

## ***Fox Rothschild Franchise Fundamentals Podcast***

# **Bankruptcy Fundamentals in Franchising – Part II**

***Featuring John Gotaskie of Fox Rothschild LLP***

*Welcome to the latest installment of Fox Rothschild’s Franchise Fundamentals Podcast featuring Partner John Gotaskie in Pittsburgh. Today we’ll talk about Part 2 in John’s topic of franchise agreements in bankruptcy cases and business restructurings. Part 1, if you’ve heard that, focused on some of the problems and issues that bankruptcy can, but also cannot, resolve. Part 2 today will go into a little more detail about concepts known as assumption and rejection of 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 explores the operational challenges and solutions that shape business growth. John?*

**John Gotaskie:** Thank you.

***Question:*** *In your recent presentation at the American Bar Association Annual Forum on Franchising, you and Jason Binford of the Office of Attorney General of Texas discussed the issue of assumption and rejection of executory contracts – and these of course are critical in a bankruptcy, especially in the franchise industry. We talked about the assumption and rejection of contracts in our last podcast, but maybe you can give a brief refresher on the concepts again?*

**John Gotaskie:** Sure. For any executory contract, a debtor has two choices: assumption or rejection, each leading to different results. Under the Bankruptcy Code, the debtor or bankruptcy trustee decides whether to perform its obligations. If the debtor agrees to perform, it’s called “assumption” of the contract. And if a debtor refuses to perform, it’s called “rejection.” Franchisees that file for bankruptcy protection and want to continue doing business will also want to assume the franchise agreement. Of course the franchisor may object if it’s motivated to push the franchisee out of its system.

***Question:*** *John, tell our listeners more about “rejection.”*

**John Gotaskie:** Instead of outright assumption of a franchise agreement or employment contracts, a debtor may choose to reject them. Such a rejection is treated like a breach of the agreement and leads to what are considered to be rejection damages, which generally are breach of contract damages.

***Question:*** *John, in your ABA Forum presentation, you addressed the concept of “rejection” in a case known as “Tempnology.”*

**John Gotaskie:** That's right. While Chapter 11 bankruptcy cases usually deal with the franchisee as debtor, bankruptcy filings by franchisors are becoming more common. The holding in *Tempnology* will be relevant where a franchisor/debtor seeks to reject a franchise or perhaps an area development agreement and the related trademark license.

*Question:* John, you also discussed one court's interpretation of rejection in a case known as *Lubrizol*.

**John Gotaskie:** That's right. *Lubrizol* was a court of appeal case that pre-dated *Tempnology*. It involved a licensed metal coating technology. After the licensor filed for bankruptcy protection, the court allowed the licensor to reject the license agreement and ruled that the rejection terminated the licensee's right to use the intellectual property. That court concluded that the value of the metal coating technology would be worth more to the bankrupt licensor without the restrictions of the *Lubrizol* agreement. The reaction from the business community to this decision was frankly consternation. It seemed that a licensee of intellectual property could do everything right, could completely comply with the terms of its contract and still be stripped of all of its rights should the licensor become insolvent and in need of protection from creditors. The *Lubrizol* decision thus left licensees with no right after rejection other than to recover money damages, which really wasn't helpful.

*Question:* And there had been other judicial interpretations in a case known as *Sunbeam Products*.

**John Gotaskie:** True. The *Sunbeam* case was a different court of appeal. And that case was about a company that made box fans covered by patents and trademarks. The company went into bankruptcy and was purchased by Sunbeam. Sunbeam then tried to reject certain company contracts with vendors. The Seventh Circuit here concluded that the rejection of an executory contract in bankruptcy does not – I loved this word they used – “vaporize” the contract. Instead, it merely results in a breach of contract. And consequently, the non-debtor licensee's contractual rights to utilize the licensed patents and trademarks remain intact.

*Question:* John, let's get back to the *Tempnology* case if we could. How does that factor in?

**John Gotaskie:** Well as I mentioned, *Lubrizol* and *Sunbeam* were from different courts of appeals, and the Supreme Court in *Tempnology* resolved the split between those two appellate courts. In the case, *Tempnology* had signed really an unfavorable licensing agreement with another company involving trademarked clothing and accessories. *Tempnology* filed for bankruptcy in order to reject the licensing contract, which it believed was really burdensome. The case has a convoluted history, but ultimately the Supreme Court agreed more with the *Sunbeam* analysis and ruled that rejection of a trademark license agreement by a debtor/licensor, does not “vaporize” the rights of the non-debtor licensee. Subject to certain limitations, the licensee still has whatever rights it would have under state law if the licensor breached and bankruptcy had not been filed. Now most importantly for the licensee, that includes the right to continue utilizing the trademarks pursuant to the terms of the license agreement. To be clear, this right to continued use does not mean that the licensee's obligations are obviated; to the contrary,

the licensee must continue to fulfill all of its contractual obligations, specifically including the obligation to pay all royalties as they come due.

***Question:** John, what are the lessons from the Tempnology case for franchising?*

**John Gotaskie:** That's a good question. As I mentioned, we expect that more franchisor bankruptcy cases will be coming up. And what we have seen in the past is that a common strategy of bankrupt franchisors has been to reject area development agreements, planning to either renegotiate them or to resell those areas as part of a bankruptcy sale to new owners or as a way of raising cash. Such a strategy, I believe under *Tempnology*, is really no longer viable. Instead, such agreements will need to be terminated on their merits to proceed with same strategy, and that will be more complicated and costly. Second, *Tempnology* really demonstrated to debtor/licensors that one tool of bankruptcy – that being rejection – was not as powerful as the debtor community had thought. Other bankruptcy tools may or may not be a better fit for a particular situation. And finally, *Tempnology* highlights in a special way the essential need for pre-bankruptcy planning for all issues, but now especially for trademark issues.

***Question:** John, there's so much more that you and Jason Binford presented at the ABA Forum on Franchising.*

**John Gotaskie:** Yes. We covered disclosure obligations, contract limitations, broken business models and the control of the company. The costs of bankruptcy are often much more than people expect.

***Question:** John, I wish we could cover more of these issues, but unfortunately we're out of time for today. Listeners, be sure to [listen to Part 1](#) of this two-part 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](mailto:jgotaskie) – that's J-G-O-T-A-S-K-I-E – at [foxrothschild.com](mailto: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](http://www.foxrothschild.com).*