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

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Jason Binford's article, *Assigning a Franchise Agreement over the Franchisor's Objection: Bankruptcy May Make it Possible*,[1] in the fall 2012 edition of this *Journal* discussed whether a franchisee, as a debtor in a bankruptcy proceeding, could use Section 365 of the Bankruptcy Code to assign the franchise agreement over the refusal or objection of the franchisor. Mr. Binford contends that a franchisee in bankruptcy has a fair chance of compelling its franchisor to accepting a replacement franchise. Since the passage of the modern Bankruptcy Code in 1978, a number of decisions have broadly interpreted a debtor's power under Section 365 to assign contracts that, by their terms, would otherwise restrict assignment. But three Supreme Court cases suggest an evolving trend that limits a debtor's ability to expand property and contract rights from what the rights would be under non-bankruptcy law in the absence of a bankruptcy. In my view, this trend now dominates bankruptcy practice. Prior rulings of bankruptcy courts that allowed debtors to assign a franchise agreement over the franchisor's objection exist only in memory.

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The difference in point of view between the Binford article and my comments reflects a tension that has existed in bankruptcy law since the enactment of the 1978 Code. Should the Bankruptcy Code provide substantive relief to debtors, with a policy bias that favors allowing debtors a "fresh start" that might preserve jobs and enhance creditor recoveries? Or is it largely a procedural mechanism for adjusting state law rights to enforce debts owed by insolvent debtors, with a true business reorganization being available to the debtor that can satisfy the procedures but without any statutory bias that favors reorganization?[2]

Evolution of the Happenstance of Bankruptcy Rule

The former view, that there exists some pro-debtor (or pro-bankruptcy estate) bias in the Code in the treatment of the rights of others, is found in cases like the Fourth Circuit's decision in *In re Shangra-La, Inc.*,[3] which looked at the power to assign contracts from the perspective of how an assignment would benefit creditor recoveries. But this view can seem unprincipled: why should the enforceability of a franchisor's rights under the franchise agreement depend upon whether the franchisee pays its creditors?

The second view, that the Bankruptcy Code is largely a procedural scheme for creditors to exercise state law substantive rights to their debtors' assets (or to the value of those assets), is found in a trilogy of Supreme Court cases that started with *Butner v. United States*[4] and continued with *United States v. Whiting Pools*[5] and *Raleigh v. Illinois Department of Revenue*.[6] 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 parties in a bankruptcy proceeding are not different from their rights outside of bankruptcy.[7] This has been sometimes referred to as the happenstance of bankruptcy rule: "to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy."[8]

The happenstance of bankruptcy rule has been applied in a number of contexts. In *Peterson v. McGladrey*,[9] a chapter 7 trustee in a suit against an accounting firm that had audited the pre-bankruptcy debtor argued that his standing as a bankruptcy trustee should free him from having to overcome the defendant's *in pari delicto* defense that was otherwise available under state law. Rejecting the trustee's argument, the Seventh Circuit held that the trustee succeeded to the claim as it existed under state law—no more, no less.[10]

The Supreme Court affirmed the happenstance rule when it overruled what had been a long-established practice in most circuits of not allowing unsecured creditors to include in their bankruptcy claims legal fees incurred in the bankruptcy case.[11] Simply, if the claimant has a contractual right to include legal fees in its claim that is enforceable under state law, the right should continue in the bankruptcy of the claimant's debtor. Otherwise, those creditors who did not negotiate for the right to charge legal fees to the debtor will enjoy, compared to what would happen outside of bankruptcy, a relative greater recovery than those creditors who did secure the right.

The "happenstance of bankruptcy" rule not only prevents debtors and trustees from expanding estates beyond state law limits, but also prevents creditors from encroaching on rights that would be available to a debtor outside of bankruptcy. In *Patterson v. Schumate*,[12] the Supreme Court considered the right of an individual debtor to funds held in a qualified pension plan. In turning back an effort by a trustee to seize the plan assets for the benefit of the debtor's creditors, the Court held that by filing for bankruptcy the debtor's rights to the funds were not diminished from what they were outside of bankruptcy.

The Bankruptcy Code does include exceptions to the "happenstance of bankruptcy" rule. Of particular importance to franchisers, Section 365(a), as seen in the automobile manufacturer bankruptcies,[13] permits a franchisor, even one that

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will continue its business post-bankruptcy, to "reject" a franchise agreement and thereby free itself of obligations under the agreement. By rejection, the franchisor effectively ends a franchise that under state law it could not terminate except for cause.[14] Rejection leaves the franchisee with only a pre-bankruptcy unsecured claim for its damages.[15]

Section 365 and the Happenstance of Bankruptcy Rule

Section 365 might seem to be one of the Bankruptcy Code's sections that grants debtors and trustees rights that do not exist under state law. Under Section 365(a), a contract may be assumed and assigned without the non-debtor party's consent regardless of whether the contract's terms prohibit assignment. Section 365(b)(1) permits assignment even where the debtor has defaulted under the contract as long as the debtor can cure the default. Under Section 365(b)(2), a contract can be assumed and assigned—even if by its terms it terminated or could be terminated upon the bankruptcy or insolvency of the debtor. These sorts of bankruptcy termination provisions are referred to as ipso facto clauses.

On closer inspection, however, these subsections of Section 365 actually implement the policy of the happenstance rule by effectively nullifying state law rights to terminate or modify a contract solely because the other party to the contract has entered bankruptcy, or has committed a breach of the contract that can be wholly rectified. The overarching policy of these provisions and the case decisions discussed above is therefore not so much maintaining non-bankruptcy law rights and entitlements, but preserving the pre-bankruptcy debtor and the legal relationships it has with other parties. As is clear from the court rulings, however, to preserve does not mean to enhance.[16]

Section 365's broad general rule, i.e., that contracts can be assumed and assigned by a debtor or trustee notwithstanding a contractual provision that would prevent either, makes perfect sense where the contracts principally involves fungible goods or services. In such a case, the assignment of the debtor's contractual rights and duties to another party equally capable of performing those duties does not prejudice the non-debtor party to the contract. For example, a contract might provide for the debtor to sell a fixed quantity of a fungible good, such as coal, to the non-debtor party for a fixed price. There is no policy reason why the debtor should not be able to assign the contract to another party that could supply the same quantity and quality of coal at the same price. Presumably the debtor (and thus its creditors) would receive as consideration for the assignment the spread between the then market price of coal and the price the non-debtor party is obligated to pay. In fact, to allow the non-debtor party to escape the contract (as it might want to do if the market price for coal has fallen) solely because its contracting partner has filed for bankruptcy would, by allowing it a windfall, violate the happenstance rule.[17]

Not all contracts, however, deal with fungible goods or services. The broad rights of assignment under Section 365(a) and (b) give way where the debtor's obligations under the contract are in some way unique or personal. Under Section 365(c)(1), a debtor or trustee may not, over the objection of the non-debtor party, assign a contract if "applicable law" would excuse the non-debtor party from accepting performance from, or rendering performance to, any party other than the debtor. Applicable law, as used in Section 365(c), means state law and non-bankruptcy federal law.[18]

Before discussing how Section 365(c)(1) works and whether it permits the assignment of contracts that could not be assigned outside of bankruptcy, it is worthwhile to consider whether it is even needed. In the absence of Section 365(c)(1), under Section 365(f)(2) a debtor would still have to demonstrate "adequate assurance" that the proposed assignee of a contract will not default under the contract. In other words, that the proposed assignee could perform under the contract in the same manner as the debtor was bound to perform. If the contract were a franchise agreement that had very particular operating standards, the court would have to find adequate assurance that the assignee could satisfy those standards. In making that determination, the court must consider the contract in its entirety as it is written.[19] A bankruptcy court cannot relieve the assignee of certain contractual duties or modify those duties.[20]

There are several reasons why a court should not be in the business of adjudging whether a proposed assignee could perform what might be numerous and technical requirements of the contract. First, the court could be wrong in its determination that the assignee can perform under the contract. An erroneous determination would saddle the other party to the contract with a non-performing partner it did not select and burden it with the cost and delay of terminating that partner. Second, bankruptcy courts are busy, and the time it would take to assess a proposed assignee's ability to perform under numerous operating requirements is time not spent on all the other matters that come before a bankruptcy court. By including Section 365(c)(1) in the Bankruptcy Code, Congress required only that courts determine generally whether a contract is one that under state law the non-debtor party cannot be compelled to accept performance from an assignee of the debtor. If it is, the statute provides that the contract cannot be assigned over the objection of the non-debtor party.

Personal Service Contracts

Determining whether a particular contract falls under Section 365(c)(1) may not always be as easy as the above example concerning coal suggests. In making the determination, a court is to be guided by applicable law, an expression that means the law that would govern enforcement of the contract outside of bankruptcy.[21] In most cases, applicable law means state law, although non-bankruptcy federal laws, such as those governing trademarks, might also apply.[22]

But applicable law cannot mean any state law that concerns the assignment of contracts. Many states would presumably permit the enforcement of general assignment prohibitions and of ipso facto clauses that allow for the termination of a contract merely because one of the parties has filed for bankruptcy. Broadly read, Section 365(c)(1) would

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allow the enforcement of such a clause, but that would render Section 365(b) (which allows for the assignment of contracts notwithstanding the presence of an ipso facto clause) meaningless. This potential conflict between the two subsections of Section 365 is avoided by courts reading Section 365(c)(1) as applying only to those laws that excuse a party from accepting performance from an assignee for a reason other than an ipso facto right of termination.[23] The types of contracts that might contain enforceable rights to refuse consent to an assignment are very broadly referred to as personal services contracts. These could be contracts for true personal services, such as a performance by a particular opera singer; a business arrangement akin to a franchise, where one party is relying on a particular attribute, i.e., skill, location, access to financing, of the other party; or a trademark license arrangement, where the licensor is relying on the particular identity and reputation of the licensee.[24]

Of course, it is not always easy to say which contract involves personal services and which does not—most cases are not as easy as the contract hiring Lady Gaga to sing at your daughter's wedding. This is especially true with business arrangements involving the sale of branded goods, such as automobiles, or that combine the sale of a branded product with a particular type and quality of service, such as a restaurant.

When a debtor or trustee seeks to assign a contract (such as a franchise agreement) that may involve personal services, the non-debtor party must object to the assignment and specify the applicable non-bankruptcy law that would excuse such party from accepting performance from the proposed assignee. In cases involving an attempt to assign a franchise or distribution agreement, the applicable law will likely be a state franchise act or some act applicable to particular products, such as motor vehicles. Once the court determines that the cited state law does in deed govern contracts for personal services (as opposed to a general law that might allow for the enforcement of ipso facto clauses), and that the contract at hand involves the types or services regulated by the state law, the court is bound to apply any provision in the state law that restricts the right to assign the contract.

As an illustration, suppose that a debtor that operated a restaurant franchise sought to sell its business and to assign its franchise agreement to a new operator that has no restaurant experience. Suppose also that under the franchise agreement the franchisor could reasonably refuse consent to an assignment, and that case law in the applicable state holds that a franchisor acts reasonably when it refuses consent to an assignment to an inexperienced operator. Finally, suppose that the proposed new operator, albeit inexperienced, has ample resources and demonstrates a genuine desire to succeed.

Would a court following the "happenstance of bankruptcy" rule allow assignment of the contract over the objection of the franchisor? The answer should be no because state law would allow the franchisor to refuse consent to the assignment. This should be the outcome no matter how much "adequate assurance" of the proposed assignee's ability or willingness to perform is offered to the franchisor, and no matter how much the assignment will benefit the debtor and its creditors. If the outcome were otherwise, the debtor would have achieved something it could not have achieved outside of bankruptcy—the assignment of its franchise to an inexperienced operator. More fundamentally, it would have converted a contract right with limited assignment rights to one with potentially broad assignment rights and thus enhanced the monetary value of the contract. Although that may sound great for the debtor and its creditors, it is not what the franchisor bargained for. The preservation of those rights take precedence over a general goal of enhancing creditor recoveries.

Not every case will be as easy. The franchisor's basis for refusing consent might be untested under applicable state law. In that case, the bankruptcy court may have to determine the lawfulness of the franchisor's action. The court's determination, however, will be guided by the factors that a state court, applying state law, would apply.

Many states have laws that govern specific types of franchise/distribution relationships, such as the laws for automobile dealerships. Often, a state administrative agency is charged with administering the law and adjudicating disputes arising under the law. Is there a procedural component to the happenstance of bankruptcy rule that would require bankruptcy courts to abstain from hearing contract assignment and termination disputes that, outside of bankruptcy, would be heard in the first instance by an administrative agency? Although no appellate court has squarely addressed the issue, a bankruptcy court should abstain from deciding state law issues where there exists a state agency with the specific authority and specialized experience to deal with the issue.[25]

Section 365 might seem to be one of the Bankruptcy Code's sections that grants debtors and trustees rights that do not exist under state law.

Although franchise agreements are now generally regarded as no more assignable in bankruptcy than they would be outside of bankruptcy, there are reasons why a franchisee facing termination might file for bankruptcy. The filing will trigger an automatic stay, which will give the franchisee some breathing room to organize its defense to the franchisor's action or even provide momentary leverage for a settlement. The automatic stay will stop actions by creditors, allowing the franchisee to devote its full efforts to preserving its franchise. A bankruptcy filing might even make it possible for a franchisee to raise the money needed to either defend a termination proceeding or to cure the alleged defects in its franchise.

One thing that a bankruptcy filing should not do is change the rules on whether the franchise can be assigned to a new operator. Whatever statutes, regulations, and contracts that applied on the moment before the bankruptcy case was filed

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should still apply. Moreover, the bankruptcy court should defer to whatever non-bankruptcy administrative or judicial procedure might exist that in the absence of bankruptcy would govern the resolution of disputes between the franchisor and the franchisee.[26] Of course, this does not mean that the franchisor will necessarily succeed in blocking an assignment of the franchise agreement. As Binford discusses in his article, assignment might well be permitted under applicable non-bankruptcy law.[27]

The period of 2008–2010 saw a number of automobile dealership bankruptcies.[28] Most ended in liquidation, but a few ended in sales of the entire business, including the franchise agreement, to new operators. Although these cases yielded no written opinions, in each case involving a sale of the dealership the franchisor's contractual right to consent (as that consent right might be limited by state law) to the new operator was respected.[29] Typical of these cases is *Bill Heard Enterprises*,[30] which involved several automobile dealerships. In its order authorizing the sale of the dealerships, the court directed General Motors to "determine whether the Stalking Horse [selected purchaser] is qualified to own and operate the dealerships included in the Offered Property and Offered Assets. Such approval by GM shall not be unreasonably withheld under any applicable law."[31]

The happenstance of bankruptcy rule, as it applies to the assignment of franchise or dealer agreements, has become well ingrained. At this point, in my view, it is unlikely that a court would allow an assignment of such an agreement over the franchisor's objection unless it found a state or non-bankruptcy federal law basis to do so.

Endnotes

1. Jason Binford, *Assigning a Franchise Agreement over the Franchisor's Objection: Bankruptcy May Make it Possible*, 32 Franchise L.J. 71 (Fall 2012).

2. A recent strong statement favoring the procedural view of the Bankruptcy Code is found in *Peterson v. McGladrey*, 676 F.3d 594, 598 (7th Cir. 2012) ("Bankruptcy is a means of administering claims that are defined by tort, contract, and other generally applicable bodies of law. Congress has modified these claims in some respects, and changed some distribution priorities, but unless the Code makes such an alteration the job of the bankruptcy court is to gather all of the debtor's assets, as state law defines those assets, and distribute them according to the creditors' rights under state law. In the main, bankruptcy law is designed to provide a single forum for resolving competing claims to assets defined by other bodies of law.").

There are provisions in the Bankruptcy Code that clearly do favor the incumbent debtor, such as the automatic appointment of the debtor as a "debtor in possession" upon the commencement of the case, the high hurdle for the dislodgement of a debtor in possession or the dismissal of the case, and the exclusive period a debtor has to propose a plan of reorganization. When it comes to the rights of creditors to be paid on their debts, however, this bias disappears: unless they agree otherwise, creditors are entitled to all of the value of the enterprise, to the complete exclusion of owners, until their claims have been paid in full with interest. *See* 11 U.S.C. § 1129(b).

3. 167 F.3d 843, 849 (4th Cir. 1999).

4. 440 U.S. 48 (1979).

5. 462 U.S. 198 (1983).

6. 530 U.S. 15 (2000).

7. One area where the Bankruptcy Code grants debtors a right that does not exist under state law is the power to reject executory contracts under Section 365(a). Although rejection does not terminate the contract, it does allow the debtor to avoid any affirmative obligations under the contract after the effective date of rejection. *See* Sunbeam Prods. v. Chicago Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012). In a franchise agreement, a rejection of the franchise agreement by the bankrupt franchisor will effectively terminate the franchise, leaving the franchisee with an unsecured claim for its damages. *See* Paul Norman**,** *Synopsis of Bankruptcy Law Applicable to Motor Vehicle Manufacturers and Dealers,* Nat'l Auto Dealers Ass'n, *available at* www.nada.org /NR/rdonlyres/2D71C664-6A27-4F87-88BC-32EC4180BD08/0/NADA_summary_bankruptcy _law.pdf. As recognized recently in the automotive bankruptcy cases, the debtor's broad power to reject deal agreements trumps the dealer's state law right to be terminated only for cause. *See In re* Old Carco LLC, 470 B.R. 688 (S.D.N.Y. 2012).

8. *Butner*, 440 U.S. at 55.

9. 676 F.3d 594 (7th Cir. 2012).

10. *Id*. at 598.

11. Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co*.,* 549 U.S. 443 (2002).

12. 504 U.S. 753 (1992).

13. *E.g*., In re Old Carco LLC, 470 B.R. 688 (S.D.N.Y. 2012).

14. *See generally id*. *See also* Norman**,** *supra* note 7.

15. Other examples of where the Bankruptcy Code overrides state law include Section 547, under which a payment to a creditor prior to the bankruptcy filing can be avoided as a preference even though no such right exists under state law. Also, the plan of reorganization sections of Chapter 11 allows debts to be paid over time, even though under state law creditors generally in effect have the right to force a liquidation.

16. *E.g*., Peterson v. McGladrey, 676 F.3d 594, 598 (7th Cir. 2012).

17. *E.g.,* Butner v. United States, 440 U.S. 48, 55 (1979) ("Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'") (citing Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 609 (1961)).

18. *See* 3 Collier on Bankruptcy ¶ 365.07[1][c] (16th ed. 2010), collecting and discussing court of appeal cases that have addressed the breadth of the term "applicable law" for Section 365(c)(1) purposes.

19. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984) (a contract must assume the entire contract cum onere (subject to all of its terms)).

20. *See In re* Village Rathskeller, Inc., 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1998) ("the debtor or trustee is not free to retain favorable features of a contract and reject the unfavorable ones.").

21. Collier*, supra* note 18.

22. *E.g*., *In re* CFLC, Inc., 89 F.3d 673 (9th Cir. 1996) (concerning assignment of patent license); *In re* W. Elec., Inc., 852 F.2d 79 (3d Cir. 1988) (concerning assignment of government contract).

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23. *See* Collier, *supra* note 18, ¶ 365.07[1][a] ("If a contract or lease is nonassignable solely because it contains a nonassignment clause, section 365(c) does not prevent the assumption or assignment of the contract or lease. Instead, section 365(c) is directed to contracts that, regardless of their provisions with respect to assignment or performance, would be nonassignable under applicable nonbankruptcy law.").

24. It is not essential that a contract be a personal service contract in order for it to fall under Section 365(c)(1). 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). *See generally In re* Headquarters Dodge, Inc., 13 F.3d 674 (3d Cir. 1993). Thus, for example, a franchisor's refusal to consent to the assignment of a franchise to an operator that proposed to move the location of the business, on the grounds that the new location was too close to an existing franchise, should be respected under Section 365(c)(1) regardless of the extent to which the franchise agreement involved personal services.

25. *See* NLRB v. Adams Delivery Serv., 24 B.R. 589 (B.A.P. 9th Cir. 1982); *In re* Platinum Motors LLC v. Automobili Lamborghini SpA, Case No. 09-ap-01294 (Bankr. C.D. Cal. 2009), Order Granting Emergency Motion of Automobili Lamborghini America LLC to Remand Improperly Removed Action entered on May 4, 2009.

26. *Id.*

27. Binford, *supra* note 1, at 75–77. *See* In re Headquarters Dodge, Inc., 13 F.3d 674 (3d Cir. 1993) (applicable state law governs the determiniation of whether an automobile manufacturer acted reasonably in terminating a dealer).

28. *See, e.g., In re* Hickory Automotive Group, Inc., Case No. 08-51464 (W.D.N.C.); *In re* Platinum Motors LLC, Case No. 8:09-bk-12472 (C.D. Cal.); Calabasas Euro Auto Group, LLC, Case No. 8:09-bk-12593 (C.D. Cal.); *In re* Westhampton Classic Cars, Case No. 09-73009 (E.D.N.Y. 2009); *In re* Allison Automotive Group Inc., Case No. BK-N-11-51983 (D. Nev.); *In re* Big Apple Volkswagen, LLC, Case No. 11-11388 (S.D.N.Y. 2011); *In re* B.A. Wackerli Co., Inc., Case No. 09-40202 (D. Idaho 2009).

29. *E.g.*, *In re* Bill Heard Enters., LLC, Case No. 08-83029 (N.D. Ala. 2008) (Order on Debtors' Motion Pursuant to 11 U.S.C. §§ 105, 363, and 364 and Fed. R. Bankr. P. 2002, 6004 and 6006 for an Order Approving Sales Procedures, Sales Protections and Notice Procedures entered on Oct. 15. 2008); *In re* Big Apple Volkswagen, LLP, Case No. 11-11388 (S.D.N.Y. 2011) (Order Approving Sale Procedures and Terms, Including Break-Up Fee, for the Sale of the Debtor's Automobile Dealership Assets entered on July 13, 2010); *In re* Champion Motor Group, Inc., Case No. 09-71979 ((E.D.N.Y. 2009) (Order Approving Procedures in Connection With Sale of Debtor's Assets; Approving Form of Asset Purchase Agreement; Scheduling Auction and Hearing to Consider Approval of Sale; Approving Procedures Related to Assumption of Certain Executory Contracts and Unexpired Leases and Approving Form and Manner of Notice Thereof, entered on February 1, 2010); *In re* Copans Motors, Inc., Case No. 09-18807 (S.D. Fla. 2009) (Order Granting Motion for Sale of Property Assets Related to Audi Dealership to Qvale Auto Group, Inc. entered on Dec. 23, 2009).

30. *In re* Bill Heard Enters., LLC, Case No. 08-83029 (N.D. Ala. 2008).

31. *See id.* (Order on Debtors' Motion Pursuant to 11 U.S.C. Sections 105, 363, and 364 and Fed. R. Bankr. P. 2002, 6004 and 6006 for an Order Approving Sales Procedures, Sales Protections and Notice Procedures, p. 3, entered on Oct. 15. 2008.