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AMERICAN BAR ASSOCIATION
Forum on Franchising

The Franchise Lawyer

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Message from the Chair

By Ron Coleman, Parker, Hudson, Rainer & Dobbs LLP

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Happy Summer to everyone! I hope your workdays are full of interesting franchise counseling, transactions, or litigation, and that you have time to enjoy seasonal activities wherever you might be.

Some might think this time of year is a slow period for the Forum since we are between meetings, but I can assure you there is a lot going on. All our committees are active, and several are putting together Zoom events to connect and inform our membership. The Women's Caucus held an excellent webinar on women's health in the workplace on May 25. The Program Committee has organized several events for the coming months. These include a "Best of the Forum" presentation in June featuring the Annual Developments plenary from the 2021 Atlanta meeting, a program in August on ESG issues sponsored by the Diversity Caucus, and a collaborative program between the Young Lawyers Division and Corporate Counsel Division in September. Take advantage of these great programs as we lead up to our Annual Meeting this fall.

Speaking of the Annual Meeting, Co-chairs Jason Adler and Ben Reed continue to prepare for "Anchors Aweigh" (yes, that's the correct spelling) in San Diego on November 2–4. Our presenters are busy writing their papers and preparing to deliver the top-quality content that is the hallmark of our Forum. Registration is now open, so please make your plans to attend and register as soon as possible. There is no better place to be than San Diego in the fall, especially with your Forum colleagues.

In addition to the great content and networking opportunities, it is very important for us to get back to our pre-COVID attendance levels to help sustain our Forum financially. With 900+/- attendees in 2018 and 2019, we were able to generate significant revenues each year that not only covered the costs of the meeting but also supported the budget and work of our Forum throughout the year. As anyone paying attention to the economy well knows, costs are increasing everywhere, and the Forum's costs are no exception. We have many fixed costs for our Annual Meeting that we cannot do anything about,

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When Do Unilateral Attorney's Fees Provisions Become Mutual?

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The recovery of attorney's fees is a consideration in almost every litigation. The prospect of not only paying your own legal fees but also the other party's fees can deter meritorious claims and influence the course of litigation. Regardless of the forum, issues, or parties, assessing the probability of fee recovery is important.

To tip the scales, some contract drafters shift the risk of an unsuccessful outcome by employing unilateral attorney's fees provisions. Such unilateral provisions award fees to one party regardless of whether they prevail in the lawsuit:

> Should it become necessary for [Company A] to employ an attorney to enforce or defend any provision of this Agreement, [Company B] agrees to pay all expenses so incurred, including reasonable attorney's fees and costs.

On the other hand, a "mutual," "bilateral" or "prevailing party" fee-shifting provision awards attorney's fees to the party who prevails in any lawsuit, regardless of who it is.

An attorney benefiting from a unilateral attorney's fees provision may be incentivized to

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aggressively pursue their client's claims, specious or not, as they have a contractual claim to their fees regardless of the outcome. But beware. Courts in many states will blue pencil a unilateral attorney's fees provision to make it bilateral, such that the "prevailing party" in a contract action can recover fees. Therefore, before an attorney advises his or her client that a unilateral attorney's fees provision is iron clad, the attorney should first review local law to ensure such a provision is enforceable.

State Statutes

Freedom of contract is the notion that parties are generally free to negotiate their own contract terms without governmental interference. Freedom of contract arises from the due process guaranty against the government taking liberty and property. This freedom is not without limits, however. It is a qualified right subject to a reasonable restraint "in the interest of the public welfare." *Schmidinger v. Chicago*, 226 U.S. 578, 579 (1913); *Chicago, Burlington & Quincy R. Co. v. McGuire*, 219 U.S. 549, 550 (1911).

Restraints on unilateral fee provisions differ by state. In some states, courts will convert a unilateral fee provision into a bilateral provision regardless of the type of contract. In other states, courts will intervene only in certain contracts and, even then, the level of intervention is disparate. Some states prohibit the attorney's fees clause entirely while others reform the clause to apply bilaterally.

Seven states have statutes recognizing that unilateral attorney's fees provisions warrant a restraint on the freedom of contract regardless of the type of contract: California, Cal. Civ. Code § 1717(a); Florida, Fla. Stat. Ann. § 57.105(7); Hawai'i, Haw. Rev. Stat. Ann. § 607-14; Montana, Mont. Code Ann. § 28-3-704; Oregon, Or. Rev. Stat. § 20.096(1); Utah, Utah Code Ann. § 78B-5-826; and Washington, Wash. Rev. Code Ann. § 4.84.330. These statutes apply to nearly all types of contracts, and courts will therefore interpret a unilateral attorney's fees provision as bilateral.

Other state statutes only address unilateral attorney's fees provisions for specific types of contracts. For example, Connecticut converts unilateral fee provisions into mutual provisions in leases and consumer contracts. Conn. Gen. Stat. Ann. § 42-150bb. New York creates an "implied" covenant making a unilateral fee provision mutual in certain mortgage situations. N.Y. Real Prop. Law § 282. Colorado intervenes in lease agreements to prohibit unilateral fee provisions. C.R.S. § 38-12-801(3)(b). These are but a few of the many state statutes that apply in situations where state legislatures are concerned about unequal bargaining power between contracting parties. These laws are designed to level the playing field and expand consumers' and individuals' access to legal representation.

Void Against Public Policy

In the majority of states, a contractual fee-shifting provision need not be mutual to be enforceable. However, courts and arbitration panels will only enforce contractual provisions that do not violate public policy.

For example, in *Klein v. Tiburon Development LLC*, 405 P.3d 470 (Colo. App. 2017), a lender was contractually entitled to recover its attorney fees and costs if it needed to retain an attorney to collect on the loan. *Id.* at 476. Despite unambiguous contractual language, the court stated that "determining who prevailed [in the lawsuit] is critical to resolving the issue of whether enforcing the provision [] violates public policy." The court noted that the lender actually lost the predominant part of its claim and only nominally prevailed on a secondary and uncontested issue. It further found that the lender was sanctioned for frivolous conduct. Thus, it held that "enforcing a unilateral fee shifting provision in favor of a non-prevailing party that itself was sanctioned for frivolous and vexatious conduct would violate public policy." *Id.* at 477.

A federal court in Kentucky took a different view when analyzing a unilateral attorney's fees provision under Kentucky law. In *Vasquez v. Paso Fino Horse Ass'n Inc.*, No. CV 5:18-366-DCR, 2019 WL 3842863, at *3 (E.D. Ky. Aug. 14, 2019), the court started with the premise that contracts voluntarily made between competent persons would not be set aside lightly. The court then required "a clear and certain statement of strong public policy in controlling laws or judicial precedent []" before it would set aside a contractual provision. *Id.* (quoting *State Farm Mut. Auto. Ins. Co. v. Hodgkiss-Warrick*, 413 S.W.3d 875, 880 (Ky. 2013)). The court upheld the unilateral attorney's fees provision, concluding that the most important function of courts is to enforce and maintain contracts rather than to "enable parties to escape their obligations on the pretext of public policy or illegality." *Id.* (quoting *Cumberland Valley Contractors, Inc. v. Bell Cnty. Coal Corp.*, 238 S.W.3d 644, 654 (Ky. 2007)).

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The United States Court of Appeals for the Sixth Circuit used yet a third approach, which looked to statutory law to determine whether there was a public policy reason not to enforce a unilateral attorney's fees provision. *Allied Indus. Scrap, Inc. v. OmniSource Corp.*, 776 F.3d 452 (6th Cir. 2015). The Sixth Circuit observed that absent "direct statutory conflict, Ohio law will generally give effect to such fee-shifting provisions[.]" *Id.* at 453. The court found no such conflict in the circumstances of that case but acknowledged that there are limited "exceptions that prevent parties from contracting around statutory public policy determinations [,]" such as prohibiting fee-shifting when it conflicts with foreclosure laws and denying attorney's fees that operate to evade usury statutes. *Id.* at 453.

In the franchise context, a unilateral attorney's fees provision may be at odds with a franchisee's right to recover attorney's fees under their state's franchise relationship laws. However, the existence of a unilateral attorney's fees provision in a contract in favor of one party does not necessarily bar the other party from recovering attorney's fees to the extent they have some other legal entitlement to recovery. In other words, courts will not infer a prohibition against the recovery of attorney's fees "simply because a contract contains a unilateral attorney's fee provision favorable to another party." *Best Western Int'l Inc. v. Mahroom*, No. CV07-00827-PHX-JAT, 2008 WL 2116917, at *2 (D. Ariz. May 20, 2008). In *Best Western*, a unilateral attorney's fees provision in a hotel franchise agreement entitling only the franchisor to recover fees from the franchisee did not, by negative implication, prohibit the franchisee from recovering attorney's fees from the franchisor. *Id.* The franchisee could recover attorney's fees by operation of Arizona statutory law despite the unilateral attorney's fees provision in the franchisor's favor. *Id.*

Practice Pointers

A party wishing to utilize a unilateral attorney's fees provision should begin by researching their local law. The enforceability of a unilateral attorney's fees provision differs by state. If the party's state law restrains such a provision, the party may consider a choice of law clause designating another jurisdiction.

The choice of law clause can be the difference between recovering fees or leaving empty-handed, as seen in *Precision Tune Auto Care, Inc. v. Radcliffe*, 815 So. 2d 708, 710 (Fla. Dist. Ct. App. 2002). In *Precision Tune*, the contract at issue included a Virginia choice-of-law provision, but the case was filed in Florida. On one hand, Florida law would extend attorney's fees to both parties even when the contract provided only a unilateral fees provision. Conversely, Virginia law barred blue-penciling a unilateral attorney's fees provision. *Id.* at 710. The court enforced the Virginia choice-of-law clause in the franchise agreement and refused to apply Florida's reciprocal fee statute because the court discerned "no Florida policy which would override the parties' ability to freely contract on the issue of attorney's fees." *Id.* at 710.

A party wishing to enforce a unilateral attorney's fees provision should also ensure the provision is conspicuously placed in the agreement. The provision could be capitalized, in bold font, or require initials. The drafter should ensure that the non-drafting party has an adequate opportunity to retain counsel and review the agreement. Finally, the drafter should utilize a unilateral *prevailing party* attorney's fees provision, allowing it to recover its attorney's fees but only if it prevails in the lawsuit. Otherwise, the provision could award fees to the defaulting party, making it ripe for a public policy attack.

A party seeking to avoid a unilateral attorney's fees provision should first see if it conflicts with local law. Even absent a direct statutory conflict, courts often look to the circumstances surrounding the parties' agreement to determine whether they will uphold the unilateral attorney's fees provision. Courts look at several factors to determine if a provision is unconscionable. If there is unequal bargaining power between the parties, if the language is hidden in the agreement, or if the provision awards fees to the non-prevailing party, there may be a valid claim of unconscionability. A court will also look at whether one party is unsophisticated and whether that party had an opportunity to ask questions or consult an attorney.

Conclusion

Whether you draft franchise agreements or litigate franchise disputes, the enforceability of a unilateral attorney's fees provision is crucial. Counsel should look first to their local law but also understand the inquiry does not end there. While arguments that unilateral fee-shifting provisions are unconscionable or void against public policy may seem far-fetched to some, tribunals take them seriously, especially when relative bargaining power appears unequal. Courts and arbitrators will often analyze the parties' particular circumstances when a unilateral attorney's fees provision is challenged. ■

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Must Perfect Be the Enemy of the Good? Compliance with the Franchise Agreement's Notice Provision

By Dale Alexandra Cohen and Zachary Sell, Akerman, LLP

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To the untrained eye, a franchise agreement's notice provision may seem like a boilerplate term, undeserving of scrupulous review. After all, the parties often bury these provisions in the miscellaneous section of an agreement and, in practice, franchisors routinely communicate with their franchisees on day-to-day operational matters through informal channels such as calls, emails, and even text messages or other messaging apps. However, certain types of notices, such as notices of default and termination, typically impose an affirmative formal written notice obligation.

The requisite method and means by which to furnish written notice are generally detailed in the often-overlooked notice provision. This provision may require and/or permit that notices be delivered via personal hand delivery (likely, an older form of franchise agreement) or via the U.S. Postal Service, overnight couriers, or electronic mail. Similarly, the notice provision will often specify whether the notice is effective upon delivery, receipt, or some other calculation.

Strict compliance with formal notice requirements may seem simple and straightforward; however, franchisors and franchisees routinely deviate from them, whether unintentionally or by design. For example, a party may inadvertently send the notice via the U.S. Postal Service when the agreement calls for an overnight courier, such as the United Parcel Service. In the alternative, a party may intentionally deviate from the notice provision, such as where the provision specifies an address from which the recipient has since moved or designated a recipient who is no longer employed by the other party to the agreement.

These examples beg the question: Must a party strictly comply with a franchise agreement's notice provision for its notice to be considered valid and enforceable?

Case Law

Case law surrounding this question remains relatively sparse, and most cases address this issue from a general contract law standpoint rather than in the specific context of franchising. As discussed in more depth below, many courts hold that strict compliance with a notice provision is unnecessary. However, whether a notice that fails to strictly comply is valid and enforceable will depend on myriad factors, such as whether a party actually received the notice and the facts and circumstances contributing to the deviation from the notice provision requirements. However, these decisions are not universal; certain other cases have found that strict compliance is, in fact, required.

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Strict Compliance Is Not Necessary

Actual Notice Is Sufficient

Many of the courts holding that strict compliance is unnecessary have done so on the basis that a party achieved actual notice.

In *Dunkin' Donuts, Inc. v. Towns Fam., Inc.*, No. 95 C 3666 (N.D. Ill. Oct. 4, 1995), the franchisor delivered notices of default and termination to the franchised location, as required by the franchise agreement, but only addressed the notices to one of the franchisee parties (where the franchisee was comprised of multiple parties) and not the other(s). Analyzing this issue on a motion to dismiss, the court determined that noncompliance with the technical requirements of the notice provision did not preclude the noticing party from enforcing its rights under the contract, as long as the intended recipient received actual notice. Thus, because the franchisor was able to show that all parties received notice, the court found that the franchisor's notice was sufficient.

In *Tim Hortons USA, Inc. v. Singh*, No. 16-23041-CIV, (S.D. Fla. Apr. 5, 2017), although the franchise agreement required notice to be provided by personal delivery or telefax, the franchisor sent a default notice to the franchisee via email. Following the *Dunkin' Donuts* approach, the court held that the notice was valid because the franchisor could prove that, notwithstanding the requirements of the franchise agreement, the franchisee actually received the notice.

For other cases adopting a similar approach, see *Misty Cleaning Serv. Inc. v. Indep. Grp. Home Living Program, Inc.*, 66 Misc. 3d 1209(A), 120 N.Y.S.3d 709 (N.Y. Sup. Ct. 2020) (finding that the failure to strictly comply with an agreement's notice precepts does not prevent the enforceability of a notice where the noticed party made no claim that it failed to actually receive the notice or that it was prejudiced in any way by the deviation); *Megacenter US LLC v. Goodman Doral 88th Court LLC*, 273 So. 3d 1078, 1084 (Fla. Ct. App. 3d Dist. 2019) (although the subject agreement did not contemplate delivery of a termination notice via email, the court nevertheless held it to be sufficient since the recipient actually received the notice); *11-01 36 Ave. LLC v. Quamar*, 41 N.Y.S.3d 684 (2016) (holding that although a party sent notice via email and Federal Express, in contravention to the agreement's notice provision, such notice was nevertheless sufficient because the sender achieved actual notice and the noticed party was not prejudiced by the deviation); *Life Plans, Inc. v. Sec. Life of Denver Ins. Co.*, No. 11 C 8449, 2013 WL 4052678, at *2 (N.D. Ill. Aug. 12, 2013), rev'd and remanded on other grounds, 800 F.3d 343 (7th Cir. 2015) ("when confronted with less than literal compliance with a notice provision, courts have required that a party substantially comply with the notice provision. To hold otherwise would exalt form over substance and produce an unnecessarily harsh result where the purpose of [the notice provision] clearly has been met."); *Baygold Assocs., Inc. v. Congregation Yetev Lev of Monsey, Inc.*, 916 N.Y.S.2d 639, 640 (2011) (finding that although New York precedent holds that "strict compliance with contractual notice provisions need not be enforced where the adversary party does not claim the absence of actual notice or prejudice by the deviation," in the subject case, there was no evidence that the adversary party ever actually received the noticing party's alleged notice).

Substantial Compliance May Be Sufficient, Depending on the Circumstances

Courts also consider the particular facts and circumstances surrounding the delivery of a notice and why a party deviated from notice provision requirements, particularly where the noticing party can show that strict compliance with an agreement's notice requirements would be impossible or would impair the receiving party's ability to actually receive effective and timely notice.

For example, in *Corporate Property Associates 6 v. Hallwood Group Inc.*, 792 A.2d 993 (Del.Ch. 2002), *overruled on other grounds in Corp. Prop. Associates 6 v. Hallwood Group Inc.*, 817 A.2d 777 (Del.Ch. 2003), instead of sending a notice to the attention of the particular executive named in the subject agreement's notice provision, the defendant instead sent a notice to a different high-level company executive with whom it had been in communication following the original designated recipient's departure from the company. The court agreed with the defendant that literal compliance with the subject agreement's notice provision would be senseless and that, instead, substantial compliance sufficed. In reaching its decision, the court focused on the intent of the notice provision—to provide notice to the responsible executives of the company—and found that the notice provided complied with that intent.

In deciding this issue, courts also consider whether the noticing party acted reasonably. By way of example, in *PR Acquisitions, LLC v. Midland Funding LLC*, 2018 WL 2041521 (Del. 2018), instead of sending written notice to the plaintiff as required under the agreement, the noticing party sent written notice to a third party and simply called the plaintiff to

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inform it of the same. Holding for the plaintiff, the court found that the noticing party offered "no reason other than its own error for its failure to comply with the notice provision it negotiated in the escrow agreement." *Id.* at 8. The court in *Gildor v. Optical Solutions, Inc.*, 2006 WL 4782348 (Del. 2006), also imposed a rationality component when considering the noticing party's actions. In particular, where the subject notice provision failed to include a notice address, the noticing party sent notice to just one of multiple addresses that it had on record. The noticing party subsequently learned that the other party never received its notice yet neglected to take any other steps to provide notice. Because the noticing party had other mailing addresses and an email address on file, the Delaware Court of Chancery found that it did not take "reasonable efforts" to provide actual notice to the other party.

Strict Compliance Is Necessary

While the cases above indicate that courts may accept a party's substantial compliance with notice requirements, particularly when it achieves actual notice, exceptions exist.

In *Grosso Enterprises, Inc. v. Domino's Pizza LLC*, No. CIV.A. 11-1484 (E.D. Pa. Mar. 9, 2011), the Domino's franchise agreement's notice provision allowed for email notices but required that the franchisor address all emailed written communications to the franchisee and include in the body of the email the franchisee's most current principal business address or most current home address. The court noted that the purpose of this requirement was to focus a franchisee's attention on emails specific to the franchisee and to distinguish them from regular mass emails from the franchisor. In delivering a default notice via email, however, the franchisor failed to include the franchisee's address in the default notice. As such, the court determined that the franchisor failed to properly default the franchisee and, therefore, lacked proper grounds for terminating the franchise agreement. For a similar holding, see *In re Supernatural Foods, LLC*, 268 B.R. 759, 771–772 (Bankr. M.D. La. 2001) (finding strict compliance necessary, the court would not "strip the contract of unequivocal language in an attempt to validate that which the contract does not itself validate").

Practice Pointers

Perfect compliance begins at the drafting stage of a franchise agreement. A notice provision should always be clear, reasonable, and consistent with the parties' actual standard practices. It should describe required information for any notice, such as the purpose of the notice, the proper recipient of the notice, and when the sender may deem the notice complete. Parties should also draft a notice provision to take modern practical realities into account. While some franchise agreements may still allow notice by facsimile transmission, most people no longer have fax machines. Conversely, with the use of email now ubiquitous in businesses, allowing the delivery of notice via email or electronic transmission may most accurately reflect current business practices. Email transmission has proven especially advantageous during the COVID-19 pandemic and the corresponding rise in remote work, with fewer and fewer people tethered to a physical office.

Where a party may send notice via email and overnight courier mail, the noticing party should consider utilizing both options in tandem. While perhaps more administratively burdensome than simply choosing one delivery method, this approach increases the likelihood that the counterparty will actually receive the notice and helps to avoid questions as to whether the noticing party acted reasonably in sending the notice. Noticing parties should also consider enabling tracking tools, such as delivery and read receipts, when sending email and retaining those receipts (as well as any physical delivery receipts) with a copy of the notice sent.

Conclusion

Although numerous courts have held that the failure to strictly comply with a notice provision may not necessarily render a default notice invalid, these holdings are not uniform. Even when a noticing party prevails, it will have the burden of proving that the counterparty actually received the notice, explaining why the noticing party failed to comply with the notice provision, and justifying the reasonableness of its actions. Thus, noticing parties (franchisors and franchisees alike) should remain vigilant in (a) drafting reasonable notice provisions that accurately reflect their actual practices; (b) strictly complying with agreed-upon notice provisions in their franchise agreements; and (c) prior to sending a notice, determining whether any special circumstances may require either party to take reasonable additional or different steps to ensure that their counterparty receives the actual notice. ■

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Primer on Franchisee Bankruptcies

By Daniel M. Eliades and Aidan P. Nowak, K&L Gates, LLP

Franchisees' enormous financial contribution to the U.S. economy is unquestioned. Despite this general success, however, a number of distressed franchisees will declare bankruptcy each year. Franchisees seek bankruptcy relief in pursuit of various reorganization, sale, or liquidation objectives.

Franchisees that wish to restructure their financial affairs through bankruptcy will file a Chapter 11 case. (Certain individual franchisees may also reorganize under Chapter 13.) These franchisees may seek to retain ownership of their business, albeit with a reorganized debt structure, and maintain their franchise relationship. Obtaining franchisor support for "assumption" of the franchise agreement is a critical element of a successful reorganization of a franchisee. Franchisees can also attempt to terminate their franchise agreement in Chapter 11, quantify the "rejection damages" of the franchisor, and continue to operate their business. Alternatively, franchisees can sell some or all of their property in Chapter 11 and potentially assign their franchise agreement to a third party. In this circumstance, the franchisor's consent to the assignment is usually required.

Franchisees desiring to cease operations will normally file a Chapter 7 bankruptcy. In this scenario, an independent trustee is appointed to liquidate the franchisee's assets. In rare cases, a Chapter 7 trustee may seek to assign the franchise agreement to a buyer. Chapter 7 is particularly appropriate for franchisees who wish to walk away from their business and leave the liquidation effort to a bankruptcy trustee.

When faced with a bankrupt franchisee, franchisors generally pursue some combination of the following goals.

Maintain Desired Units in Franchise System

Franchisors often seek to preserve the franchised business in their system by:

- Asking a restructured franchisee to assume the franchise agreement;
- Supporting franchisee assumption of the franchise agreement and assignment of the

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agreement to a third party that the franchisor approves;

- Agreeing to "rejection" of the existing franchise agreement and entering into a new franchise agreement with the debtor/franchisee or an approved third-party purchaser of the franchisee's assets;
- Having the franchisee surrender collateral to the franchisor, followed by the franchisor's sale of that property to a new franchisee; or
- Entering into a temporary agreement with a secured party (or its receiver), which is (hopefully) followed by a long-term franchise agreement with the ultimate purchaser.

Enhance Franchisor Position

Franchisors sometimes attempt to use a franchisee bankruptcy proceeding to:

- Negotiate favorable modification of the existing franchise agreement (such as a term extension, royalty rate increase, and/or modification of areas of protection) as part of retaining the franchise;
- Obtain reaffirmation agreements from existing guarantors or add new guarantors for the obligations of the franchisee to the franchisor;
- Take collateral securing the payment and performance of the franchisee under the franchise agreement;
- Gain commitment for completing improvements or modifications to the franchised location or business;
- Negotiate agreements with the franchisee and its secured lender concerning new or restructured financing to the franchisee and the consequences of future loan or franchise agreement defaults; and/or
- Require a change in management or retention of professional outside management for the franchised business.

Protect Franchisor Trademarks, Intellectual Property, and Brand Reputation

When the franchisor-franchisee relationship (or the franchisee itself) is beyond repair, franchisors can proactively protect their trademarks, intellectual property, and brand reputation by requesting bankruptcy court orders that compel bad acting or infringing unit owners to de-brand and dissociate themselves from the franchisor. For instance, when the franchisor has effectively terminated a franchise agreement before the franchisee files a bankruptcy petition, a bankruptcy court can provide injunctive relief if the debtor continues to use trademarks of the franchisor post-petition without the franchisor's permission. *See Ledo Pizza Sys., Inc. v. Singh*, No. CIV. WDQ-13-2365, 2013 WL 5604339, at *2 (D. Md. Oct. 10, 2013). Similarly, if a franchisor decides to end a franchise relationship after a franchisee has sought bankruptcy protection, the franchisor can seek relief from the "automatic stay" authorizing it to terminate the franchise agreement and to compel the franchisee to satisfy its post-termination non-monetary obligations under the franchise agreement. *See In re Tudor Motor Lodge Associates, Limited Part.*, 102 B.R. 936, 951 (Bankr. D.N.J. 1989) ("The fact that the automatic stay suspends termination of [a] License Agreement does not prevent termination indefinitely.").

Collect Amounts Due

Franchisors collect amounts due from bankrupt franchisees in various ways, including (i) dividends from bankruptcy proceedings after filing and allowance of a proof of claim, (ii) royalties and related fees from Chapter 11 debtors/franchisees during the pendency of the bankruptcy case but prior to assumption or rejection of the franchise agreement, (iii) "cure" payments from debtors or third parties in connection with the assumption or assumption and assignment of the subject franchise agreements, and (iv) post-bankruptcy royalties and related fees from reorganized debtors, secured lenders, and/or "new" franchisees.

Eliminate or Limit Franchisor Liability

In various circumstances, franchisors commonly request (i) bankruptcy court-sanctioned releases from franchisees and guarantors; (ii) statements of an absence of affirmative claims against a franchisor, or defenses/set-off as to amounts due, from a franchisee and guarantors; and/or (iii) bankruptcy court orders disallowing or settling affirmative claims against the franchisor. These requests may be sought as part of a franchisee plan of reorganization, in an order authorizing the assumption or rejection of the franchise agreement, in a final cash collateral order, or in an order resolving a contested matter involving the franchisor and franchisee or trustee.

Where Can a Franchisee File Bankruptcy?

All bankruptcy cases are filed in federal court. 28 *U.S.C.* § 151. A franchisee can file a bankruptcy case

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in any of the following locations: (i) where the debtor is domiciled, (ii) where the debtor's residence is located, (iii) where the debtor's principal place of business is located, (iv) where the debtor's principal assets in the United States are located for the greater of one hundred eighty (180) days before filing the petition, or (v) in the same district as a pending bankruptcy case concerning the debtor's affiliate, general partner, or partnership. 28 *U.S.C. § 1408*. Thus, a franchisee that is a business entity can commence a bankruptcy proceeding in one of several jurisdictions.

Common Types of Franchisee Bankruptcy Cases

The most common types of bankruptcies for franchisees are cases under Chapter 7 (Liquidation), *11 U.S.C.* §§ 701 *et seq*., and Chapter 11 (Reorganization) of the Bankruptcy Code, *11 U.S.C. §§ 1101 et seq*. Individual franchisees with regular income who satisfy certain debt limitations may also attempt to reorganize under Chapter 13. *See 11 U.S.C. §§ 1301 et seq*. This article addresses only Chapter 7 and 11 matters.

Chapter 7

When a franchisee files Chapter 7, it must cease all business activities, though, in limited circumstances, the trustee may continue operations if necessary to maximize the value for the benefit of creditors. *11 U.S.C. § 704*. An independent trustee is appointed in all Chapter 7 cases. *11 U.S.C. §§ 701, 702, 704*. The trustee acts as a fiduciary for all creditors and is responsible for liquidating (or abandoning) certain property of the debtor and distributing the proceeds to creditors pursuant to statutory priorities. The trustee may also pursue claims held by the estate, including fraudulent conveyance and preferential transfer actions. *11 U.S.C. §§ 547 and 548*.

Entities do not receive a discharge of debts in Chapter 7. *11 U.S.C. § 727*. With certain exceptions, individuals are relieved of their obligation to pay pre-petition debts as a result of a Chapter 7 bankruptcy. *11 U.S.C. §§ 523 and 727*.

Chapter 11

Chapter 11 affords debtors the opportunity to reorganize, which may involve (i) the assumption or rejection of contracts such as franchise agreements, and/or (ii) the sale of property, including potential assignment of franchise agreements. *11 U.S.C. §§ 363 and 365*. Debtors can also oversee their own liquidation in Chapter 11. *CHS, Inc. v. Plaquemines Holdings, L.L.C.*, 735 F.3d 231, 238 (5th Cir. 2013).

Unlike Chapter 7, a trustee is not automatically appointed in Chapter 11 cases. *11 U.S.C. § 1104*. In Chapter 11, the debtor typically remains in control of its property, and management may continue operating the debtor's business and managing its affairs in the ordinary course. *11 U.S.C. § 1107*. The franchisee must obtain the bankruptcy court's permission for acts outside of the ordinary course of business of the debtor, including the assumption or rejection of franchise agreements or sale of the property. *11 U.S.C. §§ 363 and 365*. The debtor-in-possession has an exclusive 120-day post-petition period during which it may propose a plan of reorganization or liquidation. *11 U.S.C. § 1121(b)*.

In August 2019, Congress enacted the Small Business Reorganization Act, which streamlined Chapter 11 bankruptcy for small business debtors with debts less than $2,725,625. *11 U.S.C. § 1182(1)(A)*. These debtors have 90 days after filing bankruptcy to file a plan. *11 U.S.C. § 1189(b)*. If the bankruptcy court determines that the plan satisfies *11 U.S.C. § 1129(a)*, it must confirm the plan. *11 U.S.C. § 1191(a)*. A trustee is appointed in all small business cases but does not take control of property or operate the business. Instead, the debtor remains in possession of the estate's assets. *11 U.S.C. § 1184*.

Is the Franchise Agreement Property of the Bankruptcy Estate?

A bankruptcy filing under Chapter 7 or 11 creates an "estate," which includes "all legal or equitable interests of the debtor in property as of the commencement of the case." *11 U.S.C. § 541(a)(1)*. Property of the estate is broad in scope and includes a franchisee's interest in any franchise agreement in effect as of the petition date.

If a franchisor has validly terminated a franchise agreement pre-petition, the agreement is not part of the estate. *Days Inn v. Gainesville P-H Props., Inc. (In re Gainesville P-H Props., Inc.)*, 77 B.R. 285, 295 (Bankr. M.D. Fla. 1987). Alternatively, when a franchisor has not effectively terminated the franchise agreement pre-petition, (i) it becomes property of the estate and is subject to the protection of the automatic stay (discussed below); (ii) the debtor may continue to use the franchise system, even if it is default of the franchise agreement; and (iii) the bankruptcy court may authorize the franchisee to assume or assume and assign the franchise agreement—even if the franchisor does not consent.

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The Automatic Stay

Once a franchisee files a petition under Chapter 7 or 11, the "automatic stay" prevents a franchisor from various enforcement actions against a debtor/franchisee or property of the bankruptcy estate. *11 U.S.C.* § 362(*a*). For instance, a franchisor may not terminate an "active" franchise agreement with the automatic stay in place. In order to pursue remedies against a debtor/franchisee or its property, a franchisor must seek relief from the automatic stay "for cause." *11 U.S.C.* § 362(*d*).

Cash Collateral

Cash collateral is defined as cash and liquid property that is subject to a creditor's security interest. *11 U.S.C.* § 363(*a*). A Chapter 11 debtor may not use "cash collateral" unless each entity that has a security interest in the cash collateral consents or the bankruptcy court authorizes its use. *11 U.S.C.* § 363(*c*)(2). A secured creditor is entitled to adequate protection of its interest in exchange for the debtor's use of the collateral. *11 U.S.C.* § 363(*e*). Examples of adequate protection are (i) periodic cash payments, (ii) additional or replacement liens, or (iii) other relief resulting in the equivalent of its interest in such property. *11 U.S.C.* § 361. A franchisor that maintains a security interest in the property of a franchisee can seek various forms of adequate protection (such as payment of post-petition franchise fees and compliance with system standards) for a debtor's use of its cash collateral.

Claims

An allowed claim in a bankruptcy case is a claim, proof of which is filed with the court, and to which no objection has been sustained by the court. *11 U.S.C.* § 502(*a*). In Chapter 7 cases, the bankruptcy clerk sends a notice of the claims deadline after the trustee determines whether there are any assets available to liquidate and use to pay creditors. In Chapter 11 cases, the court will set a claims deadline. It is crucial to file a proof of claim before the bar date, as a creditor risks being denied the ability to participate in a bankruptcy distribution. Thus, franchisors should remain cognizant of bar date deadlines.

Assumption, Assignment, and Rejection of Franchise Agreements

Subject to bankruptcy court approval, debtors or trustees may assume, assume and assign, or reject franchise agreements that have not been effectively terminated prior to bankruptcy. *11 U.S.C.* § 365. A franchisor can, of course, object to the proposed disposition of its franchise agreement.

In a Chapter 7 case, an executory contract such as a franchise agreement is deemed rejected if the trustee does not assume and assign the contract within 60 days after the petition date. *11 U.S.C.* § 365(*d*)(*1*). In a Chapter 11 proceeding, a debtor may assume or reject a franchise agreement any time prior to or upon the court's confirmation of the plan. *11 U.S.C.* § 365(*d*)(*2*).

Until the debtor has assumed or rejected the franchise agreement, a Chapter 11 debtor must continue to perform under the contract, including paying post-petition fees. *In re MS Freight Distribution, Inc.*, 172 B.R. 976, 978–79 (Bankr. W.D. Wash. 1994). If a debtor rejects a franchise agreement, it is treated as if the franchisee breached the contract immediately prior to the bankruptcy filing, entitling the franchisor to reject damages for breach of contract. *11 U.S.C.* § 365(*g*).

In order to obtain bankruptcy court approval, a Chapter 11 franchisee must: (i) cure all outstanding franchise agreement defaults on or promptly after assumption, (ii) provide adequate assurance of its future performance under the franchise agreement, and (iii) compensate the franchisor for actual pecuniary loss resulting from any default. *11 U.S.C.* § 365(*b*)(*1*). Franchisees face significant challenges when seeking to assume and assign a franchise agreement to a third party over the franchisor's objection.

Conclusion

At some point, franchisee bankruptcies occur within even the most successful franchise systems. While these cases may present complicated legal issues, they can provide astute franchisors with opportunities to retain franchisees and/or units in their franchise system or effect separation. Similarly, franchisees can effectively use bankruptcy to restructure, sell, or liquidate their franchised businesses.

Regardless of the goal, counsel must have a firm grasp of applicable law to successfully navigate a franchisee bankruptcy proceeding. This article is intended to serve as a primer on franchisee bankruptcy issues. An in-depth analysis of this topic may be found in Jason B. Binford & Daniel M. Eliades, *The Bankruptcy Handbook for Franchisors and Franchisees*, American Bar Association – Forum on Franchising (2018). ■

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Limited Liability Companies: The Nesting Dolls of Diversity Jurisdiction

By Mark M. Leitner, Laffey, Leitner & Goode LLC

Lawyers who regularly practice in federal court are familiar with the "do's and don'ts" for pleading diversity of citizenship. Many of them are "don'ts." For example, don't allege that a natural person is a "resident" of a state because "resident" is not synonymous with "citizen." *See Midcap Media Finance, LLC v. Pathway Data, Inc.*, 929 F.3d 310, 313 (5th Cir. 2019). Don't allege where a corporation is "headquartered"; instead, follow the requirements of 28 U.S.C. § 1332(c)(1), and identify the state where the corporation is incorporated and the state where it maintains its principal place of business.

The rules for people and corporations are easy to obey, but lawyers often still have trouble satisfying the requirements for establishing diversity jurisdiction over limited liability companies (LLCs). This is because LLCs are the nesting dolls of diversity jurisdiction. Since at least 2010, it has been clear that dual citizenship under 28 U.S.C. § 1332(c)(1) is available only to corporations. *Hertz Corp. v. Friend*, 559 U.S. 77 (2010). As a result, "LLCs have the imputed citizenship of each of their members." *Barnes v. Fort Hamilton Family Homes*, 524 F. Supp. 3d 40, 41 (E.D.N.Y. 2021). Because the entity itself is disregarded in establishing citizenship, "the citizenship of unincorporated associations must be traced through however many layers of partners or members there may be." *Meryerson v. Harrah's E. Chicago Casino*, 299 F.3d 616, 617 (7th Cir. 2002). This can take a lot of work; one recent case involved an ownership structure that went 17 levels deep. *West v. Louisville Gas & Electric Co.*, 951 F.3d 827, 830 (7th Cir. 2020).

No matter how many layers of ownership exist, lawyers must keep opening the nesting dolls until they reach the point where there are only natural persons and corporations. Shortcuts are not allowed. For example, courts "do not blithely accept assurances along the lines of 'no one on our side is a citizen of the opposing litigant's

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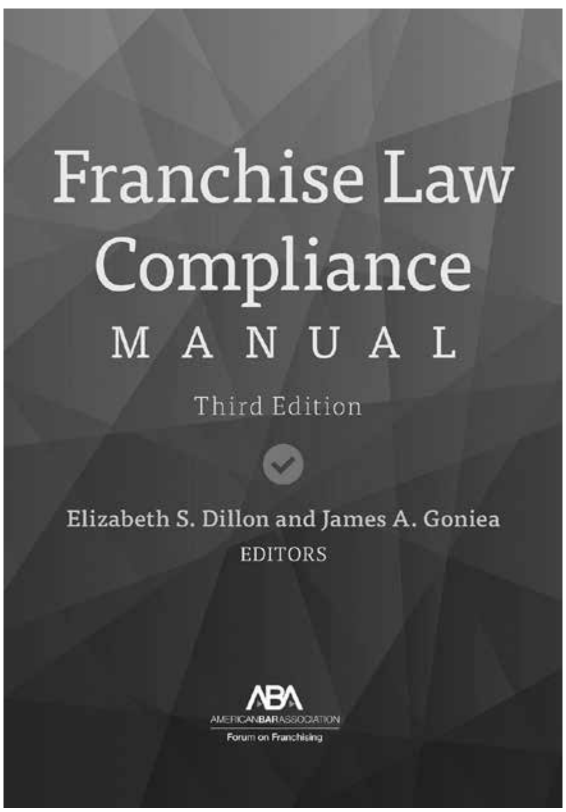
state.'" *West*, 951 F.3d at 829. When an LLC has a member that is not a citizen of any state—such as an entity within the federal executive branch, or a U.S. citizen domiciled abroad—then that LLC "can never be in federal court on the basis of diversity jurisdiction." *Barnes*, 524 F. Supp. 3d at 43.

The growing popularity of LLCs because of their informality means that lawyers who want to bring them into federal diversity cases must be prepared in advance to undergo the ordeal of the nesting dolls. It's no mere ritual. Tracing the citizenship of every member to the end is a basic requirement for subject matter jurisdiction. It is basic enough that federal district court judges sometimes raise the failure to specify citizenship of all LLC members sua sponte and either dismiss a case outright or issue an order to show cause requiring an amended pleading that explores every layer of every LLC involved. Don't get caught in that avoidable trap. ■

FRANCHISE LAW COMPLIANCE MANUAL, THIRD EDITION



Providing balanced coverage from both in-house and outside counsel, this is a practical yet comprehensive guide to establishing and maintaining a successful corporate compliance program. From intellectual property to termination, this guide covers every aspect of franchise law and will help you protect the franchisor's property, limit liability, and prepare for and limit the inevitable tensions of a franchise system.

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Message from the Chair

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including hotel F&B minimums, audio-visual expenses for the meeting rooms, and event venue minimum charges. It is crucial, therefore, to have as many attendees as possible to cover those fixed costs and generate extra revenue to support our activities throughout the year.

A positive financial return from our Annual Meeting is all the more important now because the ABA's financial support of our Forum, along with all Sections, Divisions, and Forums (SDFs), is shrinking due to the ABA's continuing membership and revenue challenges. The ABA Finance Committee recently completed its budgeting process for FY 2023 (which begins this August), and for the third year in a row the ABA reduced the funding it provides to SDFs. Unfortunately, the trend is likely to continue for the foreseeable future, so our Forum needs to remain financially strong and self-sufficient.

Rest assured that the Forum's leadership will continue to monitor these financial issues and be good stewards of our resources. We also want to maintain to the extent possible the traditional benefits we have given to our Annual Meeting presenters who put in such hard work to produce papers and presentations of the quality that our members expect. On that note, I want to point out that the Forum is unique among other ABA groups in providing presenters with both free registration for the Annual Meeting (valued at more than $1,000 for most people) and a significant stipend to reimburse some travel and lodging expenses. I know from personal involvement and speaking at other ABA meetings that other SDFs, even the largest ones like the Section of Litigation, do not provide similar benefits.

I appreciate all the support our members have given the Forum over the years, and I know we will continue to do so in the future. Let's all register and make our 2022 Annual Meeting the best one yet!

As always, feel free to contact me or any other members of the Governing Committee or senior leadership if you have questions or if we can help you get more involved in the Forum. You can reach me at rcoleman@phrd.com or 404.420.1144. ■

Message from the Editor-in-Chief

By Erin C. Johnsen, Garner, Ginsburg & Johnsen, P.A.

As we enjoy some summer sun, the editors of *The Franchise Lawyer* wanted to be sure to supply our readers with some fresh reading material for that upcoming beach trip or lake weekend. In this spring issue, our authors provide practice tips and perspectives on franchisee bankruptcies, unilateral attorney's fees provisions, notice provisions, and diversity jurisdiction issues involving LLCs.

While we all enjoy some warm summer days reading The Franchise Lawyer by the water, I encourage you to think ahead to another opportunity to engage with colleagues on issues of franchise law with a waterfront vista at the 45th Forum on Franchising Annual Meeting at the Marriott Marquis San Diego Marina on November 2–4, 2022. I look forward to seeing you all there this fall! ■

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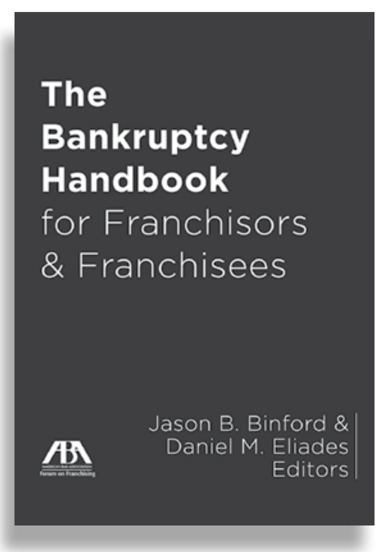
THE BANKRUPTCY HANDBOOK FOR FRANCHISORS & FRANCHISEES



Written by experienced franchise lawyers, this one-of-a-kind resource focuses exclusively on the topics and problems most likely to be faced by attorneys handling bankruptcy issues, either when representing companies that sponsor franchises, or franchisees.

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