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Executory Contracts and the Franchise Relationship

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In the context of executory contracts under the Bankruptcy Code, the franchise relationship is a strange beast. The business relationship between a franchisor and franchisee is typically represented by not one but several agreements, each dependent on the other. The documents underlying the relationship may consist of one or more of the following: a license agreement, a sales agreement, an equipment lease, a promissory note, a security agreement, a guaranty, a real property lease, UCC financing forms and so on. Often, the agreements contain cross-default provisions. What happens when a debtor decides to "cherry-pick" one of these agreements and cure only defaults under that agreement? What if the debtor agrees to cure all the monetary defaults under the agreement but boasts that it may assume a franchise without curing important non-monetary defaults? These are some of the interesting questions that arise when the franchise relationship meets the Bankruptcy Code. This article will explore how the answers to these questions may contradict normal bankruptcy assumptions (pun intended).

Integration

Under 11 U.S.C. §365, a debtor, subject to the court's approval, may assume or reject any executory contract or unexpired lease. However, if there has been a default, the debtor may not assume the contract unless the debtor "cures, or provides adequate assurance that the trustee will promptly cure, such default." 11 U.S.C. §365(b)(1)(A).

In general, executory contracts must be assumed *cum onere*. A debtor may not choose to assume only the favorable provisions of an agreement and ignore those that are burdensome. *Kopel v. Pasquale Campanile,* 232 B.R. 57, 63-64 (Bankr. E.D.N.Y. 1999). This fundamental rule has been expanded to cover contracts that are intended to embody a single or integrated transaction. *See In re Braniff,* 118 B.R. 819, 844 (Bankr. M.D. Fla. 1989) (multiple contract documents may form one uniform agreement). Thus, debtors have not been allowed to assume only one of multiple related agreements where the parties to the agreements intended for them to constitute a single contract. *See In re Karfakis,* 162, B.R. 719, 725 (Bankr. E.D. Pa. 1993) (court refused to allow debtor to assume real property lease without assuming related franchise agreement).


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Sometimes, the intent of the parties to intertwine multiple agreements is reflected in a "cross-default" provision, which would create a default under one agreement based on a default under another. Courts tend to be somewhat reluctant, however, to enforce cross-default provisions under §365, though to the extent such provisions do not contravene federal bankruptcy policy, they will be upheld. *Liljeberg Enter. Inc.,* 304 F.3d 410, 444-45 (5th Cir. 2002) (acknowledging authority from bankruptcy courts and district courts for the proposition that cross-default provisions do not integrate otherwise separate transactions or leases); *Kopel,* 232 B.R. at 65 ("Although cross-default provisions are inherently suspect, [they do not require] per se invalidation.").

Indeed, cross-default provisions are generally only enforceable under §365 if "the contract or lease at issue is part of a single, integrated transaction with the other contract or lease, such that the breach of one contract would, independent of the cross-default provision, excuse performance under the other." Resnick, Alan N., et. al., 3 *Collier on Bankruptcy* §365.05 (15th ed. 2002). Thus, the key issue is determining whether the agreements are sufficiently integrated so as to constitute a single transaction. "[C]ontract interpretation is a matter of state law, and therefore, bankruptcy courts should rely on applicable state law to determine whether an agreement is indivisible." *In re Karfakis,* 162 B.R. 719, 725 (Bankr. E.D. Pa. 1993). *See, also, In re Pollock,* 139 B.R. 938, 940 (9th Cir. B.A.P. 1992); *Café Partner/Washington 1983,* 90 B.R. 1, 5 (Bankr. D.C. 1988).

Cases from various jurisdictions provide guidance. Generally, courts have found integration where the language of the contracts indicates that they are integral parts of the same transaction. *T&H Diner Inc.,* 108 B.R. 448, 454 (D. N.J. 1989) (shared language, including a cross-default provision, in a note and lease indicated that they "were integral parts of a single transaction which transferred the entire restaurant and diner, the land upon which it operated, its equipment and goodwill to the debtor"); *East Hampton Sand & Gravel Co. Inc.,* 25 B.R. 193, 199 (Bankr. E.D.N.Y. 1982) ("The lease is part and parcel of one unified transaction whereby the creditor sold its concrete manufacturing business to the debtor."). In doing so, some courts have expressed the test as one of interdependence between the agreements. That is, integration is only found where there would have been no transaction at all without both agreements. *Kopel,* 232 B.R. at 67; *Karfakis,* 162 B.R. at 725 ("One test used to determine whether separate contracts constitute an indivisible agreement is whether the parties assented to all of the promises as a single whole, so that there would have been no agreement whatever if any promise or set of promises were struck out.").

Other factors considered by courts in making the determination as to whether two contracts are integrated for purposes of §365 include whether the documents (1) were executed at substantially the same time, (2) were executed by the same parties,[1] (3) reference each other and (4) refer to the same subject matter. *In re Independent American*

[1] At least one court, however, has held that "where documents are contemporaneously executed as necessary elements of the same transaction, such that there would have been no transaction without each of the other agreements, the fact that nominally distinct parties executed the agreements will not preclude enforcement of a cross-default provision in favor of a party whose economic interests are identical to those of the entity that is party to the document containing the cross-default provision." *Kopel,* 232 B.R. at 67.

Real Estate Inc., 146 B.R. 546, 551 (Bankr. N.D. Tex. 1992) (finding integration where the agreements in question contained overlapping terms, were executed at substantially the same time and referred to the same subject matter); *T&H Diner Inc.*, 108 B.R. at 454 (finding integration where the documents were simultaneously executed, referenced one another and contained cross-default provisions); *compare In re Integrated Health Services Inc.*, No. 00-389, 2000 Bankr. LEXIS 1310 at *11-13 (Bankr. D. Del. July 7, 2000) (finding no integration where there was separate consideration for the four contracts, which dealt with separate subject matter (real estate vs. non-competition), and where the parties were separate); *In re RBGSC Invest. Corp.*, 240 B.R. 536, 542 (Bankr. E.D. Pa. 1999) (finding no integration where leases involved different facilities and different parties); *In re Mottola*, No. 97-19361DWS, 1997 Bankr. LEXIS 2220 at *20 (Bankr. E.D. Pa. 1997) (finding no integration between shareholders' agreement and settlement agreement where they were entered into at different times, had distinct purposes and had independent utility).

Policy considerations also factor into the equation. Federal bankruptcy policy is offended where the non-debtor party seeks enforcement of a cross-default provision in an effort to extract priority payments under an unrelated agreement. However, "enforcement of a cross-defaulted provision should not be refused where to do so would thwart the non-debtor party's bargain." *Liljeberg* at 445; *Kopel* at 63-64, 65.

In short, courts attempt to recreate the objective intent of the parties by examining the documents and the facts and circumstances under which they were signed. In a franchise context, if the intent is to create a singular relationship evidenced by multiple contracts, the contracts must demonstrate that intent, and the economic consideration supporting any cross-default provisions must be explained. If, for instance, a franchisor can show that it would not have entered into a franchise agreement absent an accompanying sales agreement that obligated the franchisee to purchase its product, a court will likely require the debtor to cure defaults under both agreements.

Non-monetary Breach

Franchise agreements are also distinct because the economic value of a franchise is typically dependent on maintaining the goodwill of the franchised name, mark and practices associated with the franchise. As a result, non-monetary breaches may strike at the heart of a franchise relationship and be grounds for termination. This is contrary to the general notions associated with cure of executory contracts, which usually look to the economic defaults in question.

However, many have argued that certain non-monetary breaches of franchise agreements should prevent assumption under §365 because they are "historical facts" that cannot be cured. *See* Truitt, Lesley A., "Notes & Comment: From the Conflicting Treatment of Non-monetary Defaults in §365(b), an Exception for Franchises Emerges," 17 Bank. Dev. J. 257, 259 (2000) (arguing that "courts should not allow a franchisee-debtor to assume the franchise agreement once he has committed a material non-monetary default").

The argument is that franchise agreements represent a license of the franchisor's most valuable asset, its trademark or goodwill. Keating, William J., *Franchising Advisor*, 1.01, 3.01, 7 (1987). Courts have thus treated cases involving franchise agreements differently than they might other contracts. *See In re Deppe*, 110 Bankr. 898, 904 (Bankr. D. Minn. 1990) ("the steady maintenance of gasoline station operations during the days and hours fixed by franchise agreements is a key goodwill value to the refiner/distributor, which is given special deference in franchise litigation involving such business").

In order for a non-monetary default to be deemed noncurable for purposes of §365, however, a court must find that the default is sufficiently material to prevent the debtor from curing it. *See In re Vitanza*, 1998 Bankr. LEXIS 1497, *88 (E.D. Pa. Nov. 13, 1998) (in determining whether to enforce non-monetary defaults in the context of assumption, the court should consider "the materiality of the default at issue and whether the default caused 'substantial economic detriment' to the nondefaulting party"); *Truitt, supra*, at 278-79 (because "a material non-monetary default can severely tarnish several aspects of the business and business relationships," courts have held franchisees to a higher standard regarding the "cure" requirement when the non-monetary default is material).

Courts have held that non-monetary defaults of franchise agreements are sufficiently material so as to be deemed noncurable for purposes of §365 assumption. *In re Claremont Acquisition Corp. Inc.*, 113 F.3d 1029, 1033 (9th Cir. 1997) (dealer that had failed to operate its dealership for two weeks in violation of the franchise agreement had committed a non-monetary default constituting a historical fact that by definition could not be cured); *In re Lee West Enterprises Inc.*, 179 B.R. 204, 209 (Bankr. C.D. Calif. 1995) (debtor's failure to maintain operations of dealerships for more than five months, in violation of dealer agreement and California statute, was of sufficient substance, materiality and economic significance to constitute an incurable default); *In re Toyota of Yonkers Inc.*, 135 Bankr. 471, 477 (Bankr. S.D.N.Y. 1992) (debtor's closure of dealership for seven consecutive days, in violation of the dealer agreement and New York law, constituted a historical fact that debtor could not undo); *Truitt, supra*, at 282 (non-monetary defaults in franchise agreements "irreparably damage the goodwill, the trademark or some intangible, personal quality of a company...the 'historical fact' of the default cannot be cured, and the taint is permanent."). *But, see In re ERA Cent. Reg'l. Serv. Inc.*, 39 B.R. 738, 742 (Bankr. C.D. Ill. 1984) (rejecting argument that franchisee's failure to meet performance standards and promotion requirements under the franchisee agreements was not curable and holding that money damages may be appropriate to cure such defaults).

Thus, in certain circumstances, a debtor may be prohibited from assuming a franchise agreement because of non-monetary defaults that are deemed to be incurable. Assumption will depend not only on the terms of the franchise agreement itself, but also on the materiality of the breach and a finding that goodwill has been so damaged that assumption is impossible.

Conclusion

Contracts that arise in a franchise relationship should be handled with care, as there is a body of distinct case law that recognizes their unique character under §365. A debtor may not be allowed to sever only one of several agreements underlying an integrated franchise transaction, but may instead be forced to assume even those agreements that hamper its rehabilitation. Moreover, assumption may be barred altogether if a franchisee has breached a material provision of an agreement which, though not cast as a monetary default, damages the valuable goodwill being franchised. Bankruptcy lawyers should be circumspect when this unusual relationship is tested. ■

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