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Franchisee Bankruptcies

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FRANCHISEE BANKRUPTCIES

A. Pre-petition and Early Considerations

1. Status of Franchise Agreement

One of the first steps will be to determine the status of the franchise agreement. The franchise agreement may still be enforceable, or it may have been terminated pre-petition. A license agreement may or may not be in place. To the extent that the agreement has been validly terminated before the bankruptcy filing, there may be nothing for the debtor to assume and/or assign. These factors will affect how a case goes forward. Interestingly, in a franchisee bankruptcy, the franchisor will likely be well-informed regarding the debtor/franchisee's history and finances. The franchisor will certainly be aware of the franchisee's revenues and will likely have a feel for which locations are profitable and which locations are performing poorly.

2. Case Strategy

After the review of the franchise agreement and determination of whether the agreement is still valid, a thorough review of the franchisee's financial situation will be appropriate. In particular, questions may be focused on cash flow, and whether the cash flow and liquidity are sufficient to keep the business going. The franchisee's assets and liabilities will be examined. This information will help determine the goals and path forward for a franchisee's bankruptcy case. Usually, the options include a liquidation, a straightforward reorganization, or a sale of all or some of the stores and assets, perhaps in conjunction with a reorganization. In addition, the franchisee will have the ability to reject executory contracts and unexpired leases for unprofitable locations, and to exclude such locations from any sale or plan of reorganization.

When considering the best strategy for a franchise business, it is likely that the franchisor, like the franchisee, will want to see the locations be successful and profitable whether through a sale or through a reorganization. Depending on the specific facts, the franchisor may be an ally for the debtor/franchisee; however, if management issues have caused problems in some or all of the locations, the franchisor may not be supportive of the debtor's goals.

As set forth in this paper, to the extent that the debtor's goal is to sell some or all of the locations, the franchisor's consent and approval of the proposed purchaser (and new franchisee) will be critical. Additional considerations could arise if the franchisor is a potential bidder. The bidding procedures will need to provide that the franchisor receives the information it needs as a franchisor and will also need to implement safeguards for the franchisor regarding its status as a potential bidder.

3. Venue

Venue for all bankruptcy cases is based on 28 U.S.C. §1408, which provides:

> Except as provided in section 1410 of this title a case under title 11 may be commenced in the district court for the district—
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>> (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or
>> (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

28 U.S.C. § 1408. This statute applies in a franchisee bankruptcy case, but because there may be multiple possible venues, other considerations, including state law and binding precedent regarding assumption and assignment of a franchise agreement, may come into play in determining the best venue for a franchisee Chapter 11.

In many franchisee Chapter 11 cases, another factor regarding the choice of venue is whether the Court will be likely to approve a critical vendor motion. One thing that may be different in a franchisee bankruptcy is the number of vendors used and, importantly, whether the franchise agreement and/or the franchisor mandate what the vendors must or must not do. Interruption in the supply of goods, products, food, and supplies might cause locations to close or suffer substantial loss of business and income. Most courts tend to allow or permit payment of some pre-petition debt to a supplier that is deemed a critical vendor.[1]

B. Special Considerations in a Franchisee Bankruptcy

Executory contracts, such as franchise agreements, often play a crucial role in the success or failure of a Chapter 11 case and may in some cases be the most valuable assets of a debtor. Executory contracts are generally assumable and assignable in bankruptcy provided certain requirements are met. Moreover, provisions in an executory contract or unexpired lease which

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[1] *See generally Friedman's Inc. v. Roth Staffing Cos. (In re Friedman's Inc.)*, 2011 WL 5975283, at *3 (Bankr. D. Del. Nov. 30, 2011); *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005); *In re CoServ, L.L.C.,* 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002); *see also In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) ("The ability of a Bankruptcy Court to authorize the payment of pre-petition debt when such payment is needed to facilitate the rehabilitation of the debtor is not a novel concept."); *In re Just for Feet, Inc.*, 242 B.R. 821, 824–25 (D. Del. 1999) ("The United States Supreme Court first articulated the 'necessity of payment doctrine' . . . [whereby] courts have used their equitable power under section 105(a) of the Code to authorize the payment of pre-petition claims when such payment is deeme3d necessary to the survival of a debtor in a chapter 11 reorganization.") (internal citation omitted). *But see Cap. Factors, Inc. v. Kmart Corp.*, 291 B.R. 818, 823 (N.D. Ill 2003) ("Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.").

prohibit, restrict, or condition a debtor's ability to assign are rendered unenforceable by § 365(f)(1) of the Bankruptcy Code. Section 365(f)(1) generally covers express anti-assignment provisions and provides that "notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease . . . ."[2] This opportunity to override contractual provisions can be a powerful tool to enhance the value of a debtor's assets. However, this situation may be different in a franchisee bankruptcy. Generally, the franchisor can prevent the franchisee from assigning the franchise agreement, along with its intellectual property rights, to a third party without the franchisor's consent. In addition, depending on the jurisdiction, a franchisor may have the ability to determine whether the franchisee can even assume the franchise agreement in the first place, thus possibly altering a Chapter 11 debtor's course of action in a reorganization proceeding (or, at a minimum, dictating the debtor's choice of venue regarding where to seek Chapter 11 relief).

C. Protection of Trademark Rights Under Federal Law

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

"Federal trademark law provides that 'a licensor who grants a non-exclusive license for the use of its trademark is entitled to certain protections, including restrictions on assignment.'"[3] It is commonly recognized that the "'substantial weight of authority holds that under federal trademark law, trademark licenses are not assignable in the absence of some express authorization from the licensor, such as a clause in the license agreement itself . . . .'"[4] "The purpose of a trademark, after all, is to identify a good or service to the consumer, and identity implies consistency and a correlative duty to make sure that the good or service really is of consistent quality, i.e., really is the same good or service."[5]

"In other words, federal trademark law generally bans assignment of trademark licenses absent the licensor's consent because, in order to ensure that all products bearing its trademark are of uniform quality, the identity of the licensee is crucially important to the licensor."[6]

[2] 11 U.S.C. § 365(f)(1).

[3] *In re Rupari Holding Corp*., 573 B.R. 111, 117 (Bankr. D. Del. 2017) (quoting *Wellington Vision, Inc. v. Pearle Vision, Inc. (In re Wellington Vision, Inc.)*, 364 B.R. 129, 134 (S.D. Fla. 2007)).

[4] *Rupari Holding Corp.* at 117 (quoting *In re Trump Ent. Resorts, Inc.,* 526 B.R. 116, 123 (Bankr. D. Del. 2015); *see also Miller v. Glenn Miller Prods., Inc.,* 454 F.3d 975, 988, 992–93 (9th Cir. 2006); *N.C.P. Mktg. Grp., Inc. v. Blanks (In re N.C.P. Mktg. Grp., Inc.),* 337 B.R. 230, 235–37 (D. Nev. 2005).

[5] *Trump Ent.,* 526 B.R. at 124 (quoting *In re XMH Corp.*, 647 F.3d 690, 696, 7th Cir. 2011).

[6] *Trump Ent.* 526 B.R. at 124.

In particular, the Lanham Trademark Act, codified in Chapter 22 of Title 15 of the United States Code (the "Lanham Act"), provides that a registrant of a mark registered in the Patent and Trademark Office is entitled to nationwide trademark protection.[7] The Lanham Act defines a trademark, in part, as "any word, name, symbol, or device, or any combination thereof . . . used by a person . . . to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown."[8] Moreover, the Lanham Act prevents the unauthorized use or transfer of a federally registered trademark. For example, it:

> (a) authorizes a registrant to sue and obtain injunctive relief against the non-consensual use of trademark;[9]
> (b) provides that "[a]ny person who shall, without the consent of the registrant . . . use in commerce any reproduction . . . of a registered mark in connection with the sale . . . of any goods . . . shall be liable in a civil action";[10] and
> (c) provides that "[a]ny person who . . . uses in commerce any word, term, name, symbol, or device . . . which . . . is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services or commercial activities by another person . . . shall be liable in a civil action . . . ."[11]

D. The Franchisor's Veto Power with Respect to Assumption or Assignment of the Franchise Agreement

1. The Debtor Cannot Assign Its Franchise Agreement to a Third Party Without the Franchisor's Consent

As set forth above, the Bankruptcy Code generally allows a debtor to assume, or assume and assign, an executory contract if it cures defaults under such contract, compensates or provides adequate assurance thereof for actual pecuniary losses, and "provides adequate assurance of future performance" thereunder.[12] A debtor is generally granted these rights "notwithstanding a provision

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

[8] 15 U.S.C. § 1127.

[9] 15 U.S.C. § 1116.

[10] 15 U.S.C. § 1114.

[11] 15 U.S.C. § 1125.

[12] 11 U.S.C. § 365(a)-(b)(1).

in an executory contract . . . or in applicable law" that would otherwise restrict the assignment.[13]

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

> The trustee *may not assume or assign* any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if –
> (1)(A) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor . . .; and
> (B) such party does not consent to such assumption or assignment . . .[14]

As an initial matter, it should be noted that this section is implicated when applicable (non-bankruptcy) law prevents the non-consensual assignment of a contract. Thus, it is important first to determine whether "applicable law" might excuse the non-debtor party, *i.e.* the franchisor, from accepting performance under the contract in question from a third party. Several courts have concluded that "applicable law" for purposes of § 365(c)(1) includes federal trademark law governed by the Lanham Act.[15]

"Applicable law" under this section has also been held to include (i) the government's right to consent to the assignment of a government contract under the Anti-Assignment Act, 41 U.S.C. § 15,[16] (ii) the right of a municipality to use state law to prohibit the assignment of a contract,[17] (iii) federal patent law wherein non-exclusive patent licenses are personal and assignable only with the consent of the licensor,[18] and (iv) copyright law prohibiting the assignment of software licenses without the consent of the owner of the copyright.[19]

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[13] 11 U.S.C. § 365(f)(1).

[14] 11 U.S.C. § 365(c)(1).

[15] *See In re The Travelot Co.*, 286 B.R. 447, 454 (Bankr. S.D. Ga. 2002); *N.C.P. Mktg. Grp., Inc. v. Blanks (In re N.C.P. Mktg. Grp., Inc.)*, 337 B.R. 230, 235 (D. Nev. 2005); *Wellington Vision, Inc. v. Pearle Vision, Inc. (In re Wellington Vision, Inc.)*, 364 B.R. 129, 135 (S.D. Fla. 2007).

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

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

[18] *Perlman v. Catapult Ent. Inc. (In re Catapult Ent., Inc.*), 165 F.3d 747, 750-51 (9th Cir. 1999).

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

Since a franchisor can prevent the unauthorized use of its trademarks or other intellectual property under applicable law, the restriction on assignment under § 365(c)(1) will apply to franchise agreements. Therefore, a debtor/franchisee may not be able to assign or otherwise transfer its franchise agreement to a third party without the franchisor's express consent.[20]

2. May the Franchisor Block the Debtor/Franchisee's Assumption (and Use) of Its Franchise Agreement, Even If There Is No Intent to Assign It to a Third Party?

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

Depending on which circuit the debtor/franchisee is in, the results can vary drastically. Thus, the particular circuit could be a crucial component of the franchisor's strategy regarding the debtor/franchisee's Chapter 11 case. Given the importance of the Bankruptcy Code provisions to a franchisor who wants to retain control over the approval of franchisees in its system, it is important for the franchisor's counsel to understand the nuances of §§ 365(c)(1) and 365(e)(2) and to evaluate their impact on the jurisdiction in which the debtor/franchisee's Chapter 11 bankruptcy case will be heard.

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

Courts that apply the hypothetical test base their decisions on a plain reading of the literal

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

language of § 365(c)(1), and preclude a debtor from *assuming* an intellectual property license where the debtor is prohibited under intellectual property law from *assigning* the license agreement to a hypothetical third party, whether or not the debtor actually intends to assign the agreement to a third party following its assumption.[21] Applying the hypothetical test, or the disjunctive test, the court generally will find that if a debtor would be precluded from hypothetically assigning an agreement under applicable law, then it is also precluded from assuming such agreement in its bankruptcy case.

The principal support for the hypothetical test is a literal reading of the phrase the "trustee may not assume **or** assign" an executory contract.[22] The literal reading of this phrase prohibits the assumption of an executory contract (a franchise agreement) by a debtor/franchisee - even though the debtor/franchisee is not seeking to assign such contract - if applicable law (the Lanham Act) in a *hypothetical assignment* provides that the non-debtor party (the franchisor) to such contract did not have to accept performance from a third party. This scenario is hypothetical because the debtor/franchisee in this example is not seeking to assign (i.e., sell) the contract to anyone – but hypothetically could do so.

A case example of the hypothetical test is *Wellington Vision, Inc. v. Pearle Vision, Inc. (In re Wellington Vision, Inc.).*[23] In that case, Pearle Vision, Inc. ("Pearle Vision") sought relief from the automatic stay to terminate its franchise agreement with the debtor, arguing that the debtor could not assume the agreement because applicable law excused Pearle Vision from accepting an assignment of the agreement to a third party. The Bankruptcy Court granted Pearle Vision relief from the automatic stay, which allowed Pearle Vision to terminate the franchise agreement. On appeal, the District Court affirmed the Bankruptcy Court finding that pursuant to § 365(c)(1), the debtor/franchisee could neither assume nor assign the franchise agreement without the consent of Pearle Vision, because the franchisee had a non-exclusive trademark license with Pearle Vision pursuant to the franchise agreement, and thus, the Lanham Act excused Pearle Vision from accepting performance from an entity other than the franchisee.[24] Accordingly, the District Court found that Pearle Vision was entitled to stay relief to terminate the franchise agreement.[25]

To date, the Third, Fourth, Ninth, and Eleventh Circuit Courts of Appeal have adopted the

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[21] Section 365(c)(1) is written in the disjunctive: a debtor "may not assume **or** assign" a contract if non-bankruptcy law precludes its assignment without consent of the other party. 11 U.S.C. § 365(c) (emphasis added).

[22] *Id.*

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

[24] *Id*. at 137.

[25] *Id.* at 134.

hypothetical test with respect to license agreements or other executory contracts.[26]

Specifically, in the case of *In re Catapult Entertainment, Inc.*,[27] the debtor was formed to create an online gaming network for console video games and was party to two (2) license agreements relating to certain technologies including patents and patent applications. As part of its plan of reorganization, the debtor sought to assume the patent licenses over the licensor's objection. The Ninth Circuit held that, under the plain reading of § 365(c)(1) of the Bankruptcy Code, the debtor was barred from assuming the patent licenses without the licensor's consent. The Ninth Circuit noted that "federal patent law constitutes 'applicable law' within the meaning of § 365(c), and that nonexclusive patent licenses are 'personal and assignable only with the consent of the licensor.'"[28] The Ninth Circuit went on to hold that the debtor was precluded from assuming the patent licenses, on the basis that applicable non-bankruptcy law excused the licensor from accepting performance from any hypothetical third party - even though the debtor did not intend to assign the contract to third party. The Ninth Circuit performed an analysis of the language of § 365(c)(1), its plain meaning and legislative history, and concluded that if applicable non-bankruptcy law prohibited the non-consensual assignment of an executory contract, then a debtor would be prohibited from assuming such contract - even if the debtor did not intend to assign the contract to a third party. [29]

In addition, in the case of *In re West Electronics, Inc.*,[30] the debtor was a party to a contract with the United States government to provide missile launcher supply units to the Air Force. After the debtor filed for bankruptcy, the government moved for relief from the automatic stay to terminate the contract. The Bankruptcy Court denied the government's motion. After the District Court affirmed, the Third Circuit reversed and held that the government should have been granted stay relief to terminate the contract. In so holding, the Third Circuit analyzed § 365(c)(1) of the Bankruptcy Code and its legislative history and concluded that if non-bankruptcy law provided that the debtor could not assign the contract without the government's consent, then the debtor could not assume the contract without the government's consent.[31]

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[26] *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 257; *Perlman v. Catapult Ent., Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747, 747 (9th Cir. 1999); *City of Jamestown v. James Cable Partners, L.P. (In re St. James Cable Partners, L.P.*), 27 F.3d 534, 534 (11th Cir. 1994); *In re West Elecs., Inc.*, 852 F.2d 79, 79 (3rd Cir. 1988); s*ee also Wellington Vision*, 364 B.R. 129; *N.C.P. Mktg. Grp., Inc. v. Blanks (In re N.C.P. Mktg. Grp., Inc*.), 337 B.R. 230 (D. Nev. 2005); *aff'd,* 279 Fed.Appx. 561 (9th Cir.2008), *cert. denied,* 556 U.S. 1145 (2009); *In re Ajranc Insurance Agency, Inc.*, 2021 WL 274937 (Bankr. M.D. Fla. 2021); *In re Kazi Foods of Michigan, Inc.*, 473 B.R. 887, 890 (Bankr. E.D. Mich. 2011).

[27] *Catapult Ent.*, 165 F.3d 747.

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

[29] *Id*. at 747-754.

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

[31] *Id*. at 83.

Likewise, the Fourth Circuit adopted the hypothetical approach in the case of *RCI Technology Corporation v. Sunterra Corporation (In re Sunterra Corporation)*,[32] wherein the court held that a debtor was precluded from assuming a computer software licensing agreement on the basis that applicable copyright law excused the other party to the contract from accepting performance from any hypothetical third party - even though the debtor did not intend to assign the contract to a third party. The Fourth Circuit performed an extensive analysis of the language of § 365(c)(1), its plain meaning and legislative history, and concluded that if applicable non-bankruptcy law prohibited the non-consensual assignment of an executory contract, then a debtor would be prohibited from assuming such contract – even if the debtor did not intend to assign the contract to a third party.[33]

These cases provide significant protection to a franchisor (or a licensor of intellectual property) that desires to retain complete control over the identity of its franchisees, including whether the franchisee should be permitted to continue to use the franchisor's intellectual property once it has become a debtor in a Chapter 11 case. If the franchise agreement is essential to the reorganization of the debtor, the franchisor in these circumstances essentially have veto rights over the Chapter 11 case.[34] On the other hand, the hypothetical test has been the subject of some criticism. The draconian reality of the hypothetical test is that even when the debtor indicates no interest in assigning the agreement, assumption is prohibited if assignment is prohibited. While those courts construe the literal language of the Bankruptcy Code, such decisions seemingly jeopardize a debtor's ability to successfully reorganize without the express consent of the franchisor or the owner of the intellectual property rights at issue.[35]

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

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

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

[35] For example, the Supreme Court stated in denying a petition for certiorari in *N.C.P. Marketing Group v. BG Star Productions, Inc.*:

> The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under non-assignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful

b. The Actual Test: Assumption Prohibited Under § 365(c)(1) Only If There Is an Actual Proposed Assignment

The actual test provides that if the debtor has no intent to assign the executory contract to a third party, then it can be assumed so long as it meets the other traditional requirements of § 365 (*i.e.*, defaults are cured and adequate assurance of future performance is provided). Under this approach, the courts will make "a case-by-case inquiry into whether the nondebtor party . . . *actually* was being 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'"[36] These courts read the disjunctive "or" in § 365(c)(1) as the word "and."[37] The actual test requires that the debtor actually proposes an assignment before the courts will preclude an assumption in the first instance under in § 365(c)(1).

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

The actual test has been adopted by only the First and Fifth Circuit Courts of Appeal[38] and

> reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim - and resell at the prevailing, potentially higher market rate - the rights it sold to the debtor.

N.C.P. Mktg. Grp., Inc. v. BG Star Prod., Inc., 556 U.S. 1145, 129 S. Ct. 1577, 1577, 173 L. Ed. 2d 1028 (2009).

[36] *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (quoting *Summit Inv. and Dev. Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995)), abrogated by *Hardemon v. City of Boston*, No. 97-2010, 1998 WL 148382 (1st Cir. May 8, 1998) (withdrawn and replaced by *Hardemon v. City of Boston*, 144 F.3d 24 (1st Cir. 1998).

[37] *See Institut Pasteur*, 104 F.3d 489.

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

a number of lower courts have applied the actual test outside of the hypothetical-test circuits.[39] However, the actual test has been criticized, although it may be argued that the actual test aligns § 365(c) with sound bankruptcy policy, it may do so only at the cost of departing from at least one interpretation of the plain text of the law.[40]

It is important to note that the First and Fifth Circuits adopted the actual test in the context of issues arising under § 365(e)(2) of the Bankruptcy Code as opposed to § 365(c)(1) of the Bankruptcy Code. While these two Bankruptcy Code sections are effectively corollaries of one another, they are in fact different and address different issues.[41] Section 365(e)(1) contains the *ipso facto* provision that essentially prohibits the termination or modification of an executory contract after the commencement of the case based on (i) "the insolvency or financial condition of the debtor . . ." (ii) the commencement of the bankruptcy, or (iii) the appointment of a trustee.[42] Section 365(e)(2) contains the exceptions to the *ipso facto* provisions of § 365(e)(1). Specifically, under § 365(e)(2), the *ipso facto* provisions will not prevent the termination or modification of an executory contract if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance *to the trustee or to an assignee* of such contract or lease . . . and . . . such party does not consent to such assumption or assignment[.]"[43] Typically, § 365(e)(2) does not arise in the context of the assumption and/or assignment of a contract. Rather, it arises as a basis to seek relief from the automatic stay in order to terminate a contract upon the filing of a bankruptcy. The First and Fifth Circuits adopted the actual test in the context of § 365(e)(2). In fact, in *Mirant Corp.*, the Fifth Circuit stated that the

[39] *In re Footstar, Inc.*, 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005). Lower courts adopting the "actual test" include *Cajun Electric Members Committee v. Mabey (In re Cajun Electric Power Cooperative, Inc.)*, 230 B.R. 693 (Bankr. M.D. La. 1999); *In re Ontario Locomotive & Industrial Railway Supplies (U.S.), Inc.*, 126 B.R. 146 (Bankr. W.D.N.Y. 1991); *In re Cardinal Industries, Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990); *In re Ohio Skill Games,* 2010 WL 2710522 (Bankr. N.D. Ohio 2010); *In re Aerobox Composite Structures, LLC*, 373 B.R. 135 (Bankr. D. New Mexico 2007).

[40] Another variation of the actual test focuses on the use of the term "trustee" in § 365(c). In the case of *In re Footstar*, the court, unlike other courts that have addressed this issue, applied the plain meaning rule of statutory construction in reaching its conclusion that the "actual test" applies under § 365(c)(1). The court based its conclusion on the finding that the term "trustee," when used in § 365(c)(1), could not logically mean the "debtor in possession." *Footstar*, 323 B.R. at 572. The court reasoned that because "no provision of the Bankruptcy Code states in words or substance that references in the Code to 'trustee' are to be construed to mean 'debtor' or 'debtor in possession,'" it makes sense to prevent the trustee from assuming or assigning a contract, but not the party that originally entered into the contract with the non-debtor. *Id.* at 571-72. "Thus, where the debtor-in-possession seeks to assume . . . 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract." *In re Aerobox Composite Structures, LLC*, 373 B.R. 135, 142 (Bankr. D.N.M. 2007). While the rationale is different, the *Footstar* line of cases seems to play out the same as the actual test so long as no trustee has been appointed.

[41] *See Mirant Corp.*, 440 F.3d at 247 n.16.

[42] *See* 11 U.S.C. § 365(e)(1).

[43] 11 U.S.C. § 365(e)(2)(A) (emphasis added).

cases supporting the hypothetical test under § 365(c)(1) should not be given "any more than informative weight" when considering § 365(e)(2), because "they are by no means parallel overall or identical in effect . . . [and] are not sufficiently similar."[44]

Clearly, one of the principal bases for the adoption of the hypothetical test by the Third, Fourth, Ninth and Eleventh Circuits under § 365(c)(1) is the use of the disjunctive term "or" in the lead-in phrase to § 365(c)(1) – "the trustee may not assume or assign . . . ."[45] However, § 365(e)(2) does not contain this parallel provision, because it does not address circumstances where assumption or rejection are prohibited. Moreover, § 365(e)(2) uses the term "to the trustee or to an assignee,"[46] while § 365(c)(1) uses the term "to an entity other than the debtor or debtor in possession . . . ."[47] Prior to the 1984 amendments to the Bankruptcy Code, §§ 365(c)(1) and 365(e)(2) read the same in this regard. In 1984, Congress elected to modify § 365(c)(1) to replace "to the trustee or to an assignee" with "to an entity other than the debtor or debtor in possession." The Fifth Circuit suggests that Congress' decision to make this change in respect of § 365(c)(1) supports the use of the "actual test" for § 365(e)(2) principally because of the Fifth Circuit's analysis of the plain text of § 365(e)(2). Otherwise, Congress would not have made any changes to the language or would have made the same change to both provisions. As a result, the logical progression of this analysis is that the change made by Congress to § 365(c)(1) would support the application of the "hypothetical test" to § 365(c)(1).

In addition to the plain text analysis used by the Fifth Circuit to support the use of the actual test, the Fifth Circuit analyzed the Anti-Assignment Act[48] at issue in *Mirant Corp.*, which was the "applicable law" relied upon in that case. Under the plain text of the Anti-Assignment Act, the Fifth Circuit concluded that the prohibition on assignment in such "applicable law" required an analysis of the particular facts of the transaction at issue, because certain factual scenarios did not trigger the anti-assignment provisions contained therein. As a result, the Fifth Circuit concluded that the actual test was needed to determine whether the Anti-Assignment Act triggered the provisions of § 365(e)(2) in the first instance. An argument can be made, therefore, that the Fifth Circuit's conclusion regarding the application of the "actual test" vs. the "hypothetical test" depends on which "applicable law" is at issue. As an example, the Lanham Act prohibits the assignment of a license or franchise in all situations without the consent of the licensor/franchisor. Thus, it is unclear whether the Fifth Circuit would apply the "actual test" or "hypothetical test" in connection with the Lanham Act.

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[44] *Mirant Corp.*, 440 F.3d at 247 n.16.

[45] 11 U.S.C. § 365(c).

[46] 11 U.S.C. § 365(e)(2)(A).

[47] 11 U.S.C. §365(c)(1)(A).

[48] 41 U.S.C. §6305 (formerly cited as 41 U.S.C. § 15).

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

Faculty

Hon. Tamara O. Mitchell is a U.S. Bankruptcy Judge for the Northern District of Alabama in Birmingham, initially appointed on January 4, 1992. She served as Chief Bankruptcy Judge from Jan. 1, 1995, to Dec. 31, 2003. Prior to her appointment to the bench, Judge Mitchell practiced law in Mobile, Ala., first as a solo practitioner and later as a partner in the firm of Grodsky & Mitchell. Her practice consisted of substantial bankruptcy work along with a general civil practice. Judge Mitchell is a member of the National Conference of Bankruptcy Judges, the Alabama State Bar, the California State Bar, the Birmingham Bar Association and ABI. She has participated in numerous seminars sponsored by bar associations, law schools, the National Conference of Bankruptcy Judges, ABI and the NACTT. Judge Mitchell received her B.S. from the University of South Alabama in Mobile and her J.D. from Whittier College School of Law in Los Angeles, California.

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