Termination of Closed Franchises or Dealerships: A Potential Trap for the Unwary, but Federal Bankruptcy Law May Provide Significant Leverage to Franchisors and Suppliers

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The authors discuss the opportunities and pitfalls for franchisors/suppliers faced with economically troubled dealers who have, or who are are contemplating, closing their doors.

As economic uncertainties continue, with good news from the markets one day followed by bad news the next three or four, dealers and franchisees are increasingly likely to curtail their operations substantially or even close their businesses. Does this mean a franchisor or supplier can immediately terminate the franchise or dealer agreement? In some places, the answer is clearly "yes," but in a surprising number of others, the answer is "not so fast." Careful consideration of both the language of the applicable contracts and statutes and adequate factual inves-

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tigation are crucial. Importantly, however, federal bankruptcy law may actually provide significant leverage to franchisors and suppliers in these situations.

CLOSING THE BUSINESS OR LIMITING OPERATIONS AS GROUNDS FOR TERMINATION

Well-written dealer and franchise agreements nearly always include some requirement that the dealer/franchisee maintain normal hours of operation or even require very specific hours of operation, depending on the type of business involved. Breach of these requirements may be sufficiently material to support termination under both the contract and, in most cases, under state statutes (so long as similar breaches are handled consistently). Many agreements also provide that closing the dealership/franchised business for a specified period of time is a breach of the agreement and, therefore, grounds for termination. A number of state dealer and franchise statutes similarly provide that failure to remain open for specified periods of time allows a supplier or franchisor to terminate. These statutes vary, however, by geography and by industry and also may contain other requirements, including notice to certain administrative agencies or the dealer or franchisee before the supplier or franchisor can exercise its rights.

TIMING

The applicable contract language is always the first place to look in determining how and when termination should be carried out when a dealer or franchisee closes its doors. Even where the contract allows for immediate termination, however, state law also should be consulted. The reasons for the closure may impact the timing requirements, for example. Alternatively, there may be other circumstances that also affect the timing where, for example, there are multiple grounds for termination (e.g., non-payment of amounts due the franchisor/supplier as well as the closure).

Some statutes may also require that the dealer or franchisee be given a chance to cure the deficiency stated as grounds for the termination. While there is some question whether a dealer or franchisee that has been closed for some period of time can really "cure" by reopening, providing that opportunity regardless may still be a good idea. One reason to do so is to minimize the risk of a technical statutory violation that will increase the leverage of the dealer or franchisee in any post-termination negotiations about inventory, accounts receivable, signage, and so forth. It also may be useful to avoid any misunderstandings where, for example, a location has changed, there are extenuating circumstances that must be considered (particularly in small businesses with few employees), or bad information about whether the dealership or franchise is really closed has been provided. On the other hand, in some states, even where the supplier/franchisor has prematurely terminated (i.e., did not wait the required period), if the franchisee/dealer cannot prove that it would have cured, then damages are substantially limited. In those states, the potential damages may be sufficiently small that an immediate termination is preferable even if it violates the statute.

NOTICE

The notice of termination will be crucial, as a defective notice is itself a statutory violation under some state statutes. In addition, the dealership or franchise agreement will likely contain relevant language about how and to whom the notice must be delivered to the dealer or franchisee. It is important to include in the notice all of the grounds for termination. This is particularly true when a dealer/franchisee closes its doors unexpectedly, because there are likely to be multiple grounds.

Where the applicable contract or statute provides for a specific notice period, care should be taken to ensure that the effective date of the termination complies with those provisions as well as with any requirements about the method of notice (Must it be sent by certified mail or registered mail? Is a return receipt required? Is a fax acceptable?), and the person(s) to whom notice must be delivered. Where statutes require that the dealer or franchisee be given an opportunity to cure, those statutes usually require that both the opportunity and the proposed cure be reasonable and stated in the notice. In most cases, particularly where a dealership or franchisee has closed, a defect in the notice can be quickly cured by an amended notice with very little risk. It is always better, however, to get it right the first time and avoid a technical statutory violation or contractual breach and the complications that may result.

POTENTIAL RESPONSES TO THE NOTICE

None

Where a dealer or franchisee has truly gone out of business and has very little hard investment (in inventory, real estate, etc.), it is possible that the dealer or franchisee will not respond. In that case, the termination will proceed according to the terms of the notice. However, where there are post-termination obligations that are desirable/necessary to enforce (e.g., return of signage or other trademarked materials, transfer of phone numbers or yellow pages listings, etc.), it will be necessary to "follow-up" with the terminated dealer or franchisee to ensure that those obligations are met. Where possible, use those "follow-up" contacts to obtain a release of any claims the dealer may have. Consider forgiving some, if not all, of any unpaid accounts receivable as an incentive for the dealer or franchisee to sign the release.

Request to Approve Assignment/Sale

Many agreements prohibit assignment by the dealer or franchisee without the consent of the supplier/franchisor. Often the agreement also contains language suggesting that the decision to approve or reject a proposed assignment is in the sole discretion of the supplier/franchisor Common law doctrines may, nevertheless, constrain arbitrary or other unlawful exercise of that discretion. In addition, many statutes limit the grounds for rejecting a proposed assignment, mandate the factors that must be considered, require certain administrative actions, set certain time limits during which the rejection must be communicated or be deemed accepted, and the like. Which of these circumstances may apply, and how, will vary from state to state and, in many cases, from industry to industry. As a result, a careful review of potentially applicable statutes must be undertaken if the supplier/franchisor is inclined to reject a proposed assignment. In any event, in order to avoid claims by the potential buyer, a reasonable evaluation process should be undertaken to determine whether to reject the request.

Protest/Rejection of Termination Notice

If the dealer or franchisee has closed its business because of economics, a protest or rejection of the termination notice is more likely an attempt to improve its bargaining position with respect to a termination agreement than any real intention of continuing the business. This is particularly true where the dealer or franchisee owes substantial sums to the supplier or franchisor, is subject to a stringent post-termination non-compete, or is being hounded by other creditors and sees the supplier or franchisor as a potential source of funds to pay off those claims. Thus, the dealer or franchisor may seek to assert technical violations of the termination statute, blame the supplier or franchisor for the economic straits that forced the closing, or claim other wrongful behavior. If these issues were not known to the supplier or franchisor before the decision to terminate was made, then a careful investigation of the facts surrounding the allegations should be undertaken immediately to determine how to respond. In these circumstances, the possibility of litigation is likely significant and the risks, costs, and potential outcomes of that process should be carefully evaluated.

Bankruptcy

A bankruptcy filing by the dealer or franchisor will complicate the situation significantly, and legal counsel familiar with bankruptcy litigation should be involved immediately. The automatic stay, effective upon filing of a bankruptcy petition, will prevent any immediate action against the debtor (i.e., the dealer or franchisee). This is the debtor's most effective tool in dealing with its supplier or franchisor. However, the 2005 amendments to the Bankruptcy Code provide several powerful tools for a supplier or franchisor faced with a dealer or franchisee who seeks bankruptcy protection. These tools include:

- increased control over the assumption of executory franchise or distributorship agreements,
- a shorter period for the assumption of real property leases,
- expanded reclamation and administrative claim rights, and
- a compressed exclusivity period for the debtor to file a plan.

In addition, Congress's failure to resolve certain pre-amendment ambiguities in the Bankruptcy Code may provide additional leverage to the supplier or franchisor depending upon the federal circuit in which the bankruptcy is filed.

EXECUTORY CONTRACTS

Most franchise and distributorship agreements are executory contracts. This means that the obligations of both the franchisor/supplier and the debtor are so far unperformed on the petition date that the failure of either to complete performance would constitute a material breach excusing the other's performance. Before the 2005 amendments, the question often arose whether a debtor was required to cure nonmonetary defaults before an executory contract could be assumed in bankruptcy. This was an extremely significant issue since certain nonmonetary defaults are, by their nature, not curable. As a result, such a default could bar assumption, and subsequent assignment, of an executory contract. The 2005 amendments to the Bankruptcy Code, however, clarify that a debtor is required to cure all monetary and nonmonetary defaults before it can assume an executory contract. This means that a franchisor or supplier can effectively prevent the assumption of a franchise or distributorship agreement if there is an incurable nonmonetary default.

NON-RESIDENTIAL REAL PROPERTY LEASES

The same rule does not apply to nonmonetary defaults under non-residential real property leases. Instead, the 2005 amendments provide that a debtor may "cure" nonmonetary defaults by complying with the lease operating requirements from and after the time of assumption and curing any monetary losses incurred by the lessor due to the nonmonetary defaults. Just as important, the 2005 amendments severely limit the time within which the debtor must assume or reject such non-residential real property leases. Under the amended Bankruptcy Code, a debtor has 120 days after the petition date to assume leases of non-residential real property or the lease is deemed rejected. The debtor can obtain only one 90-day extension of the deadline without the consent of the lessor; thereafter, the debtor must obtain the lessor's consent to any further extensions. By compressing the time for assumption of non-residential real property leases, the 2005 amendments significantly strengthen the lessor's position.

RECLAMATION RIGHTS

Before the 2005 amendments, sellers had the right to make reclamation demands for goods no later than 10 days after delivery of the goods to the debtor or, if the 10 day period expired after the bankruptcy filing, no later than 20 days after delivery. The bankruptcy court had the discretion to deny the seller's request to reclaim the goods by giving the seller an administrative priority claim or replacement lien. Under the amended Bankruptcy Code, however, the franchisor/supplier may reclaim goods delivered to the debtor during the 45 day period prior to the petition date, subject to any superior rights of a creditor in the goods or their proceeds. In addition, the Bankruptcy Code now grants an administrative expense claim to a reclaiming creditor for goods received by the debtor within 20 days before the petition date if the goods were sold in the ordinary course of the debtor's business. As a result, franchisors or suppliers who sell goods to their franchisees and dealers will likely have large administrative expense claims, strengthening the negotiating position of these franchisors or suppliers in the bankruptcy proceeding.

EXCLUSIVITY PERIOD

In a reorganization, a debtor's "exclusivity" — the period of time in which only the debtor can file a plan and solicit acceptances, gives the debtor control over the direction of the bankruptcy case. Before 2005, a debtor had the exclusive right to file a plan and solicit acceptances of the plan for 120 days following the petition date, and had 180 days following the petition date in which to obtain plan confirmation. The bankruptcy court had the discretion to grant extensions of these deadlines, and courts frequently exercised their discretion to do so multiple times. Under the 2005 amendments to the Bankruptcy Code, the initial exclusivity period remains 120 days for filing a plan and 180 days to solicit acceptances and confirm a plan. Now, these deadlines cannot be extended beyond 18 and 20 months, respectively, after the petition date. In large cases, these new deadlines may be very difficult to meet, and may force the debtor to negotiate earlier with parties-in-interest, including franchisors and suppliers, concerning an agreed upon framework for a plan.

NON-BANKRUPTCY LIMITATIONS ON ASSUMPTION OF FRANCHISE/DEALERSHIP AGREEMENTS

Under both the pre- and post-2005 Bankruptcy Code, a debtor may not "assume or assign" an executory contract where "applicable law" excuses the non-debtor party from accepting performance by any party other than the debtor, and the non-debtor party does not consent to assumption or assignment. The question that then arises is if "applicable law" bars assignment, does it also bar assumption as well, even if the debtor has no intention to assign the contract? The answer to this question varies by U.S. Circuit Court of Appeals, in part due to uncertainty as to the implications of the word "or" in the phrase "assume or assign." In the Third, Fourth, and Ninth Circuits, the phrase "assume or assign" is interpreted literally — so that an executory contract cannot be assumed if "applicable law" prevents assignment, even if the debtor does not intend to assign the contract. In these circuits, then, franchise and dealer agreements that include grants of intellectual property rights may not be assumable without consent because federal law generally prohibits assignment of those intellectual property rights. This is the case even if the debtor has no intention of assigning the agreement. Conversely, in the Eighth and Tenth Circuits, a debtor may assume an executory contract that includes grants of intellectual property as long as the debtor, in fact, intends to perform rather than assign the contract.

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In a related point, a debtor cannot assume a contract to provide "financial accommodations." The implication of this rule for franchise agreements would appear to be that, if the franchisor or its affiliate is contractually obligated to extend credit to the franchisee, the debtor may not have an automatic right to assume the franchise agreement — depending upon how the agreement has been drafted.

As the above discussion makes clear, there are both opportunities and pitfalls for franchisors and suppliers faced with economically troubled franchisors and dealers who have, or are contemplating, closing their doors. A thorough factual investigation and counsel from legal advisors experienced in dealing with similar situations can help franchisors and suppliers maximize their leverage and minimize their risk in resolving these situations.