Bankruptcy and Assignment of Franchise Agreements over Franchisor's Objection: Response

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In *Counterpoint: Bankruptcy and Assignment of Franchise Agreements Over Franchisor's Objection*,[1] published in the Spring 2013 issue of the *Journal*, William J. Barrett disagreed with the analysis in my article, *Assigning a Franchise Agreement over the Franchisor's Objection: Bankruptcy May Make It Possible*,[2] published in the *Journal*'s Fall 2012 issue. The *Journal* has granted me the opportunity to respond, for which I am grateful.

The counterpoint summarizes my article as a viewpoint piece offering up the opinion that a bankrupt franchisee has a "fair chance of compelling its franchise to accepting a replacement franchisee." This is incorrect. In fact, the article states that successfully assuming and assigning a franchise agreement "could be an uphill legal battle and often requires a special set of circumstances,"[3] and that a franchisor relying on established case law such as *In re XMH Corp.*,[4] written by the influential jurist Richard Posner, is "arguing from a relative position of strength."[5] Moreover, the article does not offer any viewpoint in favor of franchisees or franchisors. Although the article discusses how a franchisee may be able to use bankruptcy law to assume and assign a franchise agreement, an equal amount of analysis is dedicated to how a franchisor could use bankruptcy law to prevent assignment.

To be clear, a bankrupt franchisee has much less than a "fair chance" at assigning the franchise agreement over the franchisor's objection. The cards are stacked against the franchisee under the law, as well as under industry practicalities. For example, an assignee that works together with the bankrupt

1. William J. Barrett, *Counterpoint: Bankruptcy and Assignment of Franchise Agreements Over Franchisor's Objection*, 32 FRANCHISE L.J. 247 (2013).
2. Jason B. Binford, *Assigning a Franchise Agreement over the Franchisor's Objection: Bankruptcy May Make It Possible*, 32 FRANCHISE L.J. 71, 71 (Fall 2012).
3. *Id.* at 71.
4. 647 F.3d 690 (7th Cir. 2011).
5. Binford, *supra* note 2, at 71.

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franchisee to force the franchisor's hand in bankruptcy court probably should not expect a healthy and functional business relationship with that franchisor going forward.

But is having the legal and practical cards stacked against the bankrupt franchisee the same as saying that it is impossible for a bankrupt franchisee to pull it off? No, it is not. Should franchisors complacently assume that "[w]hatever statutes, regulations, and contracts applied on the moment before the bankruptcy case was filed should still apply" and that any contrary case law "exist[s] only in memory"?[6] No, they should not. Such complacency is dangerous considering the fact that a great deal of modern case law interprets the non-debtor party's enforceable rights under Bankruptcy Code Section 365(c)(1) much more narrowly than the interpretation offered in the counterpoint.

While the article and the counterpoint both cover a good deal of legal ground, the dispute over whether a bankrupt franchisee could possibly assume and assign a franchise agreement over the franchisor's objection ultimately comes down to the scope of Bankruptcy Code Section 365(c)(1). Section 365(c)(1) allows a non-debtor contractual party to continue enforcing certain non-bankruptcy "applicable law," even though the debtor filed a bankruptcy petition. Section 365(c)(1) is an exception to the general rule, set forth in Section 365(f)(1), that anti-assignment clauses will not be enforced in bankruptcy.[7] As discussed in the article, it is the interplay between Sections 365(c)(1) and 365(f)(1) that could potentially allow a well-informed debtor's attorney, presented with right circumstances, to use bankruptcy law to trump the non-bankruptcy "applicable law" that otherwise would have prevented assignment outside of bankruptcy.[8]

As to the scope of Section 365(c)(1), Barrett writes: "Any contract where the non-debtor party has the non-bankruptcy law right to terminate the contract, or to refuse consent to an assignment of the contract, *for a reason other than the fact of the debtor's bankruptcy filing or its financial condition*, will presumably fall under Section 365(c)(1)."[9] To put Barrett's statement another way, Section 365(c)(1) allows the non-debtor party the continued right to enforce *any* termination or anti-assignment "applicable law," with only the very limited exception of *ipso facto* clauses.[10] Barrett states that this view allows for a resolution of a "potential conflict" between Section 365(b), which invalidates

6. Barrett, *supra* note 1, 249–50.

7. *In re* Grove Rich Realty Corp., 200 B.R. 502, 506-07 (Bankr. E.D.N.Y. 1996) ("Section 365(c)(1)(A) was enacted as an exception to the general rule of assignability."); *see also* case law cited at Binford, *supra* note 2, at 72 n.12.

8. Binford, *supra* note 2, at 72 ("A franchisee's ability or inability to assign a franchise agreement almost always turns on a bankruptcy court's determination of whether § 365(f)(1) or § 365(c)(1) applies to the particular assignment scenario.").

9. Barrett, *supra* note 1, at 249 n.24 (emphasis added).

10. Provisions invalidating an agreement on account of a bankruptcy filing or on account of the financial condition of a party are known as *ipso facto* provisions.

ipso facto clauses, and Section 365(c)(1), which allows non-debtor parties to enforce anti-assignment provisions found in "applicable law."

This interpretation puts Section 365(c)(1) in conflict with Section 365(e). Section 365(e)(2) uses language substantively identical to Section 365(c)(1) and allows enforcement of *ipso facto* clauses found in "applicable law." Therefore, franchisors (and presumably any other non-debtor party to a contract or lease) that adopt Barrett's broad interpretation of Section 365(c)(1) appear to be in the enviable position of being able to enforce every conceivable type of applicable law to prevent assignment. This stretches to the breaking point basic tenets of bankruptcy policy and statutory interpretation. Surely Congress cannot have intended to single out *ipso facto* clauses as the only exception to the enforceability of every type of non-bankruptcy law in Section 365(c)(1), only to allow such clauses to be enforced under the exact same circumstances in Section 365(e)(2).[11] Moreover, such a broad interpretation of Section 365(c)(1) would render the use of the phrase "applicable law" meaningless in Section 365(f)(1).[12] Once again, Section 365(c)(1) is an exception to the Section 365(f)(1) general rule. Naturally, exceptions must be narrower than the rule.

In order to reconcile Section 365 and the competing interests at play, the applicable law referred to in Sections 365(c)(1) and 365(e)(2) must be narrowly interpreted. Such a narrow interpretation allows non-debtor parties to prevent assignment and even terminate the agreement when the narrow circumstances are met, while maintaining the Section 365(f)(1) general prohibition of the enforcement of anti-assignment provisions.

The question then comes down to: just how narrowly should Section 365(c)(1) be interpreted? Early Bankruptcy Code case law and a continuing minority of modern cases interpret Section 365(c)(1) as applicable only to personal

11. *See In re* Catapult Enter., Inc., 165 F.3d 747, 753 n.6 (9th Cir. 1999) ("[Section] "365(c)(2)(A) expressly revises 'ipso facto' clauses in precisely the same executory contracts that fall within the scope of § 365(c)(1)."). The case law discussing the interaction between Sections 365(c)(1) and 365(e)(2) is relatively sparse. Within this small universe, a large portion of the cases discuss whether minor differences in the text of the two sections implicate the "hypothetical" versus "actual" debate, dealing with whether a non-*assignable* agreement is *assumable* by a debtor who actually has no intention of assigning the agreement. *See*, *e.g.*, In re *Cardinal Indus.*, *Inc.*, 116 B.R. 964, 975–76 (Bankr. S.D. Ohio 1990) (analyzing arguments related to the textual differences between Sections 365(c)(1) and 365(e)(2)); Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 Am. Bankr. Inst. L.R. 1, 17 (2013) (same). This debate is irrelevant, however, to a debtor who is, in fact, seeking to assign the agreement. In such a circumstance, every jurisdiction acknowledges that the effect of anti-assignment provisions must be considered. Culling out the portion of the case law dealing with the hypothetical versus actual debate, which is not relevant to an article discussing a debtor who is seeking to assign an agreement, leaves case law recognizing that Section 365(e)(2) and "Section 365(c)(1) are closely related and that Section 365(e)(2) addresses the same executory contracts that fall within the scope of Section 365(c)(1)." *In re* Footstar, Inc., 377 B.R. 785, 788 (Bankr. S.D.N.Y. 2005) (citing additional case law).

12. *See In re* Lil'l Things, Inc., 220 B.R. 583, 588 (Bankr. N.D. Tex. 1998) (analyzing Sections 365(c)(1) and 365(f)(1) in the context of assumption and assignment of a non-residential real property lease and cautioning that if Section 365(c)(1) "is interpreted too broadly it will swallow up a debtor's ability to assign its leases granted by Congress in § 365(f)").

service contracts. Barrett correctly notes that this very narrow interpretation is not currently accepted by most courts.[13] He uses that fact, however, to advance his broad interpretation of Section 365(c)(1), thus swinging the pendulum too far back in the other direction. Instead, the current majority view is that

> [f]or Section 365(c)(1) to apply, the applicable law must specifically state that the contracting party is excused from performance from a third party under circumstances where it is clear from the statute that the *identity* of the contracting party is crucial to the contract or public safety is at issue.[14]

This interpretation is appealing for a number of reasons. First, it limits the application of Section 365(c)(1), thereby ensuring that the Section 365(c)(1) exception does not swallow the Section 365(f)(1) rule. Second, it allows for the reasonable co-existence of Section 365(c)(1) and Section 365(e)(2). Third, it achieves a balance between allowing non-debtor parties to enforce their non-bankruptcy law rights in certain circumstances, while allowing the debtor to strike anti-assignment provisions, and to maximize value to creditors, when those circumstances do not apply.

None of this is to say that the majority view of Section 365(c)(1) is correct and unassailable. In fact, Section 365(c)(1) has been interpreted by courts and commentators in several different—and innovative—ways.[15] The most

13. *See* Barrett, *supra* note 1, at 249; *see also* Binford, *supra* note 2, at 77 ("In addition to responding directly to the franchisor's personal service contract arguments, the franchisor should argue that the franchisee's narrow scope interpretation of § 365(c)(1) is incorrect." (citing case law)); 3 COLLIER ON BANKRUPTCY ¶ 365.07[1][c] (16th ed. rev. 2012) ("Section 365(c) covers considerably more contracts than those that would normally be considered personal service contracts.").

14. 3 COLLIER ON BANKRUPTCY ¶ 365.07[1][c] (citing case law); *see also In re* ANC Rental Corp, Inc., 278 B.R. 714, 721 (Bankr. D. Del. 2002) ("[W]e follow the *majority of courts* addressing this issue and conclude that, for § 365(c)(1) to apply, the applicable law must specifically state that the contracting party is excused from accepting performance from a third party under circumstances where it is clear that the identity of the contracting party is crucial to the contract or public safety is at issue.") (emphasis added)). Limiting Section 365(c)(1) applicable law to non-bankruptcy law dealing in some way with the identity of a contracting party is not the same thing as arguing that Section 365(c)(1) applies only to personal service contracts. For example, a franchisor could argue that trademark law makes the identity of a trademark licensee critical to a franchise agreement, and this argument would not otherwise require the franchisor to establish that the franchise agreement is a personal service contract under applicable state law. Framed this way, the dispute will turn on the identity issue. It is conceivable for a bankruptcy court to find that the identity of a franchisee is not crucial to the agreement, especially where bankruptcy law independently entitles the franchisor to adequate assurances of future performance from the proposed assignee. *See* Binford, *supra* note 2, at 75 n.38. In addition, it is also notable that this body of "identity" case law was decided, and the commentary written, well after the "happenstance of bankruptcy" Supreme Court case law discussed in the counterpoint. *See* Barrett, supra note 1, at 247 ("These cases laid down the rule that, *except where the Bankruptcy Code specifically alters rights under state law or non-bankruptcy federal law*, the rights of the debtor and other parities in a bankruptcy proceeding are not different from their rights outside of bankruptcy.") (emphasis added)). Bankruptcy Code Section 365(f)(1) clearly alters non-bankruptcy law by making anti-assignment clauses unenforceable. The heart of this issue, therefore, is the extent to which Section 365(c)(1) dials back that alteration of non-bankruptcy law.

15. *See*, *e.g.*, Michael J. Kelly, *Recognizing the Breath of Non-Assignable Contracts in Bankruptcy: Enforcement of Non-Bankruptcy Law as Bankruptcy Policy*, 16 Am. Bankr. Inst. L. Rev. 321 (2008)

important point to understand, and the point of my article, is that the legal tools are available for a bankrupt franchisee to assemble a viable assumption and assignment argument based on legal theories currently accepted by a meaningful number of courts. Thus, while the cards remain stacked in the franchisor's favor, the prudent franchisor should be aware of the risks and the creative franchisee should be aware of the opportunities.

(analyzing the various methods taken by case law, disagreeing with the "material identity" theory and offering up yet another method for reconciling Sections 365(c)(1), 365(e)(2) and 365(f)(1)).

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