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BASICS OF FRANCHISEE BANKRUPTCIES

Jason B. Binford
Gardere Wynne Sewell, LLP
Dallas, Texas

James S. Rankin, Jr.
Parker, Hudson, Rainer & Dobbs LLP
Atlanta, Georgia

and

Robert F. Salkowski
Zarco, Einhorn, Salkowski & Brito, P.A.
Miami, Florida

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I. INTRODUCTION

Business failure is an inevitable part of any free market economy. All franchisors will encounter situations in which their franchisees are in financial distress, which can range from temporary and curable declines in revenue to the abrupt failure to satisfy payroll obligations and shut down of multiple locations. Often, franchisees seek relief under the federal Bankruptcy Code, and when they do, franchisors find themselves in a complex and often unfamiliar arena. This paper will identify and address certain issues and areas of bankruptcy law that frequently arise in franchisee bankruptcies.

The paper first discusses pre-bankruptcy issues to consider when a franchisee exhibits the first signs of material financial distress and the costs, benefits and types of Chapter 11 bankruptcy cases. It provides guidance to franchisors regarding the automatic stay that is imposed immediately upon a bankruptcy filing by a franchisee, including the scope of the stay and how to obtain relief from the stay. Next, it discusses assumption, assignment, and rejection of leases and franchise agreements. One of the most powerful tools provided to debtors in bankruptcy is the ability to assume, assign, or reject franchise agreements and other executory contracts. All franchisors should understand the basic deadlines and rules that govern executory contracts in bankruptcy cases, as well as the legal effect of assumption or rejection of contracts. The paper also addresses remedies for post-petition infringement, an overview of section 363 asset sales, and the law governing confirmation of Chapter 11 plans of reorganization.

II. PRE-BANKRUPTCY ISSUES

A. Bankruptcy Filing vs. Workout – is Chapter 11 Really the Solution?

The on-going viability of a franchisee’s business may be threatened, or at the very least, severely disrupted, in the face of an immediate termination of its franchise agreement, a foreclosure sale by its lender, acceleration of a secured loan, a threatened receivership, or an IRS levy. In those instances, a reorganization by the franchisee under Chapter 11 of the Bankruptcy Code may be its last option, especially when there are multiple creditors who are all going after the same limited financial resources.

Even though a Chapter 11 filing offers a debtor a temporary reprise, or stay, against the issues that prompted the filing, bankruptcy does have its drawbacks. These include excessive costs and expenses, the length of bankruptcy case, difficulty getting a plan confirmed, potential of conversion to a Chapter 7 liquidation, and the significant time consumed by issues surrounding a bankruptcy. And, from the perspective of a franchisor, a franchisee’s bankruptcy filing impedes its ability to enforce its rights under the franchise agreement, including its right to reject an assignment, without the approval or consent of the bankruptcy court.

Assuming the existence of a working relationship between the franchisor and franchisee, it may be in the parties’ best interests to try and work things out through negotiations and the formalization of those negotiations in either a settlement or workout agreement. A franchisee may agree, for example, to a timeframe to cure certain defaults, whether operational or financial, in turn for the franchisor agreeing to forebear on collecting the debt, from issuing a notice of termination, or from enforcing an available remedy. Whether this approach makes
sense depends on a variety of factors, including the number of creditors and their potentially disparate interests.¹

B. Pre-Negotiated Bankruptcy Cases

Bankruptcy is often a lengthy, time-consuming, and expensive process. Generally, a Chapter 11 debtor’s plan process begins with the filing of a Chapter 11 petition, following which the debtor negotiates with its creditors, seeks court approval of a disclosure statement, and finally, solicits votes on its plan.² Under a “normal” Chapter 11 filing, a debtor is given exclusivity within the first 120 days from the filing of the case to file its plan of reorganization.³ If the debtor files a plan of reorganization within this first 120 days, no other party of interest may file a separate plan of reorganization within the first 180 days from the date of the bankruptcy filing, allowing the debtor an opportunity to obtain approval of the proposed plan of reorganization from its creditors.⁴ These time periods may be extended by the bankruptcy court.⁵ Thus, assuming a debtor hits all of these timelines and no extensions are granted, a bankruptcy could drag on for at least 180 days before a creditor or other party is first able to file its proposed plan of reorganization.

Unlike a typical Chapter 11 case, a pre-packaged Chapter 11 bankruptcy is one that is negotiated and accepted by the parties prior to the filing, and then approved and confirmed by the court in a subsequently filed Chapter 11 case.⁶ Under a pre-packaged bankruptcy, a debtor and its major creditors negotiate the form of reorganization and the plan prior to the bankruptcy being filed. In negotiating the plan of reorganization before the filing of a bankruptcy, a

¹ For a detailed analysis of a structured workout, and other options beyond bankruptcy, including assignments for the benefit of creditors (ABC), see Jason B. Binford, Robert F. Salkowski, and Andra Terrell, Structured Workouts: Franchisor Strategies For Dealing With The Financially-Challenged Franchisee, ABA, 38th Annual Forum on Franchising, W-20 (2015).


³ “Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter.” 11 U.S.C. § 1121(b).

⁴ Any party in interest, including the debtor, the trustee, or creditors’ committee may file a plan if the debtor has not filed a plan that has been accepted, before 180 days after the date of the order for relief under this chapter, by each class of claims or interests that is impaired under the plan. 11 U.S.C. § 1121(c)(3).

⁵ “[O]n request of a party in interest made within the respective periods specified in subsections (b) and (c) of this section and after notice and a hearing, the court may for cause reduce or increase the 120-day period or the 180-day period referred to in this section.” 11 U.S.C. § 1121(d).

⁶ See generally, 5 NORTON BANKR. L. & PRAC. 3d § 97:1 (2017); see also U.S. Bankruptcy Court, Southern District of New York, Prepackaged Chapter 11 Guidelines, § II (“For purposes of these guidelines, a ‘prepackaged Chapter 11 case’ is one in which the Debtor, substantially contemporaneously with the filing of its Chapter 11 petition, files a Confirmation Hearing Scheduling Motion For Prepackaged Plan . . . plan, disclosure statement . . . and voting certification.”).
prepackaged bankruptcy is typically confirmed quicker, with less administrative expenses and disruption to the debtor’s business.8

C. Pre-petition Termination of the Franchise Agreement – Was it Truly Terminated?

The commencement of a bankruptcy case by a franchisee under the Bankruptcy Code creates an estate that is generally comprised of all legal or equitable interests of the debtor in property as of the commencement of the case.9 A “franchisee’s contractual rights in a franchise agreement are generally considered property of the estate, except where said agreements have been effectively terminated prior to a debtor’s filing.”10 And, as more fully developed later in this paper, “[a]ny right created in the estate by a franchise agreement is subject to the automatic stay provisions of §362 of the Bankruptcy Code” and “franchise rights which become part of the estate may be viable executory contracts capable of assumption” under the Code.11 The critical question thus becomes whether the franchise agreement was terminated pre-petition, as “the filing in bankruptcy does not revive the franchise relationship.”12

Where a franchisor has terminated a franchise agreement for cause, and the termination process is complete, with no right to cure pre-petition, the franchisee debtor does not have a property interest in the franchise agreement on the bankruptcy filing date and there is no executory contract to assume.13

Further, the automatic stay under the Bankruptcy Code does not toll the mere running of time under a contract and does not prevent the automatic termination of a contract where nothing more is to be done to effectuate the termination.14 Thus, the fact that a notice of termination provides for the automatic termination of a franchise agreement at some date after the filing of the bankruptcy does not affect the propriety of the termination itself. Conversely,

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7 One of the fastest reported prepackaged bankruptcy filings is In re Blue Bird Body Corp., Case No. 06-50026 (Bankr. D. Nev., Jan 27, 2006), in which the confirmation of the debtor’s plan of reorganization was confirmed one day after the bankruptcy was filed.

8 See generally, 9A West’s Legal Forms, DEBTOR & CREDITOR BANKRUPTCY § 14:45 (5th ed. 2017).


11 In re Motorcycle Excellence Group, Inc., 365 B.R. 370, 377–78 (Bankr. E.D.N.Y. 2006) (internal citation omitted); In re Tornado Pizza, LLC, 431 B.R. 503, 510 (Bankr. D. Kan. 2010) (“When… a debtor’s business is operated pursuant to a franchise, assumption of the franchise agreement and continued operation of the business pursuant to a Chapter 11 plan is generally an important goal of the franchisee’s bankruptcy.”).


13 In re Tornado Pizza, LLC, 431 B.R. 503 (Bankr. D. Kan. 2010); In re 717 Grand Street Corp., 259 B.R. 1, (Bankr. E.D.N.Y. 2000) (holding that franchise agreements not property of estate where notices of termination were received by franchisee prior to filing); In re Gainesville P-H Props., Inc., 77 B.R. 285, 295 (Bankr. M.D. Fla. 1987) (determining that, when the termination process has been completed and been effective prior to the date of the filing of the bankruptcy petition, there is nothing left to become part of the estate); In re AGI Software, Inc., 199 B.R. 850, 860 (Bankr. D.N.J. 1995) (“Thus, because the License Agreement was effectively terminated pre-petition, there was no agreement for the Trustee to assume or reject pursuant to § 365 of the Bankruptcy Code.”).

where the notice of termination does not become effective until after the bankruptcy filing, and the franchisee has the opportunity to cure, or an affirmative act of the franchisor is required to effectuate the termination, the notice of termination does not terminate the franchise agreement, which becomes property of the bankruptcy estate.  

D. Franchise Agreement Terms

1. Non-Enforceability of *Ipso Facto* Clauses

Franchise agreements routinely include a provision that provides for the immediate termination upon a franchisee’s bankruptcy filing. A typical provision might read:

Franchisee will be in default of this Agreement, and all rights granted in this Agreement will immediately and automatically terminate and revert to Franchisor without notice to Franchisee, if: Franchisee is adjudicated as bankrupt or insolvent; all or a substantial part of the assets thereof are assigned to or for the benefit of any creditor; a petition in bankruptcy is filed by or against Franchisee or the franchised business and is not immediately contested and/or dismissed within sixty days from filing.

These and similar provisions are known as “*ipso facto*” clauses. *Ipso facto* clauses are contractual provisions which expressly state that upon a party’s bankruptcy filing, the other party to the contract may accelerate an obligation, may declare the contract in default, or may recognize the contract as being terminated immediately upon the bankruptcy filing if the contract so provides.  

*Ipso facto clauses*, and similar contract clauses that attempt to modify the rights of a debtor-party due to the filing of a bankruptcy petition—are, as a general matter, unenforceable under Bankruptcy Code §§ 541(c) and 365(e)(1). “This is because the whole purpose of filing

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15 See generally Moody v. Amoco Oil Co., 734 F.2d 1200, 1212 (7th Cir. 1984); In re Masterworks, Inc., 100 B.R. 149, 151 (Bankr. D. Conn. 1989) (determining that a franchise agreement would be deemed property of estate, where debtor’s right to cure under had not elapsed when the petition was filed, and the franchise agreement was therefore still executory).


17 11 U.S.C. § 541 (c)(1) provides: “Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate … notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law—(A) that restricts or conditions transfer of such interest by the debtor; or (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.” 11 U.S.C. § 365 (e)(1) provides: “Notwithstanding a provision in an executory contract…an executory contract … of the debtor may not be terminated or modified, and any right or obligation under such contract… may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract … that is conditioned on—(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.”
for bankruptcy is to provide the debtor with a ‘fresh start,’ and enforcement of ipso facto clauses would punish debtors by negating this central purpose...."

2. Attempts by the Franchisor to Otherwise Protect Against Bankruptcy Losses

a. Letter of Credit to Secure an Otherwise Unsecured Claim

A “letter of credit” generally refers to those arrangements whereby a bank, acting at the request and on the instructions of its customer, is to make payments to a third party on behalf of the customer provided that the terms and conditions of the letter of credit are satisfied by the benefiting third party.\(^1\) As a tool to protect itself from future financial losses, a franchisor may require that a letter of credit be issued by a bank on behalf of the franchisee, allowing the letter of credit to be drawn upon in the event of a default.

A bankruptcy trustee may avoid any transfer of an interest of a debtor in property to or for the benefit of a creditor, made while the debtor was insolvent, on or within 90 days before the date of the filing of the petition, or between 90 days and one year before the date of the filing of the petition if such creditor at the time of such transfer was to an insider.\(^2\) Letters of credit, however, are not generally considered property of a debtor’s estate because “when the issuer honors a proper draft under a letter of credit, it does so from its own assets and not from the assets of [the debtor] who caused the letter of credit to be issued.”\(^3\) Thus, because a letter of credit generally is not an asset of a franchisee’s bankruptcy estate, a franchisor may draw upon that letter of credit after its franchisee files for bankruptcy.\(^4\)

b. Language in Franchise Agreement Bolstering a Personal Services Contract Argument

A debtor or trustee in bankruptcy may, pursuant to section 365(a) of the Bankruptcy Code, assume or reject executory contracts and unexpired leases. Generally however, an executory contract may not be assumed or assigned if applicable law excuses the non-debtor party to such contract or lease from accepting performance from, or rendering performance to, an entity other than the debtor or the debtor in possession, where such non-debtor party does not consent to the assumption or assignment.\(^5\) Personal services contracts are often cited as an example of an executory contract that is considered an exception to assignability. Thus, in

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\(^1\) In re W.R. Grace & Co., 475 B.R. 34, 152–53 (D. Del. 2012); In re Warner, 480 B.R. 641, 655 (Bankr. N.D. W.Va. 2012) (“Congress sought to invalidate restrictions on the transfer of property of the debtor, in order that all the interests of the debtor in property will become property of the estate.”).


\(^3\) Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 589 (5th Cir.1987).


\(^5\) 50 AM. JUR. 2D LETTERS OF CREDIT § 2 (2017).
order to control the assumption or assignability of a franchise agreement in the event of a
default, franchisors sometimes include language in a franchise agreement that supports the
personal services nature of the contract.

To be considered a personal service contract, there must be a special relationship
between the parties, or the party to perform must possess special knowledge or a unique skill
such that no performance save that of the contracting party could meet the obligations of the
contract. "For example, a contract to paint a picture; a contract between an author and his
publisher; an agreement to sing; an agreement to render service as a physician. All fall within
the purview of personal service contracts."25

Whether or not a contract is a personal services contract is a question of fact to be
decided under state law after all facts and circumstances are considered.26 In most states, the
test is whether the contract involves a personal relation of confidence between the parties or
relies on the character and personal ability of a party.27 In that regard, a franchisor would be
well-advised to include terms in its franchise agreements describing the personal nature of the
franchise relationship, sufficient to allow a reviewing court to understand and consider "the
nature and subject matter of the contract [and] the circumstances of the case placed in
juxtaposition with the intention of the parties."28 Still, this argument may be difficult to assert, as
a majority of courts have found that the essential criteria which earmark personal service
contracts, including the existence of a special trust and confidence or special relationship, are
absent in the typical relationship between a franchisor and franchisee.29

III. THE AUTOMATIC STAY

A. Introduction to the Automatic Stay

The automatic stay imposed by section 362 of the Bankruptcy Code is one of the most
fundamental and most important aspects of bankruptcy law. The automatic stay prevents the
commencement or continuation of actions against the debtor, or against any of the debtor's


26 In re Headquarters Dodge, Inc., 13 F.3d 674, 683 (3rd Cir.1993).

27 In re Health Plan of Redwoods, 286 B.R. 407, 409 (Bankr. N.D. Cal. 2002).


29 See, e.g., In re Bronx-Westchester Corp., 20 B.R. 139 (Bankr. S.D.N.Y. 1982) (finding that a distributorship or
franchise agreement which does not depend upon a special relationship between the parties is not a personal
services contract); In re Coors of N. Miss., Inc., 27 B.R. 918 (Bankr. N.D. Miss. 1983) (determining that,
notwithstanding distribution agreement’s prohibition against assignment, bankruptcy court has power to negate such
B.R. 661 (Bankr. W.D. Tenn. 1980); Rossetti v. City of New Britain, 163 Conn. 283, 291, 303 A.2d 714, 719 (1972); In
re Varisco, 16 B.R. 634 (Bankr. M.D. Fla. 1981) (concluding that a franchise agreement to market and distribute
baked goods was not a personal service contract and therefore was assignable); In re Sunrise Restaurants, Inc., 135
B.R. 149 (Bankr. M.D. Fla. 1991) (holding that a Burger King restaurant franchise was not a personal service contract
and therefore was assignable); In re Tom Stimus Chrysler-Plymouth, Inc. (Bankr. M.D. Fla. 1991) 134 B.R. 676, 679
(concluding that an automobile dealer franchise agreement not a personal services contract); cf. Burger King Corp. v.
Agad (S.D. Fla. 1995) 911 F.Supp. 1499, 150 ("However, under Florida law, franchise agreements are considered
personal services contracts.").
property, on account of any claim that arose or existed on or at any time prior to the date of the bankruptcy filing.\textsuperscript{30} It is designed to prevent a “race to the courthouse,” promote equality of treatment of creditors with similar claims, and give the debtor breathing room to attempt to reorganize its business, or in a Chapter 7 case, give the trustee time to liquidate and distribute the available assets in an organized manner. Importantly, the automatic stay is automatic; it comes into effect immediately upon the filing of a bankruptcy petition by or against a debtor, and no court order is required. The automatic stay is like a temporary restraining order that prevents prosecution of claims against the debtor or its assets, except that it goes into effect automatically. While there are limits to the automatic stay that will be discussed below, its scope of extremely broad, and if a creditor wants to take an action to improve its position after a bankruptcy case is filed, that action likely is prohibited by the automatic stay unless and until the creditor obtains relief from the stay.

\textbf{B. Property of the Estate}

In addition to preventing the commencement or continuation of legal proceedings, the automatic stay prevents “the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title” and “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.”\textsuperscript{31} Thus, in considering what actions may not be taken after the filing of a bankruptcy petition, a creditor needs to consider what constitutes “property of the estate.”

\textbf{1. Franchise Agreement as Property of the Estate and Pre-Petition Termination}

Property of the estate is defined broadly as “all legal or equitable interests of the debtor in property as of the commencement of the case.”\textsuperscript{32} Property of the estate includes all kinds of property interests, whether tangible, intangible, contingent or non-contingent. According to legislative history, property of the estate “includes all kinds of property, . . . causes of action, . . . ‘title’ to property, which is an interest, just as are a possessor interest, or lease-hold interest, for example . . ., and the right to a refund is property of the estate.”\textsuperscript{33}

Upon the filing of a bankruptcy petition, a debtor's rights under contracts, such as a franchise agreement, constitute “property of the estate.”\textsuperscript{34} However, whether a debtor has any rights under a contract as of the date of filing of a bankruptcy petition is determined by state law, and not by bankruptcy law.\textsuperscript{35} There is nothing in the Bankruptcy Code that revives or reinstates

\textsuperscript{30} 11 U.S.C. § 362(a).

\textsuperscript{31} 11 U.S.C. §§ 362(a)(2) & (3).

\textsuperscript{32} 11 U.S.C. § 541(a)(1).


\textsuperscript{34} Motorcycle Excellence Group, Inc. v. BMW of N. Am., LLC, 365 B.R. 370, 377 (Bankr. E.D.N.Y. 2006) (“[A] franchisee's contractual rights in a Franchise Agreement are generally considered property of the estate, except where said agreements have been effectively terminated prior to a debtor's filing.”); see also In re Cardinal Indus., Inc., 116 B.R. 964, 971 (Bankr. S.D. Ohio 1990); In re Varisco, 16 B.R. 634, 637 (Bankr. M.D. Fla. 1981).

contractual rights that have already been lost prior to the filing of a bankruptcy petition. Rather, “to the extent such an interest [in property] is limited in the hands of the debtor, it is equally limited in the hands of the estate.”36 If a debtor has no rights under a contract under applicable state law at the time that the bankruptcy petition is filed, then there is no “property of the estate” under section 541 of the Bankruptcy Code to which the automatic stay would apply.37

If a contract like a franchise agreement has been validly and completely terminated prior to the filing of a bankruptcy petition, then the contract does not become property of the estate.38 However, whether a contract has been “finally” terminated can be subject to dispute. First, the parties must determine exactly when the bankruptcy petition was filed, because any action by the franchisor to terminate that occurred after the filing will not be effective. Today, bankruptcy courts accept the filing of a bankruptcy petition electronically, at any time of the day or night, and in certain circumstances, it will be important to determine the exact minute that the petition was filed in order to determine the rights of the parties as of that time. If a franchise agreement has a notice and cure provision, or a grace period for performance, and the cure or grace period has not expired as of the time of filing of the petition, then the debtor’s rights under the agreement will become property of the estate, and the automatic stay will apply. However, if the franchisor has taken every act required to terminate and the termination has occurred prior to the moment that the petition is filed, then the debtor will have no rights under the agreement in its bankruptcy case.39

Similarly, if a franchise agreement is set to expire by its terms, simply by the passage of time, even after the petition date, there is nothing in the Bankruptcy Code that extends the term of the agreement or precludes expiration by the passage of time (as distinguished from an act of the franchisor). As a result, if a franchise agreement has expired prior to a bankruptcy filing or expires after the petition date, the debtor may have no surviving rights under the agreement that would constitute property of the estate.40

2. Exercise of Dominion or Control Over Premises or Personal Property of the Debtor

Even if a franchise agreement has been validly terminated or expired, there may be actions that a franchisor wants to take that are barred by the automatic stay. In some instances, a landlord may approach a franchisor and try to make arrangements to prevent a location from “going dark” as a result of the financial distress of a franchisee. However, a debtor’s rights under a real estate lease also constitute property of the estate, and a landlord or franchisor who attempts to interfere with a debtor’s right to possess and control its premises violates the automatic stay. Similarly, a debtor’s ownership or even mere possession of fixtures, furniture


37 In re Tut’s Pyramid, Inc., 178 B.R. 867, 871 (Bankr. M.D. Fla. 1995) (pointing out that “[n]othing contained in the Bankruptcy Code provides the Debtor with any rights greater than those which it had acquired under its contract”); In re Vote, 276 F.3d 1024 (8th Cir. 2002); In re Universal Seismic Assocs., Inc., 288 F.3d 205 (5th Cir. 2002); Moody v. Amoco Oil Co., 734 F.2d 1200 (7th Cir. 1984).


40 In re Atkins, 237 B.R. 816, 818 (Bankr. M.D. Fla. 1999) (“Nothing remains for the debtor to assume once a lease has expired.”).
and equipment is an interest in property that is subject to the automatic stay. Therefore, regardless of whether a debtor has rights under a franchise agreement, as a practical matter, “taking over” a location at which a franchisee operates (or operated) usually will require the franchisor or landlord to obtain relief from the automatic stay.

C. Scope of the Automatic Stay and Exceptions to Stay

The automatic stay:

operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy] case . . . , or to recover a claim against the debtor that arose before the commencement of the case . . . ;
(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case . . . ;
(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
(4) any act to create, perfect, or enforce any lien against property of the estate;
(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the [bankruptcy] case . . . ;
(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case . . . ;
(7) the setoff of any debt owing to the debtor that arose before the commencement of the [bankruptcy] case . . . against any claim against the debtor; and
(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under [the Bankruptcy Code].

Taken together with the broad definition of “property of the estate,” this statute means that almost anything that a franchisor or other creditor would want to do will be subject to the automatic stay. There are exceptions, however, to the automatic stay that may apply in particular circumstances. The automatic stay does not prevent the commencement or continuation of criminal actions or proceedings, and it does not prevent the withholding, suspension or restriction of a professional or occupational license under state law. The automatic stay does not apply to the “interception of a tax refund” or to assessments, audits,

notices and demands relating to tax liabilities. In addition, the automatic stay will not preclude “any act by a lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property.”

With respect to acts that affect property of the estate, the automatic stay continues until the property is no longer property of the estate. With respect to other actions, the stay continues until the earliest of (a) the time the case is closed, (b) the time the case is dismissed, or (c) the time that a discharge is granted or denied.

D. Relief From the Automatic Stay

1. For Cause, Including Lack of Adequate Protection

If the automatic stay applies, then a franchisor or other creditor may file a motion with the bankruptcy court seeking relief from the automatic stay. Section 362(d) of the Bankruptcy Code describes the grounds on which a bankruptcy court may grant relief from the automatic stay. Under section 362(d)(1), the court may grant relief from the stay “for cause, including the lack of adequate protection of an interest in property of such party in interest.” Though a creature of statute, adequate protection is rooted in the Fifth Amendment’s prohibition against the taking of private property without just compensation. In essence, a creditor who has an interest in property of the estate is entitled to have that interest protected during the case, or there may be a violation of the Fifth Amendment. Although the concept of adequate protection is flexible, the requirement that adequate protection be provided is uncompromising.

In the franchise context, a debtor’s ongoing violation of quality, trademark usage, and other standards under the franchise agreement may establish a lack of “adequate protection” of the franchisor’s interests in intellectual property or other “cause” for relief from the automatic stay under section 362(d)(1). Bankruptcy courts have recognized that the value of a franchisor’s intellectual property, and in many cases that value of the franchisor’s entire business, depends upon the public having a favorable view of the franchisor’s brand and trademarks. A franchisee who violates quality and other standards may harm the brand in the sense that customers of the franchisee may not obtain the consistent, dependable, high quality goods and services that the franchisor has worked to develop and promote. The franchisor’s “reputation to the general public is at stake,” and a debtor franchisee must adequately protect


47 11 U.S.C. § 362(b)(10). Consult section 362(b) for the entire list of exceptions, which are voluminous and the product of special interest lobbying.


49 United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982) (“The bankruptcy power is subject to the Fifth Amendment’s prohibition against taking private property without compensation.”).

50 See In re Magnus, 50 B.R. 241, 243 (Bankr. N.D. 1985) (adequate protection “encompasses the basic constitutional requirement that a creditor’s interest in property cannot be in any respect impaired or subjected to increased risk without assurance that the creditor will realize the benefit of its bargain”) (citations omitted).

51 In re B-K of Kansas, Inc., 69 B.R. 812, 815 (Bankr. D. Kan. 1987); see also In re MCC Humble Auto Paint, Inc., 2011 Bankr. LEXIS 3288 (Bankr. S.D. Tex. 2011) (determining that the brand was being harmed by the debtor’s failure to remove franchise signs, and continued application of the automatic stay was conditioned upon debtor’s removal of signs).
that reputation or the franchisor can obtain relief from the automatic stay. Thus, a hotel franchisee who fails quality inspections may not be able to establish that the franchisor’s interests in property are adequately protected, and the franchisor may be entitled to relief from the stay. However, a debtor who has cured pre-petition quality deficiencies and can prospectively satisfy franchise standards is entitled to the benefits of the automatic stay and “cause” does not exist to lift the stay.

In addition to lack of adequate protection, section 362(d)(1) permits the court to grant relief from the automatic stay “for cause.” “ Cause” is not defined and is an intentionally broad and flexible concept which must, of necessity, be determined on a case by case analysis. Many courts have ruled that the failure of a debtor to make post-petition payments under an executory contract like a franchise agreement constitutes “cause” for stay relief. Lack of required insurance coverage also is a well-recognized “cause” for granting relief from the automatic stay that is similar to showing a lack of adequate protection of the creditor’s interests in property.

2. Lack of Equity and Reorganization Not Realistic

Section 362(d)(2) of the Bankruptcy Code provides that the court may grant relief from the stay “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.” If a debtor is unable to assume and assign a franchise agreement under section 365, then arguably, the debtor has no “equity” in its rights under the agreement that could be used to support a reorganization of the business. If a court determines that a debtor cannot assume a franchise agreement because applicable non-bankruptcy law does not permit it without the franchisor’s consent, and the franchisor does not consent, then in effect, the debtor has no equity in the agreement. In addition, if a franchise agreement will expire by its terms before a debtor will be able to propose and confirm a Chapter 11 plan of reorganization, then the debtor has no equity in the agreement that can be used to reorganize. Under section 362(g), the

52 The debtor bears the burden of proof on the issue of adequate protection. 11 U.S.C. § 362(g)(2).
54 In re Cumberland Corral, LLC, 2014 Bankr. LEXIS 936 (Bankr. M.D. Tenn. 2014); see also In re Holly’s, Inc., 140 B.R. 643 (Bankr. W.D. Mich. 1992) (concluding that the pre-petition mismanagement of a franchisee had been cured by new management and cause did not exit to lift the stay).
56 In re B-K of Kansas, Inc., 69 B.R. 812, 815 (Bankr. D. Kan. 1987); In re Skipworth, 69 B.R. 526 (Bankr. E.D. Pa. 1987); In re Ocaiso, 97 B.R. 825 (Bankr. E.D. Pa. 1989). In addition, the debtor’s failure to pay post-petition royalties indicates that the debtor may not be able to cure defaults in order to assume the franchise agreement under section 365, which is another basis for relief from the automatic stay. In re Ramreddy, Inc., 440 B.R. 103 (Bankr. E.D. Pa. 2009).
59 In re Watts, 181 B.R. 109, 110 (Bankr. N.D. Ala. 1994) (granting relief from automatic stay to lessor because even if assumed, lease would expire in three weeks, and “[n]o true benefit, therefore, can result to the Debtor from assumption of the lease”).
franchisor has the burden to show lack of equity, which usually involves showing that the franchise agreement cannot be assumed under section 365, or even if it is assumed, cannot form the basis for a plan of reorganization.

Franchisee debtors will almost invariably argue that the franchise agreement is “necessary to an effective reorganization” under section 362(d)(2)(B). However, “[w]hat this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization that is in prospect. This means . . . that there must be ‘a reasonable possibility of a successful reorganization within a reasonable time.’” Thus, under section 362(g) of the Bankruptcy Code, the debtor bears the burden to establish that reorganization is a “reasonable possibility” within a “reasonable time.” Bankruptcy courts are likely to give an honest debtor every opportunity to reorganize, but as time passes, if a debtor does not make progress or fails to solve significant business issues, the court may conclude that a debtor cannot meet its burden, especially if material post-petition liabilities are accruing and not being paid as and when due.

IV. ASSUMPTION, ASSIGNMENT, AND REJECTION OF FRANCHISE AGREEMENTS

A. Introduction and Definition of Executory Contract

The assumption, rejection, or assignment of franchise agreements is governed by Bankruptcy Code section 365, dealing with executory contracts. Understanding how section 365 deals with the situation first requires an understanding of what exactly an executory contract is. The most widely accepted definition is one developed by law professor Vern Countryman (referred to as the Countryman test). That is, a contract will be considered executory if, at the time of the bankruptcy filing, there are material unperformed obligations remaining by both parties. Put a slightly different way, if at the time the test is applied one party decided to stop performing and the other party had a resulting viable breach of contract claim, then the agreement is executory. Executory contracts become property of a debtor’s bankruptcy estate and are subject to the assumption and rejection provisions of section 365. If a contract is not executory, it is not subject to section 365 and cannot be either assumed or rejected. The ability to assume, reject, or potentially assign an agreement can be a very critical part of a bankruptcy case. Thus, for example, if a court determines that an important

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61 Generally, post-petition claims must be paid in full in cash in order to confirm a Chapter 11 plan of reorganization. 11 U.S.C. § 1129(a)(9).


64 Gloria Mfg. Corp. v. Int’l Ladies’ Garment Workers’ Union, 734 F.2d 1020, 1021-22 (4th Cir. 1984) (quoting the Countryman article and defining an executory contract as a contract “under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other”).

agreement is not executory, that decision alone may make the difference between a debtor being able to reorganize versus liquidating.66

A body of case law has developed analyzing whether certain intellectual property licenses are non-executory, based on how extensive the rights retained by the licensor are. The Exide Technologies case67 provides a helpful example. The case involved battery manufacturer Exide Technologies. In June of 1991, Exide sold most of its North American industrial battery business to a company called Enersys Delaware, Inc. The sale included a trademark license by Exide to Enersys allowing Enersys to use the Exide trademark in the industrial battery business. The license was perpetual, exclusive, and royalty-free. Years later, Exide decided it wanted to re-enter the North American industrial battery business and determined that a Chapter 11 bankruptcy case would be the means to wrestling its trademark back from Enersys. Exide filed bankruptcy and sought to reject the trademark license agreement. The bankruptcy court made a determination that the agreement was executory, and thus subject to rejection. Enersys appealed to the Third Circuit.

The Third Circuit began its analysis by noting the well-accepted definition of an executory contract. That is, “a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”68 The court turned to whether Enersys had substantially performed under the license, which was included among the documents effectuating the 1991 sale.69 The court determined that Enersys had performed by making payment to Exide and otherwise by operating under the terms of the license for a decade thereafter.70 The court also held that Exide’s obligations under the license (including refraining from using the mark outside the industrial battery business and observing certain quality standards) were not sufficient to make the license executory because the obligations did not relate to the purpose of the sale agreement.71 Because Enersys had

66 The harsh effect of rejecting an executory contract actually led Congress to amend the Bankruptcy Code. In Lubrizol Enters. Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043 (4th Cir. 1985), a debtor/patent licensor sought to reject the license. The licensee objected to the rejection, arguing that an analysis of a debtor’s business judgment in determining to reject an executory contract should include weighing the effect of the rejection on the non-debtor party. Id. at 1047-48. On appeal to the Fourth Circuit, the court held that the business judgment analysis should only analyze whether the rejection will benefit the debtor. The court recognized the “serious burdens” and “financial difficulty” placed on non-debtor parties when an executory contract is rejected. Furthermore, the court acknowledged that the possibility of rejection “could have a general chilling effect on the willingness of such parties to contract at all with businesses in possible financial difficulty.” Id. at 1048. But, the court stated: “Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable.” Id. In 1988, Congress enacted the Intellectual Property Licenses in Bankruptcy Act, which created Bankruptcy Code section 365(n). Section 365(n) provides protections to certain intellectual property licensees to lessen the harsh effects of rejection and also to help address the “chilling effects” noted in the Lubrizol case. See Jaffe v. Samsung Elecs. Co., 737 F.3d 14, 23 (4th Cir. 2013) (discussing the enactment of section 365(n) and the related legislative history).

67 In re Exide Techs., 607 F.3d 957 (3d Cir. 2010).

68 Id. at 962 (quoting In re Columbia Gas Sys. Inc., 50 F.3d 233, 239 (3d Cir. 1995)).

69 The court concluded that, while the parties purported to effectuate the sale via multiple written documents (including an asset purchase agreement and the trademark license), the documents all constituted one integrated agreement to sell. Id. at 960-61.

70 Id. at 963.

71 Id. at 964.
substantially performed and had no further *material* obligations, the court therefore concluded that the license agreement was not executory and was not subject to rejection.

The *Exide* case provides a rather extreme example (a perpetual, exclusive, and royalty-free license) to illustrate the point of what may, and may not, be considered material obligations for an analysis of whether an agreement is executory. While franchise agreements necessarily include trademark licenses, the nature of the franchisor/franchisee relationship normally will not be the same as that in the *Exide* case. In addition, franchise agreements necessarily include a myriad of other mutual obligations separate and apart from obligations arising under the trademark license. Therefore, it is generally accepted that franchise agreements are executory contracts governed by Bankruptcy Code section 365.\(^{72}\)

**B. Deadline for Assuming or Rejecting Franchise Agreements**

A debtor is not required to make the assumption/rejection decision immediately following the bankruptcy filing. Rather, in a Chapter 11 case, the debtor can delay the decision until confirmation of a plan. Depending on the case, plan confirmation may take quite some time. During the period prior to assumption or rejection, the non-debtor party is required to continue performance. The debtor, for its part, is not required to perform strictly under the agreement, but is required to pay the non-debtor party the value for the benefits provided to the bankruptcy estate. While the benefit to the estate is not necessarily the same as the payment terms under the agreement, in practice debtors typically continue to pay the non-debtor party under those terms.

During the pre-assumption/rejection time period, the non-debtor party is therefore protected from the standpoint of continuing to receive payments. However, the non-debtor party must deal with the uncertainty associated with not knowing whether it will remain in a long term contractual relationship with the debtor. If such uncertainty is causing actual damage to the non-debtor party’s business (as opposed to merely nervousness or inconvenience), the non-debtor party’s remedy is to seek an order from the bankruptcy court compelling the debtor to decide whether to assume or reject the agreement.

In the context of a bankrupt franchisee, the franchisor will demand continued royalty payments and general compliance with the franchise agreement during the franchisee’s bankruptcy case. A franchisor generally will receive such relief for a number of reasons. First, if the franchisee were to fall down on its obligations to maintain the brand (as required in the franchise agreement), that would have a negative effect on the franchisor’s entire business. Thus, the franchisor would seek, and almost certainly would be granted, relief from the bankruptcy court pursuant to Bankruptcy Code section 365(d)(2) either compelling the debtor to assume or reject the franchise agreement or to otherwise perform pending that decision.

The case *In re Poco Springs Co.*\(^{73}\) provides an example of the factors considered by a bankruptcy court in this circumstance. The case involved the bankruptcy filing of a franchisee that distributed beverages for multiple different franchisors. Following the bankruptcy filing, two of the franchisors filed motions under Bankruptcy Code section 365(d)(2) seeking to compel the debtor to assume or reject the franchise agreement, based on the franchisors’ assertions that

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\(^{72}\) See Norton Bankruptcy Law and Practice 3D § 121:2 (2017) (“It is well established that a franchise agreement is an ‘executory contract’ within the meaning of Code §365.” (citing cases)).

the debtor’s poor performance and failure to meet obligations under the franchise agreements was causing the franchisor’s harm. The court analyzed the motions by weighing “the interests at stake, the balance of hurt to the litigants, the good to be achieved, and the safeguards afforded these litigants.”

74 The court ultimately imposed “rather short deadlines” for the debtor to make the assumption or rejection determination. However, different deadlines were set for different franchisors, based on the court’s determination that one franchisor had the financial wherewithal to wait longer for the determination than the other franchisor.

On a more practical level, a debtor/franchisee in a Chapter 11 case typically will bend over backwards to satisfy the demands of the franchisor because the franchise agreement is almost certainly one of the most valuable bankruptcy estate assets.75 For these reasons, a debtor franchisee almost always will continue to make royalty and other payments to the franchisor during the entire bankruptcy case.

The franchise agreement assumption/rejection dynamics discussed above apply to a Chapter 11 case.76 There are different statutory deadlines for Chapter 7 cases. Upon the filing of a Chapter 7 bankruptcy case, a trustee is automatically appointed.77 The Chapter 7 trustee’s job is to liquidate the assets of the debtor and to otherwise maximize estate assets for the benefit of creditors. This may include a trustee filing preference or fraudulent transfer lawsuits to claw back money or assets. Commonly, one of a Chapter 7 trustee’s first acts will be to immediately close a debtor’s business. The Bankruptcy Code provides authority for a Chapter 7 trustee to continue operating a business, but such post-filing operations are very uncommon in Chapter 7 cases.78 Because the business will be shut down and the assets liquidated, the Chapter 7 trustee will not seek to assume the franchise agreement.

Unlike in Chapter 11, in Chapter 7 the rejection of an executory contract such as a franchise agreement is subject to a specific statutory deadline. Pursuant to Bankruptcy Code section 365(d)(1), any executory contract not assumed or rejected within 60 days following the filing (if such period is not extended by the court) is deemed rejected by operation of law. In practice, however, the trustee will likely file a motion to reject the franchise agreement as soon as possible in order to minimize or prevent the accrual of post-filing administrative expense liabilities.

C. Requirements for and Effect of Assumption of Franchise Agreement

In a Chapter 11 case, it is much more common for the franchisee debtor to assume rather than reject the franchise agreement. Assumption of any executory contract requires the debtor to: (a) cure all past due amounts (in other words, pay current any unpaid amounts under

74 Id. at *3 (quoting In re Grant Broadcasting of Philadelphia, Inc., 71 B.R. 891, 902 (Bankr. E.D. Pa. 1987)).

75 In re Ramreddy, Inc., 440 B.R. 103, 113 (Bankr. E.D. Pa. 2009) (“It is obvious that the PMPA Franchise Agreement is the Debtor’s most valuable asset and that a successful reorganization in this case would require that the Debtor assume the agreement.”).

76 A debtor’s decision to assume or reject a real property lease is subject to specific statutory deadlines discussed infra at section IV.D.


78 11 U.S.C. § 721 (“The Court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate.”).
the agreement), and (b) provide the other party to the agreement with “adequate assurance of
future performance.” The policy reason for requiring a debtor to provide adequate assurance of
future performance is to demonstrate to non-debtor contractual parties that they will not find
themselves dealing with another bankruptcy filing soon after the debtor emerges.

Adequate assurance can take many different forms and is specific to the facts of the
case. If the debtor party was not behind on any payments and otherwise performed under the
agreement, the debtor’s mere promise to perform likely will suffice. On the other hand, if the
debtor had a history of missed payments and general non-compliance, the non-debtor party
may be entitled to material assurances such as a cash deposit or a letter of credit. In practice,
franchisors dealing with a debtor franchisee seeking to assume the franchise agreement rarely
press the point of adequate assurance of future performance. In the case of a habitually
financially troubled franchisee, a franchisor is foregoing a valuable opportunity to protect itself if
it chooses to ignore this requirement under the Bankruptcy Code.

Generally speaking, assumption of executory contracts is often accompanied by
assignment of the contract to a third party. Assignment of a franchise agreement is discussed
in further detail below. However, due to a linguistic ambiguity in the Bankruptcy Code, coupled
with a split in authority among courts, a debtor franchisee seeking to assume a franchise
agreement may be required to deal with assignment issues even when the franchisee has no
intention of actually assigning the agreement. The issue has the potential to greatly complicate
assumption of a franchise agreement, and to give the franchisor a tremendous amount of
leverage over the debtor franchisee.

The ambiguity is found in Bankruptcy Code section 365(c), which states that a debtor
may not assume or assign an executory contract if applicable law prohibits assignment. A
franchisee/debtor seeking only to assume (and not to assign) a franchise agreement will argue
that the issue of “applicable law” does not apply (see further discussion below regarding
“applicable law”). The test provides that if a debtor is not actually seeking to assign an

79 11 U.S.C. § 365(b)(1)(A); see also Jason B. Binford, Beyond Chimerical Possibilities: The Meaning and Application

80 Nevertheless, it is not uncommon for Chapter 11 debtors to once again seek refuge in bankruptcy. In fact, the filing
of a new bankruptcy case relatively soon after emergence is derivisely referred to as a “Chapter 22.” See Kenneth M.
Miskin and Evagelia E. Papadimas, When One Chapter 11 is Filing Just is Not Enough, 23 J. BANKR. L & PRAC. 2
(April 2014) (discussing the statutory implications related to filing another Chapter 11 bankruptcy case). The success
rate of companies making it through a Chapter 11 case and succeeding thereafter has been the subject of a
significant amount of empirical research, much of it done by UCLA School of Law Professor Lynn LoPucki who has
developed a “Bankruptcy Research Database.” See, e.g., Lynn LoPucki, The Practical Advantage From Empirical
Research, 34 AM. BANKR. INST. J. 32 (Feb. 2015).

81 Cf. In re Yardley, 77 B.R. 643 (Bankr. M.D. Tenn. 1987) (permitting a senior citizen individual debtor to assume his
apartment lease on the promise that he would not (again) pull a knife on the apartment complex security guard).

82 See Binford, supra note 80, at 217 n.153 (citing cases requiring tangible assurances such as deposits and letters of
credit).

83 11 U.S.C. § 365(c)(1): “The trustee may not assume or assign any executory contract or unexpired lease of the
debtor, whether or such contract or lease prohibits or restricts assignment of rights or delegations of duties, if . . .
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 . . . such party does not consent to such
assumption or assignment . . . .”
agreement, then the section 365(c) issue of whether such an agreement is assignable is not relevant. A number of circuit courts have agreed with this reasoning, adopting the “actual test” regarding assumption of an executory contract.  

Other courts read section 365(c) literally, on the basis that the use of the disjunctive “or” means that if an agreement is determined to be unassignable, then the debtor cannot assume it, even if no assignment is contemplated in the first place. Put another way, these “hypothetical test” jurisdictions read section 365(c) to say that if applicable law prohibits assignment, a debtor may neither assume nor assign such an agreement. While this distinction may seem academic, it can have very significant real world implications. In actual test jurisdictions, a franchisee seeking only to assume the franchise agreement will not be concerned with assignment matters. In contrast, a debtor franchisee in hypothetical test jurisdictions will essentially be at the mercy of the franchisor. A franchisor seeking to press the point will essentially have the power to prohibit any reorganization because a franchisee incapable of assuming the franchise agreement is dead in the water. Because this has the potential to be a threshold issue (i.e., determinative of whether Chapter 11 makes sense in the first place), a multi-unit franchisee with the ability to file bankruptcy in various jurisdictions would be well advised to consider this issue and chose an actual test jurisdiction over a hypothetical test one.

D. Real Property Leases

The assumption or rejection of the franchise agreement will usually be the focus of either a franchisor or a franchisee bankruptcy case. The assumption or rejection of a real property lease, however, has the potential to be equally as important. Prior to 2005, real property leases were treated no differently than executory contracts in the respect that debtors could delay the assumption/rejection decision for the extended period of time between the bankruptcy filing and plan confirmation. That changed with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Section 365(d)(4) now requires a debtor to make the assumption/rejection decision with respect to non-residential real property leases within 120 days following the bankruptcy filing. That period can be extended for cause, but not longer than an additional 90 days. Any further extension beyond 210 days requires the prior written consent of the landlord.

The 210-day deadline provides landlords with a good deal of leverage, especially in cases involving multiple locations. Consider, for example, a multi-unit franchisee that files bankruptcy, knowing that at least some of the significantly underperforming stores must be

84 See, e.g., Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997); In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

85 See, e.g., In re West Elecs., 852 F.2d 79 (3d Cir. 1988); In re Catron, 158 B.R. 629 (E.D. Va. 1993), aff'd 25 F.3d 1038 (4th Cir. 1994); In re Catapult Enter., Inc., 165 F.3d 747 (9th Cir. 1999); In re James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994).

86 While this is a significant split among circuit courts across the United States, the Supreme Court in 2009 passed on the chance to resolve the dispute, at least with respect to trademark licenses. See N.C.P. Mktg. Group Inc. v. BG Star Prods. Inc., 129 S.Ct. 1577 (March 23, 2009). Justice Kennedy included a statement in the denial of certiorari, joined by Justice Breyer. The statement acknowledged the importance of this issue, but determined that the Supreme Court was not the most suitable place for resolving the matter because resolution “might first require [the Supreme Court] to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles.” Id.
closed as part of a viable reorganization. It can take a significant amount of time, however, to craft a plan of reorganization and to make the determination of which stores to close and which stores to keep open. Moreover, a debtor will want to get the decision right the first time. If a lease is assumed and the debtor later decides that it actually needs to be rejected, the rejection damages will be considered an administrative expense claim, rather than general unsecured claim.\footnote{11 U.S.C. § 365(g)(2).} Because plan confirmation requires administrative expense claims to be paid in full (as opposed to general unsecured claims that are often paid cents on the dollar) assuming a lease that later needs to be rejected can be a catastrophically expensive mistake.\footnote{Note that there is a statutory cap on damages resulting from the rejection of any real property lease. See 11 U.S.C. § 502(b)(6). Generally speaking, Bankruptcy Code section 502(b)(6) limits rejection damages to the greater of 1 year of rent or 3 years, not to exceed 15% of the remaining rent due under the lease. Even such a capped claim, however, can be a very substantial administrative expense if the rejected lease was previously assumed.}

Complications can also arise when the franchisor is the lessor under the real property lease.\footnote{In re FPSDA I, LLC, 450 B.R. 392, 401 (Bankr. E.D.N.Y. 2011) (analyzing whether leases and franchise agreements should be considered one integrated agreement for the purposes of the assumption/rejection deadline in Bankruptcy Code section 365(d)(4) and stating: “Because the franchise agreements and the accompanying leases are the most valuable assets of the respective Debtors’ bankruptcy estates, the application of 11 U.S.C. § 364(d)(4) to deem the Dunkin’ Brands Leases and implicitly the franchise agreements rejected would benefit none of the creditors other than Dunkin’ Brands.”).} Recall from the discussion above that, in contrast to real property leases, there are no specific assumption/rejection deadlines for franchise agreements. In addition, a franchisor may be able to prevent either the assumption or the assignment of the franchise agreement by citing to “applicable law” prohibiting such assignment,\footnote{Discussed in more detail infra at section IV.E.} as discussed in more detail in section IV.E. below. However, what if the real property lease obligations are set forth within the franchise agreement (as opposed to the lease being a separate agreement)? Does that mean that the entire franchise agreement is therefore subject to the 210 day assumption/rejection deadline? Does it mean that the real property lease obligations cannot be assigned to another party? These questions are complicated by the fact that well-accepted law provides that a lease or executory contract must be either assumed or rejected in its entirety. A debtor cannot “cherry pick” particular beneficial or onerous provisions to assume or reject. Therefore, in the case of real property lease obligations being included within the terms of a franchise agreement, a franchisee debtor seeking to assume or assign only one of the agreements will be required to show that, under applicable state contract law, the agreements are separate, notwithstanding the fact that they are set forth in the same document.

**E. Requirements for and Effect of Assignment of Franchise Agreement**

As discussed above, the ambiguous language of section 365(c) complicates assumption of a franchise agreement because, at least in hypothetical test jurisdictions, the issue of assignment must be addressed. Understanding assignment of any executory contract in bankruptcy requires an analysis of the general rule and the exceptions to the general rule.

First, the general rule: Bankruptcy Code section 365(f) generally provides that provisions in executory contracts restricting assignment are not enforceable in bankruptcy. There are several exceptions to this general rule, as set forth in Bankruptcy Code section 365(c). First, an
anti-assignment provision will be enforced if the agreement at issue is a personal service contract. The policy reason is that a non-debtor party who negotiated for the services of a uniquely qualified company or individual should not be forced to accept anyone other than that person or company under the agreement. Franchisors have made the argument that the franchise agreement is a personal service contract because the particular franchisee was selected after a rigorous process. But, such arguments have met with limited success, especially if (as is common) the franchise agreement is assignable under other circumstances.\(^91\) Acknowledging the prospect of assignment cuts strongly against the argument that the particular franchisee is the only person or entity in the world that the franchisor would have chosen for that particular franchise agreement.

An anti-assignment provision will also be enforced if “applicable law” excuses the non-debtor party from accepting performance from anyone else other than the debtor. It would not make sense to interpret “applicable law” broadly because, for example, state contract law could be cited as the basis to enforce any anti-assignment clause. In that sense, the section 365(c) exception would swallow the section 365(f) general rule. Rather, applicable law has been interpreted as law that in some way addresses the identity of the debtor as the contracting party. Identity is the issue in personal service contracts (discussed above). Identity is also an issue in the context of trademark licenses. Generally speaking, franchisors have been able to argue successfully that the Lanham Act is “applicable law” that prohibits assignment of a trademark license agreement without the consent of the licensor. The majority of courts addressing that issue have held that a non-debtor franchisor can use the Lanham Act to prohibit a debtor franchisee’s assignment of the franchise agreement over the franchisor’s objection.\(^92\)

F. Requirements for and Effect of Rejection of Franchise Agreements and Covenants Not to Compete

Rejection of an executory contract or lease is treated under the Bankruptcy Code as a breach of the agreement\(^93\) and relieves the debtor party of any further obligations under the agreement. The non-debtor party’s remedy is limited to filing a proof of claim for the damages resulting from the breach. Such damages are treated under the Bankruptcy Code as general unsecured claims.\(^94\)

\(^{91}\) See, e.g., In re Tom Stimus Chrysler-Plymouth, Inc., 134 B.R. 676, 678 (Bankr. M.D. Fla. 1991) (determining that a Chrysler franchise agreement was not a personal service contract because it was not based on any sort of “special trust and confidence [or] special relationship” between the parties); see also In re Klien, 218 B.R. 787, 791 (Bankr. W.D. Pa. 1998) (same).


\(^{93}\) Rejection of an agreement is not synonymous with termination of the agreement, because an agreement can be breached, but not necessarily terminated. In the case of a rejected franchise agreement, the parties generally treat rejection as termination, leaving the debtor party to move forward free of obligations and the non-debtor party to file a claim. However, the distinction can be important with respect to a trademark license if, for example, the franchisor does not wish to have the rejected license considered terminated to preserve the right to assign the license (on the same unexpired terms) to a non-debtor third party. The fact that rejection is not the same thing as termination also comes into play with respect to the potential on-going enforceability of non-compete provisions, discussed later in this section.

\(^{94}\) 11 U.S.C. § 365(g).
While the non-debtor party can no longer enforce the terms of a rejected agreement, the issue is not so simple with respect to non-compete obligations. Some courts have held that when a franchise agreement containing a non-compete provision is rejected, the debtor is relieved of all obligations and the non-debtor party (typically the franchisor) is required to monetize its damages related to the non-compete obligations and include such damages in the proof of claim.

In re JRT, Inc.,95 provides an example. The case dealt with a franchisee of TCBY Systems, Inc. (TCBY) who operated six yogurt shops in Michigan. The franchise agreement provided that franchisees were required to request authority from franchisor TCBY to sell food products other than yogurt. The franchisee requested permission to sell soups and sandwiches and TCBY denied the request. The franchisee later filed Chapter 11 bankruptcy and sought to reject the franchise agreement arguing, among other things, that the locations could be profitable only if soups, sandwiches, and other brands of yogurt were sold there. At the hearing on the motion to reject the franchise agreement, TCBY made several arguments that the rejection did not preclude TCBY from enforcing non-compete provisions in the agreement. First, TCBY argued that, while some portions of the franchise agreement may be executory and subject to rejection, the non-compete provisions were not. TCBY relied on a Sixth Circuit case Leasing Serv. Corp. v. First Tenn. Bank Nat'l Assoc.96 where the court determined that the rejection of an equipment leasing agreement did not extend to a rejection of the equipment lessor’s security interest in the collateral. The JRT court determined that the circumstances in the Leasing Serv. case were “entirely different” because, unlike a party with a lien in collateral, TCBY did not have enforceable right in any property.97 TCBY also argued that the non-compete provisions was a separate agreement and thus not affected by the rejection of the franchise agreement. The JRT court refused to accept that argument as well, finding that “the parties intended the covenant not to compete to be an obligation which should be considered together with the other [franchise agreement] terms and conditions.”98 This led the court directly to the conclusion that “[t]he covenant not to compete is an integral, non-divisible part of the executory franchise agreement; therefore, the court holds that the entire franchise agreement, including the covenant not to compete, may be rejected.”99

Other courts disagree with this analysis generally on the basis that a covenant not to compete essentially is an agreed-upon injunction between the parties, rather than a claim that can be monetized into damages. Therefore, the non-debtor party does not have a “claim” related to the non-compete provision, as that term is defined under the Bankruptcy Code. These courts thus conclude that a non-debtor party has the right to continue enforcing the non-

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96 826 F.2d 434 (6th Cir. 1987).
98 Id. at 323.
99 Id.; see also In re Norquist, 43 B.R. 224, 225-26 (Banr. E.D. Wash. 1984) (permitting rejection of a covenant not to compete that was part of a partnership agreement because it furthered the goal of allowing a debtor to relieve itself of burdensome future obligations while [it] is trying to recover financially”); In re Rovine, 6 B.R. 661, 666-67 (Bankr. W.D. Tenn. 1980) (permitting a Burger King franchisee to reject the non-compete provision as part of rejecting the franchise agreement on the grounds that the franchisor’s related damages constituted a claim and thus the franchisor’s remedy was to file a claim in the case).
compete, even after the franchise agreement has been rejected.\textsuperscript{100} Still other courts hold that, because rejection of a franchise agreement is legally deemed a breach of the agreement, rather than a termination, covenants such as non-compete provisions remain enforceable.\textsuperscript{101}

The issue of whether non-compete provisions survive rejection of an executory contract has been the subject of a relatively large amount of commentary.\textsuperscript{102} The fact that courts remain split on such an important issue can be troubling for franchisors. The specific issues that divide the courts, however, may provide franchisors with options for strengthening their arguments in the event a franchisee files bankruptcy. Placing the non-compete obligation into a separate agreement may allow the franchisor to argue that it is non-executory and not subject to rejection. It would also be helpful to the franchisor to include language in the agreement stating that monetary damages are not an adequate remedy, thus bolstering the argument that rejection of the agreement cannot simply be reduced to a monetary claim in a bankruptcy case.

V. REMEDIES FOR POST-PETITION INFRINGEMENT

A. Introduction

A franchisor is prohibited under the automatic stay provision contained in section 362 of the Bankruptcy Code from taking any action to terminate or enforce the terms of its franchise agreement after its franchisee files for bankruptcy under Chapter 11. That section states in relevant part:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title... operates as a stay, applicable to all entities, of-- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title; (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title; (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate; (4) any act to create, perfect, or enforce any lien against property of the estate; (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title; (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title; (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and (8) the commencement or


\textsuperscript{101} See In re Noco, Inc., 76 B.R. 839, 844 (Bnrr. N.D. Fla. 1987) (citing In re Carrere, 64 B.R. 156 (Bankr. C.D. Cal. 1986)).

continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.103

Despite a franchisee seeking protection from its creditors under the Bankruptcy Code, a franchisor nonetheless continues to have certain interests with respect to the manner in which the franchised business operated during the pending bankruptcy, and whether the franchisee is complying with the terms of the franchise agreement itself; is, for example, the franchisee complying with system standards, maintaining the condition of the business, installing required equipment, payment royalty fees, or using the trademarks in the prescribed manner? If a franchisee’s compliance with its contractual obligations under the franchise agreement post-petition is deficient, a franchisor must move for relief from the automatic stay under section 362(d) of the Bankruptcy Code104 in order to effectuate a termination or to otherwise enforce its rights under a franchise agreement.105 And, even if relief is granted, “the parties [are simply returned] to the legal relationships that existed before the stay became operative.”106 “Thus, even if a franchisor obtains an order from the bankruptcy court lifting the automatic stay, it will have to seek its termination of the franchise agreement or other appropriate remedy in a non-bankruptcy court of competent jurisdiction.”107

B. Procedural issues

An estate is created upon the filing of a bankruptcy petition that is comprised of “all legal and equitable interests of the debtor in property as of the commencement of the case.”108 A franchise agreement that has not been fully performed or terminated pre-petition are generally considered property of the estate under § 541(a)(1).109 Because “a franchise agreement is essential to a franchisee’s ability to reorganize and may be the estate’s most valuable asset,”110 bankruptcy courts are hesitant, especially early on in a bankruptcy case, to lift the automatic

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104 11 U.S.C. § 362(d) provides in relevant part that:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, 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; (2) with respect to a stay of an act against property under subsection (a) of this section, if—(A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.

105 See generally, In re ERA Central Reg’l Servs., Inc., 39 B.R. 738, 741 (Bankr. C.D. Ill. 1984) (franchise agreement was property of the bankruptcy estate and the automatic stay barred termination of the franchise agreement without court approval).

106 In re Kahihikolo, 807 F.2d 1540, 1542 (11th Cir. 1987).


stay and allow a franchisor the right to proceed against its franchisee in the absence of a pre-petition termination or incurable breach.\footnote{Incurable defaults can either be a default for which a contract or statute does not give to the breaching party an opportunity to cure or is a default that simply cannot possibly be fixed within the contractual or statutory cure period. See Jason J. Stover, \textit{No Cure, No Problem: State Franchise Laws and Termination for Incurable Defaults}, 23 FRANCHISE L.J. 217, 218–19 (2004).

\footnote{111}{11 U.S.C. §§ 363(c)(1) & 1108.}}

VI. SECTION 363 ASSET SALES

\section{A. Legal Requirements}

Over the past few years, an increasing number of business debtors have used section 363 of the Bankruptcy Code to sell substantially all of their assets, free and clear of liens, within the first few months of a Chapter 11 case, instead of pursuing reorganization under a confirmed Chapter 11 plan. Generally, a section 363 sale will be faster and cheaper than pursuing confirmation of a plan of reorganization, and may be accomplished by motion without the need for voting by creditors. It may be the only option that is realistically available to a debtor who is suffering accelerating operational losses in addition to the administrative costs resulting from being in Chapter 11.

A debtor in a Chapter 11 case may operate its business in the ordinary course of business, and may sell property in the ordinary course of business, without specific court approval.\footnote{See, e.g., \textit{Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)}, 722 F.2d 1063, 1070-71 (2d Cir. 1983); \textit{In re Ionosphere Clubs, Inc.}, 100 B.R. 670 (Bankr. S.D.N.Y. 1989); \textit{Fulton State Bank v. Schipper (In re Schipper)}, 933 F.2d 513, 515 (7th Cir. 1991).} If a debtor wants to sell property outside of the ordinary course of business, it must obtain court approval under section 363(b) of the Bankruptcy Code, which provides in part that a debtor “after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.”

While the precise language used by courts differs, a debtor is entitled to the benefit of a version of the business judgment rule in connection with a motion to sell assets under section 363. A debtor’s sale of business assets outside of the ordinary course of business should be approved by the court if the debtor can demonstrate a sound business justification for the proposed transaction.\footnote{In re Gulf States Steel, Inc. of Ala., 285 B.R. 497, 514 (Bankr. N.D. Ala. 2002).} In determining whether to approve a sale, courts consider (a) whether the parties have acted in good faith, (b) whether the transaction will produce a fair and reasonable price for the property, (c) whether accurate and reasonable notice of the transaction was given to interested parties, and (d) whether a sound business justification exists for the transaction.\footnote{See \textit{In re Cont'l Air Lines, Inc.}, 780 F.2d 1223, 1226 (5th Cir. 1986); \textit{In re Ernst Home Ctr., Inc.}, 209 B.R. 974 (Bankr. W. D. Wash. 1997).} A debtor’s decision to enter into a transaction which is outside of the normal course of the debtor’s business must be based on reasonable business judgment.\footnote{115}{The court may approve a transaction which is outside of the normal course of the debtor’s business if the

\footnote{113}{In re Gulf States Steel, Inc. of Ala., 285 B.R. 497, 514 (Bankr. N.D. Ala. 2002).}

\footnote{114}{See \textit{Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)}, 722 F.2d 1063, 1070-71 (2d Cir. 1983); \textit{In re Ionosphere Clubs, Inc.}, 100 B.R. 670 (Bankr. S.D.N.Y. 1989); \textit{Fulton State Bank v. Schipper (In re Schipper)}, 933 F.2d 513, 515 (7th Cir. 1991).}
debtor establishes “some articulated business justification” for the transaction.\footnote{E.g., In re Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983); In re Walter, 83 B.R. 14 (Bankr. 9th Cir. 1988); In re Baldwin United Corp., 43 B.R. 888, 906 (Bankr. S.D. Ohio 1984); In re St. Petersburg Hotel Assoc., Ltd., 37 B.R. 341, 343 (Bankr. M.D. Fla. 1983).} Where a debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), bankruptcy courts generally defer to the debtor.\footnote{See Comm. of Asbestos-Related Litigants And/Or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.), 60 B.R. 612 (Bankr. S.D.N.Y. 1986); In re Acadiana Elec. Serv., Inc., 52 B.R. 609 (Bankr. W. D. La. 1985) (where estate owned 34% of stock of non-debtor corporation, court refused to second guess trustee’s business decision to agree with the other shareholders to sell the assets of that corporation).}

Some courts, however, express a preference for reorganization under a confirmed Chapter 11 plan of reorganization and criticize debtors who attempt to resolve an entire Chapter 11 case using a section 363 sale motion.\footnote{See, e.g., In re Braniff Airways, Inc., 700 F.2d 935, 939-40 (5th Cir. 1983) (section 363 sale that dictated treatment of claims under subsequent Chapter 11 plan and included broad releases of claims was improper); In re Cont’l Air Lines, Inc., 780 F.2d 1223, 1227-28 (5th Cir. 1986).} Sale motions that seek not only to sell all of the assets of a debtor, but also to distribute the proceeds and grant releases of claims, have been called “sub rosa” plans that should not be approved.\footnote{In re Gulf Coast Oil Corp. 404 B.R. 407 (Bank. S.D. Tex. 2009).} On the other hand, a sale motion that does not dictate the terms of a plan of reorganization and does not attempt to dictate or restructure the rights of creditors, but merely brings in value, is not an improper sub rosa plan.\footnote{See In re Mushroom Transp. Co., 382 F.3d 325, 339 (3d Cir. 2004) (noting that a debtor in possession “had a fiduciary duty to protect and maximize the estate’s assets.”); Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 573 (3d Cir. 2003) (same); Four B. Corp. v. Food Barn Stores, Inc. (In re Barn Stores, Inc.), 107 F.3d 558, 564-65 (8th Cir. 1997) (stating that, in bankruptcy sales, “a primary objective of the Code [is] to enhance the value of the estate at hand.”).} Over time, the idea that a sale of all assets of a debtor must occur in connection with confirmation of a Chapter 11 plan has largely been abandoned, as long as the debtor does not overreach and try to dictate the outcome of an entire Chapter 11 bankruptcy case in the context of a sale motion.

B. Mechanics of a Section 363 Sale

1. Marketing of Assets

As part of assessing the debtor’s business judgment, the bankruptcy court will want to know how the assets have been marketed. The paramount goal in any proposed sale of property of the estate is to maximize the proceeds received by the estate.\footnote{In re Naron & Wagner, Chartered, 88 B.R. 85 (Bankr. D. Md. 1988); In re Work Recovery, Inc., 202 B.R. 301, 304 (Bankr. D. Ariz. 1996).} Therefore, a debtor should be prepared to provide evidence regarding marketing of the assets that occurred prior to filing the sale motion or that will occur after filing the sale motion. If a debtor has engaged in extensive marketing prior to filing the motion, especially if a professional broker or investment banker has managed the process, a bankruptcy court is likely to require less marketing after the motion is filed. Conversely, if the marketing process will not start until the motion is filed, the bankruptcy court is likely to require extensive marketing prior to the bid deadline, and the timeline for the section 363 sale will be extended accordingly. Ultimately, the

\footnote{In re Gulf Coast Oil Corp. 404 B.R. 407 (Bank. S.D. Tex. 2009).}
bankruptcy court will review all of the facts and circumstances to determine whether the proposed manner, method and timing of the marketing of the assets is sufficient to fully expose them to the marketplace.122

2. **Bidding Procedures**

Most section 363 sale motions contemplate a two-step process. Initially, the debtor asks the court to approve bidding procedures, which are rules and deadlines for a public bidding process. The debtor will ask the court to enter a “bid procedures order” that does not approve any particular sale but sets the rules for an auction. Most bid procedures will set deadlines for submission of written bids, schedule an auction if bids are received, establish a deadline for filing objections to the sale, and set a date and time for the hearing to consider approval of the highest and best bid. Bid procedures also define what it takes to be a “qualified bidder,” what constitutes a “qualified bid,” establish good faith deposit requirements, require bidders to remain in place as a “back up” bidder for some period of time in case a higher bidder fails to close, and establish dates for the debtor to file schedules and lists of contracts that will accompany the asset purchase agreement. Finally, if there is a stalking horse bid, the bid procedures order may establish a break-up fee, expense reimbursement and minimum overbid requirements, each of which is discussed in more detail below. Procedures intended to enhance competitive bidding are consistent with the goal of maximizing the value received by the estate and therefore are appropriate in the context of bankruptcy sales.123

3. **Stalking Horse Bids**

When formulating a section 363 sale motion, a debtor must decide whether to seek approval of a “stalking horse bid” or to establish rules for an open auction without any bidder in hand. A stalking horse is a bidder who has signed a binding contract and committed to purchase the assets, subject only to higher and better bids and bankruptcy court approval. Usually, the marketplace will view a sale motion with a “stalking horse” more favorably than an open auction without a stalking horse because having at least one committed bidder indicates that a sale is likely to close.

In exchange for serving as a stalking horse, a bidder usually will want bid protections in the bid procedures order. First, the stalking horse will want its actual expenses, usually subject to a cap, to be reimbursed by the debtor if another bidder buys the assets. Second, the stalking horse may want a true break-up fee, which is a fee paid by the debtor to the stalking horse if another bidder buys the assets. Most stalking horse bidders will want to impose a minimum overbid, such that to be a qualified bidder, another bidder must exceed the stalking horse bid by a minimum amount. Finally, it is common for a stalking horse bidder to insist upon minimum bid increments in order to avoid immaterial overbids that extend and delay the conclusion of the auction.

Approval of break-up fees, expense reimbursement and other stalking horse bid protections is governed by the business judgment rule in some jurisdictions and by the general

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122 *See In re Balco Equities Ltd.*, 323 B.R. 85 (Bankr. S.D.N.Y. 2005) (determining that the marketing time was reasonable when a sale was proposed one year after case was filed).

123 *In re Fin. News Network, Inc.*, 126 B.R. 152, 156 (S.D.N.Y. 1991) (“[C]ourt-imposed rules for the disposition of assets . . . [should] provide an adequate basis for comparison of offers, and [should] provide for a fair and efficient resolution of bankrupt estates.”).
administrative expense jurisprudence under section 503(b) of the Bankruptcy Code in other jurisdictions. The Third Circuit Court of Appeals has concluded that the determination as to whether to approve break-up fees or expense reimbursements “depends upon the requesting party’s ability to show that the fees [or expenses] were actually necessary to preserve the value of the estate.” There are at least two instances in which bidding incentives may provide benefit to the estate: (1) if “assurance of a break-up fee promoted more competitive bidding, such as by inducing a bid that otherwise would not have been made and without which bidding would have been limited;” and (2) where the availability of bidding incentives induce a bidder to research the value of the assets and submit a bid that serves as a minimum or floor bid on which other bidders can rely, “the bidder may have provided a benefit to the estate by increasing the likelihood that the price at which the Debtor is sold will reflect its true worth.”

C. Treatment of Secured Claims of Franchisors

In some cases, a franchisor may possess a security interest or lien in assets of the franchisee to secure amounts owed under the franchise agreement. If the assets being sold are subject to liens that the debtor proposes to divest from the assets, then in addition to satisfying the business judgment test, the debtor must satisfy section 363(f) of the Bankruptcy Code. Section 363(f) provides, in part, that a debtor “may sell property under subjection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Because section 363(f) is drafted in the disjunctive, satisfaction of any one of its five requirements will suffice to permit the sale of assets “free and clear” of liens, claims and encumbrances. The congressional record indicates as follows:


126 Id. at 537.

127 Id.


129 See In re Kellstrom Indus., Inc., 282 B.R. 787, 793 (Bankr. D. Del. 2002) (“Section 363(f) is written in the disjunctive, not the conjunctive, and if any of the five conditions are met, the debtor has the authority to conduct the sale free and clear of all liens.”); Citicorp Homeowners Servs., Inc. v. Elliot (In re Elliot), 94 B.R. 343, 345 (E.D. Pa. 1988) (same).
Subsection (f) permits sale of property free and clear of any interest in the property of an entity other than the estate. The trustee [or debtor-in-possession] may sell free and clear if applicable nonbankruptcy law permits it, if the other entity consents, if the interest is a lien and the sale price of the property is greater than the amount secured by the lien, if the interest is in bona fide dispute, or if the other entity could be compelled to accept a money satisfaction of the interest in a legal or equitable proceeding. Sale under this subsection is subject to the adequate protection requirement. Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale.\(^{130}\)

If secured creditor consent to a sale cannot be obtained, a debtor may allege that the interest of the creditor is subject to bona fide dispute. In determining existence of a bona fide dispute for purposes of section 363(f)(4), the court must determine whether there is objective basis for either factual or legal dispute as to the validity or enforceability of the debt or lien. It does not require the court to resolve the underlying dispute.\(^{131}\) In the franchise context, before asserting rights under section 363(f) as a secured creditor, the franchisor should make sure that it has properly perfected its security interests by filing financing statements under the Uniform Commercial Code, having its lien noted on motor vehicle certificates of title, or otherwise following applicable state law. If a franchisor’s lien is not perfected, then it is subject to bona fide dispute for purposes of section 363(f)(4).\(^{132}\)

D. Customary Deadlines and Procedures for Addressing Contracts

Often, a debtor will file a section 363 sale motion that includes a request to approve the assumption and assignment of executory contracts under section 365 of the Bankruptcy Code.\(^{133}\) A franchisor who is served with a section 363 sale motion should quickly review the motion to determine if the debtor may seek to assume and assign the franchise agreement. In many cases, the buyer of the assets has not yet been identified or has not yet decided which contracts to take and which contracts to reject. In these instances, a debtor may propose to file and serve on counterparties a list of proposed contracts to be assumed and assigned several days prior to the date scheduled for the auction. The list usually will include the debtor’s opinion with respect to the amount required, if any, to cure all defaults under the contract. Then, counterparties will have a few days, or perhaps a week, to object to the assumption and assignment of any listed contract and the proposed cure amount.

Unfortunately, most debtors provide very little time for a counterparty to an executory contract to file an objection to assumption and assignment of the contract. It is common for the bid deadline, the auction date and the hearing to approve a sale to occur within a period of a

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131 In In re Collins, 180 B.R. 447 (Bankr. E.D. Va. 1995), the court ruled that it must determine whether there is an objective basis for either a factual or legal dispute as to the validity of the debt. This standard does not require the court to resolve the underlying dispute, just determine its existence. Courts utilizing this approach have held the parties to an evidentiary standard: evidence must be provided to show factual grounds that there is an “objective basis” for the dispute. Id. at 452.

132 In re Bedford Square Assocs., L.P., 247 B.R. 140 (Bankr. E.D. Pa. 2000) (determining that an improperly recorded interest in real estate was subject to avoidance and therefore in bona fide dispute).

133 See section III, supra.
week or ten days, which significantly limits the time for counterparties to contracts to react. To an extent, this shortened time cannot be avoided; if the debtor does not know what the buyer wants until the buyer is identified and commits, then the debtor cannot provide more notice. From a franchisor perspective, however, two approaches can be used to address tight deadlines associated with assumption and assignment in the context of a section 363 sale. First, a franchisor may object to the bid procedures to try to convince the court to force the debtor to provide more, and better, notice to affected contract counterparties. For example, the debtor can be required to send the notice of proposed contracts to be assigned by electronic mail and to include in the notice the exact basis for the debtor’s calculation of cure amounts. Second, in many cases, it makes sense for a franchisor to file a preemptive objection to assumption and assignment of the franchise agreement, even before the debtor designates contracts to be assigned. A franchisor can describe in its objection whether the contract is able to be assumed and assigned without the consent of the franchisor; what will be required to cure monetary and non-monetary defaults; and what forms of adequate assurance of future performance will be required from any buyer. By being proactive, a franchisor can mitigate the usual “fire drill” that occurs when a debtor finally decides which contracts it wants to assume and assign to a buyer.

**VII. CHAPTER 11 PLAN CONFIRMATION**

**A. Legal Requirements**

Confirmation of a Chapter 11 plan generally involves grouping creditors with similar claims into classes, obtaining court approval of a disclosure statement that provides certain information to creditors, sending ballots to creditors to enable them to vote to accept or reject the plan, and evaluating whether a sufficient number and dollar amount of creditors in each class have voted to accept the plan. The required contents of a Chapter 11 plan are set out in section 1123 of the Bankruptcy Code. To confirm a Chapter 11 plan of reorganization or liquidation, a debtor also must satisfy each of the requirements set forth in section 1129(a) of the Bankruptcy Code. The debtor bears the burden of proof on each of these elements. While a complete discussion of section 1129(a) is beyond the scope of this paper, some of the requirements that are commonly contested are discussed below.

**B. Process for Confirmation of Chapter 11 Plans**

1. **Disclosure Statements**

Franchise lawyers will be very familiar with the concept of providing a disclosure statement to potential franchisees, and a similar concept applies with respect to Chapter 11 plans. Section 1125(b) of the Bankruptcy Code requires that a disclosure statement providing “adequate information” be transmitted to each holder of a claim or interest prior to voting to accept or reject the plan or the deadline for objecting to confirmation of a Chapter 11 plan. “Adequate information” is defined as “information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a

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hypothetical investor typical of the relevant class to make an informed judgment about the plan. 

In In re Metrocraft Publishing Services, Inc., the court provided a list of information that should be included in a disclosure statement in order to provide adequate information, which includes the following:

1. the events which led to the filing of a bankruptcy petition;
2. a description of the available assets and their value;
3. the anticipated future of the company;
4. the source of information stated in the disclosure statement;
5. a disclaimer;
6. the present condition of the debtor while in Chapter 11;
7. the scheduled claims;
8. the estimated return to creditors under a Chapter 7 liquidation;
9. the accounting method utilized to produce financial information and the name of the accountants responsible for such information;
10. the future management of the debtor;
11. the Chapter 11 plan or a summary thereof;
12. the estimated administrative expenses, including attorneys’ and accountants’ fees;
13. the collectibility of accounts receivable;
14. financial information, data, valuations or projections relevant to the creditors’ decision to accept or reject the Chapter 11 plan;
15. information relevant to the risks posed to creditors under the plan;
16. the actual or projected realizable value from recovery of preferential or otherwise voidable transfers;
17. litigation likely to arise in a nonbankruptcy context;
18. tax attributes of the debtor and tax consequences of the proposed plan; and
19. the relationship of the debtor with affiliates.

In most cases, the bankruptcy court will conduct a hearing to approve the disclosure statement as containing “adequate information” before the plan is sent out for voting, and then later conduct a separate hearing on confirmation of the Chapter 11 plan and section 1129(a). In some cases involving small businesses, the court has discretion to combine the disclosure statement hearing and the confirmation hearing into one hearing.

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137 Id. at 568.
2. Voting Requirements

A Chapter 11 plan will group creditors and equity owners into classes based upon the similarity of their claims. A plan may place a claim or interest in a particular class only if the claim or interest is substantially similar to the other claims or interests in such class. Often, each secured claim will be put in its own class, there will be one class of general unsecured creditors, and the equity interests will be put in one class. After the disclosure statement has been approved by the court, it will be mailed with the Chapter 11 plan and forms of ballots to all creditors and equity interest holders. The package will include instructions on completing and returning the ballots and will specify deadlines for voting and filing objections to confirmation.

A class of claims has accepted a plan if the plan has been accepted by creditors that hold at least two-thirds in dollar amount and more than one-half in number of the allowed claims in such class that have actually submitted ballots. Only actual votes are considered for purposes of the dollar amount and numerosity requirements, so if only one creditor in a class submits a ballot and votes to accept the plan, the class has voted to accept the plan. Acceptance of the plan by each class is important under section 1129(a) for several reasons. If a class has not accepted the plan, then the debtor must satisfy the "cram down" requirements in section 1129(b) of the Bankruptcy Code with respect to that class. Also, a Chapter 11 plan may not be confirmed unless at least one class, excluding insiders, has voted to accept the plan.

3. Common Reasons to Object to Confirmation

The list of requirements for confirming a Chapter 11 plan is long, but several provisions are more commonly litigated than others.

a. Compliance with the Bankruptcy Code

Section 1129(a)(1) provides that a Chapter 11 plan must comply with the other provisions of the Bankruptcy Code. This means that if a plan proposes to assume or assign an executory contract or lease, the debtor must comply with section 365. In addition, if a Chapter 11 plan proposes that a personal guarantor of the debtor's obligations under a franchise agreement will be released from his or her guaranty, the franchisor can argue that the plan violates section 524(e) of the Bankruptcy Code, which provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."
b. **Best Interests of Creditors**

Section 1129(a)(7) requires that with respect to each impaired class of claims or interests, each holder of a claim or interest of such class (i) has accepted the plan or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that the holder would so receive or retain if the debtor were liquidated under Chapter 7 of the Bankruptcy Code on such date. This provision applies to “each holder of a claim or interest,” so unless there is unanimous acceptance of the plan, the debtor will be required to show that creditors will receive more under the plan than they would receive if the business was shut down and liquidated. The “best interests” test generally is satisfied through a comparison of the estimated recoveries for a debtor’s stakeholders in a hypothetical Chapter 7 liquidation of the debtor’s estate against the estimated recoveries under the debtor’s plan.\(^\text{145}\)

\[\text{145} \quad \text{See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 442 n.13 (1999) (explaining that 'the 'best interests' test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan'); In re Adelphia Commc'n's Corp., 368 B.R. 140, 251 (Bankr. S.D.N.Y. 2007) (explaining that § 1129(a)(7) is satisfied when impaired holder of claim would receive "no less than such holder would receive in a hypothetical chapter 7 liquidation").}\]

\[\text{146} \quad \text{See United States v. Energy Res. Co., Inc., 495 U.S. 545, 549 (1990); IRS v. Kaplan (In re Kaplan), 104 F.3d 589, 597 (3d Cir. 1997); see also In re U.S. Truck Co., Inc., 47 B.R. 932, 944 (E.D. Mich. 1985) ("Feasibility does not, nor can it, require the certainty that a reorganized company will succeed."), aff'd, 800 F.2d 581 (6th Cir. 1986).}\]

\[\text{147} \quad \text{Kane v. Johns-Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988).}\]

\[\text{148} \quad \text{In re Walker, 165 B.R. 994 (E.D. Pa. 1994); In re Stuart Motel, Inc., 8 B.R. 48 (Bankr. S.D. Fla. 1980).}\]

\[\text{149} \quad \text{11 U.S.C. §§ 541(a)(1), 1123(b)(3)(A); see also, e.g., In re Spanson, Inc., 426 B.R. 114, 143 (Bankr. D. Del. 2010) ("a debtor may release claims in a plan . . . if the release is a valid exercise of the debtor’s business judgment, is fair, reasonable, and in the best interests of the estate.").}\]

c. **Feasibility and Adequate Means of Implementation**

Section 1129(a)(11) requires that “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.” In other words, the plan must be feasible and the debtor is not likely to default under the plan. The “feasibility” requirement does not require a guarantee of success by the debtor.\(^\text{146}\) Rather, a debtor must demonstrate a reasonable assurance of success.\(^\text{147}\) Similar to the feasibility requirement, section 1123(a)(5) of the Bankruptcy Code provides that a plan must provide “adequate means” for its implementation. To satisfy this provision, the debtor must offer specifics and cannot rely on hope and speculation about the source of funding for the plan.\(^\text{148}\)

d. **Plan Releases**

Often, a Chapter 11 plan will contain releases of claims and related injunctions that are binding on the debtor and others. Claims belonging to a debtor are property of the debtor’s estate and may properly be released as part of a settlement, including pursuant to a plan of reorganization.\(^\text{149}\) The standards for approval of a settlement under section 1123(b)(3)(A) of the Bankruptcy Code are generally the same as those utilized in connection with Bankruptcy Rule 9019, namely that the settlement exceeds the lowest point in the range of reasonable litigation
Debtor releases that are a key component of an overall settlement embodied by a plan should be approved only if they “[are] a valid exercise of the debtor’s business judgment, [are] fair reasonable, and [are] in the best interests of the estate.” In weighing the appropriateness of releases by debtors embodied in an injunction contained in a plan of reorganization, courts frequently consider a five-factor test set forth in *In re Zenith Electronics Corp.*:

1. An identity of interests between the debtor and the third party, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
2. Substantial contribution by the non-debtor of assets to the reorganization;
3. The essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success;
4. An agreement by a substantial majority of creditors to support the injunction, specifically if creditors in the impaired class or classes overwhelmingly vote to accept the plan; and
5. A provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction.

The court should weigh the equities of the releases following a “fact-specific review.”

e. **Absolute Priority Rule**

If a class of creditors does not accept the plan, then the debtor must “cram down” that class under section 1129(b) of the Bankruptcy Code. With respect to an impaired class of unsecured creditors that does not accept a plan, the allowed claims of such creditors must be paid in full under the plan before any class of junior claims or interests can “receive or retain under the plan on account of such junior claim or interest any property.” In other words, old equity cannot retain its equity, or receive any value, if the class of unsecured creditors does not accept the plan and is not being paid in full under the plan. This requirement is known as the “absolute priority rule.” However, if the old equity owners contribute “new value” to the debtor under the plan, which generally must be money, and the payment by the old equity holders is reasonably equivalent to the value of the equity being retained by them, then the court may confirm the Chapter 11 plan.

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151 *In re Spansion*, 425 B.R. at 143.


VIII. CONCLUSION

Given the myriad of issues at hand, it is easy to why a franchisee bankruptcy case has the potential to be chaotic and unpredictable. In fact, it is common in Chapter 11 bankruptcy cases across all industries for the end result of the case to be quite different than what was initially intended. Nevertheless, while dealing with unpredictability will always be a meaningful part of bankruptcy practice, the issues discussed above provide franchisors, franchisees, and other parties in interest with important guideposts along the way toward plan confirmation, sale consummation, or orderly liquidation.

It is also critical to keep in mind that in the case of a franchisee bankruptcy, the general bankruptcy concepts present in any Chapter 11 case run alongside the on-going and unique relationship between a franchisor and franchisee. In normal (non-bankruptcy) circumstances, the franchisor/franchisee relationship certainly can become adversarial and otherwise contentious. The stress, expense, and uncertainty of bankruptcy only exacerbate the potential for conflict. However, franchisors and franchisees who keep in mind that they have many interests in common (not the least of which is maximizing the value of the brand) stand the best chance of weathering the bankruptcy storm.
AUTHOR BIOGRAPHIES

Jason B. Binford

Jason Binford is a Dallas-based partner in the financial restructuring and reorganization practice group of Gardere Wynne Sewell, LLP and a member of the firm’s global supply network industry team. He works with franchisors, franchisees and related parties to provide workable, real-world solutions to deal with financial distress. Jason draws on his experience as a corporate litigator and an attorney board certified in business bankruptcy law to assist in every aspect of a financial reorganization, whether inside or outside the courtroom. His understanding of, and experience with, complicated issues of franchise law provides an uncommon level of agility and legal sophistication in these matters. Jason’s experience also extends beyond franchise issues, including the representations of debtors, creditor committees, lenders, creditors and every other meaningful stakeholder in large to midsize Chapter 7 and 11 cases across a diverse set of industries. He has been recognized through board certifications from the Texas Board of Legal Specialization and the American Board of Certification, as well as being named a Rising Star and a Super Lawyer by Thomson Reuters every year since 2011.

Jason is actively involved in the Forum on Franchising, where he has previously spoken at the annual conference and published multiple articles in the Franchise Law Journal. He also serves as an associate editor of the Franchise Law Journal. He is currently co-editing a book for the American Bar Association that covers the varied intersections between franchise and bankruptcy law, scheduled to be published in 2018.

James S. Rankin, Jr.

Jay Rankin is a partner in the bankruptcy practice group at Parker, Hudson, Rainer & Dobbs LLP in Atlanta, Georgia. He primarily represents asset-based lenders and lender groups in connection with chapter 11 bankruptcy cases in the Southeast, Delaware and New York, workouts, forbearance arrangements, foreclosures and state and federal receiverships. Jay’s practice includes defending creditors in avoidance actions and other adversary proceedings, including preference, fraudulent conveyance, and equitable subordination actions; representing purchasers of assets in bankruptcy sales; assisting franchisors, landlords and equipment lessors with assumption, rejection, claims allowance and other bankruptcy issues; and prosecuting and defending creditors’ rights and lender liability actions in state and federal courts, including writ of possession, fraud, receivership and guaranty litigation. Jay is an active member of the American Bankruptcy Institute, the Atlanta Bar Association (Bankruptcy Section), and the Atlanta Chapter of the Turnaround Management Association and is listed in Chambers USA Leading American Business Lawyers as a leading business lawyer in bankruptcy/restructuring.

Robert F. Salkowski

Robert F. Salkowski is a partner with the law firm of Zarco, Einhorn, Salkowski & Brito, P.A., located in Miami, Florida. Robert has practiced franchise, dealership and distribution law for over 25 years, and regularly represents franchisees, automobile dealers and hotel owners throughout the United States. Robert also frequently lectures about franchise and distribution matters, has authored numerous articles on these subjects in industry and legal publications, and has received a number of awards and recognitions from national publications, including The Best Lawyers in America for Franchise Law.