

Treatment of Franchisee Leases under § 365(d)

Written by:

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) substantially revised 11 U.S.C. § 365 to significantly limit a debtor's time to assume or reject nonresidential real property leases. Prior to BAPCPA, upon establishing "cause," a debtor could (and routinely did) extend its time to assume or reject nonresidential real property leases for extended periods, often through and including the date of confirmation of a reorganization plan.²



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Under the previous law, a debtor met its burden of cause so long as it (1) could show that it was current on its post-petition rent obligations and (2) provided adequate assurance of future performance.

As amended by BAPCPA, § 365(d)(4) of the Bankruptcy Code presently states, in pertinent part:

(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

About the Authors

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ments and Dunkin leases were "part of the same transaction," and before the debtors could assume the Dunkin leases, they must first "pay [Dunkin Brands] all monies due thereunder and pay [Dunkin Brands]

all royalties and advertising fees due pursuant to their Franchise Agreements."⁵ This was a critical issue in the case.

If the court had adopted Dunkin' Brands' arguments, the debtors would have been forced to either reject the Dunkin leases, which in turn would effectively terminate the related franchise agreements, or (1) satisfy all pre-petition arrears under the Dunkin leases and (2) assume the Dunkin leases without the opportunity to negotiate any adjustments under the franchise agreements. The debtors argued that if Dunkin' Brands were correct, (1) the debtors should

- (ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.³

In response to strong lobbying efforts by real property owners, landlords and managing agents, § 365(d) was amended, setting defined limitations on the time period to assume or reject nonresidential real property leases. Most significantly, § 365 as amended requires that any extension past 210 days must be

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approved, in writing, by the landlord. The result is that any advantage, real or perceived, is now held by the landlords.

In *In re FPSDA I LLC, et al.*,⁴ the bankruptcy court was faced with whether the deadlines under § 365(d)(4) applied where the nonresidential real property leases were integrated with executory contracts, specifically franchise agreements. In *FPSDA*, the debtors operated a network of 12 Dunkin' Donuts franchises in New York and Maryland. Various Dunkin' Donuts entities ("Dunkin Brands") served as both the franchisor of all 12 locations, as well as the landlord for four locations ("Dunkin leases"). The debtors and Dunkin Brands engaged in extensive negotiations to resolve outstanding issues between the parties, but when it became obvious that no resolution was forthcoming, Dunkin Brands refused to consent to an extension of time to assume or reject the Dunkin leases.

In addition to refusing to extend the debtors' time under § 365(d)(4), Dunkin Brands argued that the franchise agree-

not be restricted by the time limitations imposed by § 365(d)(4)(B)(ii); (2) the integrated transaction must be treated as an executory contract under § 365(d)(2); and (3) the debtors should have until confirmation of their reorganization plan to assume both the franchise agreements and Dunkin leases.⁶

In its decision,⁷ the court noted that pursuant to the express terms of both the franchise agreements and the Dunkin' leases, in the event that the debtors defaulted under the leases, Dunkin' Brands had the right to terminate the corresponding franchise agreement.⁸ After analyzing the relationship between the franchise agreements and the Dunkin' leases, the court held that the Dunkin leases and franchise agreements constituted an integrated transaction and should be treated as a single controlling agreement.⁹

⁵ Dunkin' Brands Motion for Relief from Stay, dated Nov. 29, 2010, ¶¶ 19-26.

⁶ Debtors Motion for an Order (i) Determining that the Non-Residential Real Property Leases in these Cases Must not be Assumed or Rejected under 11 U.S.C. § 365(d)(4) at this Time or (ii) in the Alternative to Assume the Non-Residential Real Property Leases in these Cases under 11 U.S.C. § 365(d), dated Jan. 20, 2011.

⁷ *In re FPSDA*, supra, n. 4 at 15. Note that this decision only applies to the Dunkin' leases.

⁸ *Id.* at 12.

⁹ *Id.* at 11.

¹ The authors represented the debtors in *In re FPSDA I LLC, et al.*

² See *In re Hochinger Investment Company of Delaware, et al.* (Bankr. D. Del.), Case No. 99-02261; *In re Montgomery Ward LLC, et al.* (Bankr. D. Del. 2008), Case No. 00-4667; *In re Worldcom Inc.*, 326 B.R. 292 (S.D.N.Y.), Case No. 02.

³ Emphasis added.

⁴ *In re FPSDA I LLC, et al.*, Case No. 10-75439 (Bankr. E.D.N.Y. Mar. 22, 2011).

Having determined that the Dunkin leases and franchise agreements constituted one controlling agreement, the court held that the debtors could not assume any of the Dunkin leases unless they cured all of the defaults under the leases and their respective franchise agreements.¹⁰ The court noted that under § 365(d)(2), the debtors had until confirmation of the reorganization plan to determine whether to assume or reject executory contracts such as the franchise agreements. However, the court also recognized that the time to assume or reject a free-standing non-residential real property lease was limited to 120 days from the entry of an order for relief, plus a 90-day extension upon order of the court.¹¹ In light of this time limitation, the court stated that where an integrated transaction involved a non-residential real property lease and a related executory contract, an issue of law arose as to when a debtor must assume or reject the entire transaction.¹²

In *FPSDA*, after considering pre-BAPCPA law, the purpose of the Code and the equities of the situation, the court held that the appropriate time limit to assume or reject the integrated agreement would be pursuant to the more generous deadline for executory contracts found in § 365(d)(2).¹³ The court recognized that § 365(d)(4) would provide a creditor serving the dual role of franchisor and landlord with superior power to determine the course and outcome of a debtor's bankruptcy case.¹⁴ Such a situation would be contrary to the underlying goal of bankruptcy to give a debtor a "fresh start," and would allow a franchisor to exert its powers as a landlord to pressure a debtor to determine prematurely whether to assume or reject a franchise agreement based on its refusal to extend the debtor's time to assume or reject the lease.¹⁵

In making this decision of first impression, the court recognized that the franchise agreements and accompanying leases were the most valuable assets of the respective debtors' bankruptcy estates, and that the application of § 365(d)(4) would benefit only Dunkin Brands.¹⁶

FPSDA demonstrates the impact that the revised § 365(d)(4) may have on a bankruptcy case. Amended § 365(d)(4) significantly shifts the balance of power from the debtors to the landlords, which has had significant impact in retail bank-

ruptcy cases in particular. Since the enactment of BAPCPA, the real estate world has certainly changed. Back then, landlords were anxious to take back their locations and rent them to new tenants at higher rates. Today, with a generally softer real estate market, many landlords are willing to extend the time constraints so long as they can continue to collect rents. *FPSDA* has eroded at least a piece of the BAPCPA nonresidential real property changes, and perhaps, now that we have lived with BAPCPA in a different real estate era, it is time to revisit the 2005 BAPCPA nonresidential real property amendments.

Section 365(d)(4) should be amended to remove the strict time limitation and allow a debtor to extend its time to assume or reject nonresidential real property leases by showing cause. However, to avoid the lengthy extensions that debtors historically obtained, "cause" should be defined by statute so as to make the standard more rigorous than under the pre-BAPCPA version of the statute. This would address commercial landlords' concerns with respect to open-ended extensions of time, while allowing debtors a reasonable opportunity to assess their business operations and make reasonable determinations with respect to their nonresidential real property leases. ■

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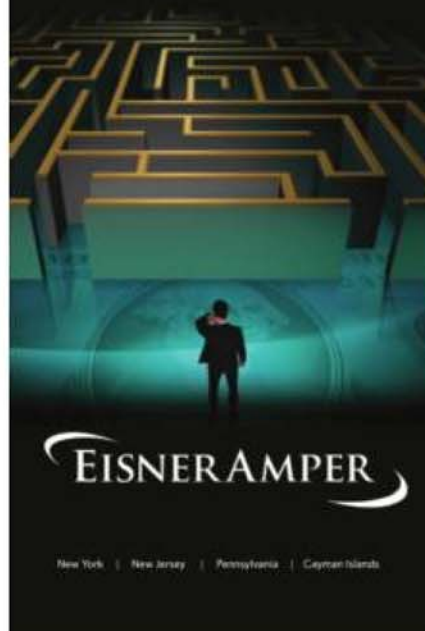
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¹⁰ *Id.* at 14.

¹¹ *Id.* at 18.

¹² *Id.*

¹³ *Id.* at 21.

¹⁴ *Id.* at 22.

¹⁵ *Id.*

¹⁶ *Id.* at 25-26.