

PUBLICATION

Franchise Agreements in Bankruptcy: Fiasco or Fortuity

Authors: Nelwyn W. Inman

August 1, 2008

Your franchisee files bankruptcy; is this good news or bad news? It could be either depending on whether the debtor wishes to keep the franchise in place or plans to let it go. The Bankruptcy Code has special rules on how a debtor can treat this type of agreement where it was entered into prior to the filing of the bankruptcy and remains in effect as of the time the case was filed.

A franchise agreement which is in effect at the time a bankruptcy case is filed is an executory contract. The Bankruptcy Code has special provisions about how executory contracts — such as franchise agreements to which the debtor is a party — are treated. These rules do not apply where a franchise agreement was properly terminated before a bankruptcy is filed. The filing of a bankruptcy does not breathe new life into an agreement in which the debtor already lost his contractual rights prior to the case being filed. Likewise, these rules do not apply to an agreement entered into with a debtor-in-possession after a case is filed.

In general, the Bankruptcy Code gives the debtor (or trustee if one has been appointed) in a Chapter 11 case the right to assume or reject an executory contract such as a franchise agreement. The debtor also has certain rights to assign an executory contract which has been assumed. The debtor's assumption or rejection is subject to court approval except where there is an expiration of the time given to assume, in which event it is automatically deemed to be rejected.

The debtor must assume or reject a franchise agreement as to the whole agreement; the debtor cannot pick and chose the parts he wants to keep and those he wants to drop. What constitutes a “whole” agreement is not always determined by the structure or arrangement of the documents evidencing the agreement. Where several documents are all part of one transaction, one dependent on the other, and linked together by the nature of transaction, they will likely be considered a single agreement, the parts of which must all be assumed or all rejected. The determination of what constitutes a single executory contract or several separate ones will be governed by applicable state law, though the bankruptcy court will decide the issue. For example, where a franchisee enters into a franchise agreement and in conjunction therewith also enters into a software license agreement at the same time, those two documents, even though signed separately, will likely be deemed a single executory contract such that the debtor must assume both or reject both.

The time for the debtor assuming an executory contract and the conditions to be met by the debtor are not unlimited. In a Chapter 7, if the trustee has not assumed the executory contract within 60 days of the filing of the case, the contract is deemed to have been rejected. The trustee can ask the court to extend this deadline. In a Chapter 11, the debtor (or the trustee if one has been appointed) has until confirmation of the plan to assume or reject an executory contract. Often, the plan itself will provide for either assumption or rejection.

Since the time between filing of the case and confirmation of a Chapter 11 plan is many months, if not years, the nondebtor party to the executory contract can file a motion with the court asking that the debtor or trustee be compelled to assume or reject the executory contract. Where a case has been pending for a long time, especially where there is no immediate prospect for confirmation of a plan, the court is more inclined to compel the debtor to decide whether to assume or reject an executory contract. Although a Chapter 11 debtor should be paying all on-going charges incurred in the operation of its business after the case is filed, the court will also

be more likely to compel a decision when the debtor is not staying current on the charges incurred under the agreement since the case was filed.

If the debtor or trustee assumes an executory contract, the Bankruptcy Code requires that the debtor: (a) cure defaults or provides adequate assurance that the defaults will be cured; (b) compensate the other party for pecuniary loss or provide adequate assurance of the same; and (c) provide adequate assurance of future performance on the contract. The debtor must cure all defaults, including the prepetition payment defaults, and any on-going operational defaults. Defaults (not including payment defaults) which are impossible to perform do not have to be cured. What constitutes adequate assurance of future performance is judged in commercial terms based on analysis of the facts. This assurance relates not only to the ability to make future payments but also the ability of the debtor to perform in other respects in compliance with the contract being assumed.

In general, a debtor who can properly assume an executory contract has the right to assign it to another party. This most commonly comes up in the context of a debtor selling its business. In cases where the debtor intends to sell its hotel, the debtor will move the court to allow it to assume the franchise agreement so the debtor can assign its rights in the franchise agreement to the purchaser. An executory contract can be assigned to the extent that it is otherwise assignable under applicable law. A recitation in the contract that it cannot be assigned is not necessarily sufficient to bar assignment. Still, the debtor does not have an unfettered right to assign any executory contract.

Where unique characteristics or qualifications of the debtor were part of the consideration for the contract, assignment may be barred. For example, a contract for an entertainer to perform a show would likely not be assignable since the contract would have been based on the individual talent of the debtor. In cases where a hotel debtor has sought to assume a franchise agreement and assign it to a purchaser, it can be argued that they are not assignable because the decision to grant the rights to the debtor was based not just on the ability to perform financially but on the skill of the debtor in operating and managing a hotel. The purchaser should go through the application, screening and training process before being granted the license rather than being allowed to step into the shoes of the debtor.

If a franchise agreement is not expressly assumed, it is deemed rejected, and the franchisor has a general unsecured claim against the estate for damages. The Bankruptcy Code provides that the rejection constitutes a breach of the contract which is deemed to have occurred immediately before the filing of the petition. By rejecting the agreement, the trustee or debtor forgoes the benefits of performance by the other party but avoids the burden of performance by the estate. While the charges which accrued after the case was filed are in this context part of the prepetition claim, to the extent that the contract benefited the estate after the case was filed, a claim can also be made for payment of the charges incurred during the case as an administrative expense to be paid in full and on a higher priority than payments to general unsecured creditors.

Where the debtor wishes to keep the franchise agreement either for continued operations of its own or for the purposes of assigning it to a purchaser of the property, the debtor will be compelled to assume the agreement. This will obligate the debtor to cure all defaults, even those that occurred prior to the filing of the bankruptcy. It will also require the debtor to demonstrate its ability to perform under the agreement going forward. With assumption of the franchise agreement, the franchisor is given the full benefit of its agreement.

Where the debtor rejects the franchise agreement, the prospects for compensation are not bright. The franchisor will have a general unsecured claim against the estate; however, such claims are often paid pennies on the dollar or nothing at all. Thus, the means of recovery where a debtor rejects the franchise agreement are very limited.

In the event either of assumption or ultimate rejection, understanding and enforcing the duties and obligations of the debtor at the outset of the case can help not only in gaining compensation in the short term but also in speeding a determination of whether there will be a the future in the franchise with the debtor.