Seventh Circuit Suggests That Longer Assumption/Rejection Deadline Should Govern Integrated Franchise and Commercial Lease Agreements

Brad B. Erens
Mark G. Douglas

It is broadly accepted that the abbreviated deadline for a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume or reject an unexpired lease of nonresidential real property with respect to which the debtor is the lessee does not apply to executory contracts or unexpired leases of residential real property or personal property. Less clear, however, is which deadline for assumption or rejection in the Bankruptcy Code applies to an "integrated" contract or group of "inseparable" agreements that includes both a commercial real estate lease and another type of contract or lease.

This was one of the thorny questions that the Seventh Circuit addressed, albeit obliquely, in *A&F Enters., Inc. II v. Int'l House of Pancakes Franchising LLC (In re A&F Enters., Inc. II)*, 2014 BL 34222 (7th Cir. Feb. 7, 2014). In *A&F Enterprises*, the court of appeals examined, among other things, a franchisee-lessee's likelihood of success on a motion for a stay pending appeal of an order determining that its franchise agreement expired when a related nonresidential real property lease was deemed rejected pursuant to section 365(d)(4) of the Bankruptcy Code. In granting the stay, the Seventh Circuit wrote that "[t]here are powerful arguments in favor of" the franchisee's argument that the longer assumption or rejection deadline stated in section 365(d)(2) should apply to the related contracts.

Assumption and Rejection of Executory Contracts and Unexpired Leases

Section 365(a) of the Bankruptcy Code authorizes a trustee or DIP, with court approval, to assume or reject most executory contracts and unexpired leases during the course of a bankruptcy case. If the debtor has defaulted under the contract or lease, assumption is subject to the conditions set forth in section 365(b) (e.g., cure of certain defaults and adequate assurance of future performance).

The general rule is that a trustee or DIP must assume or reject a contract or lease in its entirety. This rule prohibits the debtor from "cherry-picking," or accepting the benefits of a contract or lease without also assuming its burdens. However, some courts have recognized arguably an exception to this principle by allowing assumption or rejection of only part of a lease or contract if the court concludes that the document actually constitutes multiple, severable agreements under applicable nonbankruptcy law based upon the intent of the parties. *See*, *e.g.*, *In re Hawker Beechcraft, Inc.*, 2013 BL 156513 (Bankr. S.D.N.Y. June 13, 2013); *In re Contract Research Solutions, Inc.*, 2013 BL 117998 (Bankr. D. Del. May 1, 2013); *In re Buffets Holdings, Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008). Courts have also ruled that related "inseparable" or "integrated" agreements must be assumed or rejected together rather than separately. *See*, *e.g.*, *KFC Corp. v. Wagstaff Minn., Inc. (In re Wagstaff Minn., Inc.)*, 2012 BL 757, *4 (D. Minn. Jan. 3, 2012) ("Two or more contracts that are 'essentially inseparable' should be viewed as a single indivisible agreement and assumed or rejected in their entirety."); *In re Union Fin. Servs. Grp., Inc.*, 325 B.R. 816 (Bankr. E.D. Mo. 2004). Inseparability is similarly determined on the basis of the intent of the parties. *Id.*; *accord In re AbitibiBowater Inc.*, 418 B.R. 815 (Bankr. D. Del. 2009); *Philip Servs. Corp. v. Luntz (In re Philip Servs., Inc.)*, 284 B.R. 541 (Bankr. D. Del. 2002).

Section 365(d) governs the time frame for the assumption or rejection decision, depending upon the chapter of the Bankruptcy Code that applies and the nature of the contract or lease.

Pursuant to section 365(d)(2), the trustee or DIP in a chapter 9, 11, 12, or 13 case may assume or reject an executory contract or unexpired lease of residential real property or of personal property at any time prior to confirmation of a plan, unless the court shortens the time upon the request of the nondebtor party to the agreement.

For unexpired nonresidential real property leases with respect to which the debtor in any bankruptcy case (except a chapter 15 case) is the lessee, section 365(d)(4) provides that a lease "shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor," if the trustee or DIP does not assume or reject the lease by the earlier of: (i) 120 days after the petition date; or (ii) confirmation of a plan. The court may extend the 120-day period by up to 90 days upon a showing of "cause," but any additional extensions are not authorized unless the lessor consents in writing.

A franchise agreement is an executory contract subject to the assumption or rejection deadline set forth in section 365(d)(2). *See Dunkin' Donuts Franchising LLC v. CDDC Acquisition Co. (In re FPSDA I, LLC)*, 470 B.R. 257, 262 (E.D.N.Y. 2012).

However, if a franchise agreement is part of an integrated agreement or series of contracts that also includes a lease of nonresidential real property, it may be unclear whether section 365(d)(2)

or section 365(d)(4) controls the deadline for assumption or rejection. This was one of the questions addressed by the Seventh Circuit in *A&F Enterprises*.

A&F Enterprises

A&F Enterprises, Inc. II and various affiliates (collectively, "A&F") managed and operated 19 separate franchised International House of Pancakes ("IHOP") restaurants in Illinois. A&F filed for chapter 11 protection in Illinois on February 28, 2013.

At the time of the filing, A&F's primary assets consisted of 19 IHOP franchise agreements and the corresponding building and equipment leases. For all but four of the restaurants, the franchise relationship at each location was memorialized in three separate contracts, all of which contained cross-default provisions.

A&F obtained court approval to reject the agreements with respect to two of the IHOP locations, but it neither assumed the leases covering the remaining 17 locations within the 120-day period specified in section 365(d)(4) nor sought an extension of the time to assume or reject.

As franchisor, IHOP sought an order of the bankruptcy court declaring that the building leases for those locations were therefore automatically rejected and, by way of the cross-default provisions, that the corresponding franchise agreements and equipment leases expired. A&F countered that, because the building leases were just one component of the larger franchise arrangement with IHOP, section 365(d)(2)'s more generous time limit applied to the entire package of integrated contracts.

On August 5, 2013, the bankruptcy court ruled that the real property leases were deemed rejected as of June 28, 2013, by operation of section 365(d)(4). However, to give the parties additional time to brief the issue, the court deferred a ruling on whether the related franchise agreements and equipment leases expired on that date. After the additional briefing, the bankruptcy court ruled on September 23, 2013, that the franchise agreements and equipment leases expired as of the date the real property leases were deemed rejected.

Both the bankruptcy court and the district court denied A&F's motions for a stay pending appeal. Among other things, the district court, in assessing the likelihood that A&F would succeed on the merits of an appeal, rejected A&F's argument that every court which has reviewed the issue "has viewed the intersection of franchise agreements and nonresidential leases to be a unified issue and has applied § 365(d)(2)." *See In re A&F Enters., Inc. II*, 2013 BL 279511, *2 (N.D. Ill. Oct. 8, 2013), *rev'd*, 2014 BL 34222 (7th Cir. Feb. 7, 2014). According to the district court, none of the cases cited by A&F was binding authority, and A&F, faced with uncertainty regarding the interplay between contracts governed by different statutory deadlines, should have sought an extension of the deadline to assume or reject the real property leases.

A&F appealed the district court's ruling to the Seventh Circuit.

The Seventh Circuit's Ruling

A three-judge panel of the Seventh Circuit reversed. At the outset, the court of appeals noted that "[t]he sole issue for us now is whether the bankruptcy court's orders should be stayed pending resolution of the appeals on the merits." Even so, the Seventh Circuit briefly addressed the merits

in applying the standard for granting a stay pending appeal, which includes an assessment of the likelihood that the party seeking the stay will succeed on the merits of its appeal.

The court explained that although A&F and IHOP agreed on the effects of their contractual arrangement, they disputed whether the agreements should be viewed as a single integrated contract or as separate but related contracts that might be assumed or rejected individually. The Seventh Circuit found that the entire package of agreements would be worthless unless the agreements were all assumed together, due to the purpose and terms of the individual contracts, including various usage restrictions and cross-default provisions.

Because the real property leases, the franchise agreements, and the equipment leases were inseparable, the Seventh Circuit concluded that reference to the plain language of the Bankruptcy Code was unavailing—there is an irreconcilable conflict between sections 365(d)(2) and (d)(4), the court reasoned, because it is unclear which provision's deadline for assumption or rejection should apply to a hybrid contract. According to the court, "Creating an exception [to either provision for an integrated contract] is unavoidable, so we have no choice but to look beyond the text."

The Seventh Circuit explained that there are "powerful arguments" in support of A&F's argument that the longer deadline in section 365(d)(2) should apply, consistent with chapter 11's purpose in affording debtors a fair opportunity to reorganize. Two bankruptcy courts, the Seventh Circuit noted, have held on nearly identical facts that section 365(d)(4) "does not apply to a lease that is so tightly connected to a franchise arrangement." *See In re FPSDA I, LLC*, 450

B.R. 391 (E.D.N.Y. 2011), *leave to appeal denied*, 470 B.R. 257 (E.D.N.Y. 2012); *In re Harrison*, 117 B.R. 570 (Bank. C.D. Cal. 1990). "Though we are provisionally persuaded that A&F's position has substantial merit," the court wrote, "we emphasize that we aren't deciding the issue today."

Given the absence of a clear-cut answer on the legal issue, the Seventh Circuit based its decision whether to grant a stay pending appeal on the balance of potential harms. It concluded that the potential harm to A&F from terminating its franchises and putting an end to its prospects for reorganization in chapter 11 outweighed any potential damage to the goodwill associated with IHOP's trademark by allowing A&F to continue operating the restaurants pending the outcome of the appeal. The Seventh Circuit accordingly reversed the district court's ruling and stayed execution of the bankruptcy-court order deeming the real property leases rejected and the franchise agreements and equipment leases terminated.

Outlook

Because of its procedural posture, *A&F Enterprises* does not provide any definitive guidance on the substantive legal question of whether section 365(d)(2) or section 365(d)(4) determines when an integrated group of disparate leases and contracts (i.e., including both nonresidential real property leases and other leases or contracts) must be assumed or rejected. Had the Seventh Circuit decided the issue on the merits, it would have been as a matter of first impression in the circuit courts of appeal. However, unless the parties reach a settlement, the Seventh Circuit may yet have an opportunity to weigh in on the issue.

Despite the nondispositive nature of its reasoning on the merits, the Seventh Circuit's analysis suggests that it sees a reasonably strong case for applying the longer assumption/rejection deadline contained in section 365(d)(2). According to the court, allowing a franchise agreement to expire by operation of a cross-default provision in a related commercial lease that is not timely assumed under the abbreviated deadline set forth in section 365(d)(4) does not comport with the goal of chapter 11 (i.e., to afford debtors an opportunity to reorganize).

This approach mirrors the reasoning articulated by the handful of other courts that have considered this issue. For example, in *FPSDA*, the bankruptcy court emphasized that if section 365(d)(4) were to apply to a combined franchise-lease agreement, the franchisor-landlord would be provided with a "superior power to determine the course and outcome of such debtor's bankruptcy case than intended," which would allow the franchisor-landlord to pressure the debtor to assume or reject the franchise agreement simply by refusing to extend the time to assume or reject the lease. *See FPSDA*, 450 B.R. at 401.