Fox Rothschild Franchise Fundamentals Podcast

Bankruptcy Fundamentals in Franchising – Part I

Featuring John Gotaskie of Fox Rothschild LLP

Welcome to the latest in Fox Rothschild's Franchise Fundamentals Podcast featuring Partner John Gotaskie in Pittsburgh. In part 1 today, we'll talk about franchise agreements in bankruptcy cases and business restructurings, focusing on the problems and issues that bankruptcy can, but also cannot, resolve. Part 2 will deal with the assumption issue and rejection of executory contracts such as franchise agreements.

John edits Fox's Franchise Law Update blog. He represents clients in a variety of corporate, venture finance, franchising, licensing and distribution matters as well as in bankruptcy and commercial litigation. His Franchise Fundamentals Podcast library covers a broad variety of key concerns, business strategy and legal updates, and it explores the operational challenges and solutions that shape business growth. John, good morning.

John Gotaskie: Thank you. Good morning.

Question*: John, you recently co-presented on this topic at the American Bar Association Annual Forum on Franchising. Your co-presenter was Jason Binford of the Office of the Attorney General of Texas.*

John Gotaskie: Yes, the ability to seek refuge from creditors in a bankruptcy court is an important, and powerful, tool for businesses, especially during difficult economic periods. It was great to partner with Jason in dissecting this complex topic, about which we are both chapter authors in an ABA book.

Question*: Can you provide a broad overview for our listeners?*

John Gotaskie: Sure. The American system of bankruptcy is really predicated on giving a company a "breathing spell" and a fresh start so as to allow it to formulate a plan to reorganize debts and emerge from bankruptcy free of burdensome obligations. This ideal is demonstrated by Chapter 11 of the Bankruptcy Code itself, which provides that a debtor's management stays in control of the company during the bankruptcy case as what is called a "debtor-in-possession." Absent a showing of mismanagement or other malfeasance, management control is then maintained throughout the bankruptcy process. This procedure stands in contrast with insolvency proceedings in other countries, or even in some states, where it is typical for a trustee or receiver to take control of the case from the outset. In fact, Chapter 11 has been described as providing the United States with an economic competitive advantage over other countries because it allows for creativity and risk-taking without the immediate fear of management losing control over the business.

Question*: John, with so many franchisors and franchisees facing uncertain futures as a result of the coronavirus pandemic, won't more and more be seeking Chapter 11 bankruptcy protection?*

John Gotaskie: Unfortunately, yes, we expect that to be the case. Nonetheless, at this point I still feel that it's very important for prospective debtors to conduct the due diligence necessary to determine if bankruptcy is the right fit. It's especially critical to remember that a bankruptcy filing is not a foregone conclusion in a financial hardship. It's an option to be considered. Prospective debtors should evaluate whether it is a good and/or realistic option.

Question*: John, if I'm a company with significant debt, what are some of the most important benefits of bankruptcy that I should consider?*

John Gotaskie: I think the number one thing is that debtors have the power to assume or reject executory contracts. And that's a very attractive element of bankruptcy here in the United States. The concept of executory contracts is vital and integral to the entire Bankruptcy Code, but strangely enough, the Code doesn't define the term "executory contact." Despite the lack of definition, the Code goes into great detail about what can and cannot be done with them. So what are they? The legislative history of the Code states that executory contracts "generally include contracts on which performance remains due to some extent on both sides. Thus, their touchstone is that the parties to a contract must both owe material duties to each other. Franchise agreements are themselves executory contracts. But they also encompass service contracts, equipment leases and real property leases.

Question: *So, what does it mean to assume or reject contracts in bankruptcy?*

John Gotaskie: Really good question. To assume a contract means that the debtor agrees to perform the contract while the debtor refusing to perform the contract is simply the rejection of the contract. Pretty simple, right? Importantly, however, while the non-debtor party is waiting to learn whether the debtor will assume or reject a contract, it must keep performing the contract as if no bankruptcy had been filed. And that's part of where the power of this part of the Code comes from.

Question: *How does a debtor assume the contract?*

John Gotaskie: Again, good question. They must first cure all economic defaults (in other words, they've got to pay up). Second, they have to cure all noneconomic defaults (performance to certain service standards, for example). Third, they have to cure any actual pecuniary loss, and so that might extend to attorneys' fees or other issues that are in the contract but are not strictly economic defaults. And last, and perhaps most complicated, they need to provide adequate assurances of future performance. In other words, they need to prove to the court that they can perform the contract in the future and won't simply fall back into default after the case ends.

Question: *Are there downsides to the rejection of contracts?*

John Gotaskie: Yes. Rejection of contract is tantamount to a breach of contract. As such, there are limitations and downsides, because some post-rejection rights and obligations remain unclear under current law. At a minimum, rejection of contract results in breach of contract damages that create an unsecured claim for the non-debtor party. If the contract had not been previously assumed in the bankruptcy case, the claim is deemed to have arisen as of the filing date of the bankruptcy petition. Unfortunately, such unsecured claims are often paid out at pennies on the dollar.

On the other hand, if the rejected contract is secured — for example, an equipment lease secured by a financing statement declaring an interest in the equipment — the secured creditor typically has the right to obtain its collateral. And if the value of the collateral is less than the value of the outstanding debt, the secured debtor will generally have an unsecured claim for the amount of the debt in excess of the value of the collateral.

Question: *Bankruptcy seems to then set up some pretty difficult and high-stakes discussions?*

John Gotaskie: That's true. In fact, it almost always makes sense for any debtor, but especially a franchisee considering a bankruptcy, to discuss the issues with its creditors and its franchisor. Franchisors don't often take "surprise" bankruptcy filings very well. The ultimate takeaway is that, if at all possible, a prospective debtor really should give a bankruptcy filing a great deal of thought before taking the leap. Understanding what is at stake will give the debtor the best chance at using Chapter 11 as an effective tool for fixing the problems with an otherwise viable company's financial situation.

Question*: John, is bankruptcy a vexing area of the law?*

John Gotaskie: We talked about this in our presentation. I think I would say that it <u>can</u> be a vexing area of the law. Bankruptcy law is federal law, and it's grounded in the Constitution. Cases proceed before federal courts and are governed by the Bankruptcy Code. But the Bankruptcy Code doesn't answer all questions. So state and federal non-bankruptcy law frequently plays an important role, especially on matters such as property rights. This includes federal intellectual property law. In one case known as <u>*Tempnology*</u>, the United States Supreme Court clarified a difficult issue at the intersection of intellectual property rights and bankruptcy law. In *Tempnology*, the Court held that rejection of a trademark license by the licensor constituted a breach of an executory contract under the Bankruptcy Code. The decision resolved a split in the decisions of several United States Courts of Appeal.

Question*: John, what about a franchisee's right to assign trademark rights in the context of bankruptcy?*

John Gotaskie: That can be a tough issue for the franchisee and one of the reasons you've got to discuss these things ahead of time. That's because in the typical franchisor/franchisee context, the franchise agreement is the critical operative document, right? And the cornerstone of all franchise agreements is the franchisor's grant of a revocable and non-exclusive license to use certain of its intellectual property and other proprietary information. This could be any combination of trademarks, service marks, trade names, copyrights and/or trade secrets. Federal trademark law provides that a licensor (in our case, the franchisor) who grants a non-exclusive license for the use of its trademark is entitled to certain protections, including, effectively, a veto on assignment of the license. So again, talking it out ahead of time is really important.

Question*: Thank you, John. Unfortunately we are out of time for today. Listeners, be sure to listen to part 2 of our series. To confidentially discuss the possibility of bankruptcy with your franchise, or to discuss his ABA Forum presentation, please contact John Gotaskie at 412-394-5528 or at jgotaskie – that's J-G-O-T-A-S-K-I-E – at foxrothschild.com. For more about our firm, or to subscribe to Fox's Franchise Law Update blog, please visit us on the web at www.foxrothschild.com.*