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Matthew J. Burne

THE EFFECT OF FRANCHISOR BANKRUPTCY ON EXECUTORY SUPPLY CONTRACTS: DOES THE FRANCHISEE HAVE A REMEDY?

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I. INTRODUCTION

In 2010, between forty to fifty percent of consumer retail and service purchases were from franchised businesses.[1] Categories of these purchases encompass a broad spectrum of products and services.[2] Despite the large percentage of consumer purchases emanating from franchised businesses, overall consumer spending has decreased.[3] The decrease in consumer spending has led to an increase in the number of bankruptcy petitions filed by franchised businesses.[4] The position of this article is that given the relative youth of franchise business in relation to United States bankruptcy law, a gap exists in the protections offered to some parties of the franchise relationship, particularly the franchisee. The goal of this article is to identify that gap and provide a potential course of action by which franchisees may protect their interests.

Franchisees are often individuals, partnerships, or small corporate entities that assume the risk of capital investment, debt, and other liabilities required to open and operate a franchised business.[5] In a typical franchise relationship, the franchisor develops the business concept and system and provides the initial and

* Barry University School of Law, J.D. 2012; Culinary Institute of America, A.O.S. Culinary Arts 2003; Saint Joseph's University, B.S. Food Marketing 2002; active member of the Pennsylvania Bar Association.

1. *See Franchise Statistics*, FRANCHISE CONSULTANTS, INC., http://www.franchiseconsultantsinc.com/statistics.html (last visited Oct. 30, 2012) ("Franchise businesses account for about 50% of all retail sales in the United States."); *Quick Franchise Facts, Franchise Industry Statistics,* AZFRANCHISES.COM, http://www.azfranchises.com/franchisefacts.htm (last visited Jan. 30, 2013) ("It is estimated that the franchise industry accounts for approximately 50% of all retail sales in the US."); *see also Franchise Statistics*, FRANFINDERS, http://www.franfinders.com/blog/franchise-statistics (last visited Jan. 30, 2013).

2. *See Franchise Categories Franchises,* ENTREPRENEUR.COM, http://www.entrepreneur.com/franchises/index.html (last visited Jan. 30, 2013).

3. *Economic News Release: Consumer Expenditures 2010*, U.S. BUREAU OF LABOR STATISTICS (Sept. 27, 2011), *available at* http://www.bls.gov/news.release/archives/cesan_09272011.pdf.

4. *Cf.* Karen Redmond, *Bankruptcy Filings Down From 2010 Levels, News Archives,* U.S. COURTS (Aug. 5, 2011), http://www.uscourts.gov/News/NewsView/11-08-05/Bankruptcy_Filings_Down_From_2010_Levels.aspx?CntPageID=1 (noting that business bankruptcy filings in 2007 totaled 23,889, while 2010 business bankruptcy filings totaled 59,608, with the largest increase occurring between 2008 and 2009).

5. Don Daszkowski, *The Role of the Franchisee, Franchises,* ABOUT.COM http://franchises.about.com/od/franchisebasics/a/franchisee-role.htm (last visited Jan. 30, 2013).

> The first function you have in your new endeavor is as an investor into your business. You will need to invest financially with an initial franchising fee, but also be prepared to pay any additional costs that might be necessary to get the business up and running[,] such as equipment costs.

Id.

ongoing support service, advertising, and product development.[6] A franchisee relies on the franchisor to provide these services to facilitate the efficient and profitable operation of the franchised business. One such service is supply contracts. To ensure consistency within the franchise system, franchisors typically enter into term contracts with various parties within distribution channels.[7] The franchisor uses economies of scale, along with the collective bargaining and purchasing power of its company-owned outlets and franchised outlets, for the supply of goods needed for the operation of the franchise system.[8] Problems arise for all parties when these services cease to exist.

One circumstance, which can cause support services to disappear, is the filing of a Chapter 7 bankruptcy petition by the franchisor.[9] This occurrence can bring the entire franchise system to a halt.[10] A franchisor bankruptcy affects trademark rights, loans and credit lines guaranteed by the franchisor.[11] In addition, a myriad of other problems may occur.[12] One major issue is that the supplier may or may not continue to perform the supply contracts.[13] The nonperformance of supply contracts leaves the franchisee with no ability to purchase the goods needed to profitably run the franchised business.[14] High rent or mortgage payments on prime real estate, high overhead and payroll, and a static menu or product line are costs that cannot be covered without the availability of the proper goods at the proper price point. Currently, the United States Bankruptcy Code offers the franchisee little, if any, protection in such situations.[15] In a Chapter 7 bankruptcy, the continued performance of supply contracts by the debtor is at the discretion of the Bankruptcy trustee.[16] Therefore, the non-debtor franchisee has no power to force a supplier to perform, and thus the franchisee is unprotected.[17]

The analysis of this gap in bankruptcy law will begin with an overview of the supply contracts within the franchise relationship.[18] Next will be an analysis of the franchisee's rights as a third party beneficiary to contracts.[19] Following, will be a discussion of relevant sections of the Bankruptcy Code, Article 2 of the Uniform Commercial Code, and the course of action by which the franchisee can obtain specific performance of a supply contract.[20]

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6. *See id.*
7. STUART HERSHMAN & ANDREW A. CAFFEY, *Structuring a Unit Franchise Relationship*, FUNDAMENTALS OF FRANCHISING 76 (Rupert M. Barkoff & Andrew C. Selden, eds., 3d ed. 2008) [hereinafter HERSHMAN & CAFFNEY].
8. *Id.* at 76–77.
9. *See* Terrance M. Dunn, *The Impact of a Franchisor's Bankruptcy on a Franchisee*, *Franchise Lawyer Blog*, EINBINDER & DUNN, LLP (Oct. 27, 2010), http://www.ed-lawfirm.com/blog/2010/10/the-impact-of-a-franchisors-bankruptcy-on-a-franchisee.shtml.
10. *See id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. 11 U.S.C. §§ 101–1532 (2006).
16. *Id.* § 365.
17. *Id.*
18. *See infra* Part III.
19. *See infra* Part IV.
20. *See infra* Part V–VI.

II. HYPOTHETICAL

To aid in this discussion, consider the following hypothetical: The franchisor is McGillin's Pub (McGillin's), the franchisee is Farley's, Inc. (Farley's), and the food supplier is Baines Foodservice (Baines). McGillin's has entered into a supply contract (Supply Contract) with Baines for the supply of Mozzy's Mozzarella Sticks (Mozzy's). Mozzy's are made with a special Irish beer batter and are named by brand on McGillin's menu. There is no substitute product on the market, and Baines is the exclusive distributor of this product in the geographical region where McGillin's franchises are located. McGillin's executed a Supply Contract, whereby Baines will be the exclusive supplier of Mozzy's to all McGillin's locations. Through the Supply Contract, McGillin's will give Baines projected usages on a quarterly basis to ensure that Baines stocks adequate inventory to service McGillin's. Baines has covenanted to provide all McGillin's locations with a consistent supply of the product at a set price for the term of the contract. The end price to all McGillin's locations will be below the market price for other mozzarella sticks carried by independent vendors. Farley's is not expressly named in the Supply Contract, but delivery by Baines to individual locations is required. Additionally, each franchised McGillin's location is obligated to pay suppliers under its respective franchise agreement. The payment provisions of the franchise agreements are incorporated by reference to the Supply Contract under the payment section.

The Supply Contract term is for two years. One year into the term of the contract, McGillin's becomes insolvent because of lack of sales and overextended, unleveraged development. McGillin's has filed a Chapter 7 Bankruptcy petition because there is no hope of reorganization under Chapter 11. The costs of redesigning and marketing the McGillin's business concept are not economically feasible due to McGillin's financial state. Therefore, McGillin's will liquidate rather than attempt reorganization. Pursuant to section 365(a) of the Bankruptcy Code, the trustee has elected to seek court approval to reject all executory contracts. Assume for this hypothetical, that the Bankruptcy Court has approved rejection.[21]

Having opened only three years ago, Farley's has not yet recovered on its initial capital investment and wishes to continue operation under the McGillin's concept and menu. The community in which Farleys' franchises are located has accepted the McGillin's business concept and the sales trends show a promise for growth in those markets. Integral to continuation of this business is keeping the existing food cost structure in place to enable it to meet the overhead costs. Farley's seeks to have Baines continue to supply its Mozzy's because there is no similar product or distributor that services its geographical area.

21. § 365(a).

III. THE ROLE OF EXECUTORY SUPPLY CONTRACTS IN FRANCHISE RELATIONSHIPS

The franchise system is built on core elements that allow the system to function like a well-oiled machine.[22] One key element to the franchise system is the long-term supply contract.[23] Executing such contracts allows a franchise to ensure consistent raw materials, products and services.[24] This ultimately leads to consistency in the end product delivered by the Franchise to the consumer. For example, an order of mozzarella sticks at a T.G.I. Friday's in Scranton, Pennsylvania, is the same as an order of mozzarella sticks at a T.G.I. Friday's in Orlando, Florida.

As discussed above, in order for the franchise to achieve consistency, the franchisor enters into contracts on behalf of the entire franchise system, including both franchised and company-owned outlets.[25] To be beneficial to the supplier, the franchisor, and the franchisee, contracts must be for extended periods of time—in most instances one year or longer.[26] Such contracts have reciprocal performances due throughout their term.[27] Thus, these contracts fall within the description of 'executory contract'.

An executory contract is a contract "on which performance remains due to some extent on both sides."[28] In determining whether a contract is executory, courts commonly apply the "Countryman Test."[29] This test states: "[A] contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and

22. ROBERT T. JOSEPH & LEE N. ABRAMS, *Antitrust Law*, FUNDAMENTALS OF FRANCHISING 258 (Rupert M. Barkoff & Andrew C. Selden, eds., 3d ed. 2008).

23. Douglas C. Berry, David M. Byers, & Daniel J. Oates, *Open Price Agreements: Good Faith Pricing in the Franchise Relationship*, 27 FRANCHISE L.J. 45, 45 (2007) [hereinafter *Open Price Agreements*].

24. HERSHMAN & CAFFEY, *supra* note 7, at 76–77 ("Stringent quality control, uniformity and regular supply are key elements of any nationwide franchising system."); JOSEPH & ABRAMS, *supra* note 21, at 258 ("Standardization also can promote operation efficiency for both the franchisor and the franchisee . . . .").

25. HERSHMAN & CAFFEY, *supra* note 7, at 76 ("[The Franchisor] also might negotiate purchase and distribution agreements with manufactures and distributors.").

26. *See Open Price Agreements*, *supra* note 23, at 45.

> In a franchise system based on sales of the franchisor's products, the franchisor and franchisee aim to establish a long-term relationship in which the franchisee continually will purchase and resell the franchisor's goods to the public, whether those products are coffee, gasoline, soft drink concentrate, or hamburger patties. Those goods are the lifeblood of the franchise because they (along with the franchisor's trade and service marks) define the franchise and ensure a consistent customer experience, which is critical to the success of a network of independently operating dealers or franchisees.

Id.

27. *The Franchisor's Obligations, Basic Guidelines, Law & Agreements*, BUSINESS-OPPORTUNITIES.BIZ, http://www.business-opportunities.biz/franchise/2009/07/29/the-franchisor's-obligations/ (last visited Oct. 30, 2012) [hereinafter *The Franchisor's Obligations*].

28. 3 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY, ¶ 365.02[2][a] at 365-16 (MB, 16th ed. 2012) [hereinafter COLLIER].

29. *In re* Ehmann, 319 B.R. 200, 203–04 (Bankr. D. Ariz. 2005) (citing *In re* Robert L. Helms Constr. & Dev. Co., 139 F.3d 702, 705 (9th Cir. 1998)).

thus excuse the performance of the other.'"[30] A material breach occurs when nonperformance by one party defeats the purpose of the contract.[31]

Applying this test, supply contracts are executory contracts.[32] The franchisor will negotiate a price and quantity with a manufacturer or distributor.[33] The franchisor uses the combined purchasing power of the entire franchise system with the purpose of leveraging the best possible price and to ensure the supply of consistent products to the franchisee.[34] In such a relationship, continued obligations of performance exist for all parties through the term of the contract.[35] First, the franchisor's performance requires calculation of projected usage from the accountings submitted by the franchisees based on past usages.[36] These calculations are submitted to the supplier to ensure the supplier stocks adequate inventory.[37] This process will occur throughout the term of the contract.[38] Second, the supplier performs by delivering products to the franchise locations at the specified price.[39] Third, each individual location pays the supplier for the product delivered by the supplier.[40] In some contracts, the payment is made by the franchisee; in others, the franchisor makes payment on behalf of the franchisee.[41]

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30. *Id.*; *see also* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 469 (1973).

31. 17 AM. JUR. 2D *Contracts* § 706, 664–65 (2011).

> A material breach occurs when there is a breach of an essential feature of the contract, which induced the party to enter into it. The breach must go to the substance of a contract and defeat the parties' object in making it. It has similarly been said that the breach must relate to a matter of vital importance, go to the essence of the contract, or defeat an essential purpose of the contract.

Id.

32. *In re* Penn Traffic Co., 322 B.R. 63, 69 (Bankr. S.D.N.Y. 2005) ("Defining 'executory' and determining its consequences present no difficulty in cases where the obligations on both sides remain wholly unperformed, as in a . . . supply contract where the provision of services or goods is offset by the contemporaneous obligation to pay for the services or goods provided.").

33. *Open Price Agreements*, *supra* note 23, at 46–47.

> [T]he franchise relationship places the franchisor in the unique position of dictating the franchisee's relationships with third-party vendors. Ostensibly to maintain the quality and image of the franchise, the franchisor may require as part of the agreement that the franchisee purchase all of its supplies from a third-party vendor (or limited group of vendors) designated by the franchisor.

Id.

34. *Id.*

35. *The Franchisor's Obligations*, *supra* note 27.

36. Jack Pearce, *How Suppliers Support Strong Franchise Relations*, INTERNATIONAL FRANCHISE ASSOCIATION, http://www.franchise.org/HowSuppliersSupportStrongFranchiseRelations.aspx (last visited Oct. 30, 2012).

37. *Id.*

38. *See id.*

39. *See* Jillian Suwanski, *Quiznos Settlement Sparks Franchisee Focus on Supply Chain Issues*, BAKER DONELSON HOSPITALITAS (Apr. 14, 2010) *available at* http://www.bakerdonelson.com/files/Publication/e19dd34e-23b3-439b-8b0511711caf81ef/Presentation/PublicationAttachment/1d80357b-c426-49dc-aa3a-6973f2d66c2b/Hospitalitas-2010-Issue-2.pdf; *see also* Don Sniegowski, *Franchisees Create Online Purchasing Cooperative*, BLUE MAUMAU (Sept. 26, 2012, 9:07 PM), http://www.bluemaumau.org/11972/franchisees_create_online_purchasing_cooperative.

40. *See* Suwanski, *supra* note 39; *see also* Sniegowski, *supra* note 39.

41. HERSHMAN & CAFFEY, *supra* note 7, at 76.

If the supplier ceases delivery to franchise locations, there has been a material breach.[42] Therefore, supply contracts, as they exist in the franchise relationship, are executory contracts under the Countryman Test.[43]

IV. FRANCHISEES AS BENEFICIARIES TO SUPPLY CONTRACTS

Benefits of supply contracts—in the franchise relationship—flow in three directions.[44] First, the supplier benefits by the guaranteed volume of sales and assurance of payment.[45] Second, the franchisee benefits from a reliable supply of consistent products at a consistent below-market price.[46] Third, the franchisor benefits from control over the quality of supply, rebates from the supplier, the wholesale price, and ultimately from royalties collected from franchisees who operate profitably.[47] However, when a franchisee is not expressly named in the contract, a deeper analysis is necessary to uncover its benefit.[48]

Using the McGillin's hypothetical, the individual franchisee, Farley's, is not named in the Supply Contract and is not an express beneficiary. Therefore, to assert its rights under the Supply Contract, Farley's must establish that it is an intended third party beneficiary. An intended beneficiary gains a benefit of a contract "by the virtue of a promise."[49]

A. The Law of Third Party Beneficiary

Under the Restatement of Contracts, "a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and . . . the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance."[50] "A court in determining the parties' intention should consider the circumstances surrounding the transaction as well as the actual language of the contract."[51] In order for a party to have rights as a beneficiary to a supply contract, that party need not be expressly named in the contract.[52] These rights arise when

42. 17 AM. JUR. 2D *Contracts* § 706, *supra* note 31.
43. *In re* Ehmann, 319 B.R. 200, 204 (Bankr. D. Ariz. 2005).
44. Danny Goldberg, *Locating the Best Vendors For Your Franchise*, INTERNATIONAL FRANCHISE ASSOCIATION, http://www.franchise.org/Franchise-Industry-News-Detail.aspx?id=35914 (last visited Jan. 30, 2013).
45. *Id.*
46. Eddy Goldberg, *The Benefits of the Franchise Model*, FRANCHISING.COM, http://www.franchising.com/howtofranchiseguide/benefits_of_the_franchise_model.html (last visited Oct. 30, 2012).
47. *Id.*
48. Hawkinson v. Bennett, 962 P.2d 445, 467–68 (Kan. 1998).
49. RESTATEMENT (SECOND) OF CONTRACTS § 302 cmt. a (1981).
50. *Id.* § 302 (1)(b); *See, e.g.*, Cutler v. Hartford Life Ins. Co., 239 N.E.2d 361 (N.Y. 1968); CF Indus. v. Transcon. Gas Pipe Line Corp., 448 F. Supp. 475 (W.D.N.C. 1978); Gilbert Fin. Corp. v. Steelform Contracting Co., 145 Cal. Rptr. 448 (Cal. Ct. App. 1978); Ross v. Imperial Constr. Co., 572 F.2d 518 (5th Cir. 1978); Am. Elec. Power Co. v. Westinghouse Elec. Corp., 418 F. Supp. 435 (S.D.N.Y. 1976); Republic Nat'l Bank v. Nat'l Bankers Life Ins. Co., 427 S.W.2d 76, 81 (Tex. Civ. App. 1968).
51. RESTATEMENT (SECOND) OF CONTRACTS § 302 reporter's note, cmt. a (1981).
52. *Hawkinson*, 962 P.2d at 467–68.

the circumstances tend to show that the contract was formed to provide that party with the benefit of performance.[53]

The Restatement goes on to state that "[a] promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may enforce the duty."[54] In other words, once a party is established as an intended beneficiary, the promisor owes a duty of performance to that party.[55] The United States Supreme Court, all eleven United States Circuit Courts of Appeal, and a majority of state courts recognize the rights of third party beneficiaries in contract disputes.[56]

The availability of third party beneficiary rights in a contract raises the question of whether that beneficiary is entitled to an equitable remedy. "Where specific performance is otherwise an appropriate remedy, either the promisee or the beneficiary may maintain a suit for specific enforcement of a duty owed to an intended beneficiary."[57] Comment *a* to Section 307 explains that the inclusion of a beneficiary in this section is based upon the fact that "[h]e is the real party in interest . . . ."[58] This section has been applied by courts to afford third party beneficiaries equitable remedies.[59]

B. Third Party Beneficiary Rights in Franchise Relationships

The concept of a third party beneficiary as it applies to franchise relationships is not new. In *Tynan v. General Motors Corp.*, the New Jersey Superior Court stated that "[t]he right of a third party beneficiary rests chiefly upon the fact that the contract will create reasonable expectations on his part and will induce him to change his position in reliance."[60] In the eyes of the New Jersey Superior Court, in order for a third party to assert a right to a contract, that party must have some

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53. *Id.* at 468.

54. RESTATEMENT (SECOND) OF CONTRACTS § 304 (1981).

55. *Id.* § 304 cmt. b.

56. Arthur Anderson LLP v. Wayne Carlisle, 556 U.S. 624, 631 (2009) ("'[T]raditional principles'of state law allow a contract to be enforced by or against nonparties to the contract through 'assumption, piercing the corporate veil, alter ego, incorporation by reference, third-party beneficiary theories, waiver and estoppel' . . . .").

57. RESTATEMENT (SECOND) OF CONTRACTS § 307 (1981).

58. *Id.* § 307 cmt. a.

> Where a contract creates a duty to a beneficiary under the rule stated in § 304, the beneficiary is a proper party plaintiff either in an action for damages or in a suit for specific performance. He is the real party in interest within the meaning of any statute requiring suit to be brought by such a party.

Id.

59. *See generally* Campanella Corp. v. Lyndon Realty Trust, 611 F. Supp. 864 (D. Mass. 1985); *In re* Kaplan 143 F.3d 807 (3d Cir. 1998); McAndrews Law Offices v. Sch. Dist. of Phila., No. 06-cv-5501, 2007 U.S. Dist. LEXIS 9888 (E.D. Pa. Feb. 9, 2007); United States v. CFW Constr. Co., 583 F. Supp. 197 (D.S.C. 1984); Pub. Agencies Opposed to Soc. Sec. Entrapment v. Heckler, 613 F. Supp. 558 (E.D. Cal. 1985); Hawkins v. Gilbo, 663 A.2d 9 (Me. 1995); Lakew v. Mass. Bay Transp. Auth., 844 N.E.2d 263 (Mass. App. Ct. 2006).

60. 591 A.2d 1024, 1031 (N.J. Super. Ct. App. Div. 1991) (citing 4 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 775 (West 1951)). The case was a dispute over defendant's withholding consent to a transfer of a franchise agreement from the franchisee to the plaintiff. *Id.* The court held that the plaintiff could not assert his right as a third party beneficiary because "no agreement or contract was presented which could reasonably give rise to such an expectation." *Id.*

relationship with the franchisor which would create a reasonable expectation of performance and induce reliance.[61] In *Tynan,* the Plaintiffs asserted third party beneficiary rights as a prospective franchisee after the franchisor denied consent to their purchase of an existing franchise.[62] New Jersey franchise legislation protected franchisees from a franchisor unreasonably withholding consent to an assignment of a franchise agreement.[63] Because the plaintiff was not an intended beneficiary of this legislation or the franchise agreement, he had no standing as a third party beneficiary.[64] The Plaintiff thus had no expectation of reliance; such an expectation of reliance can only be created by the parties to the contract.[65] Applying *Tynan* to the McGillin's hypothetical, the franchisee, Farley's, is already a beneficiary to the contract because it has a relationship with the franchisor and receives benefits of the delivered product at the fixed price.

In *Collins v. International Dairy Queen, Inc.*, the United States District Court for the Middle District of Georgia explained that the parties to the contract created the rights in third party beneficiaries "by manifesting an intention to do so."[66] The court also stated that the contract must be "intended for their direct benefit rather than . . . their incidental benefit."[67] Continuing its analysis, the court stated, "[w]hether the third party was an intended beneficiary may be determined by examining both the writing itself as well as the surrounding circumstances known to the parties."[68] In *Collins*, the court determined that the defendant, a master franchisor, was an intended beneficiary to sub-franchise agreements because the agreements were entered into with the intent of benefiting the defendant.[69] The court reached this decision by looking at the written agreement, which obligated the franchisor to provide services such as sales training, advertising, merchandising programs and service, and trademark licenses.[70] These services were for the benefit of the franchise system including the franchisor.[71] Therefore, the defendants could enforce an arbitration provision from the sub-franchise agreement to which they were not named a party.[72] This right only extended to those agreements that did not name with certainty the beneficiaries of the arbitration clause.[73]

The Kansas Supreme Court reached a similar position, by deciding in *Hawkinson v. Bennett* that a master franchise agreement between a franchisor and master franchisee provided benefits to the sales franchisee.[74] The plaintiff,

61. *Id.*
62. *Id.*
63. *Id.* at 1027–28.
64. *Id.* at 1032.
65. *Tynan*, at 1031.
66. 2 F. Supp. 2d 1465, 1469 (M.D. Ga. 1998) (citing Beverly v. Macy, 702 F.2d 931, 940 (11th Cir. 1983)).
67. *Id.* (citing Ross v. Imperial Contsr. Co, 572 F.2d 518, 520 (5th Cir. 1978)).
68. *Id.* (citing *Beverly*, 702 F.2d at 941).
69. *Id.* at 1469.
70. *Id.*
71. *Id.*
72. *Collins*, 2 F. Supp. 2d at 1469.
73. *See id.* at 1471.
74. 962 P.2d 445, 468 (Kan. 1998).

Hawkinson, was a sales franchisee who had contracted directly with the franchisor.[75] The defendants, Communications World International (CWI), and master franchisees Robert and Linda Barrett, formed a contract whereby all support services for sales franchisees were to be provided by the master franchisee.[76] When the Plaintiff's franchise agreement was prematurely terminated for not meeting sales quotas, he brought suit seeking damages stemming from the breach of the master franchise agreement by the master franchisee.[77] The court determined even though the franchisee was not expressly named in this agreement it was still a third party beneficiary to the master franchise agreement.[78] In this case, the court ruled that a sales franchisee, not specifically named to a master franchise agreement, was entitled to damages when the master franchisee failed to perform its obligation of providing services to that sales franchisee.[79]

As demonstrated in these decisions, several courts have reached the determination that third party contract rights do exist in the franchise arena, particularly with regard to the franchisee.[80] The United States Bankruptcy Court for the Middle District of Florida gave a clear statement of this relationship when deciding *In re Business Products, Inc.*[81] The Court stated, "in a franchise situation the franchisee usually makes a substantial commitment in time and money, to develop and establish the business of selling the product or service of which the franchisor will also be a beneficiary."[82] Logically, if the franchisor is a beneficiary of the efforts of the franchisee, then the franchisee is a beneficiary of the actions of the franchisor. Following the reasoning of *Collins* and *Hawkinson*, the efforts and benefits of a franchisor in negotiating a supply contract run to the franchisee, even when that franchisee is not specifically or expressly named in the contract.[83] In the McGillin's hypothetical, if Farley's is not specifically named in the Supply Contract, it still has a right to the benefits of the contract as a third party beneficiary.

C. Third Party Beneficiaries Rights, When a Franchisor Files Bankruptcy

Once Farley's has established its right as a third party beneficiary, the next issue is whether Farley's can exercise this right when the express beneficiary of the contract files for bankruptcy. Given the narrow scope of this topic, case law,

75. *Id.* at 451–52.
76. *Id.* at 452.
77. *Id.* at 467–68.
78. *See id.* (citing Parrish Chiropractic v. Progressive, 874 P.2d 1049, 1056 (Colo. 1994)). The Kansas Supreme Court looked at a master franchise agreement between the franchisor and master franchisee. *Id.* This agreement obligated the Master franchisee to provide direct benefits of administrative and market support among other things to sales franchisees such as the Plaintiff. *Id.*
79. *Hawkinson*, 962 P.2d at 468.
80. *See generally* Tynan v. Gen. Motors Corp., 591 A.2d 1024 (N.J. Super 1991); Collins v. Int'l. Dairy Queen, Inc., 2 F. Supp. 2d 1465 (M.D. Ga. 1988); *Hawkinson*, 962 P.2d 445.
81. 90 B.R. 514, 516 (Bankr. M.D. Fla. 1988).
82. *Id.*
83. *See generally Collins*, 2 F. Supp. 2d 1465; *Hawkinson*, 962 P.2d 445.

regarding the direct issue of a franchisee's third party beneficiary right in a supply contract, is particularly limited because a majority of franchisors file Chapter 11 bankruptcy petitions.[84] In order to build an understanding and a theory on how franchisees may assert their rights in the bankruptcy arena, an analogy must be found from similar circumstances.

One such analogy exists between this topic and the effects of bankruptcy on supply contracts outside of franchise relationships. *In re United Energy Coal, Inc.* offers similar circumstances.[85] The case involves a dispute over a coal supply contract.[86] A Chapter 7 debtor, United Energy Coal, sued the defendant, VEPCO, for breach of contract and tortious interference for termination of a supply agreement between the defendant and one of the debtor's customers, Buffalo, Inc.[87] The debtor was a guarantor to this contract but was not a party to the contract.[88] The debtor asserted its right as a third party beneficiary to the contract.[89] The court stated that a third party may assert rights even when not expressly named in the contract.[90] To do so, the third party "must show that the parties to the contract 'clearly and definitively intended it to confer a benefit on him.'"[91] The debtor based its intended beneficiary status on five circumstances: (1) the debtor being named as a party in an unexecuted draft of the supply agreement; (2) the debtor being expressly named as a guarantor of the agreement; (3) the debtor actively supplying coal to Buffalo and making direct deliveries to the defendant; (4) the debtor dedicating coal reserves to the defendant; and (5) the defendants unwillingness to execute the supply agreement without the debtor as guarantor.[92] The court ruled that the debtor did not provide definitive evidence that the defendant intended to benefit the debtor when entering into a contract with the debtor's customer.[93] "The debtor certainly benefited from having a jointly controlled business execute a lucrative contract, [but] the benefit [was] only incidental."[94] Merely serving as a guarantor to a contract did not make the debtor an intended beneficiary; the debtor had no obligation to supply coal to the defendant or to demand payment from the defendant for that coal.[95]

Distinguished from *In re United Energy Coal, Inc.* is *Oil Express National v. Burgstone*, which involved a supply contract between Oil Express and Citgo Oil.[96] The initial suit was brought by Oil Express, the plaintiff, against its franchisees, the

84. 11 U.S.C. § 365 (2006).
85. No. 06-453, 2008 Bankr. LEXIS 3709, *4–5 (Bankr. N.D.W.V. Nov. 19, 2008).
86. *Id.* at *5.
87. *Id.* at *5–6.
88. *Id.* at *3–4.
89. *Id.* at *7.
90. *Id.* at *28 (citing Horney v. Mason, 35 S.E.2d 78, 80 (Va. 1945)).
91. *In re United Energy Coal*, 2008 Bankr. LEXIS 3709, at *28 (citing Ward v. Earnst & Young, 435 S.E.2d 628, 634 (Va. 1993)).
92. *Id.* at *30–31.
93. *Id.* at *32–33.
94. *Id.* at *35.
95. *Id.* at *33.
96. 958 F. Supp. 366, 372 (N.D. Ill. 1997).

defendants, for failure to pay fees due under their franchise agreements.[97] The defendants filed a counterclaim seeking *inter alia* damages as third party beneficiaries to the supply contract between the plaintiff and Citgo.[98] The provisions of this supply contract obligated Citgo to supply the plaintiff and the defendants with petroleum products for a fixed price.[99] Citgo was supposed to collect on certain bulk deliveries to Oil Express locations and then pay back a certain amount to Oil Express, which Oil Express was to place in an advertising fund.[100] The supply contract contained the following provision regarding the advertising fund: "[t]he funds shall be held by Oil Express in a segregated, audited account and shall be used by Oil Express for payment of advertising services performed on behalf of Oil Express or its franchisees."[101] In applying Illinois law, the court reasoned, "if a contract be entered into for a direct benefit of a third person not a party thereto, such third person may sue for breach thereof."[102] In light of this case, a franchisee may sue on a supply contract to which they are not expressly named if they are an intended beneficiary.[103] Applying the rule from *Oil Express* to the McGillin's hypothetical, the Supply Contract provisions for delivery to and payment by the franchisee gives Farley's standing as an intended beneficiary or third party beneficiary to the supply contract.

V. Does Bankruptcy Cause the Release of the Supplier From Its Obligations Under the Contract?

The next issue is whether the supplier, as the nondebtor party, is relieved of any contractual obligations when the franchisor files a Chapter 7 bankruptcy petition. To resolve this issue, the Bankruptcy Court must determine what protections, if any, the Bankruptcy Code offers a third party beneficiary of a contract to which the debtor is a party. Bankruptcy is a collective proceeding involving more parties playing different roles than state debt collection proceedings.[104] To complicate this issue further, bankruptcy has a "profound effect on the franchise relationship because of the complicated symbiosis between the franchisor and franchisee."[105]

Several sections of the Bankruptcy Code are relevant to the analysis of how bankruptcy affects the contractual rights of a franchisee.[106] First, it must be

97. *Id.* at 368.
98. *Id.* at 372.
99. *Id.*
100. *Id.*
101. *Id.*
102. *Oil Express*, 958 F. Supp. at 372 (citing People *ex rel.* Resnik v. Curtis & Davis, Architects & Planners, Inc., 400 N.E.2d. 918, 919 (Ill. 1980)).
103. *Id.* at 372–73.
104. Nat'l Bankr. Review Comm. Final Report, Vol. 1, 527 (1997) ("As a collective proceeding, bankruptcy involves a multiplicity of parties, more than are involved in the routine debt collection process. The effects of bankruptcy inevitably go beyond direct relationships between the bankruptcy estate and its creditors.").
105. Craig R. Tractenberg, *What the Franchise Lawyer Needs to Know About Bankruptcy*, 20 FRANCHISE L. J. 3 (2000).
106. *See generally id.*

determined if the filing of a bankruptcy petition is considered a material breach of contract and what effect section 365 has on that contract.[107] Section 365 governs the assumption or rejection of executory contracts under the Bankruptcy Code.[108] If the contract is assumed or assigned, performance will continue and the franchisee will not have an issue until the contract term has expired.[109] However, if the court approves an application for rejection of the contract and a third party beneficiary seeks specific performance of that contract, the following questions must be answered.[110] First, under section 101(10), can a franchisee be a creditor to the franchisor?[111] Second, under section 101(12) and 101(5), does the term "debt" include contractual obligations?[112] Finally, under section 524(e), does the nonrelease of a nondebtor party's liability extend to contractual obligations?[113] If the answer to each of these questions is "yes," the supplier is still bound by a rejected executory contract and the franchisee may pursue an action as a third party beneficiary in state court.[114]

A. Does the Filing of a Chapter 7 Bankruptcy Petition Constitute a Material Breach Releasing the Supplier of the Obligation to Perform?

Under the Restatement and applicable case law, a material breach releases the non-breaching party of its obligation to perform under the contract.[115] This is particularly true with executory contracts where future performance is required.[116] In light of this rule, the question is whether the filing of a bankruptcy petition constitutes a material breach of a contract, therefore relieving the nondebtor party of their obligation to perform.

The answer to this question is rooted in the application of section 365(e) of the Bankruptcy Code.[117] This section prohibits the *ipso facto* termination of contractual rights upon filing a bankruptcy petition.[118] Section 365(e) provides that "an

107. *Id.* at 4.
108. 11 U.S.C. § 365 (2006).
109. Tractenberg, *supra* note 105, at 4.
110. *See* § 101; *see also* § 524.
111. § 101(10).
112. *Id.* § 101(12).
113. *Id.* § 524(e).
114. *Id.* § 101; *see also* § 524.
115. RESTATEMENT (SECOND) OF CONTRACTS § 237 ("[I]t is a condition of each party's remaining duties to render performances to be exchanged under an exchange of promises that there be no uncured material failure by the other party to render any such performance due at an earlier time.");

> A material failure of performance has, under this Section, these effects on the other party's remaining duties of performance with respect to the exchange. It prevents performance of those duties from becoming due, at least temporarily, and it discharges those duties if it has not been cured during the time in which performance can occur.

Id. at § 237 cmt. a.
116. *In re* First Prot., Inc., 440 B.R. 821, 831 (9th Cir. 2010) (citing *In re* Ehmann, 319 B.R. 200, 204 (Bankr. D. Ariz. 2005)) ("A contract is executory only when the 'obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'").
117. 11 U.S.C. § 365(e) (2006).
118. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 803 (2d ed. 2009) (citing 11.U.S.C. § 365(e)).

executory contract . . . and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision . . . that is conditioned on . . . the commencement of a case under this title."[119] This section is intended to protect the debtor from termination on what may be an asset of the bankruptcy estate.[120] Section 365 also allows the debtor-in-possession or trustee to make the judgment call as to whether to continue to perform under that contract, reject the contract, or assign the contract for the benefit of the creditors.[121] The mere filing of the petition by a franchisor does not allow the supplier to terminate the supply contract.[122]

Returning to the hypothetical, McGillin's filing of a Chapter 7 bankruptcy petition does not constitute a material breach of the Supply Contract with Baines. Thus, the Supply Contract remains unaffected at the threshold of the bankruptcy filing under section 365(e).

B. Assumption or Rejection of an Executory Contract

The next issue is what the trustee will do with an executory contract after filing the bankruptcy petition. Under the Bankruptcy Code, in a Chapter 7 case, the trustee has the sole right to assume or reject an executory contract.[123] If the trustee assumes the contract, the analysis need not proceed because presumably the supply contract will continue to be performed.[124] Many times this will be the course of action in a Chapter 11 case because the debtor continues to operate the business and relieves itself of a portion of its debt.[125] Thus, the need for continued supply is present.[126] The decision to assume or reject in Chapter 11 is dependent upon whether a continuing performance will benefit the reorganization of the estate.[127]

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119. § 365(e).
120. *Id.*
121. *See In re* Chateaugay Corp., 10 F.3d 944, 954 (2d Cir. 1993).
122. § 365(e).
123. *Id.* § 365(a).
124. Tractenberg, *supra* note 105, at 4.
125. TABB, *supra* note 118, at 1039 (citing H.R. Rep No. 595, 95th Cong. 1st Sess. 220 (1977)).

> "The Purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and provide a return for its stockholders. . . . " In essence, chapter 11 is based on the idea "that a business is worth more alive than dead—i.e., it is worth more as a going concern than in a forced sale liquidation."

Id.

126. *Id.*
127. *In re* Chateaugay Corp., 10 F.3d 944, 954–55 (2d Cir. 1993).

> The main purpose of Section 365 is to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time providing "a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so." The estate's election to assume a contract or lease under Section 365 entitles the other contracting party to assert its claims on a priority basis. Section 365 does not confer any power of election upon the other contracting party.

Id. (citations omitted).

Chapter 7 involves a different decision under section 365 because the bankruptcy case is a liquidation, in which the debtor's business will not continue.[128] In liquidation, the bankruptcy trustee has the duty to act in the best interests of the creditors and other parties in interest; rejection of the contract may be the best course of action for the trustee.[129] The bankruptcy trustee may elect to assign of the contract, so long as the assignment will bring benefit to the Bankruptcy Estate or a minimum not cause a detriment to it.[130] If the contract is to be assigned, the trustee will have to first assume the contract and then assign it, the effect of which relieves the estate of the debtor of any liability under the contract.[131]

Assignment of a contract under section 365 has four requirements.[132] First, the trustee's assignment must not be in contradiction with the language of the contract.[133] Second, the trustee must assume the contract within sixty days of filing of the petition.[134] Third, prior to assignment all defaults of the debtor under the contract provisions must be cured.[135] Fourth, the assignee must give the nondebtor party adequate assurance of future performance under section 365(f)(2)(B).[136] The Bankruptcy Code does not define adequate assurance; this is a determination for the court on an *ad hoc* basis.[137] Factors used by courts include, but are not limited to, "payment history[,] evidence of profitability[,] amount of rent owing in the future[,] and financial condition."[138]

In the McGillin's hypothetical, if the Chapter 7 trustee assigns the Supply Contract to the franchisees, Farley's will get performance. If the trustee chooses to reject the contract, Farley's must take a two-step approach to force performance by the supplier; one step falls under the jurisdiction of the bankruptcy court and the other falls outside its jurisdiction.

C. Nonrelease of the Supplier from the Supply Contract

Pursuant to section 365, if the court approves the rejection of a supply contract, the supplier is released of his obligations to the franchisee.[139] However, section

128. TABB, *supra* note 118, at 108.
129. 11 U.S.C. § 704(a) (2006).
130. *Id.*
131. *In re Chateaugay Corp.*, 10 F.3d at 954–55 (citing 11 U.S.C. § 365(k)).
132. *See* § 365.
133. COLLIER, *supra* note 28, at ¶ 365.09.
134. § 365(d)(1) ("A contract will be deemed rejected if the trustee does not assume or reject it with in sixty days of filing.").
135. *Id.* § 365(b)(1)(A)–(B); *see In re* Superior Toy & Mfg. Co., 78 F.3d 1169 (7th Cir. 1996).
136. § 365(f)(2)(B).
137. *In re* LRP Mushrooms, No. 09-18529, 2010 WL 2772510, at *11 (Bankr. E.D. Pa. July 13, 2010).

> [T]he Bankruptcy Code does not define the phrase "adequate assurance of future performance." Compliance with this provision is determined on a case-by-case basis, dependent upon the facts and circumstances in each instance. A debtor need not prove that it will 'thrive and make a profit,' or provide an 'absolute guarantee of performance[.]'

Id. (citations omitted).
138. *Id.* at *12 (citing Connellsville Plaza v. Jiffy Foods Corp., 92 B.R. 136, 138 (W.D. Pa. 1988)).
139. *In re* Chateaugay Corp., 10 F.3d 944, 954–55 (2d Cir. 1993); 11 U.S.C. § 365.

524(e) may provide the franchise grounds to obtain specific performance.[140] This section states that the discharge of debt of a debtor does not affect the liability of nondebtor parties on the debt.[141] Generally, the bankruptcy court does not have the authority to release the liability of non-debtors.[142] In these circumstances, the position is that the debtor's (franchisor's) release of its contractual obligations does not affect the supplier's obligation to the franchisee, who is a third party beneficiary.[143] After establishing its right as a third party beneficiary, and in order to use section 524(e), the franchisee must establish that performance of the supply contract is a debt.[144]

The Bankruptcy Code states, "[t]he term 'debt' means liability on a claim."[145] The Supreme Court held that "the meanings of 'debt' and 'claim' [are] co-extensive."[146] Section 101(5) defines a claim as a "right to payment, whether or not such right is . . . equitable."[147] In section 101(5)(B), a claim is further defined as a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right . . . is reduced to a judgment, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured."[148] If a claim is a right to payment, which may be equitable, and a debt is liability on a claim, then a debt may be an equitable liability such as an obligation to perform.[149] Specific performance of a contractual obligation, an equitable remedy, is considered a debt when applying sections 101(5) and 101(12).[150] Therefore, performance of the supply contract is considered a debt.[151]

Section 524(e) of the Bankruptcy Code reads as follows: "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[152] How does this pertain to a franchisee's claim against a supplier who has contracted with a bankrupt franchisor?

The legislative intent of this subsection was to allow the debtor to be relieved of obligations under 524(a), while ensuring that no other party benefits from the

140. 11 U.S.C. § 524(e) (2006).

141. *Id.*

142. *See In re* Lowenschuss, 67 F.3d 1394, 1402 (9th Cir. 1995); *In re* Airadigm Commc'ns, Inc., 519 F.3d 640, 655–56 (7th Cir. 2008); *In re* Cont'l Airlines, 203 F.3d 203, 207–08 (3d Cir. 2000); *In re* Jet Fla. Sys., Inc., 883 F.2d 970, 973 (11th Cir. 1989).

143. *See In re Lowenschuss*, 67 F.3d at 1401–02.

144. *Id.*

145. § 101(12).

146. Pa. Dept. of Pub. Welfare v. Davenport, 495 U.S. 552, 558 (1990) ("[T]he Bankruptcy Code defines 'debt' as a 'liability on a claim.' This definition reveals Congress' intent that the meanings of 'debt' and 'claim' be coextensive."); *See also* COLLIER, *supra* note 28, ¶ 101.12 (citing *In re* Southmark Corp., 88 F.3d 311, 317 (5th Cir. 1996); *In re* Redburn, 193 B.R. 249, 261 (Bankr. W.D. Mich. 1996)).

147. § 101(5)(A).

148. *Id.* § 101(5)(B).

149. *Id.* §§ 101(5)(A)–(B), (12).

150. *Id.* §§ 101(5), (12).

151. *Id.*

152. *Id.* § 524(e).

debtors discharge.[153] "[I]t in no way precludes application of [this] section to third parties who may be indirectly liable to [the] plaintiff."[154] The National Bankruptcy Review Commission (Commission) gave a detailed report of this section using various Bankruptcy and Circuit Court decisions that applied this section.[155] The Commission recommended Congress amend the section to leave the release of nondebtor parties of their liabilities to the discretion of the creditors to whom the nondebtor owed that liability.[156] In reaching this recommendation, the Commission reasoned that "creditors are in the best position to determine whether they will benefit from the release of their claims against third parties through the bankruptcy process."[157] Moreover, the Commission, citing primarily to 9th and 10th Circuit cases from the early 1990s, determined that "bankruptcy courts lack the power or the jurisdiction to prevent a creditor from enforcing a judgment against a nondebtor party."[158] Under the Commission's recommendation, only voluntary releases will be permitted where a creditor shows an informed and willing release of its claim against a third party.[159] The decision whether to release should then be reviewed by the court.[160] If failure to release the nondebtor would be a detriment to the bankruptcy estate, the court could step in and enjoin these third party actions.[161]Applying the Commission's recommendation here, it is hard to imagine how the failure to release a supplier of its liability to the third party beneficiary franchisee could have any detrimental effect on the franchisor's bankruptcy estate. In this case, the contract represents no asset of the estate.

Section 524(e) is most frequently used in cases involving a debtor being released from liabilities for civil judgments.[162] Creditors seeking enforcement of these judgments against the debtor's insurance company typically use section 524(e) in proceedings against the insurance company outside of the Bankruptcy

153. PETER SULLIVAN & MICHAEL J. YAWORSKY, 3A Bankr. Service L. Ed. § 28:241 (2003). ("[The] language of 11 U.S.C.A. § 524(a) and (e) reveals that Congress sought to free debtor of personal obligations while ensuring that no one else reaps a similar benefit[.]").

154. *Id.* (citing Green v. Welsh, 956 F.2d 30 (2d Cir. 1992)).

155. *See* Nat'l Bankr. Rev. Comm. Final Report, *supra* note 104.

156. *Id.* at 534.

> Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.

Id.

157. *Id.* at 535.

158. *Id.* at 535 n.1338.

159. *Id.* at 538.

160. *Id.*

161. Nat'l Bankr. Review Comm. Final Report, *supra* note 104, at 538 (citing *In re* Master Mortg. Inv. Fund, Inc., 168 B.R. 930, 935. (Bankr. W.D. Mo. 1994)).

162. *See In re* Segerstrom, 247 F.3d 218 (5th Cir. 2001); *In re* Edgeworth, 993 F.2d 51, 53 (5th Cir. 1993); Food Lion, Inc. v. S.L. Nusbaum Ins. Agency, Inc., 202 F.3d 223 (4th Cir. 2000); Waterson v. Hall, 515 F.3d 852, 856 (8th Cir. 2008); *In re* Hendrix, 986 F.2d 195, 197 (7th Cir. 1993); *In re* Jet Fla. Sys., Inc., 883 F.2d 970, 976 (11th Cir. 1989); Hejmanowski v. Bykowicz, No. 09-CV-915A, 2010 WL 161446 (W.D.N.Y. Jan. 13, 2010); U.S. Fire Ins. Co. v. Weishorn, No. 3:08 CV 226-MU, 2009 WL 3300040 (W.D.N.C. Oct. 13, 2009).

Court system.[163] Section 524(e) was applied to a dispute involving a bankrupt franchisor in 1994 by the U.S. Bankruptcy Court in the Eastern District of Pennsylvania.[164] The case of *In re West Coast Video Enterprises, Inc.* involved an action brought by franchisees against the debtor and the debtor's principals.[165] The franchisees motioned the Bankruptcy Court to reopen a Chapter 11 bankruptcy case and invalidate a release of the debtor and certain named principals.[166] This release was part of the Chapter 11 reorganization plan.[167] The franchisees signed this release as part of the sale of their franchise to a third party.[168] Before bringing this motion, the franchisees filed a claim in the Pennsylvania Court of Common Pleas against the debtor and its principals seeking damages for misrepresentations concerning the franchise agreement.[169] The Bankruptcy Court, applying section 524(e), held that the release signed by the franchisees did not preclude them from bringing claims against the non-debtor parties who were not named in the release.[170] In reaching this decision, the Court applied a five criteria test.[171]

Although this test is specific to Chapter 11 cases, the rule coming out of this case applies to the McGillin's hypothetical.[172] In *Westcoast*, the principals to the debtor were not named in the release; therefore, they were not relieved from their liability for the misrepresentation claim or breach of the franchise agreement.[173] Likewise, in the McGillin's hypothetical, Farley's is a third party beneficiary to the Supply Contract. Therefore, Baines is not released of its obligation to perform the Supply Contract by McGillin's Chapter 7 bankruptcy petition. McGillin's next course of action is to pursue a specific performance in a nonbankruptcy forum using section 524(e) to show that Baines is still obligated to the franchisees as third party beneficiaries of the Supply Contract.

163. *See In re Segerstrom*, 247 F.3d 218; *In re Edgeworth*, 993 F.2d at 53; *Food Lion*, 202 F.3d 223; *Waterson*, 515 F.3d at 856; *In re Hendrix*, 986 F.2d at 197; *In re Jet Fla. Sys., Inc.*, 883 F.2d at 976; *Hejmanowski*, 2010 WL 161446; *U.S. Fire Ins. Co.*, 2009 WL 3300040.
164. 174 B.R. 906, 911 (Bankr. E.D. Pa. 1994).
165. *Id.* at 907.
166. *Id.*
167. *Id.* at 908.
168. *Id.*
169. *Id.*
170. *In re Westcoast Video Enterprises, Inc.*, 174 B.R. at 911.
171. *Id.* (citing *In re* Master Mortg. Inv. Fund, Inc., 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994)).

> (1) There is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate. (2) The non-debtor has contributed substantial assets to the reorganization. (3) The injunction is essential to reorganization. Without it, there is little likelihood of success. (4) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment. (5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

Id.

172. *Id.* at 908.
173. *Id.* at 912.

VI. ASSERTING A RIGHT TO SPECIFIC PERFORMANCE

Food supply contracts in the franchise relationship are also sale of goods contracts.[174] Generally, sale of goods contracts are covered by state contract law, and a majority of states have adopted the Uniform Commercial Code (U.C.C.).[175] Section 2-716 of Article 2 of the U.C.C. provides for specific performance "where the goods are unique or in other proper circumstances."[176] The goal of awarding specific performance in sale of goods contracts is "to give the buyer rights to the goods comparable to the seller's rights to the price."[177]

Pursuant to section 2-716, a buyer may obtain specific performance "if after reasonable effort he is unable to effect cover for such goods or the circumstances reasonably indicate that such effort will be unavailing."[178] The test for uniqueness under the U.C.C. is not only specific to the goods, but also determined by looking at the totality of the circumstances surrounding the contract.[179] "[U]niqueness is not the sole basis of the remedy under this section for the relief may also be granted 'in other proper circumstances' and inability to cover is strong evidence of 'other proper circumstances.'"[180] When a court decides to award specific performance on a contract, the court "may include such terms and conditions as to payment of the price, damages, or other relief as the court may deem just."[181] In sum, to get specific performance on a sale of goods contract, the buyer must prove three elements: (1) uniqueness of goods identified by the contract (looking at the totality of circumstances surrounding the contract); (2) no cover is available; and (3) the requesting party "demonstrate that remedies at law are incomplete and inadequate to accomplish substantial justice."[182] The buyer must prove this by a preponderance

174. U.C.C. § 1-201(18) (2010) ("'Fungible goods' means: (A) goods of which any unit, by nature or usage of trade, is the equivalent of any other like unit; or (B) goods that by agreement are treated as equivalent."); § 1-201(12) ("'Contract', as distinguished from 'agreement', means the total legal obligation that results from the parties' agreement as determined by [the Uniform Commercial Code] as supplemented by any other applicable laws."); *see also* §§ 2-106–107.

175. *States Adopting the UCC, Uniform Commercial Code*, USLEGAL, http://uniformcommercialcode.uslegal.com/states-adopting-the-ucc/ (last visited Jan. 30, 2013).

176. U.C.C. § 2-716(1) (2011).

177. *Id.* § 2-716 cmt. 4.

178. *Id.* § 2-716(3).

179. *Id.* § 2-716 cmt. 2 ("The test of uniqueness under this section must be made in terms of the total situation which characterizes the contract.").

180. *Id.*

181. *Id.* § 2-716(2).

182. Lucente v. Int'l Bus. Machines Corp, 310 F.3d 243, 262 (2d Cir. 2002); *see also* Barton Grp., Inc. v. NCR Corp., 796 F. Supp. 2d 473, 502 (S.D.N.Y. 2011); Smart & Co. v. Food Sys. Global Co., No. 08-5079, 2008 WL 4381679, at *5 (D. Minn. Sept. 26, 2008).

> [A buyer] is entitled to specific performance to obtain the [g]oods under the Uniform Commercial Code. . . . "where the goods are unique or in other proper circumstances". . . . [and] "for goods identified to the contract if after reasonable effort the buyer is unable to effect cover for such goods or the circumstances reasonably indicate that such effort will be unavailing . . . ."

Smart, 2008 WL 4381679, at *5.

of the evidence.[183] Courts then apply a balancing test, weighing the possible irreparable harm of not granting specific performance to the buyer against the likelihood of irreparable harm to the seller if specific performance is granted.[184]

Several courts have applied the U.C.C. test for specific performance to supply agreements.[185] The Delaware Chancery Court used the U.C.C. test as enacted under Delaware statute in *E.I. du Pont de Nemours & Co. v. Bayer CropScience L.P.*[186] In this case, the plaintiff sought a preliminary injunction against the defendant enjoining the defendant from terminating a supply agreement for a patented chemical used by the plaintiff in the production of USDA safe herbicide.[187] The defendant claimed the plaintiff breached the license agreement by manufacturing another product with the patented chemical.[188] The Court applied the U.C.C. test and looked at the four corners of the supply agreement.[189] Although the product was unique under this test and cover was not available, the granting of specific performance would cause irreparable harm as the use of the product outside the license agreement competes directly with the defendant's own product in that category.[190]

In *Barton Group, Inc. v. NCR Corp.*, the plaintiff, a food packaging consultant, sued the defendant, a food packager, for specific performance on a contract provision granting the plaintiff a percentage of future sales.[191] The Southern District of New York stated that specific performance is allowable in unique circumstances; "'[a] court may grant specific performance where money damages would not suffice, such as when 'the subject matter of a particular contract is unique and has no established market value.'"[192] The court held that specific performance was not the correct remedy because the payment of money was not a unique circumstance and the payment of a percentage of future sales was too speculative.[193]

Applying the U.C.C. and the common law test to the McGillin's hypothetical, the franchisee must prove four things in order to obtain specific performance of the Supply Contract. First, it must show unique circumstances. In this case, Baines is the exclusive supplier of Mozzy's, the menu includes the brand name for Mozzy's, and the menu price is set at an amount that affords the margins that allow the restaurant to function profitably. Second, it must show there is no available cover for this product. Because Baines is the exclusive distributor of this product, there is

183. Naughty Monkey LLC v. Marinemax Ne. LLC, No. C.A. 5095 VCN, 2010 WL 5545409, at *8 (Del. Ch. Dec. 23, 2010).

184. *Id.*; *see also* E.I. du Pont de Nemours & Co. v. Bayer CropScience L.P., 958 A.2d 245, 251 (Del. Ch. 2008); Int'l Casings Grp, Inc. v. Premium Standard Farms, Inc., 358 F. Supp. 2d 863, 877 (W.D. Mo. 2005).

185. *See generally* Naughty Monkey, 2010 WL 5545409; E.I. du Pont de Nemours, 958 A.2d 245; Int'l Casings Group, 358 F. Supp. 2d 863.

186. 958 A.2d 245.

187. *Id.* at 246.

188. *Id.*

189. *See id.*

190. *Id.* at 258.

191. 796 F. Supp. 2d 473, 476 (S.D.N.Y. 2011).

192. *Id.* at 502.

193. *Id.* at 503.

no other practical way of procuring this product and therefore, there is no available cover.

Third, the franchisee must prove that remedies at law are not adequate. In this case, legal remedies hinder Farley's ability to operate profitably. Baines has a counter argument that it could pay for the menus to be reprinted removing Mozzy's from the menu or raising the menu price. This argument fails because raising the menu price will reduce the franchisee's price advantage in relation to its competitors. This price increase will also disrupt the margin through reduced sales and increased food costs.

Fourth, the franchisee must be prepared to provide evidence that the remedy of continued performance by Baines outweighs the potential harm to Baines. The harm to Baines is the increased risk of breach by the franchisee if it becomes insolvent and cannot pay for deliveries or continue to purchase inventory which Baines has in stock. These circumstances provide the perfect backdrop for the formation of a purchasing cooperative among the franchisees who wish to continue operating. The existence of a cooperative will provide adequate protection to Baines. Such an entity can guaranty the purchases of the individual locations. The guaranty can be secured by collecting fees from members of the cooperative and placing those funds in an escrow account.

Purchasing cooperatives of this type are utilized in the food service industry. For example, the Pan Gregorian Group was formed by independent restaurateurs in the Northeast corridor, primarily New York, New Jersey, and Connecticut.[194] This group combines the purchasing power of its members, mainly of Greek heritage, to garner the best possible prices on staple food items and supplies they all use.[195] Purchasing cooperatives are not something new to the food industry. In 1926, the Independent Grocers Alliance (IGA) was formed "to ensure that the trusted, family-owned local grocery store remained strong in the face of growing chain competition."[196] Even the supplier arm of the food distribution channel utilizes the purchasing cooperative entity as a tool to garner the best possible pricing.[197] The Independent Marketing Alliance is a purchasing and marketing cooperative comprised of regional broad-line food service distributors.[198] The goal is to combine purchasing power of these distributors to compete with what is commonly known as the "big two" in the foodservice distribution industry; i.e. Sysco and U.S. Foodservice, Inc.[199]

After proving the elements of unique product or circumstances, no available cover, and no irreparable harm to the supplier, the franchisee stands a good chance of acquiring specific performance on the supply agreement.[200] Still, to secure this

194. *What is Pan Gregorian Enterprises*, *About Us*, PAN GREGORIAN ENTERPRISES, http://www.pge-nj.com/index.html (last visited Jan. 30, 2013).
195. *Id.*
196. *What is IGA*, *About IGA*, IGA, http://www.iga.com/about.aspx (last visited Jan. 30, 2013).
197. *Id.*
198. *Independent Marketing Alliance*, *Vision*, *Goals*, *Commitment*, IMA, http://www.imaforce.com/ (last visited Jan. 30, 2013).
199. *Id.*
200. *See* U.C.C. § 2-716 (2011).

remedy, the franchisee should take steps to show adequate protection for the supplier.[201]

VII. CONCLUSION

A gap exists in the Bankruptcy Code where franchisees may lose their supply chain upon the filing of a bankruptcy petition by the franchisor. In light of this gap, the major issue is: can a franchisee acquire specific performance on a supply contract when a franchisor has filed Chapter 7 bankruptcy and the franchisee is not expressly named in the supply contract? The answer is a qualified "yes." This issue will only arise if the Chapter 7 trustee rejects the supply contract under section 365 of the Bankruptcy Code. To obtain an order for specific performance of the supply contract, the franchisee must establish several things.[202]

Using the McGillin's hypothetical to explain this course of action, Farley's must establish a right as a third party beneficiary to the Supply Contract because it is not expressly named.[203] Farley's must prove it was an intended beneficiary, not merely an incidental beneficiary.[204] Several factors establish Farley's as a third party beneficiary to the supply contract: (1) the franchise agreement between McGillin's and Farley's obligates the franchisor to provide services such as negotiating supply contracts; (2) the obligation of Baines to deliver product to each franchise location under the Supply Contract; (3) the requirement that each franchise location pay Baines for deliveries; and (4) the reference to the franchise agreement in the payment section of the Supply Contract.

After establishing its right as a third party beneficiary, Farley's must then show that a rejection of the Supply Contract by McGillin's, under section 365 of the Bankruptcy Code,[205] has no effect on Baines pursuant to section 524(e) of the Bankruptcy Code.[206]

Finally, Farley's must file a complaint in nonbankruptcy court seeking specific performance under Article 2 of the U.C.C., or applicable state statute, for specific performance in contracts for the sale of goods.[207] To obtain specific performance, Farley's must show: (1) unique circumstances; (2) lack of cover; (3) no adequate remedy at law; and (4) the benefit of specific performance outweighs the potential harm to Baines.[208] To show this, the franchisees, who intend to continue operating, should consider establishing a purchasing cooperative to pool their purchasing power and provide the supplier with the security to continue performing under a

201. *Id.*
202. *Id.*
203. Parrish Chiropractic v. Progressive, 874 P.2d 1049, 1056 (Colo. 1994).
204. *Id.*
205. 11 U.S.C. § 365 (2006).
206. *Id.* § 524(e).
207. U.C.C. § 2-716 (2001).
208. *Id.*; *see also* Barton Grp., Inc. v. NCR Corp., 796 F. Supp. 2d 473, 502 (S.D.N.Y. 2011); E.I. du Pont de Nemours & Co. v. Bayer CropScience L.P., 958 A.2d 245, 251 (Del. Ch. 2008).

supply agreement—perhaps through a guaranty of purchase made by the individual members.