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An Overview of Chapter 11 Franchisee Cases

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The franchise industry played a large role in the 2021 economic recovery associated with the COVID-19 pandemic by providing "advancement opportunities at all levels of the economic ladder" and "steady growth on business opening and output contributions."[1] In 2021, "the total output generated by franchised establishments improved significantly by 16.3 percent, to $787.7 billion," and it is predicted that the total output grew to $826.6 billion in 2022.[2]

Notwithstanding the substantial financial production of franchising in the U.S., even the most successful franchise systems will encounter franchisees in financial distress. In addition, with the U.S. economy softening, franchisors are increasingly worried about the financial health of their franchisees.

Troubled franchisees will often seek refuge in the bankruptcy courts, hoping to reorganize their business affairs under chapter 11. Although a chapter 11 filing by an existing franchisee may present complex challenges for a franchisor, if managed properly a bankruptcy filing may provide opportunities for an attentive franchisor. When faced with a franchisee in chapter 11, the franchisor should consider the following: (1) is there a desire to maintain this franchised location in the system; (2) how can we protect the brand's marks, intellectual property and reputation; (3) how can we collect amounts due; and (4) is there a way to enhance our position?

Where Can a Franchisee File for Bankruptcy?

Venue in bankruptcy is important because it can dictate substantive legal outcomes. A franchisee can file a bankruptcy case in any of the following locations: (1) where the debtor is domiciled; (2) where the debtor's residence is located; (3) where the debtor's principal place of business is located; (4) where the debtor's principal assets in the U.S. are located for the greater of 180 days before filing the petition; or (5) in the same district as a pending bankruptcy case concerning the debtor's affiliate, general partner or partnership.[3] Thus, a franchisee that is a business entity can commence a bankruptcy proceeding in one of several jurisdictions.

Is the Franchise Agreement Property of the Bankruptcy Estate?

The filing of a bankruptcy petition creates a bankruptcy estate that consists of all "property" of the debtor.[4] The Bankruptcy Code broadly defines "property" as "all legal or equitable interests of the debtor in property as of the commencement of the case."[5] Property of the estate "includes all kinds of property including tangible and intangible property [and] causes of action."[6]

Courts have consistently held that existing contract rights of a debtor, such as an interest in a franchise agreement, are property of the bankruptcy estate.[7] Therefore, where the franchise agreement is active at the commencement of the case, the franchisee may continue, at least temporarily, to use the franchisor's marks and operate within the franchise system post-petition.

However, if the franchise agreement has been terminated pre-petition, it does not become the bankruptcy estate and cannot be revived because the creation of property rights cannot be expanded where none existed under state law.[8] As such, the franchisee is not entitled to use the franchisor's marks and operate within the franchise system post-petition, and is barred from attempting to assume or assign the agreement.

Is the Franchise Agreement an Executory Contract?

"Executory contract" is not defined under the Bankruptcy Code. However, "[t]he generally accepted definition of 'executory contract' is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[9] Unless previously terminated, most franchise agreements will be considered executory con-

1 2022 Franchising Economic Outlook, Int'l Franchise Ass'n & FRANdata (2022), at 1, *available at* franchise.org/sites/default/files/2022-02/2022-Franchising-Economic-Outlook.pdf (last visited Jan. 23, 2023).
2 *Id.*
3 28 U.S.C. § 1408.
4 11 U.S.C. § 541; *see also* "Bankruptcy Estate," *Black's Law Dictionary* (11th ed. 2019).
5 11 U.S.C. § 541.
6 H.R. Rep. No. 95-595, at 367-68 (1977).
7 *Matter of Pester Ref. Co.*, 58 B.R. 189, 192 (Bankr. S.D. Iowa 1985) ("Contractual rights constitute intangible property which is included within the definition of property of the estate.").
8 *In re Vote*, 276 F.3d 1024 (8th Cir. 2002).

tracts because of the ongoing material obligations of each of the parties.

The Automatic Stay

The filing of a bankruptcy petition operates as a stay of "any action to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate,"[10] This is colloquially referred to as the "automatic stay," which temporarily bars the franchisor from, among other things, pursuing collection efforts, terminating the franchise agreement and compelling the franchisee to discontinue the use of the franchisor's marks.[11] Willful violation of the automatic stay could subject a franchisor to sanctions.[12]

Obtaining Relief from the Automatic Stay

In re Tudor Motor Lodge Assocs. Ltd. P'ship noted that "[t]he fact that the automatic stay suspends termination of [a Franchise] Agreement does not prevent termination indefinitely."[13] An interested party may be granted relief from the automatic stay for "cause":

> 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.[14]

"Cause" sufficient to modify the automatic stay is not defined in the Bankruptcy Code or detailed in applicable legislative history.[15] Thus, what constitutes "cause" for stay-relief purposes "is an intentionally broad and flexible concept [that] must, of necessity, be determined on a case-by-case analysis."[16]

The moving party has the burden to make an initial showing of "cause" for relief from the stay.[17] The *In re M.J. & K. Co. Inc.* court observed that "[o]nce cause is shown to exist, the debtor must prove that it is entitled to the protections afforded by the stay."[18] The *In re Sonnax Indus. Inc.* court noted that "[t]he burden of proof on a motion to lift or modify the automatic stay is a shifting one. Section 362(d)(1) requires an initial showing of cause by the movant, while Section 362(g) places the burden of proof on the debtor for all issues other than 'the debtor's equity in property.'"[19] Only where the movant fails to make an initial showing of cause, however, may the court deny relief without requiring any showing from the debtor that it is entitled to continued protection of the automatic stay.[20]

Franchisors have shown sufficient "cause" for stay relief to terminate a franchise agreement where there has been nonpayment of post-petition royalties, lack or lapse of insurance coverage, or post-petition quality defaults; other valid causes may be considered by the court. The Bankruptcy Code provides that executory contracts that cannot be assigned under nonbankruptcy law may not be assumed and assigned in a bankruptcy case without the permission of the contracting party.[21] Franchisors have increasingly argued that if a franchisee is legally precluded from assuming and assigning the franchise agreement, sufficient "cause" exists for relief from the stay.

Assumption or Rejection of Franchisor Agreements

Section 365 of the Bankruptcy Code allows a debtor to assume or reject any executory contract or unexpired lease to which it is a party, subject to court approval.[22] Until the debtor has assumed or rejected the franchise agreement, a chapter 11 debtor must continue to perform under the contract, including paying post-petition fees.[23]

The bankruptcy court uses a business-judgment standard to determine whether to approve rejection, assumption or assignment.[24] Depending on a franchisor's goals, assumption can provide a pathway for the retention of desirable units. On the other hand, in the case of a substandard franchisee, the exacting requirements for assumption could expedite the elimination of a problem site.

If a franchisee decides to reject the franchise agreement, a primary issue is whether rejections benefit general unsecured creditors.[25] Courts may also consider whether (1) the contract burdens the estate financially, (2) rejection would result in a large claim against the estate, and (3) the debtor showed real economic benefit resulting from the rejection.[26] If a debtor rejects a franchise agreement, it is treated as if the franchisee breached the contract immediately before the bankruptcy filing, entitling the franchisor to reject damages for breach of contract.[27] If the franchise agreement is rejected, the franchisor should work with the franchisee to de-identify the location, as this will protect the franchisor's marks.

Where there are no defaults, assumption of a franchise agreement will be granted if assumption is in the best interests of the estate, as determined in the debtor's business judgment. By contrast, where there is an existing default, the Bankruptcy Code requires that the debtor/franchisee clear three specific hurdles as a condition of assumption. Specifically, the debtor must do the following: (1) cure

9 *In re Level Propane Gases Inc.*, 297 B.R. 503, 507 (Bankr. N.D. Ohio 2003), *aff'd*, No. 02-16172, 2007 WL 1821723 (N.D. Ohio June 22, 2007) ("Executory contracts in bankruptcy are best recognized as a combination of assets and liabilities to the bankruptcy estate; the performance the nonbankrupt owes the debtor constitutes an asset, and the performance the debtor owes the nonbankrupt is a liability.").
10 *See* 11 U.S.C. § 362(a).
11 *See In re Krystal Cadillac Oldsmobile GMC Truck Inc.*, 142 F.3d 631, 637 (3d Cir. 1998); *In re ERA Cent. Reg'l Servs. Inc.*, 39 B.R. 738 (Bankr. C.D. Ill. 1984).
12 Section 362(k)(1) of the Bankruptcy Code allows the court, upon a finding of a "willful" violation of the automatic stay, to award "actual damages, including costs and attorneys' fees," as well as punitive damages "in appropriate circumstances." 11 U.S.C. § 362(k)(1).
13 *In re Tudor Motor Lodge Assocs. Ltd. P'ship*, 102 B.R. 936, 951 (Bankr. D.N.J. 1989).
14 11 U.S.C. § 362(d)(1).
15 *In re M.J. & K. Co. Inc.*, 161 B.R. 586, 590 (Bankr. S.D.N.Y. 1993).
16 *Matter of Holly's Inc.*, 140 B.R. 643, 687 (Bankr. W.D. Mich. 1992).
17 *See In re Sonnax Indus. Inc.*, 907 F.2d 1280, 1285 (2d Cir. 1990).
18 *In re M.J. & K. Co. Inc.*, 161 B.R. at 590.
19 *In re Sonnax Indus. Inc.*, 907 F.2d at 1285 (quoting 11 U.S.C. § 362(g)(1)).
20 *Id.*; *see also* 2 L. King, *Collier on Bankruptcy* ¶ 362.10 (15th ed. 1992) (moving party required to make showing of cause under § 362(d)(1), then burden of proof (*i.e.*, risk of nonpersuasion) shifts to party opposing motion).
21 11 U.S.C. § 362(c).
22 11 U.S.C. § 362(a), *et seq.*
23 *In re MS Freight Distrib. Inc.*, 172 B.R. 976, 978-79 (Bankr. W.D. Wash. 1994).
24 *In re Gardiner Inc.*, 831 F.2d 974, 975 n.2 (11th Cir. 1987); *In re Health Sci. Prods. Inc.*, 191 B.R. 895, 909 n.15 (Bankr. N.D. Ala. 1995).
25 *See In re Orion Pictures Corp.*, 4 F.3d 1095, 1098 (2d Cir. 1993), *cert. dismissed*, 114 S. Ct. 1418 (1994); *In re Kong*, 162 B.R. 86, 94 (Bankr. E.D.N.Y. 1993).
26 *In re Riodizio Inc.*, 204 B.R. 417, 425 (Bankr. S.D.N.Y. 1997).
27 11 U.S.C. § 365(g).

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all defaults or provide adequate assurance of prompt cure; (2) provide compensation or adequate assurance of prompt compensation for pecuniary loss; and (3) provide adequate assurances of future performance.[28] *Each* requirement must be satisfied before assumption can be approved, and the party seeking to assume bears the burden of establishing that all of the requirements have been met.[29] The decision to assume a contract allows the contract to continue to operate and does not change the obligations of the parties.

Assumption or rejection may occur at any time prior to the debtor's confirmation of a reorganization plan, but the court, on request of any party to such contract, may enter an order fixing a specified period within which a debtor must assume or reject.[30] While public-policy considerations afford the debtor breathing room upon the filing of a bankruptcy petition, they are not without limits. The bankruptcy court has wide discretion to determine how much time is reasonable for assumption or rejection.

Franchisor Claims

Once a franchisee is in bankruptcy, a franchisor is always going to be concerned with how to recover on its economic claims. Franchisors should address pre-petition amounts due by filing a timely proof of claim. The bar date for the filing of such claims in a chapter 11 case is typically from 90 days post-petition to the time of confirmation. Such dates also can be fixed by motion and court order; if the franchise agreement was still in existence at the beginning of a case, a franchisor will always have some time to file a claim following any rejection of that contract.

The validity and amount of a creditor's claim are presumptively established via its proof of claim. In a bankruptcy case, "[a] proof of claim executed and filed in accordance with these rules shall constitute *prima facie* evidence of the validity and amount of the claim."[31] An objector to a claim bears the burden of producing evidence sufficient to negate the claim's *prima facie* validity.[32] Once met, the burden of production shifts to the claimant, who must prove the validity and amount of the claim by a preponderance of the evidence.[33] However, "[t]he burden of production shifts only when the objectant has produced facts sufficient to demonstrate that an actual dispute exists; a mere denial of the claim's validity or amount will not suffice."[34] If the franchise agreement is rejected and terminated, bankruptcy courts will generally enforce liquidated damage provisions pursuant to applicable state law.

Where a franchise agreement has been terminated, the filing of a proof of claim not only preserves a franchisor's ability to receive some economic distribution on account of its claim, it also confers standing in the bankruptcy case for voting on or objecting to any proposed reorganization plan.

It should also be noted that any fees incurred by the debtor under the franchise agreement in the post-petition period are typically entitled to administrative-priority status.[35] The Bankruptcy Code grants a heightened priority to these post-petition fees on the notion that the debtor has derived a post-petition benefit from the continued use of the franchisor's system and marks, and that the costs of this benefit should be paid on a current basis in the ordinary course of business.

If a franchisor is not being paid post-petition fees, it can seek to compel payment or seek a variety of other remedies, such as relief from the stay for termination, dismissal of the bankruptcy case or conversion to a chapter 7 liquidation proceeding. A franchisor must always be vigilant regarding its post-petition fees and make sure that any administrative claim is properly classified and paid by the debtor.

Conclusion

As previously noted, although a chapter 11 filing by an existing franchisee may present complex challenges for a franchisor, if managed properly a bankruptcy filing may provide opportunities for an attentive franchisor. abi

28 11 U.S.C. § 365(b)(1).
29 *Id.*
30 11 U.S.C. § 365(d).
31 Fed. R. Bankr. P. 3001(f); *see also In re BRI Corp.*, 88 B.R. 71 (Bankr. E.D. Pa. 1988); *In re Bates*, 81 B.R. 63 (Bankr. D. Ore. 1987); *In re Ousley*, 92 B.R. 278 (Bankr. S.D. Ohio 1988); *In re Hudson Oil Co.*, 91 B.R. 932 (Bankr. D. Kan. 1988); *In re VTN Inc.*, 69 B.R. 1005 (S.D. Fla. 1987) (all interpreting 11 U.S.C. § 502(a) as providing that proof of claim constitutes *prima facie* evidence of validity and amount of claim).
32 *See In re Allegheny Int'l Inc.*, 954 F.2d 167, 173 (3d Cir. 1992); *In re Wells*, 51 B.R. 563, 566 (D. Colo. 1985).
33 *In re Frederes*, 98 B.R. 165, 167 (Bankr. W.D.N.Y. 1989) (citing *In re Equip. Serv. Ltd.*, 36 B.R. 241, 243 (D. Ala. 1983)).
34 *Id.*
35 Administrative-expense claims are claims for certain debts that preserve the estate. *See* 11 U.S.C. § 503(b).