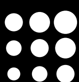
Practice
Guides

FRANCHISE

Fourth Edition

Contributing Editor
Philip F Zeidman



LEXOLOGY
Getting the Deal Through

FRANCHISE

Practice Guide

Fourth edition

Contributing Editor
Philip F Zeidman

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Getting the Deal Through

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Publisher
Edward Costelloe
edward.costelloe@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development managers
Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan Brennan
dan.brennan@gettingthedealthrough.com

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Preface

Philip F Zeidman[1]

In my introduction to *Lexology Getting the Deal Through – Franchise*, I described an experience many of us have had. I recounted a general counsel's arrival at the office to find a message from his boss, posing a series of questions about franchising in a number of countries around the world – questions to which the general counsel, understandably, has no ready answers. The same experience, of course, is familiar to outside counsel encountering a client's expectations.

A survey of the available sources of information comes up empty. None is sufficiently comprehensive yet digestible. *Lexology Getting the Deal Through – Franchise* seeks to meet that need by posing and answering the key questions one must address about franchising in a country. Now in its 16th edition, it covers 19 countries, and has proven its value many times over. It is a classic 'desk book' that belongs next to your telephone (if you still have one) or your computer.

But what then? After your response – rapid and impressive, no doubt – what happens when you need to delve more deeply into the issues raised by your company's or client's plan to expand by franchising? For that purpose, a book that provides answers to threshold questions, however succinct and authoritative, is, as social scientists say, 'indispensable but insufficient'.

By now you know that franchising touches, glancingly or with full force, on almost every legal discipline. And you also know that none of those disciplines addresses franchising as squarely as you would like; that there are shockingly few law schools that include franchising in their curriculum; and that there are no course books that adequately cover the territory you will need to traverse.

Enter Lexology Getting the Deal Through's *Practice Guide – Franchise*.

If *Lexology Getting the Deal Through – Franchise* was designed to be left on your desk, *Practice Guide – Franchise* can perhaps best be thought of as the book you will take on your next flight (this assumes, of course, that the coronavirus crisis will finally have eased sufficiently to permit the resumption of that aspect of business and legal life).

So settle in.

Adjust your seat, your footrest and your reading light.

1 Philip F Zeidman is a partner at DLA Piper LLP (US).

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You will almost certainly want to begin by examining the fundamental legal doctrines, statutes and regulations that govern how franchising is treated in law. That obviously requires an understanding of how different countries have chosen to regulate franchising explicitly (or declined to do so). So you begin with 'Global Overview of Specific Franchise Statutes and Regulations', which includes a handy chart at the end, keyed to the various approaches. But you will also want to step back and examine two broader and older legal constructs that are essential. One of those inquiries will be to learn how franchising is treated in the foundational legal structures of different countries, in 'Common Law and Civil Law on Franchising Issues'. Under what circumstances will the analyses under those two systems lead to different results? And you will need to have a grasp of another overarching theme, depending on how a country has chosen to apply it, or not, as the case may be (see 'Good Faith and International Franchising').

It is also important to keep in mind that franchising is constantly evolving to take advantage of new techniques and approaches. Prominent among the new techniques are e-commerce and social media, and problems that arise in this context are frequently the result of e-commerce not having been addressed adequately in the original franchise agreement and relationship.

The decision of how best to go about the business of expansion is, along with selecting the countries you wish to target, certainly at the threshold of your business and legal initiative. And understanding these critical first issues will surely consume a sizeable share of the time on your flight.

Now it's time to turn to the heart of the franchise relationship, and examine how the franchisor and the franchisee choose to express the bargain they have reached. Much of this process is understanding how elements of that bargain can best be articulated to leave as little as possible to be the subject of differing interpretations. But the parties are not entirely free to do whatever they wish, nor is one party free to demand that its wishes be adopted in all respects, because franchise laws and other bodies of law impose limits and restrictions on the parties. Some of the key provisions of the franchise agreement are discussed. 'Covenants against Competition' offers an excellent overview of this important tool for franchisors to protect their intellectual property and network, while 'EU Competition Law' examines a broader range of restrictions commonly found in franchise agreements in the EU context.

Other bodies of law, of course, impinge upon franchising, and an understanding of how they interface is important to a competent franchise lawyer. 'Consumer Protection' begins by addressing the concept of a consumer, which may differ by jurisdiction, and discusses the consequence of applying consumer protection laws to franchising. 'Data Protection and Privacy' highlights the challenge presented to multinational franchisors in complying with the laws in this area adopted in more than 100 jurisdictions, and suggests some approaches to meeting that challenge. 'Franchising and Insolvency' dives into the unfortunate scenario where franchisees (and, to a lesser extent, franchisors) enter into insolvency proceedings. For most franchise systems, bricks-and-mortar operations remain their backbone. They will find a comprehensive treatment of this topic in 'Real Estate Development in the Cross-Border Franchise Context'.

Among the subjects addressed by countries that have chosen to regulate franchising, the most common obligation is probably the duty to provide a prospective franchisee with information on the basis of which an informed investment decision can be made. The most robust embodiment of that obligation is the franchise disclosure document, discussed in some detail

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in the chapter 'Franchise Disclosure Documents under Statutes in South America'. An even broader example of a regional approach is the chapter on 'Franchising in the European Union'.

Ladies and gentlemen, we are beginning our descent.

You have not, of course, been exposed to every nook and cranny of franchise law. That would require, at a minimum, several trips around the world.

But you can disembark now. You're off to a good start.

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Part 4

Other Legal Considerations

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Franchising and Insolvency

Michael J Lockerby and Sharon M Beausoleil[1]

Introduction

Franchising is a critically important element of the United States economy and has proven to be a successful and profitable business model for countless franchisors and franchisees. However, franchising is not immune to the financial difficulties present in any industry. Virtually every franchisor or franchisee will, during the life of a franchise system, have to deal with issues of financial insolvency and perhaps experience a bankruptcy filing – whether as a creditor in another party's bankruptcy case or (hopefully less likely) as the party filing for bankruptcy. Franchisors and franchisees alike therefore need to be aware of the issues arising when the unique relationship between a franchisor and its franchisee is affected by financial insolvency or bankruptcy. To that end, this chapter begins with an overview of general bankruptcy concepts, followed by an analysis of the assumption and rejection of executory contracts such as franchise agreements and trademark licences. Much of the chapter focuses on executory contract issues because of their primary importance in any franchisor or franchisee bankruptcy. Following a discussion of these bankruptcy concepts, the chapter covers pre-bankruptcy planning and other tactics that parties may employ to prepare for the bankruptcy filing of another party and maximise their rights and their ability to get paid. The chapter concludes with a recap of the most important insolvency and bankruptcy issues in franchising. The topics addressed are intended to provide anyone involved in franchising with sufficient information about bankruptcy law and concepts to deal with, survive and perhaps even profit from a tumultuous financial situation.

General bankruptcy concepts

Objectively, bankruptcy can be an important and powerful tool for dealing with debt and cleaning up a balance sheet. For many, however, bankruptcy has negative connotations. That is not surprising in view of the fact that bankruptcy can be the end result of a failed business venture and is sometimes (but certainly not always) synonymous with financial liquidation. In some ways,

1 Michael J Lockerby is a partner and Sharon M Beausoleil is a senior counsel at Foley & Lardner LLP.

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certainly, bankruptcy is something to be avoided. Techniques for lessening the impact of bankruptcy are discussed later in the chapter. First, however, to deal with (and perhaps avoid) bankruptcy, it is necessary to understand how it works.

The jargon related to bankruptcy can be daunting. For the purposes of this discussion, however, only a few bankruptcy vocabulary words are critical. In the United States, bankruptcy is governed by federal law. Article 1, section 8 of the US Constitution specifically empowers Congress to 'establish . . . uniform Laws on the subject of Bankruptcies throughout the United States'. Since the founding of the republic, there have been a number of different federal bankruptcy laws. The current governing federal statute is the Bankruptcy Code, enacted in 1978 and codified in Title 11 of the United States Code. Bankruptcy proceedings are held before federal bankruptcy judges, who are 'adjuncts' of district court judges in the sense that their rulings are subject to review by article III judges who have lifetime tenure. Different types of bankruptcy cases are subject to different chapters of the Bankruptcy Code. The principal chapters are Chapter 7, governing liquidations, which are managed by a court-appointed trustee; Chapter 11, governing financial restructuring or reorganisations of businesses, which are generally managed by the current management of the debtor;[2] Chapter 13, governing financial reorganisations of individuals; and Chapter 15, governing international or cross-border bankruptcy cases. Unless otherwise noted, this chapter focuses on Chapter 11 business reorganisations.

Colloquially, the word 'bankruptcy' is often used to refer to going out of business. In practice, however, Chapter 11 bankruptcy cases in the United States are used to reorganise a business as a going concern, sell all or part of the business as a going concern to third parties or liquidate the business on an orderly basis. For reorganisation, a debtor employs the Chapter 11 process to shed itself of burdensome debt and obligations, and confirms a plan of reorganisation that allows the reorganised debtor to emerge from bankruptcy.

The Bankruptcy Code includes provisions that address property of the debtor's bankruptcy estate, claim priorities, asset sales, plans, and causes of action (including preferences and fraudulent transfers). It is also routine, however, for a bankruptcy case to decide questions of state law or non-bankruptcy federal law – such as breach of contract, fiduciary duty issues, lien priorities and trademark law as set out in the federal Lanham Act. The principals in a Chapter 11 bankruptcy case are the debtor (the party filing the bankruptcy), the secured creditors (holders of debt that can look to specific property for their satisfaction), unsecured creditors (holders of debt that is not secured by any property), contract counterparties, the Official Committee of Unsecured Creditors (a group of five to seven unsecured creditors appointed in large to medium-sized cases that is designated to speak for the entire unsecured creditor class), and the United States Trustee (a member of the Department of Justice responsible for the administrative side of bankruptcy cases as well as enforcement of bankruptcy laws).

The filing date of a bankruptcy case, known as the petition date, is very important. The automatic stay is a worldwide injunction that comes into place upon the filing of a bankruptcy case. Any attempt by a creditor to take possession of estate property, or to collect on a pre-petition

2 The Bankruptcy Code has special provisions for dealing with small businesses under Subchapter V of the Bankruptcy Code. See 11 U.S.C. §§ 1181–1195. A substantive discussion of the requirements of a Subchapter V bankruptcy case is beyond the scope of this article. It is important to note, however, that Subchapter V bankruptcy cases move on a much faster timetable.

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debt (Including exercising offset rights), is a violation of the automatic stay. For these purposes, property of the estate is interpreted very broadly to include any type of property in which the debtor could possibly have an interest. Bankruptcy judges take the automatic stay very seriously. As a result, penalties for wilful stay violations can include contempt of court and, in some cases, punitive damages. The rule of thumb is that when there is any doubt whatsoever that something could be the property of the estate, seek authority from the bankruptcy court before taking action. Non-debtor parties should also be careful about seeking to enforce clauses in a franchise or other agreement that purport to automatically terminate the agreement upon a bankruptcy filing. Such clauses are known as ipso facto clauses. Ipso facto clauses are not enforceable under bankruptcy law. A party seeking to enforce a termination pursuant to an ipso facto clause will be found to have violated the automatic stay, even if the party erroneously thought that the terms of the agreement authorised it to take action.

For asset sales, a debtor is required to obtain court authority to sell its property. Such sales are known as '363 sales', in reference to the governing section of the Bankruptcy Code. These asset sales could include discrete assets or substantially all the assets of the debtor. If the debtor is selling a major portion of its assets (ie, substantially all the assets of the debtor), the debtor will seek to establish bidding procedures to identify potential bidders, hold an auction and sell its assets free and clear of liens and encumbrances for the highest and best price that can be obtained. Highest and best price does not mean necessarily an all-cash bid. Considerations for highest and best price include cash paid, assumption of liabilities by the buyer and timing to close the sale transaction. Non-debtor parties should be aware that 363 sales can move through bankruptcy court very quickly and can have significant potential impact on the non-debtor party's rights as both a creditor and a contractual counterparty. The non-debtor party should therefore pay close attention – and object – to any troublesome proposed sale procedures or terms. Generally speaking, the bankruptcy court will not scrutinise a proposed sale to ensure that the debtor is actually entitled to all the relief sought. It is up to the non-debtor parties to raise the issues before the court. For an orderly liquidation (called a 'liquidating 11'), the debtor may employ a combination of a 363 sale process and plan process to monetise its assets and distribute the proceeds.

Executory contracts, assumption and rejection

Agreements critical to the franchise relationship – including the franchise agreement, trademark licence, equipment leases and real property leases – will be deemed 'executory contracts' and 'unexpired leases' in a bankruptcy case. An executory contract is any agreement where, as of the petition date, there are material unperformed obligations by both parties. Executory contracts and unexpired leases are governed by section 365 of the Bankruptcy Code, which provides debtors with powerful options that are not available under contract law anywhere outside bankruptcy. With respect to executory contracts, a debtor has three choices: assumption, assumption and assignment to a third party, or rejection. If the debtor chooses to reject an executory contract, the debtor is no longer obligated to perform under the executory contract. However, the executory contract itself is not terminated by the rejection. Instead, the rejection constitutes a pre-petition breach under the contract. The non-debtor non-breaching party will have whatever property rights that it would have outside bankruptcy. The non-debtor party also has the right to file a damages claim generally in the amount to which the non-debtor party would be entitled for breach of contract. However, such a rejection damage claim is deemed to

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be a general unsecured claim under the Bankruptcy Code. In addition, as to real property leases, the landlord's unsecured rejection damage claim is subject to a statutory cap in an amount the greater of one year's rent or 15 per cent of the remaining rent owing under the term of the lease (not exceeding three years' worth). The fact that rejection damage claims are unsecured claims can be very significant because in many Chapter 11 cases, such claims are paid at pennies on the dollar – if at all.

Under US bankruptcy law, rejection is treated as a deemed breach of an agreement that occurred before the petition date. However, a special provision for the Bankruptcy Code will come into play if the rejecting party (such as a debtor or franchisor) is the licensor of certain intellectual property. Bankruptcy Code section 365(n) provides protections to certain non-debtor licensees of intellectual property. If section 365(n) applies, after rejection by the licensor or debtor, the licensee may either elect to continue using the licence for the remaining term (subject to certain conditions) or treat the rejection as a termination and file its claim for rejection damages. Unfortunately, the issue is complicated by the fact that the Bankruptcy Code does not consider trademark licences to be intellectual property for the purposes of section 365(n). A recent US Supreme Court opinion addressed this trademark issue in the *Mission Product* case.[3] In the *Mission Product* opinion, the Supreme Court confirmed that a rejection constitutes a pre-petition breach only. However, the contract is not terminated. What rights the trademark licensee would have outside bankruptcy the trademark licensee would maintain, even after rejection of the contract in bankruptcy. While the debtor can stop performing under the contract, the debtor cannot rescind the licence it has already conveyed to the licensee, including the use of trademarks. As a result, non-debtor franchisees should carefully review their rights in the case of a bankrupt franchisor seeking to reject the franchise agreement (including the trademark licence) and any rights it may have when it is the non-breaching party.

The fact that rejection is treated as a breach (rather than a termination) under the law also has implications for covenants not to compete. Covenants not to compete are a common tool for protection in the franchising relationship. Franchisors often take the position that the damages they would incur from competition by a former franchisee are very difficult to calculate. For that reason, franchisors are rarely satisfied with merely receiving a monetary unsecured claim in the bankruptcy following the rejection of an agreement that includes a covenant not to compete. Generally speaking, bankruptcy courts in the United States have recognised the legal distinction inherent in covenants not to compete and have permitted enforcement post-rejection. A few bankruptcy courts, however, have held that rejection of a franchise agreement means that the covenant not to compete is unenforceable so that the franchisor's sole remedy is to file a monetary claim. Franchisors should therefore be aware of the issue and prior holdings of courts within the jurisdiction.

The second option available to debtors is to assume an executory contract. If a debtor assumes a contract, the debtor is now obligated to perform under the contract. Assumption requires the debtor to 'cure' (ie, make current) all monetary defaults and provide the non-debtor party with 'adequate assurance of future performance'. However, a non-debtor party must pay attention to what the debtor identifies as the cure payment. Often, the debtor will list a US$0.00 cure payment. Failure by the non-debtor counterparty to object means that the non-debtor party has

3 *Mission Product Holdings, Inc v Tempnology, LLC*, 139 S Ct 1652 (2019).

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waived the right to collect any past due amounts under an assumed contract. Adequate assurance of future performance means assurances that the debtor will have the financial wherewithal to continue performing under the agreement for its remaining term. Depending on the facts of the case, such assurances can take many different forms, ranging from a mere promise to perform on one end of the spectrum to a monetary deposit on the other end. The law requires debtors to assume executory contracts and leases in their entirety and as written. A debtor cannot cherry-pick favourable provisions of an agreement to assume while rejecting other provisions. However, the threat of rejection is often used by debtors to force the non-debtor party to the negotiating table in an attempt to revise the agreement by consent and seek a bankruptcy court order assuming it as amended.

In a sale context, the third option available to the debtor is to assume and assign executory contracts and unexpired leases to a third party. An assumption and assignment of an executory contract or unexpired lease to a third party requires the debtor or the assignee to cure all monetary defaults. In addition, the debtor must demonstrate that the assignee of the executory contract or unexpired lease has the financial wherewithal to perform as and when due for the remaining term of the executory contract or unexpired lease.

Depending on the potential severity of a rejection, the non-debtor party may very well find it more advantageous to agree to certain amendments in conjunction with assumption rather than incur rejection losses. The 'assume as a whole' issue also has implications relevant to franchising because the franchise relationship often involves several different agreements (eg, the franchise agreement, a real property lease and supply agreements). During the course of a bankruptcy case, it can become a strategic move by either the debtor or non-debtor party to argue that the purported separate agreements are actually one integrated agreement under applicable state contract law. If the bankruptcy court agrees, the court will ignore the fact that the agreements were purportedly separate and will require the debtor to assume or reject all the agreements as one. This could limit the flexibility of a debtor and provide the non-debtor party with negotiating leverage.

From the perspective of the non-debtor party, assumption of an executory contract is generally considered ideal because the non-debtor party is ultimately in a position to be economically unharmed by the bankruptcy filing. The issues become quite a bit more complicated, however, where the debtor seeks to assume, and then assign, an executory contract. The general rule in bankruptcy law is that contractual anti-assignment provisions are not enforceable. For example, an agreement may explicitly state that it is not assignable without the written consent of the non-assigning party. Outside bankruptcy, such a provision is perfectly enforceable under applicable state contract law. That is typically not the case in bankruptcy, however. Pursuant to Bankruptcy Code section 365(f), the provision is not enforceable. In other words, the debtor is free to assign the agreement without consent of the non-debtor party. The policy behind section 365(f) is that assigning agreements is often a key method to maximise value for the debtor's bankruptcy estate, through a going-concern sale of the business, for example. The general rule set out in section 365(f), however, is subject to an exception that is directly relevant to franchise bankruptcy cases. Bankruptcy Code section 365(c) states that anti-assignment provisions will be enforceable – notwithstanding section 365(f) – if 'applicable law' excuses the non-debtor party 'from accepting performance from or rendering performance to an entity other than the debtor'. Applicable law in this context means non-bankruptcy law applicable to the contractual relationship between the debtor and non-debtor party. Courts throughout the United States have

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generally held that federal law governing trademarks – codified in the Lanham Act – qualifies as such applicable law. Therefore, a franchisee filing bankruptcy will very likely be unable to assign the franchise agreement (which always includes a trademark licence) without the consent of the franchisor.

Bankruptcy Code section 365(c) also allows the non-debtor party to prevent assignment if the agreement is deemed to be a contract for personal services. A personal services contract is one in which the identity of the franchisee was critical to the deal struck between the franchisor and franchisee. While franchisors may consider the franchisee's identity to be very important for matters such as financial wherewithal and ability to perform, courts generally require true unique qualities to consider an agreement to be for personal services. For example, an agreement to hire someone to sing a concert would clearly be a personal service agreement because if the singer were to assign that contract to another party with dubious singing ability, it would not make sense for the deal that was struck.

With respect to assumption and assignment, the situation can become more complicated, and counter-intuitive. This is especially true where the debtor seeks merely to assume an agreement that otherwise would be deemed unassignable under Bankruptcy Code section 365(c). Because of ambiguity in the text of the statute, some courts have determined that if an executory contract is unassignable under applicable law, then the debtor is prohibited from assuming it, even if the debtor has no actual intention of assigning the agreement. The jurisdictions in the United States taking this position are known as 'hypothetical test' jurisdictions because they require a hypothetical analysis of assignability. Other jurisdictions are deemed 'actual test' jurisdictions because the court will analyse assignability only if the debtor actually is seeking to assign. In franchise bankruptcy cases, the franchise agreement will be one of the principal assets of the debtor's estate. Thus, if the debtor is prohibited from assuming that agreement in bankruptcy, it calls into question whether a bankruptcy filing even makes sense in the first place. In practice, courts in hypothetical test jurisdictions usually will not address the issue unless the non-debtor party presses the point. This provides non-debtor parties (such as a franchisor in the case of a bankrupt franchisee) with a tremendous amount of negotiating leverage.

Both assumption and rejection require the debtor to file a pleading with the court (ie, a motion or a proposed plan) and obtain a court order following notice and, typically, a hearing. Sometimes, a debtor will file a motion to assume or reject very early, perhaps on the same day as the case is filed. Much more often, however, the debtor will not make the assumption or rejection decision until later in the case. The law imposes a deadline on debtors with respect to leases of non-residential real property. In that context, the debtor is required to make its decision within 210 days of filing the bankruptcy case.[4] Any extension beyond 210 days requires the express written consent of the non-debtor landlord. For all other types of executory contracts and leases, however, there is no statutory deadline. This means that the debtor is free to wait until confirmation of the plan to decide whether to assume or reject. If there is a 363 sale, the buyer of the debtor's assets may request that the debtor put parties on notice of potential executory contracts and

4 Bankruptcy Code section 365(d)(4)(A) provides for an initial period of 120 days and allows for an extension of 90 days (thus the 210-day total). Debtors typically will request the 90-day extension as a matter of course in the bankruptcy case, and bankruptcy courts routinely grant such requests.

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unexpired leases to be assumed and assigned. The period following the petition date and before a debtor's assumption or rejection decision is known as the twilight period.

During the twilight period, non-debtor parties must continue to perform under the terms of the agreement. Debtors are not strictly required to perform, but they must pay for any economic benefit they receive under the agreement. This usually means that debtors will continue to perform their post-petition obligations and make payments to the non-debtor party that come due under the agreement following the petition date. However, if the debtor fails to perform, the non-debtor party is not permitted to exercise the remedies set out in the agreement. Exercising such remedies would violate the automatic stay. Rather, the non-debtor party's remedy is to seek relief from the bankruptcy court. In that situation, the bankruptcy court may:

- set a specific deadline for the debtor to assume or reject the agreement;
- enter an order requiring the debtor to pay all amounts that came due post-petition; or
- grant the non-debtor party an administrative expense claim for the unpaid post-petition amounts.

Administrative expense claims are one of the highest-priority claims in a bankruptcy case and must be paid in cash in full to confirm a plan. While non-debtor parties are entitled to seek relief from the bankruptcy court during the twilight period, non-debtor parties nonetheless often find it to be frustrating because the uncertainty of assumption versus rejection is left hanging over their heads.

Pre-bankruptcy planning

A basic understanding of executory contracts, assumption and rejection puts a party in a position to strategise as to how to either avoid being a creditor in a bankruptcy case or maximise its position if bankruptcy truly is inevitable. As noted above, upon the filing of a bankruptcy case, all a debtor's property becomes the property of the bankruptcy estate. That includes the debtor's interests in contracts such as franchise agreements. However, if an agreement is terminated before the bankruptcy filing, a bankruptcy filing will not 'resurrect' the agreement. Rather, the terminated agreement does not become property of the bankruptcy estate, and the non-debtor party is relieved of having to deal with assumption or rejection in the first place. Non-debtor parties should, however, ensure that they actually terminated the agreement as of the petition date and in accordance with applicable non-bankruptcy law. For example, following an alleged termination, it is not uncommon for parties to continue acting as if the agreement remained in effect. In that context, a bankruptcy court may find that the non-debtor party waived termination. Also, non-debtor parties should be aware of the effect of contractual cure periods. For example, if an agreement provides the prospective debtor with 30 days to cure following written notice of a default, and the debtor files bankruptcy on the 29th day of the cure period, then the agreement becomes property of the estate. As a result, the automatic stay prohibits the non-debtor party from taking any further action to effectuate the termination. If the debtor instead files bankruptcy on the 31st day, the termination would have been effective pre-petition, and the agreement would not become property of the estate. Unexpired real estate leases may have certain requirements under applicable non-bankruptcy law that must be satisfied first (ie, state court proceedings to have taken place before the effectiveness of any lease termination or redemption period issues).

Aside from executory contract issues, there are other actions that non-debtor parties can take to put themselves in a better position to recover as a creditor. General unsecured claims are

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among the lowest priority in a bankruptcy case. These are paid only if there are sufficient funds in the bankruptcy estate to pay all secured claims, administrative expenses and priority claims in full. Therefore, it is prudent for non-debtor parties to have options other than merely filing an unsecured claim. Pre-bankruptcy payment protection options include a security deposit, a letter of credit and a non-debtor guaranty of payment. Each option has its own pros and cons.

If the non-debtor party requires a security deposit to secure the debtor's payment obligations, the security deposit will act as collateral to secure the non-debtor's claim during the pendency of the debtor's bankruptcy case. This assumes that the security deposit is obtained pre-bankruptcy. Insisting on a security deposit post-petition to secure a pre-petition claim is not an option. While security deposits help ensure eventual payment to a creditor, the security deposit remains property of the estate and is therefore subject to the automatic stay. As a result, the creditor must seek court permission before drawing down or otherwise taking possession of the security deposit. Often, the application of a security deposit will be addressed either as part of assumption of the executory contract or unexpired lease, or as part of a claim objection proceeding brought by the debtor or plan trustee after confirmation of the plan.

Payment protection may also be obtained through the issuance of a letter of credit by a financial institution ensuring payment of the debt. Practically speaking, a letter of credit operates in much the same way as a security deposit. However, when the letter of credit obligor later files bankruptcy, there is a key distinction. Because the letter of credit is issued by a non-debtor third party, the letter of credit is not considered property of the debtor's estate. Therefore, a non-debtor creditor is free to draw down on the letter of credit to recover on its claim. That said, creditors should be aware that some debtors will request relief from the bankruptcy court to expand the automatic stay to cover letters of credit, to stay the draw-down for a period while the debtor attempts to reorganise.

A common method of payment protection in the franchising relationship is a personal guaranty of payment. For example, if the franchisee (the party executing the franchise agreement) is a limited liability company, the franchisor may insist that the individual members of the LLC execute personal guaranties to secure payment of the LLC franchisee's obligations to the franchisor. If the LLC franchisee later files bankruptcy, the bankruptcy does not affect the guaranty obligations of the non-debtor individuals. Individual guarantors who do not realise this fact may have a rude awakening when the bankruptcy case they filed to stave off franchisee creditors results in a lawsuit against them personally to collect on the guaranty. As with the letter of credit, a debtor may request an order from the bankruptcy court staying enforcement of the guaranty while the debtor attempts to reorganise. While bankruptcy courts have granted such requests, it is rare and requires special circumstances such as a small corporate franchisee operated by a handful of individual guarantors who would be unduly distracted if they had to defend personal guaranty suits at the same time as assisting with the debtor's bankruptcy case.

There are other pre-bankruptcy issues of which non-debtor parties should be aware. These include potential liability for payments by the debtor deemed fraudulent or preferential and thus subject to subsequent claw-back. This also applies to security deposits or letters of credit obtained within the 90 days before the bankruptcy filing. A substantive discussion of those issues is beyond the scope of this chapter. That said, non-debtor parties who are aware that their contractual counterparty is teetering on insolvency and may be filing for bankruptcy soon should recognise that their payment collection efforts and other actions may ultimately be

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closely scrutinised by a bankruptcy court or a bankruptcy trustee. Accordingly, the non-debtor party would be well advised to seek counsel in a situation of this kind.

Conclusion

For the uninitiated, bankruptcy and insolvency issues in the United States can be confusing to say the least. First and foremost, bankruptcy changes things. Rights and remedies that are perfectly permissible and enforceable outside bankruptcy may be delayed or unenforceable at all once a bankruptcy case has been filed. In addition, non-debtor parties should take heed of the automatic stay. The automatic stay applies to assets of the debtor located anywhere in the world, and bankruptcy courts have little patience for parties who ignore the restrictions. Finally, there are pre-bankruptcy steps a non-debtor party can take to provide itself with some measure of protection and to otherwise maximise the non-debtor party's rights as a creditor. But there is very little a non-debtor party can do to completely prevent its contractual counterparty from filing bankruptcy. In other words, an absolutely 'bankruptcy proof' franchise agreement has yet to be written.

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Appendix 1

About the Authors

Michael J Lockerby
Foley & Lardner LLP

Michael J Lockerby is a partner in the law firm of Foley & Lardner LLP, which has more than 1,100 lawyers in 24 offices in the United States, Mexico, Europe and Asia. Mr Lockerby is resident in the firm's Washington, DC office.

Mr Lockerby is the national co-chair of the firm's distribution and franchise practice and is ranked as one of the top franchise lawyers in the nation by *Chambers USA*, among others. For more than 35 years as a trial lawyer, he has been on the cutting edge of the intellectual property, antitrust, business tort and franchise law issues that face all suppliers of products sold through independent dealers, distributors and franchisees. He regularly appears before federal and state trial and appellate courts and arbitrators from coast to coast.

On behalf of a number of clients, Mr Lockerby has led the nationwide litigation of system-wide issues and class action claims. Such issues include pricing and monopolisation claims, consolidation of overlapping distribution networks, rebranding of trademarked products formerly distributed under another brand, enforcement of exclusive dealing requirements, 'encroachment claims' raised by direct sales and internet marketing, implementing new standards for franchisees and dealers, and disputes with franchisee and dealer associations. The industries in which he has litigated and advised clients include computer hardware and software; telecommunications and other high-technology products; alcoholic beverages; construction, forestry, farm, utility, industrial and outdoor power equipment; motor vehicles; petroleum marketing; and franchisors of restaurants, hotels, and personal and professional services.

Sharon M Beausoleil
Foley & Lardner LLP

Sharon M Beausoleil is a senior counsel in the law firm Foley & Lardner LLP. Ms Beausoleil is resident in the firm's Houston, Texas office.

Ms Beausoleil is a member of the firm's bankruptcy and business reorganisations practice. For more than 20 years as a lawyer, she has focused her practice on complex bankruptcy

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matters and related bankruptcy litigation. Her clients include secured and unsecured creditors, major contract parties and parties interested in acquiring assets from distressed companies. She regularly appears before federal bankruptcy courts. The industries in which she has litigated and advised clients include the aviation, chemical, energy, maritime and refining sectors. She has also advised clients regarding storage, terminalling, distributorships, franchise and petroleum marketing matters.

Foley & Lardner LLP
Washington Harbour
3000 K Street, NW
Suite 600
Washington, DC
20007-5109
United States
Tel: +1 202 945 6079
Fax: +1 202 672 5399
mlockerby@foley.com

1000 Louisiana Street
Suite 2000
Houston
TX 77002-2099
United States
Tel: +1 713 276 5500
Fax: +1 713 276 5555
sbeausoleil@foley.com

www.foley.com

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