-bankruptcy, a franchisee's right to assume and assign the agreement is very broad. Notwithstanding, franchisors can block such assignments under certain circumstances. Specifically, section 365(c)(1) of the Bankruptcy Code requires Courts to determine whether a contract is one where under applicable law, a franchisor cannot be compelled to accept performance from an assignee.

For example, it is well established that personal service contracts fall within the ambit of 365(c)(1)'s limitation on assignment to third parties. *In re Taylor*, 913 F.2d. 102, 106 (3d Cir. 1990). Courts in New Jersey have ruled that certain franchise agreements call for the personal services of the franchisee as the owner operator, and in such circumstances, courts uphold the Franchisor's expectation to look to the designated owner-operator as the only acceptable performing party. In the context of a bankruptcy case, the court will look to apply governing state law to determine whether the franchise agreement is truly a personal service contract. A noted in the *Taylor* case, such a determination will depend upon the nature of the contract, the circumstances of the case and the intent of the parties to the contract. Some of the circumstances considered are the extent of the franchisee's ownership interest in the franchise, the extent to which the nature of the dealership permitted personal service of the franchisee, the multi-franchise character of the operation, the number of employees in the dealership operation, and other factors.

Another opportunity for a franchisor to object to the assignment of its franchise agreement contracts under section 365(c)(1) of the Bankruptcy Code, is in the context of trademark licenses. Under federal trademark law, trademark licenses are not assignable in the absence of express authorization from the licensor. *Miller v. Glen Miller Prods., Inc.*, 454 F.3d. 975, 988. 992-993 (9th Cir. 2006). Accordingly, since applicable law prevents assignments of trademark licenses outside of bankruptcy, such agreements cannot be assigned in a bankruptcy proceeding. Indeed, certain courts have extended the application of this rule to prevent assumption of the trademark license by the debtor itself. In *In re Trump Entertainment Resorts, Inc*, the Delaware bankruptcy court determined that because the trademark agreement was unassignable pursuant to non-bankruptcy law, under a “Hypothetical Test” the Debtor could not even assume trademark license, even where the debtor had no intention of assigning the license to a third-party. 526 B.R. 116, 118 (Bankr. D. Del. 2015).

Whether it be personal service contracts, trademark licenses or other contracts deemed non-assignable outside of bankruptcy, Franchisors should be vigilant in monitoring franchisees who may seek to assign such contracts despite the restrictions of section 365(c)(1) of the Bankruptcy Code.

Adequate Assurance of Performance

Even where a franchise agreement has not been terminated pre-bankruptcy and is not subject to the anti-assignment provisions of section 365(c)(1), a franchisor may still object to assumption and/or assignment of its franchise agreement, where the franchisee/debtor has not provided “adequate assurance” of future performance. The Debtor must be able to establish that it or the proposed assignee can promptly cure outstanding defaults and prospectively perform in accordance with the precise terms and conditions of the Franchise Agreement. An assignee must be able to meet financial conditions and operational standards set forth in the agreement. Again, a franchisor must be vigilant in monitoring the bankruptcy case and make sure that procedures are set forth to allow for examination of the proposed assignee’s to perform in accordance with the precise terms of the Franchise Agreement.

National Law Review, Volume XII, Number 26