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Preparing for a franchisor bankruptcy filing

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For franchisees, weathering a franchisor bankruptcy requires preparation, including knowing about issues raised in the filing.

By Jason B. Binford
HNN columnist

The franchise business model appears to be as popular, and as profitable, as ever. But, there are always exceptions to the general rule. The bankruptcy filings of Quiznos and Sbarro demonstrate that franchisor bankruptcy is a possibility. This is true, of course, whether the franchisor is in the foodservice or hotel industries.

For franchisees, weathering such a storm requires preparation, including obtaining a working knowledge of the particular issues raised in a franchisor bankruptcy filing. A franchisee armed with such knowledge stands a much better chance of protecting its rights as a contract counterparty and otherwise making it through the bankruptcy process as painlessly as possible.

The first days of the bankruptcy case
The beginning of a large corporate bankruptcy filing usually involves a flurry of activity, including the company filing the case (the "debtor") seeking many different types of relief from the bankruptcy court via a long series of emergency motions. The actions taken by the debtor/franchisor and other parties in interest will be driven by the ultimate goal of the bankruptcy filing. If the franchisor is seeking a rapid sale of its business, it will file a sale motion seeking to set up the procedures for effectuating a sale. From the perspective of a franchisee not familiar with bankruptcy, a bankruptcy sale can happen in a disturbingly short period of time.

Even if a sale is not contemplated from the beginning of the franchisor's case, the first days of the case will involve a significant amount of activity, some of which could directly affect the franchisee. In a well-run bankruptcy case, the franchisor will work to communicate its intentions to franchisees in order to stabilize the business as much as possible.

However, franchisees cannot absolutely count on effective and consistent communication from the franchisor. Rather, franchisees should review the bankruptcy pleadings and other available information in an attempt to ascertain as soon as possible whether the franchisor intends to sell, reorganize or (unfortunately) liquidate. Throughout this process, a franchisee should maintain focus on what ultimately will most directly impact the franchisee: how the bankruptcy case will affect the particular franchisee's franchise agreement.

The fork in the road
In a bankruptcy case, a franchise agreement will be considered an executory contract. This term simply means that, at the time of the bankruptcy filing, there are materially unperformed obligations by both parties.

Debtors have the choice of either assuming or rejecting executory contracts. This choice, as applied to the franchise agreement, will have enormous impact on the franchisee counterparty. Typically, however, the assumption/rejection choice is not made by a debtor immediately following the filing of a bankruptcy case. Many months could pass before a debtor makes its decision known by filing a motion seeking entry of an order providing for the assumption or rejection of a particular agreement.

During the period prior to assumption or rejection, the non-debtor party will be required to perform under the terms of the agreement, but the debtor is not strictly bound to perform. In some cases, this dynamic might require the non-debtor party to file a motion with the bankruptcy court seeking either to compel the debtor's performance under the agreement, or to compel the debtor to make its assumption or rejection decision.

Assumption
In most every case, the franchisor's assumption of the franchise agreement will be the best case scenario for the franchisee. Assumption will require the franchisor to "cure" all past defaults, meaning that all obligations of the franchisor under the agreement must be brought current. If the franchisor chooses to assume the agreement, it must assume in its entirety without changes. A franchisor cannot use bankruptcy law to change the terms of the agreement. That said, in the real world of hard-nosed negotiations, debtors frequently use the threat of rejection to convince a counterparty to accede to the assumption of an agreement with certain amendments.

The franchisor will also be required to provide the franchisee with adequate assurance of future performance. This will be proof that, following the bankruptcy case, the franchisor will have the wherewithal to continue performing under the agreement. If the franchisor is not seeking to assign the agreement, the adequate assurance of future performance requirement will not be difficult to meet. Sometimes the franchisor's simple promise to perform will suffice. If the franchisor is seeking to assume the franchise agreement and assign it to a new entity, however, the new entity will be required to show that it has the financial ability and the expertise to perform under the agreement.

Rejection
It is a hard fact that a franchisor bankruptcy filing might result in rejection of the franchise agreement. The franchisor will take the position that rejection terminates all of the franchisee's rights under the franchise agreement, including the franchisee's rights as a trademark

licensee. Depending on the jurisdiction where the bankruptcy case is pending, the franchisee might be able to argue that it retains the right to use the trademark and other intellectual property post-rejection. However, even if the franchisee is able to convince a bankruptcy court of this argument, it almost certainly would be a pyrrhic victory because following rejection, the franchisor would not be required to perform under the franchise agreement.

Even if the franchisee is able to make use of intellectual property, it is difficult to see how a franchise relationship could move forward without any franchisor support. In addition, a franchisee should be mindful that some courts have held that covenants not to compete contained within a franchise agreement will remain enforceable against the franchisee, even after rejection of the franchise agreement. Thus, an unfortunate franchisee could find itself in the position of no longer being part of a franchise system and also subject to liability if it attempts to strike out on its own in the same industry.

Thankfully for franchisees, the bankruptcy filing of a large franchisor and an accompanying rejection of large numbers of franchise agreements is not very common. Therefore, while franchisees should not live in fear that a franchisor bankruptcy filing might be just around the corner, franchisees likewise should have the knowledge and skillset to understand the issues that will arise, should they find themselves in that unfortunate position.

Jason Binford is a director in the Dallas-based law firm of Kane Russell Coleman & Logan PC where he practices in the firm's Insolvency, Bankruptcy & Creditor Rights section. His experience includes representation of debtors and creditors in large to mid-size Chapter 11 and Chapter 7 cases. He has significant familiarity and expertise in issues unique to vendor creditors, as well as 363 sales, intellectual property, landlord/tenant and franchise issues.