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Executory Contracts in Bankruptcy: Navigating the Legal Ambiguities

Best Practices for Debtors and Creditors in Assuming or Rejecting Contracts

THURSDAY, MARCH 1, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Executory Contracts in Bankruptcy

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What is an Executory Contract?

The Countryman Definition

Under the classic Countryman definition, a contract is an "executory" contract if

> the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.

Vern Countryman, *Executory Contracts in Bankruptcy (Part 1)*, 57 Minn. L. Rev. 439, 460 (1973) (emphasis added).

- The Countryman definition is widely accepted as the guide for determining whether or not a contract is “executory” and thus subject to assumption or rejection under Section 365. *See, e.g., COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 381 (2d Cir. 2008).

An Additional Test: The Functional Approach

- Under the Functional Test, a court "looks to whether assumption or rejection of the contract in question would benefit the debtor's estate, regardless of whether any material obligations remain outstanding on the part of only one party to the contract." *In re: Worldcom*, 343 B.R. 486 (Bankr. S.D.N.Y. 2006).
- A number of courts have used the functional test in determining whether a contract is executory. *See, e.g. In re Lavigne*, 114 F.3d 379, 386-87 (2nd Cir. 1997); *In re Austin Development Co.*, 19 F.3d 1077 (5th Cir. 1994); Chattanooga Memorial Park v. Still (In re: Jollly), 574 F.2d 349 (6th Cir. 1978); *see, also*, *Stevens v. CSA, Inc*., 271 B.R. 410 (D. Mass. 2001) (noting that courts in First Circuit can use both Countryman Standard and Functional Approach in evaluating a contracts executoriness).

Disguised Financing

A "lease" may be recharacterized as a disguised financing arrangement and, thus, 365 of the Bankruptcy Code would not be applicable. Courts generally consider some or all of the following factors : (1) whether the agreement includes a purchase option at the end of the lease and whether the option exercise price is nominal; (2) whether the value of the total lease payments is greater than or equal to the original cost of the leased property; (3) whether the lease term covers the entire useful life of the subject property; (4) whether the lease payments were calculated to provide a return on an investment, rather than payment for use of the subject property; (5) whether the lease payments were calculated at market rate; (6) whether the lessee's obligations are those obligations ordinarily associated with ownership of property; (7) whether the property was purchased by the lessor specifically for the lessee's use; and (8) the intent of the contracting parties. In re Integrated Health Services, Inc., 260 B.R. 71, 75-76 (Bankr. D. Del. 2001).

Master Leases and Other Master Contracts

- ***General Rule:*** In order for a contract or lease to be assumed or rejected under §365 of the Bankruptcy Code, the contract or lease must be assumed or rejected in its *entirety. See, e.g., N.L.R.B. v. Bildisco & Bildisco*, 104 S. Ct. 1188, 1199 (1984) (when a trustee or debtor exercises assumption rights under Section 365 "it assumes the contract *cum onere*“).
- ***Exception*:** If a contract or lease can be divided into several different agreements, some of the agreements may be assumed or rejected under § 365 - without assuming or rejecting the entire contract or lease.

Is the Contract or Lease Severable?: Intent of the Parties and The Gardinier Test

- *In re Gardinier*, 831 F.2d 974 (11th Cir. 1987) ("Gardinier"). In *Gardinier*, the Eleventh Circuit developed a three-pronged test to determine severability. The Gardinier court employed three factors: (i) the nature and purpose of the obligations (are they the same or different); (ii) whether the consideration paid for the obligations is separate and distinct; and (iii) the extent to which the respective obligations are interrelated.

Is the Contract or Lease Severable?: Tests for Severablity Continued

- **Intention of the Parties**: Courts consider the intent of the parties in determining whether multiple documents were meant to be one integrated agreement, or a single document was intended to be a collection of severable agreements. See, e.g., *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. 837 (Bankr. C.D. 1999).
- **Timing of Execution:** Some courts have found that agreements that were executed by the same parties, at the same time and for the same purpose, should be construed as a single, integrated contract for purposes of Section 365. *See, e.g.*, *Ameritrust Co. N.A. v. White*, 73 F.3d 1553 (11th Cir. 1996); *Carvel Corp. v. Diversified Management Group, Inc. (In re Carvel Corp.)*, 930 F.2d 228 (2nd Cir. 1991).

Effect of Post-Petition Conduct

- Post-petition events can affect the ability of a debtor to reject.
- **Expiration of a contract by its own terms**: *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co*., 855 F.2d 1054, 1061 (3d Cir. 1988) ("[a] contract may not be assumed under § 365 if it has already expired according to its terms").
- **Action by the debtor:** *In re Spectrum Info. Techs., Inc.*, 193 B.R. 400, 404 (Bankr. E.D.N.Y. 1996) (finding employment agreement no longer executory where debtor discharged employee after petition was filed and prior to motion to reject agreement, as employee "no longer had any material unperformed obligations under the . . . [a]greement").

Post-Petition Events Continued

- Unilateral conduct by the non-debtor party, however, cannot prevent invocation of a debtor's 365 rights. See, e.g. *COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 381 (2d Cir. 2008)(case law does not support the "notion that a non-debtor party's unilateral post-petition actions can vitiate the executory status of a contract where the debtor has done no more than exercise its Code-granted right to enjoy 'breathing space' while deciding whether to assume or reject the contract.").

Unexpired Leases: Options

- The choices available to the debtor include the following:
  1) the debtor may assume the lease,
  2) the debtor may reject the lease, or
  3) the debtor may assume the lease and then assign the lease to another party.

Unexpired Leases: Time to Decide

- **Nonresidential Real Property**: Under the Bankruptcy Code, the debtor-lessee is allowed a minimum of 120 days to decide between three potential courses of action with respect a lease of nonresidential real property. 11 U.S.C. § 365(d)(4)(A).
- **Residential Real Property or Personal Property**: Under Chapters 11 and 13, the debtor may assume or reject an unexpired lease of residential real property or of personal property at any time before the confirmation of a plan, unless the court orders that the debtor make an earlier determination. 11 U.S.C. § 365(d)(2). In a Chapter 7 case, a lease of residential real property or of personal is automatically deemed rejected if the trustee does not assume or reject the lease within 60 days after the petition is filed. 11 U.S.C. § 365(d)(1).

While You Are Waiting – The Debtor's Obligations

- Prior to assumption or rejection, the debtor is required to perform its obligations under a lease of non-residential, real property.
- The Debtor must timely perform under a lease of personal property within 60 days of the petition date.

Is the Obligation to the Non-debtor Landlord Superior to Other Post-Petition Obligations?

- Is this payment obligation an "administrative claim" and thus equal to all other administrative claims, or a special form of statutory payment senior to all others.
- Courts generally hold that a landlord does not have priority over other administrative claims. In re Ames Dep't Stores Inc., 306 B.R. 43 (Bankr. S.D.NY 2004); *In re PYXSYS Corporation*, 288 B.R. 309, 314 (D. Mass. 2003) ("(t)he majority view is that since §365(d)(3) contains no explicit authority for the payment of administrative rent claims as a priority to the derogation of other claims against the insolvent estate, these claims are not entitled to superpriority status."). Some courts, however, have held that a landlord is entitled to priority, and that the duty to pay lease obligations is senior to other post-filing expenses. *In re PYXSYS Corporation*, 288 B.R. 309, 314 (D. Mass. 2003); *In re Duckwall-ALCO Stores Inc*., 150 B.R. 965 (D. Kan. 1993).

Rejection By the Debtor-Lessor

- Under Section 365(h) of the Bankruptcy Code, "Congress has afforded tenants of debtors who are lessors special protections in the event a debtor as lessor rejects a lease…In the case of a Debtor/lessor's rejection of a lease, [the trustee or debtor-in-possession's power to reject] is limited and tenants are given two options: either treat the lease as terminated and make a claim for damages, or continue in possession and pay rent." *In re Haskell L.P.*, 321 B.R. 1, 6-7 (Bankr. D. Mass. 2005).

Rejection By The Debtor Tenant of a Nonresidential Lease

- When a lease is rejected, the landlord is entitled to a general, unsecured lease rejection damages claim for the "rent reserved by such lease," without accelerating any payments, for the greater of either:
  1) one year, or
  2) 15%, not to exceed three years following the earlier of either (a) the date the debtor filed bankruptcy or (b) the date the landlord recovered possession of the property.

  15% of what? Courts are divided on whether the 15% applies to the total rent due or to the term remaining under the lease. *In re Connectix Corp*., 372 B.R. 488 (Bankr. N.D. Cal. 2007)(collecting cases).

The Rent Measurement Approach

- Rent – Under the rent measurement method, damages are calculated by calculating 15% of the total amount of rent due over the remaining life of the lease.
- Example –If a lease with 10 years remaining at a monthly rent of $10,000 is rejected, the rejection damages for future rents should be $180,000.00.
  - $10,000 x 12 months per year = $120,000 per year
  - $120,000 x 10 years = $1,200,000
  - $1,200,000 x .15 = $180,000 (which does not exceed three years rent of $360,000 and is greater than one year of rent of $120,000)

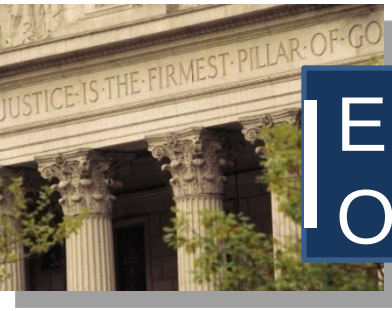
The Term Measurement Approach

- Term – Under the term measurement method, damages are calculated by the time remaining on the lease and, specifically, by calculating the rent due under the lease during the first 15% of the remaining lease term.

- This approach would make a difference in the amount of the landlord's rejection damages where the lease provides for lease payments that either increase or decrease as the lease term progresses.

What Is Included in the "Rent Reserved" Claim

- As noted above, when a lease is rejected, the landlord is entitled to a lease rejection damages claim for the "rent reserved by such lease," but what is meant by "rent reserved" and what does that mean for damages that do not fall within the definition of rent reserved? If they are allowed, are they subject to the statutory cap on damages?



Environmental, Removal, and Repair Obligations

- A question which often arises in the context of rejection is how costs associated with a tenant's failure to restore the property to pre-occupation condition and/or the removal of environmental wastes should be treated.

  Many courts conclude that these costs should be included as part of rejection damages and, thus, treated as general, unsecured claims. Factors considered by the courts, however, suggest that, under some circumstances, these damages might be entitled to priority treatment as a post-filing/pre-rejection obligations.

Key Factors in Determining How Removal, Repair, and Environmental Clean-up Costs Are Treated

- The timing of when the damage occurred or the hazardous materials were brought onto the property -- If the damage occurred post-filing but pre-rejection, the court might view the cost as an administrative expense.

- The wording of the lease provisions relating to removal, repair and environmental clean-up costs -- Is the wording of the lease such that the obligation to repair or remove does not arise until termination? Or, alternatively, is the language such that the obligation arises prior to termination?

Guarantors and the Statutory Cap On Damages

- Does the statutory cap apply to a third-party guarantor's obligations?
- The widely accepted view is that the statutory damages cap does apply to the guarantor's obligations where the guarantor is a debtor in bankruptcy.

Security Deposits and the Statutory Cap on Damages

- Is a security deposit a separate source of recovery or, alternatively, must the amount of the security deposit be deducted from the landlord's statutorily capped damages?
- The generally accepted view is that the amount of a debtor-tenant's security deposit should be deducted from the landlord's capped damages claim. If the security deposit is equal to or less than the landlord's capped claim, the landlord is entitled to recover only the remaining balance from the estate. If the amount of the security deposit is higher than the cap, the landlord is required to return the excess amount to the estate.

Letters of Credit and the Statutory Cap on Damages

- Is a letter of credit subject to the statutory cap on damages or is a letter of credit a separate source of recovery?
- Many courts have concluded that the amount recovered by the landlord on a letter of credit should be deducted from the landlord's capped damages claim. *See, e.g., Solow v. PPI Enterprises (U.S.) Inc. (In re PPI Enterprises (U.S.) Inc.)*, 324 F.3d 197 (3d Cir. 2003).

Assumption and the Business Judgment Rule

- The second option available to the debtor is assumption. The debtor may "assume" the lease and continue operating under it.
- The assumption of a lease must satisfy the "business judgment rule."
- A debtor's decision to assume a lease is generally given a high degree of deference by the courts.
- It is extremely difficult for a landlord to establish that assumption does not meet the Business Judgment Rule test.

Under the Bankruptcy Code, there are 3 general requisites which must be met before a lease that is in default may be assumed:

1) The default must be cured or adequate assurance must be given that the default will be cured promptly.
2) The other contracting party must be compensated or adequately assured of prompt compensation for monetary damages caused by the default.
3) Adequate assurance of future performance must be given.

Cure

- The Bankruptcy Code provides that, to assume a lease in which a default has occurred, the debtor must cure the default and provide compensation for any actual pecuniary loss resulting from such default, or provide adequate assurance that cure and compensation will occur promptly.
- In many cases, a "cure" will require the payment of past due rental or other monetary obligations.

Attorney's Fees

- The required cure of defaults does not create an independent right to attorney's fees

- However, if the lease provides for attorney's fees and the default triggers entitlement to attorney's fees under applicable non-bankruptcy law – the required cure includes attorney's fees

Defaults That Do Not Need to Be Cured

The Bankruptcy Code provides that the debtor is not required to cure a default that is a breach of a provision relating to:

(i) the insolvency or financial condition of the debtor;

(ii) the commencement of bankruptcy;

(iii) appointment or taking possession by a trustee in bankruptcy or a custodian before bankruptcy; and

(iv) any "penalty rate or provision" relating to a default arising from debtor's failure to perform non-monetary obligations under the unexpired lease.

Non-Monetary Defaults

- If a cure of non-monetary defaults would be impossible, only monetary defaults need be cured in order for the lease to be assumed. 11 U.S.C. § 365(b)(1). For example, a debtor's failure to operate in the past cannot be cured.
- Once assumed, however, the debtor must cure non-monetary defaults.

Adequate Assurance of Future Performance

- In cases involving a pre-bankruptcy default, assumption of an unexpired lease in default may occur only when the debtor provides "adequate assurance" of future performance.
- The Bankruptcy Code is silent on what constitutes "adequate assurance of future performance."

Shopping Center Leases

The Bankruptcy Code offers special protection for landlords under shopping center leases by defining what constitutes adequate assurance of future performance in these leases.

Adequate Assurance of Future Performance In Shopping Center Leases

- The Bankruptcy Code provides that adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—
  - (A) of the source of rent, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
  - (B) that any percentage rent due under such lease will not decline substantially;
  - (C) that assumption or assignment of such lease is subject to all the provisions of the lease, including (but not limited to) provisions such as a radius, location, use, or exclusivity provisions, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
  - (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

Assignment

- Once assumed, the lease may be assigned to a third party.
- The assignee must provide adequate assurance of future performance whether or not there has been a default under the lease.

Executory Contracts in Bankruptcy: Resolving the Legal Ambiguities

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Intellectual Property and Licenses

What is Intellectual Property?

11 U.S.C. 101(35A):

- Trade secret;
- Invention, process, design;
- Patent application;
- Plant variety;
- Work of authorship protected under Title 17; and
- Mask work protected by copyright law.

Intellectual Property and Licenses

First Order of Business – Is the license really a license?

In re DAK Indus. Inc., 66 F.3d 1091 (9th Cir. 1995).

In DAK, Microsoft gave DAK a non-exclusive license to integrate Microsoft software into computer systems sold by DAK to end-users. The court concluded that the "license" was actually a sale, based on the following factors:

1. Pricing and timing of payment most closely resembled a sale (payment was due at signing and subsequent payments were based upon units sold and not duration of use of the software);
2. DAK received all rights under the agreement - DAK received all units upon first payment;
3. DAK was permitted to sell the software, not simply use it.

Holding: The "license" was a sale, and not a license. Therefore, Section 365 of the Code did not apply.

Intellectual Property and Licenses

Second Order of Business – Is the license an executory contract?

- **Is it exclusive?** A license is exclusive if the holder has all the rights of the copyright owner, to the extent of the license, such that the holder may freely transfer his rights. *See* 17 U.S.C. 201(d)(2); *Sony Corp. of America v. Universal City Studios, Inc*., 464 U.S. 417 (1984).
  - As a general rule, exclusive licenses are **not executory**. *In re Golden Books Family Entert*., 269 B.R. 300 (Bankr. D. Del. 2001).
- **Is it nonexclusive?** A license is non-exclusive if the holder does not obtain the rights of ownership, but instead acquires only a personal interest in the license. *In re CFLC, Inc*., 89 F.3d 673, 679 (9th Cir. 1996).
  - Non-exclusive licenses are **executory** (presuming material performance remains due). Most patent, trademark, technology and other intellectual property licenses are executory contracts. *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043, 1045 (4th Cir. 1985).

Intellectual Property and Licenses

Third Order of Business – Is it assumable/assignable?

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if-

- (1)(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 the debtor in possession; and
- (B) such party does not consent to such assumption or assignment[.]

See 11 U.S.C. 365(c).

Intellectual Property and Licenses

What does "applicable law" mean? It depends:

- Some courts say it's limited to state laws that enforce anti-assignment provisions. *Matter of Midway Airlines, Inc.*, 6 F.3d 492, 495 (7th Cir. 1993); *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984).
- Some courts say it's any law focused on the rights of the non-assigning third party and the material nature of the identity of the parties. *In re Magness*, 972 F.2d 689, 696 (6th Cir. 1992).
- But, the plurality of courts say…

Intellectual Property and Licenses

…applicable law is federal common law or copyright/patent/trademark law (17 U.S.C. 101 et seq.; 35 U.S.C. 261; 15 U.S.C. 1129). *Everex Systems, Inc. v. Cadtrax Corp*., 89 F.3d 673 (9th Cir. 1996); *In re Alltech Plastics, Inc*., 71 B.R. 686, 689 (W.D. Tenn. 1987).

- General Rule (the "hypothetical" test) – Since a non-exclusive license may not be assumed or assigned by a licensee under applicable copyright law, a debtor in possession licensee may not assume or assign a non-exclusive license absent the consent of the non-debtor party.
  - Contracts in which the debtor is licensee of intellectual property are inherently non-assignable under federal law absent the licensor's consent. *In re Catapult Entertainment, Inc*., 165 F.2d 747, 752 (9th Cir. 1999).
  - Followed at least in in Third, Fourth, Ninth, and Eleventh Circuits
- First and Fifth Circuits follow "actual" test, which looks to whether an actual assignment will occur. These courts have permitted debtors to assume and retain otherwise non-assignable contracts
- To be covered later in the program

Intellectual Property and Licenses

- Rejection of licenses: Section 365(n)
  - Only applies to licensors of intellectual property.
  - Trademarks not IP for purposes of Section 365. In re Exide Technologies, 607 F.3d 957 (3d. Cir. 2010).
  - Licensees have two options:
    1. Treat the contract as terminated (presuming the rejection amounts to a material breach). The licensee then loses its ability to use the content provided under the lease. The licensee has a claim for damages.
    2. Retain rights under the license to the same extent the rights existed immediately prior to the bankruptcy, subjection to Section 365(n)(B).

Personal Services Contracts

Personal Services Contract – A contract under which the parties' respective duties are so unique that the obligee has a substantial interest in having the original obligor perform, rendering the contract non-delegable.

- Professional services (physician, lawyer, architect);
- Option to purchase stock given to an employee;
- Agency agreement for the sale of land
- Certain government contracts
- It is possible for a contract to be "personal" to a corporate entity. *In re Compass Van & Storage Corp*., 65 B.R. 1007, 1010 (Bankr. E.D.N.Y. 1986).

Personal Services Contracts

- Section 365(c)(1) – Trustee may not assign an executory contract if applicable law excuses a party, other than the debtor, from performing under the contract.
- Virtually every state excuses a party from performing, e.g., *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 740 (Cal. 1957) ("[T]he duties imposed upon one party may be of such a personal nature that their performance by someone else would in effect deprive the other party of that for which he bargained. The duties in such a situation cannot be delegated.").

Ride-Through Doctrine

- Ride-Through Doctrine = Do Nothing Approach.
- The Bankruptcy Code does not require a Chapter 11 debtor to assume or reject an executory contract (although creditors commonly force the issue pursuant to Section 365(d)(2)).
- Application of the doctrine is often the result of the Debtor failing to expressly assume/reject and further failing to address the issue in the plan (sometimes through neglect, sometimes tactically).

Ride-Through Doctrine

Ride-Through Doctrine by Circuit

- First Circuit. *In re Dehon, Inc*., 352 B.R. 546 (Bankr. D. Mass. 2006) (neither approved nor rejected).
- Second Circuit. *In re Texaco, Inc*., 254 B.R. 56 (Bankr. S.D.N.Y. 2000) (approved).
- Third Circuit. *In re Polysat, Inc*., 152 BR. 886 (Bankr. E.D. Pa. 1993) (approved).
- Fourth Circuit. In re Jones, 591 F.3d 308 (4th Cir. 2010) (disapproved).
- Fifth Circuit. *Stumpf v. McGee*, 258 F.3d 392 (5th Cir. 2001) (approved).
- Sixth Circuit. *In re Pulaski Highway Exp., Inc*., 57 B.R. 502 (Bankr. M.D. Tenn. 1986) (abstaining from deciding); Matter of Fred Sanders Co., 22 B.R. 902 (Bankr. E.D. Mich. 1982) (acknowledging existence).
- Seventh Circuit. *In re Whitcomb & Keller Mortgage Co*., 715 F.2d 375 (7th Cir. 1983) (approved).
- Eighth Circuit. *In re Family Snacks, Inc*., 257 B.R. 884 (8th Cir. BAP 2001) (approved).
- Ninth Circuit. *In re JZZ L.L.C.*, 371 B.R. 412 (9th Cir. BAP 2007) (approved).
- Tenth Circuit. *In re Dynamic Tooling Systems, Inc*., 349 B.R. 847 (Bankr. D. Kan. 2006) (approved).

Ride-Through Doctrine

- Be aware of potential post-bankruptcy consequences:
  - Exercise of remedies
  - Likely no right to cure to salvage the contract
  - No discharge to limit liability
  - Ipso facto clause is enforceable
  - State law applies
- Creditors: Consider whether to “lie in wait”

Questions?

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Limitations on the Assumption and Assignment of Executory Contracts and Unexpired Leases

March 1, 2012

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Section 365(c) of the Bankruptcy Code

- An executory contract or unexpired lease may not be assumed or assigned if:
  - Applicable law excuses the counter-party from accepting performance from someone other than the debtor, and the counter-party objects to assumption or assignment (§ 365(c)(1));
  - Contract is a loan, debt financing, or agreement to issue a security to the debtor (§ 365(c)(2));
  - Contract is a lease of non-residential real property that was terminated prepetition (§ 365(c)(3)).

Section 365(e)(2) of the Bankruptcy Code

- "Ipso facto" provisions are enforceable where:
  - Applicable law excuses the counter-party from accepting performance from someone other than the debtor, and the counter-party objects to assumption or assignment (§ 365(c)(1)); or
  - Contract is a loan, debt financing, or agreement to issue a security to the debtor (§ 365(c)(2)).
- 365(c) vs. 365(e)(2) – These sections are substantially identical and are often interpreted synonymously.
  - Section 365(c) applies to restrict assignment/assumption regardless of what the contract says. *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984).
  - Section 365(e)(2) only operates by its terms if the contract provides for termination upon a bankruptcy filing.

Where "applicable law" precludes forced assumption or assignment

- This exception is most often used to refer to personal contracts.
  - Personal contracts are not assignable as a matter of common law and some state laws.
  - Example: Attorney contingency fee contracts are not assignable. *In re Tonry*, 724 F.2d 467 (5th Cir. 1984).
  - Example: Golf club memberships are personal contracts and thus are not assignable. *In re Magness*, 972 F.2d 689 (6th Cir. 1992).
  - The purpose of section 365(c)(1) is "to protect non-debtor third parties whose rights may be prejudiced by having a contract performed by an entity other than the one with which they originally contracted." *In re First Protection, Inc.*, 440 B.R. 821 (B.A.P. 9th Cir. 2010).
- Most courts apply the exception beyond personal contracts if there is a law or regulation addressing assignment.
  - *See Matter of Midway Airlines, Inc.*, 6 F.3d 492 (7th Cir. 1993) (rejecting the notion that section 365(c) relates only to personal contracts).
  - Example: Military weapons production contract not assignable in light of federal anti-assignment act (41 U.S.C. § 15(a). *In re West Electronics Inc.*, 852 F.2d 79 (3d Cir. 1988).

"Applicable Law" (cont'd)

- Courts differ as to how broad "applicable law" should be construed.
- Broad interpretation – "Applicable law" does not need to specifically address assignment.
  - Example: *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983): FAA, as operator of the Washington National Airport, was excused from accepting assignment of a lease for an airport gate because FAA regulations provided that "[n]o person may engage in any commercial activity on the Airport without the approval of, and under the terms and conditions prescribed by, the Airport Manager."
- Narrow interpretation – "Applicable law" must specifically excuse the counterparty from the result of an assignment.
  - *In re James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994): city ordinance which prohibited assignment of city contracts was not the same as a law that excuses city from accepting performance.
  - *In re Wills Motors, Inc.*, 133 B.R. 303 (Bankr. S.D.N.Y. 1991): state law which gave franchisees the right to reasonably withhold consent to an assignment did not qualify as an "anti-assignment" law.

Partnership and LLC Agreements

- Partnership Agreements
  - The Uniform Partnership Act provides that "no person can become a member without the consent of all the partners."
  - Majority view: The UPA's prohibition on assignment constitutes "applicable law" for purposes of section 365(c)(1) – partnership agreements are generally not assumable/assignable without consent. *In re Morgan Sangamon P'ship*, 269 B.R. 652 (Bankr. N.D. Ill. 2001); *In re Catron*, 158 B.R. 629 (E.D. Va. 1993).
  - Minority view: Court adopted a practical approach which looks to the "materiality of the identity of the partners to the performance of the obligations remaining to be performed under the partnership in question." *In re Antonelli*, 148 B.R. 443 (D. Md. 1992) (allowing assignment of partnership interests in real estate partnerships governing "matured" projects).
- LLC Agreements
  - Section 365(c)(1) does not apply to LLC membership agreements because assumption does not impact any non-debtor third party. *In re First Protection, Inc.*, 440 B.R. 821 (B.A.P. 9th Cir. 2010).
  - Several courts have said that the rights of non-debtor LLC members to exercise first rights of refusal to purchase a member's economic interest do not implicate an ipso facto prohibition under section 365(e). *Capital Acquisitions and Management Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006).

IP Licenses

- Copyright Licenses
  - Exclusive copyright licenses provide the debtor with a property right that is freely transferable. Non-exclusive copyright licenses cannot, as a matter of law, be assigned without the owner's consent. *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re Golden Books Fam. Ent., Inc.*, 269 B.R. 300, 309 (Bankr. D. Del. 2001).
- Patent Licenses
  - Both exclusive and non-exclusive patents are personal and nondelegable. *In re Catapult Ent., Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re Aerobox Comp. Structures, LLC*, 373 B.R. 135, 141 (Bankr. D. N.M. 2007).
- Trademark Licenses
  - Trademark licenses are not assignable absent a clause expressly authorizing it. *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011).

Franchise Agreements

- Franchise Agreements
  - Courts apply a case-by-case analysis to determine if a franchise agreement resembles a "personal services" contract. *See, e.g., In re Sunrise Restaurants, Inc.*, 135 B.R. 149 (Bankr. M.D. Fla. 1991) ("To run a Burger King retail establishment does not require a special knowledge in a conventional sense"); *Matter of Bronx-Westchester Mack Corp.*, 20 B.R. 139 (Bankr. S.D.N.Y. 1982) (distributorship agreement contained "no special personal relationship").
  - Some state laws also may be relevant to bar assignment, even if the franchise agreement itself is silent. *Wills Motors, Inc.*, 133 B.R. at 305 (examining a Connecticut law that allowed franchisors to reasonably withhold consent).
  - Courts have also analyzed franchise agreements as a form of license to use a trademark. *See In re Wellington Vision, Inc.*, 364 B.R. 129 (S.D. Fla. 2007).

"Applicable Law" – Hypothetical vs. Actual Test

- Section 365(c)(1) states that a trustee may not "assume or assign" an executory contract or unexpired lease if (a) applicable law excuses the counterparty from "accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession", and (b) the party does not consent.

- If read literally, section 365(c)(1) would prohibit even assumption by itself without assignment (e.g., a debtor itself seeks to continue performing under the contract).

"Applicable Law" – Hypothetical vs. Actual Test (Cont'd)

- Courts are split as to whether section 365(c)(1) should be interpreted to prohibit assumption by itself.
  - The "Hypothetical" Test: Some courts hold that a contract or lease may not be assumed if applicable law would excuse a hypothetical assignment.
    - Courts following this view adhere to the clear terms of the statute and the notion that "we must hold Congress to its words." *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 754 (9th Cir. 1999).
    - This view has been adopted by the 3rd, 4th, 9th and 11th Circuits. See *Catapult Entertainment, Inc.*, 165 F.3d at 755 (9th Cir. 1999); *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re James Cable Partners*, 27 F.3d 534 (11th Cir. 1994); *In re West Electronics, Inc.*, 852 F.2d 79 (3d Cir. 1988).
  - The "Actual" Test: Other courts hold that the restrictions under section 365(c)(1) apply only if the debtor intends to assign the contract or lease.
    - Courts following this view reason that a plain meaning of the statute undermines the legislative purpose of section 365(c)(1), because the mere assumption of a contract by a debtor in possession does not force the counterparty to accept performance from a third party. *See In re Footstar, Inc.*, 323 B.R. 566, 573 (Bankr. S.D.N.Y. 2005).
    - This view has been adopted by the 1st and 5th Circuits. *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997).
    - Courts in the 2nd, 6th, 8th and 10th Circuits have adopted the "actual" test. *Aerobox Composite Structures, LLC*, 373 B.R. 135 (Bankr. D.N.M. 2007); *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005); *In re Cardinal Industries, Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990); *Matter of GP Exp. Airlines, Inc.*, 200 B.R. 222 (Bankr. D. Neb. 1996)

365(c)(2) – Non-Assumable Loans

- The purpose of section 362(c)(2) is to ensure that a debtor cannot force a creditor "into the untenable position of having to extend straight cash to an insolvent debtor."
  - *In re Cannonsburg Env. Assocs., Ltd.*, 72 F.3d 1260, 1266 (6th Cir. 1996) (quoting 1 Collier Bankr. Manual 365.02[2] (3d ed. 1995)).
  - A debtor can use existing cash collateral (§ 364) but cannot draw new funds under a prepetition facility.
- A contract to make a financial accommodation
  - *In re United Airlines, Inc.*, 368 F.3d 720 (7th Cir. 2004) (Financial accommodation includes a guaranty or other form of suretyship); *In re Cole Bros., Inc.*, 154 B.R. 689 (W.D. Mich. 1992) (dealership agreements which contained terms for flooring facility were financial accommodations);
- The portion of an agreement which includes a contract to make a loan or financial accommodation must be the central purpose of the agreement.
  - *In re Thomas B. Hamilton Co., Inc.*, 969 F.3d 1013 (11th Cir. 1992); *see also United Airlines, Inc.*, 368 F.3d at 724 (explaining that a grace period under a lease does not render the lease nonassignable, simply because it has the effect of extending credit); *In re Charrington Worldwide Enterp., Inc.*, 110 B.R. 973 (M.D. Fla. 1990) (advance of funds to carriers on account of tickets sold by travel agents was not the central purpose of travel agency agreements); *In re Peaches Records and Tapes, Inc.*, 51 B.R. 583 (B.A.P. 9th Cir. 1985) (calculation of lease payments based on gross sales does not render lease a financial accommodation).

Non-Assumable Loans (Cont'd)

- Unlike contracts falling under section 365(c)(1), contracts that fall under section 365(c)(2) are unassumable even if the counterparty consents.
  - *In re Sun Runner Marine, Inc.*, 945 F.2d 1089 (9th Cir. 1991).

- One exception to section 365(c)(2) – loan agreements entered into in contemplation of a bankruptcy filing.
  - *In re TS Indus., Inc.*, 117 B.R. 682 (Bankr. D. Utah 1990): a debtor finalized prepetition in contemplation of a bankruptcy filing, but sought to reject the agreement when the debtor proposed an alternate plan. The creditors' committee opposed rejection, arguing that the prepetition facility formed the basis of its alternative plan. The court refused to approve rejection, and held that section 362(c)(2) would not apply because the lender specifically contemplated the bankruptcy case when negotiating the facility.

365(c)(3) – Terminated Leases of Nonresidential Property

- Section 365(c)(3) states that a lease of nonresidential real property may not be assumed or assigned if it was terminated prepetition.

- This provision stands for the noncontroversial notion that a lease of nonresidential property may not be assumed if it was terminated prepetition (regardless of continuing possession). *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala. 2003); In *re Hickory Point Indus., Inc.*, 83 B.R. 805 (M.D. Fla. 1988).

- Even if the prepetition termination could be avoidable, section 365(c)(3) upends the avoidance claim. *In re Haines*, 178 B.R. 471 (Bankr. W.D. Mo. 1995).

“Ride Through” Arguments

- What if a non-assumable/assignable contract is not addressed during the case?
  - *In re O’Connor*, 258 F.3d 392 (5th Cir. 2001): A general partner filed for chapter 11 bankruptcy relief, and the partnership agreement was neither assumed or rejected. Following confirmation, the chapter 11 trustee sought to recover amounts owed under the partnership agreement.
  - Held: The partnership agreement was not assumable under section 365(c)(1).
  - Held: Generally, executory contracts and unexpired leases which are neither rejected or assumed during a case, “ride through” and remain binding. Court held that the “ride through” doctrine applies even to agreements that are not assumable.
  - *See also In re Hernandez*, 287 B.R. 795 (Bankr. D. Ariz. 2002) (there is no difference between a contract that, under § 365(c)(1), cannot be assumed, and one which is neither assumed nor rejected. Each is simply unaffected by the bankruptcy proceedings.”).