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BANKRUPTCY LAW

Franchise Frenzy

Defending your business against an auto manufacturer Chapter 11

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As the top auto executives decide between taking a corporate jet to Washington, D.C., or carpooling down in eco-friendly hybrids to propose the latest iteration of a bailout package to save their companies, the country is in turmoil. The country is experiencing an unprecedented financial meltdown while in the midst of the political uncertainty that accompanies the sunset of one administration and the transition to its successor. In this context, it is virtually impossible to predict what will happen to the Big 3. As it stands today, it appears possible that a car czar will be appointed and the Big 3 will receive some modified bridge loan to give some interim stability to the factories in an attempt to stem job losses and stave off a Chapter 11 filing or filings.

If these funds prove insufficient to achieve the goal of sustainable viability, many dealers rightfully would be concerned about how a Chapter 11 bankruptcy process would impact their business. Naturally, there are hundreds of issues related to dealers that could arise; however, we opted to focus on just one: how would a Chapter 11 filing impact a manufacturer's ability to shut down a dealership point?

The bankruptcy code provides a Chapter 11 debtor with significant leverage over its contract counter-parties. For example, a debtor, in most instances, can assign a favorable contract to a third party as part of an asset sale notwithstanding a provision in the underlying contract prohibiting such a transfer. A debtor could also just reject an unfavorable contract with very few adverse consequences.

If a debtor rejects the contract, the counterparty's rejection damages (including those for future damages) are merely treated as prebankruptcy general unsecured claims. These claims are the lowest priority, coming ahead of only the debtor's equity holders, and are last to be paid and often only receive pennies on the dollar. This generally gives a distressed entity the greatest opportunity to reorganize.

Not all contracts, however, are treated identically under the bankruptcy code. For example, Section 365(n) of the code carves out special treatment for intellectual property licenses where the debtor is the licensor. 11 U.S.C. § 365. In broad terms, Section 365(n) still permits a debtor to reject an intellectual property license, but permits the debtor's licensee to elect to retain its rights under the license. An automobile dealer may have a keen interest in Section 365(n) because its dealership agreement typically contains a license to use its manufacturer's trademarks and trade names. While Section 365(n) likely does not have a direct benefit for dealers if a manufacturer files for bankruptcy, the circumstances of its addition to the bankruptcy code and relevant case law interpreting it are nevertheless instructive.

Congress added Section 365(n) to the bankruptcy code in direct response to the fourth circuit's decision in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol,* the debtor owned certain metal coating process technology and granted Lubrizol a non-exclusive license to use the technology. The debtor decided to reject Lubrizol's license so that the debtor would be free to sell or re-license the same technology free of the restrictions placed on such a transfer in Lubrizol's license. The Fourth Circuit, in deference to the debtor's business judgment, approved the rejection notwithstanding its potentially devastating effect on nondebtor Lubrizol.

Congress' reaction to the *Lubrizol* decision was swift. Congress added Section 365(n) to the bankruptcy code to give licensees like Lubrizol the ability to retain their rights under an intellectual property license even if the debtor elects to reject the license. In such a circumstance, the debtor would be free of any affirmative obligations under the license (such as updating the technology or continuing to train the licensee's personnel) but the licensee could still use the technology.

Since many intellectual property licensees base their entire business on the use of certain licensed technology, Congress intended Section 365(n) to provide licensees with comfort that their licenses (and by extension their own busi-

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ness) could not unilaterally be yanked out from under the licensee at any time if the licensor is in bankruptcy. The legislative history of section 365(n) discusses the fear that the *Lubrizol* holding would have a chilling effect on technological innovation in the United States because companies would be hesitant to rely on intellectual property licenses.

The legislative history, however, also recognizes case law holding generally that rejection should not be permitted if the harm caused to the nondebtor party is "grossly disproportionate" to the purported benefit to the debtor's estate. See, e.g., *In re Huang*, 23 B.R. 798 (9th Cir. B.A.P. 1982); *In re Petur U.S.A. Instrument Co., Inc.,* 35 B.R. 561 (Bankr. W.D. Wash. 1983). The disproportionate harm suffered by the licensee in *Lubrizol* is the root cause of any chilling effect the decision had on licensees. Congress' enactment of Section 365(n), therefore, was to prevent such "disproportionate harm" from befalling future licensees.

The challenge for automobile dealers in availing themselves of Section 365(n) protection is that their licenses are ordinarily for the use of their manufacturer's trademarks and trade names. The bankruptcy code definition of "intellectual property" which also defines the scope of Section 365(n) does not include the use of trademarks or trade names. Despite this apparent carve out, cases have applied Section 365(n) where the matter involved the use of both manufacturing processes and trade names. See, e.g., *In re Matusalem,* 158 B.R. 514 (Bankr. S.D. Fla. 1993). More recent case law on attempted rejection of trademark and trade name licenses, however, has held that Section 365(n) does not apply. See, e.g., *In re HQ Global Holdings, Inc.,* 290 B.R. 507 (Bankr. D. Del. 2003); *In re Centura Software Corp.,* 281 B.R. 660 (Bankr. N.D. Cal. 2002).

If a manufacturer were to seek bankruptcy protection, there is no doubt that one of its chief goals in this regard would be to reduce cash-burn and expenses to emerge as a smaller, yet more financially stable enterprise. One of the significant steps in achieving this goal would be to reduce the number of dealers nationwide. In fact, some recent reports indicate that thousands of points would need to be shuttered.

Outside of bankruptcy, if a manufacturer desires to terminate a franchise, the process would be cumbersome and would take almost a year. For example, with respect to the standard Dealer Sales and Service Agreement between General Motors Corporation and dealerships, Section 14.5 enables GM to terminate the agreement upon the occurrence of certain events such as: conviction of the dealer operator, insolvency of the dealer, going dark for over seven days, misrepresentation of the dealer, false application of the dealer or, most notably, failure of performance by a dealer. This general failure of dealer performance, appears to give GM greater discretion in termination. That provision, Section 13.2 provides as follows:

> **Failure of Performance by a Dealer** — If General Motors determines that Dealer's Premises are not acceptable, or that Dealer has failed to adequately perform its sales or service responsibilities, including those responsibilities relating to customer satisfaction and training, General Motors will review such failure with Dealer.
>
> As soon as practical thereafter, General Motors will notify Dealer in writing of the nature of Dealer's failure and of the period of time (which shall not be less than six months) during which Dealer will have the opportunity to correct the failure.
>
> If Dealer does not correct the failure by the expiration of the period, General Motors will so advise the Dealer in writing. If, however, Dealer remains in material breach of its obligations at the expiration of the period, General Motors may terminate the Agreement by giving Dealer 90 days advance written notice.

Thus, pursuant to these contractual rights, termination by GM could take close to a year. Further, manufacturers are generally limited by state law in their ability to terminate franchise agreements. Accordingly, often times, manufacturers and dealers enter into a mutual agreement to close a point under a buy-out agreement.

In a Chapter 11 bankruptcy setting, however, it is unclear whether the manufacturer would either have the financial resources or wherewithal to provide a global buy-out package to dealers. Rather, the manufacturer may just seek to utilize the powers of the Chapter 11 bankruptcy court to execute a series of wholesale dealership terminations. In such an event, the question arises whether a dealer or dealership committee (representing all or a group of dealers) could defend, delay or derail such a drastic measure.

While it may provide little or no direct benefit to dealers, consideration of Section 365(n) and the rationale behind it, dealers could gain some traction in fighting off unilateral rejection by the manufacturer. Rejection is ordinarily subject to the very broad so-called "business judgment rule" which is exceptionally deferential to the debtor's decisions.

By explaining the rationale and legislative history behind Section 365(n), dealers may be able analogize their situation to the unfortunate licensee in *Lubrizol*. Although the *Lubrizol* court lacked any tools at the time to overrule the debtor's business decision to reject, a bankruptcy judge today benefits from the hindsight of the *Lubrizol* experience. A bankruptcy judge may pause before permitting a Big 3 manufacturer to put a dealer out of business through rejection. This may represent, perhaps, the dealers' best opportunity to force the manufacturer to negotiate. ■