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Pinnacle Foods: The Consequences for Franchisees of Filing for Bankruptcy in a Hypothetical Test Jurisdiction Versus an Actual Test Jurisdiction

By Gregory G. Hesse and Kaleb Bailey*

In this article, the authors explain to franchisees the tests used by the courts regarding the assumption of executory contracts, including franchise agreements, and which jurisdictions adhere to which test, so franchisees faced with financial troubles can strategize accordingly.

A threshold issue for a successful reorganization of a debtor franchisee relates to the right of the debtor to assume the franchise agreement to continue to operate under the franchise banner. A recent decision out of the U.S. Bankruptcy Court for the Eastern District of California in *In re Pinnacle Foods of California LLC*,[1] serves to warn franchisees of the hypothetical third party test's often "devastating" effects on the ability of debtor franchisees to reorganize, "especially when [the] debtor franchisee depends upon the maintenance of the franchise for any kind of reorganization."

This article serves to educate franchisees on the tests used by the courts regarding the assumption of executory contracts, including franchise agreements, and which jurisdictions adhere to which test, so franchisees faced with financial troubles can strategize accordingly.

EXECUTORY CONTRACTS AND UNEXPIRED LEASES IN BANKRUPTCY

One of the many considerations for an entity contemplating filing for bankruptcy is section 365 of the Bankruptcy Code (Section 365). Section 365 provides a debtor in possession the power to "assume," "reject" or "assume and assign" executory contracts or unexpired leases.[2] Through this power, the debtor in possession can assume and retain executory contracts or unexpired leases it sees as favorable (so long as it cures most defaults, including monetary defaults)

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[1] In re Pinnacle Foods of California LLC, No. 24-11015-B-11, at 7 (Bankr. E.D. Ca. Sep. 10, 2024).

[2] 11 U.S.C. § 365(a).

or reject to unburden itself of others it sees as unfavorable (though the contract counterparty is entitled to file a proof of claim against the debtor asserting a right to rejection damages).[3]

This power, however, is not unlimited. Initially, Section 365 applies only to "executory contracts" and "unexpired leases." A contract is "executory" if "under the relevant state law governing the contract, each side has at least one material unperformed obligation as of the bankruptcy petition date."[4] If a contract is not "executory," it cannot be assumed or rejected and will simply give rise to a claim – either for or against the debtor's estate.[5] In the vast majority of cases, a franchise agreement will be considered an executory contract that is subject to Section 365.

Further, Section 365(c) limits a debtor in possession's ability to assume or assume and assign certain contracts and Section 365(d) provides that the debtor in possession must assume or reject the contracts in whole versus in part and within certain time limits.[6]

THE HYPOTHETICAL OR ACTUAL TEST

Section 365(c)(1) of the Bankruptcy Code provides that a debtor in possession:

> may not assume or assign any executory contract or unexpired lease . . . if – (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.[7]

The purpose of 365(c)(1) is to prevent debtors in possession from being able to force contract counterparties to accept performance from or render

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[3] 11 U.S.C. § 365(b).

[4] In re Weinstein Co. Holdings LLC, 997 F.3d 497, 504 (3d Cir. 2021); Matter of Thornhill Brothers Fitness LLC, 85 F.4th 321, 324 (5th Cir. 2023) ("[t]he term 'executory contract' refers to a contract that 'neither party has finished performing'").

[5] See Weinstein, 997 F.3d at 504-05 (explaining that if a debtor or counterparty has fully performed so as to make the subject contract nonexecutory, then the contract simply becomes an asset or liability of the estate).

[6] 11 U.S.C. § 365(c)&(d); Thornhill, 85 F.4th at 325-26 (discussing certain hurdles to assuming and assigning, including 365(c), and stating "[w]hen it comes to assuming an executory contract, we have been clear that it's all or nothing") (emphasis in original).

[7] 11 U.S.C. § 365(c)(1)(A)&(B).

performance to a third party in the event that the contract cannot be assigned under applicable non-bankruptcy law. The classic example of such a contract is a personal services contract for unique services.[8] Though the language of this statute is seemingly straightforward, federal circuit courts have disagreed over the interpretation and application of 365(c)(1).[9]

The U.S. Courts of Appeals for the Third, Fourth, Ninth and Eleventh Circuits read 365(c)'s language of "assume or assign" combined with "an entity other than the debtor or debtor in possession" to mean that 365(c)(1)'s limitation applies when a debtor in possession seeks to either assume and perform the executory contract itself or assume and assign the contract to a third party.[10] These courts reason that 365(c)(1)(A) requires courts to ask the hypothetical question of "under the applicable law, could the [contract counterparty] refuse performance from 'an entity other than the debtor or debtor in possession[?]'"[11] If the answer to this question is "yes" (i.e., under applicable nonbankruptcy law the contract counterparty's consent is required for the debtor to be able to assign the contract to a hypothetical third party), then the debtor in possession cannot assume and perform the contract itself nor can it assume and assign the contract to a third party. This approach is called the hypothetical test.

The U.S. Courts of Appeals for the First and Fifth Circuits read 365(c)'s language as not precluding courts from considering the question of whether the debtor in possession actually intends to assume and perform the executory contract or assign the contract to a third party.[12] These courts reason that this approach is more consistent with the overall objectives of the Bankruptcy Code in that it promotes the ability of debtors in possession to reorganize and that forcing a contract counterparty to accept performance from or render perfor-

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[8] See In re Catron, 158 Bankr. 624 (Bankr. E.D. Va. 1992), aff'd. 158 B.R. 629 (E.D. Va. 1992); aff'd 25 F.3d 1038 (4th Cir. 1994).

[9] If an executory contract or unexpired lease is nonassignable solely because it contains a nonassignment clause, Section 365(c) does not prevent the assumption or assumption and assignment of such contract or lease. 11 U.S.C. §365(f)(1).

[10] See In re West Elecs. Inc., 852 F.2d 79, 82-83 (3d Cir. 1988); RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257, 265-71 (4th Cir. 2004); Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747, 749-55 (9th Cir. 1999); City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534, 537 (11th Cir. 1994).

[11] West Elecs, 852 F.2d at 83.

[12] Summit Inv. & Dev. Corp. v. Leroux (In re Leroux), 69 F.3d 608, 612-14 (1st Cir. 1995); Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.), 440 F.3d 238, 248-51 (5th Cir. 2006).

mance to the debtor in possession, the entity with which it previously contracted, does not implicate the main concern of 365(c) of unfairness to the contract counterparty through forcing it to deal with an unfamiliar third party.[13]

Thus, if the debtor in possession actually intends to assume the contract, then despite potential applicable nonbankruptcy law preventing the debtor in possession from assigning the contract to a hypothetical third party, the debtor in possession can assume the contract. But, if the debtor in possession actually intends to assume and assign the contract, then applicable nonbankruptcy law will apply to protect the contract counterparty. This approach is called the actual test.

In the circuits not mentioned above, which test applies must be determined on a bankruptcy court by bankruptcy court basis.

Knowing whether a court will apply the hypothetical or actual test is an important consideration for a business facing the prospect of having to file for bankruptcy. Depending on the nature of the business, and the available applicable nonbankruptcy law, which test applies could potentially make or break a debtor in possession's effort to reorganize and keep operating its business. The *Pinnacle Foods* opinion highlights this risk specifically for franchisees.

PINNACLE FOODS: THE CONSEQUENCES OF FILING IN A HYPOTHETICAL TEST JURISDICTION

In *Pinnacle Foods*, Pinnacle, the franchisee, moved for an order to assume six separate franchise agreements with its franchisor and contract counterparty Popeyes Louisiana Kitchen Inc. (Popeyes).[14] Pinnacle's assumption of these franchise agreements was critical to its reorganization as Pinnacle's business consisted solely of operating six Popeyes fast food restaurants.[15] Pinnacle asserted that because it was curing any prepetition defaults under the franchise agreements as required by Section 365 of the Bankruptcy Code, it could assume the franchise agreements.[16]

Popeyes disagreed, arguing that though Pinnacle's plan proposed to cure prepetition defaults as required by Section 365, Pinnacle could not satisfy the

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[13] Leroux, 69 F.3d at 612-14.

[14] Pinnacle Foods, No. 24-11015-B-11, at 2.

[15] Id.

[16] Id.

365(c)(1) hypothetical test adhered to by the Ninth Circuit.[17] Specifically, Popeyes argued that the franchise agreements could not be assigned by Pinnacle without Popeyes' consent under the Lanham Act (applicable federal trademark law) and the California Franchise Relations Act (applicable state law).[18]

Initially, the court noted that the 365(c)(1) issue raised by Popeyes went to "the very heart of [the] case" because "[i]f Pinnacle cannot assume the Franchise Agreements, there is essentially no business left to reorganize, except perhaps by a sale of the franchises."[19] The court then discussed 365(c)(1)'s limitation on a debtor in possession's ability to assume and assign contracts and how a majority of circuit courts, including the Ninth Circuit, use the hypothetical test when deciding whether the limitation applies.[20]

Then, acknowledging the "devastating effects" the hypothetical test can have on the ability of debtors in possession to reorganize, "especially when a debtor franchisee depends upon the maintenance of the franchise for any kind of reorganization," the court held that the hypothetical test prevented Pinnacle from assuming the franchise agreements because both the Lanham Act and the California Franchise Relations Act separately provided that Pinnacle would need to obtain Popeyes' consent in order to assign the franchise agreements to a hypothetical third party.[21]

THE TAKEAWAY FOR FRANCHISEES

As franchisees will have to deal with the Lanham Act and the franchise laws of the state whose law governs the franchise agreements in any case that they file, this case shows that a reorganization where the franchisee desires to continue operating its business is not possible in a hypothetical test jurisdiction unless the franchisor is willing to consent to either (i) the franchisee's assumption and continued performance of the franchise agreement, or (ii) the franchisee's assignment of such performance to a third party.

As the court here recognized:

> The application of the hypothetical test, in many situations, may give veto power over the possibility of [an] effective reorganization to the franchisor, who may also be a hostile creditor. Unfortunately, *dura lex*

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[17] Id. at 3.

[18] Id.

[19] Id. at 4.

[20] Id. at 4-6.

[21] Id. at 7-19.

sed lex – The law is hard, but it is the law.[22]

Thus, franchisees contemplating bankruptcy must understand these issues before filing for bankruptcy to ensure they do not meet a potential dead end as Pinnacle did in *Pinnacle Foods*. It may be the case that the geographic region in which the franchisee operates may not allow for a filing in an actual test jurisdiction, but if an actual test jurisdiction is available to the franchisee, those jurisdictions would allow for what Pinnacle was trying to do in its bankruptcy case. Franchisees should consult bankruptcy counsel on these issues prior to filing for bankruptcy, so that they can be best prepared.

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[22] Id. at 20.