Educational Materials

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(Almost) Everything You Wanted to Know About...Executory Contracts

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(ALMOST) EVERYTHING YOU WANTED TO KNOW ABOUT . . . EXECUTORY CONTRACTS

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Honorable Carol A. Doyle, with special thanks to Judge Doyle's law clerk, Erica Wax, for Part A of these Materials, regarding the scope of Section 365 of the Bankruptcy Code.

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Christopher Combest, for Parts C.1 through C.3 of these Materials, treating certain special issues raised by leases of real property.

Paul R. Hage, for Part D of these Materials, treating the rights and claims of non-debtor parties to executory contracts.

Lisa M. Schweitzer, for the portion of Part B of these Materials treating the assignment of executory contracts and unexpired leases generally, and for Part E, regarding licenses of intellectual property.

RULES OF CONSTRUCTION

For the purposes of these Materials:

– "Bankruptcy Code" refer to the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*

– The terms "Section" and "Sections" refer to sections of the Bankruptcy Code.

– Unless the context or discussion requires otherwise, the terms "contract" and "executory contract" are intended to include unexpired leases of real or personal property; and

– Because, in chapter 11, a debtor typically operates its business and manages its own affairs as a "debtor in possession," with largely the same duties and obligations as a bankruptcy trustee, these Materials will use the terms "trustee," "debtor in possession," and "debtor" interchangeably to refer to the entity exercising the authority to act with respect to the estate's executory contracts and unexpired leases.

A. SCOPE OF SECTION 365 OF THE BANKRUPTCY CODE

1. **Defining "executory contracts"**

Section 365 of the Bankruptcy Code governs the treatment of executory contracts and unexpired leases in a bankruptcy case. The term "executory contract" is not defined in the Bankruptcy Code. "Whether a contract is executory within the meaning of the Bankruptcy Code is a question of federal law." *In re First Protection, Inc.*, 440 B.R. 821, 831 (B.A.P. 9th Cir. 2010); *In re Soderstrom*, 484 B.R. 874, 879 (M.D. Fla. 2013).

a) Countryman *Definition*

The classic definition used by bankruptcy courts and practitioners was fashioned by Professor Vern Countryman, who defined an executory contract as "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy* (Part I), 57 Minn. L. Rev. 439, 460 (1973).

Therefore, in determining whether a given contract is executory, and thereby subject to the provisions of Section 365, the focus should be on whether the debtor and the other party to the contract still have significant obligations to perform prior to the filing of the petition. In applying Countryman's "material breach" test, a court must distinguish between a failure of a condition and a breach of a duty. *In re Hawker Beechcraft, Inc.*, 486 B.R. 264, 276 (Bankr. S.D.N.Y. 2013). The "executoriness" of a contract is determined as of the date of the filing of the bankruptcy petition. *In re Columbia Gas System Inc.*, 50 F.3d 233, 240 (3rd Cir. 1995); *In re Cent. Illinois Energy, L.L.C.*, 482 B.R. 772, 786-87 (Bankr. C.D. Ill. 2012) *aff'd sub nom. Rafool v. Evans*, 497 B.R. 312 (C.D. Ill. 2013). Contingent obligations are sufficient to render a contract executory. *In re Safety–Kleen Corp.*, 410 B.R. 164, 168 (Bankr. D. Del. 2009).

b) Bildisco Decision

Thirty years after it was decided, the Supreme Court's decision in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) ("*Bildisco*") continues to provide essential guidance regarding the treatment of executory contracts and unexpired leases in bankruptcy cases. As described in more detail elsewhere in these materials, *Bildisco* held, among other things, that:

1) While a debtor in possession is, conceptually, the same entity that it was before filing a bankruptcy petition, the Bankruptcy Code confers upon it powers to deal with its contracts, leases, and other property that it would not possess outside of bankruptcy.

2) In bankruptcy, prior to final disposition of an executory contact or unexpired lease, the contract or lease remains enforceable ***by*** the debtor against the non-debtor party, but ***not against*** the debtor by the non-debtor.

3) However, if a debtor elects to receive benefits (*e.g.*, goods; services; possession of leased premises) postpetition, it must pay for those benefits, but need pay only the fair value of the benefits received – while the agreed payment under the contract may represent fair value, the debtor may ask the bankruptcy court to find that actual "fair value" differs from the amount required under the contract.

2. **Agreements Excluded from Scope of Bankruptcy Code Section 365**

In determining whether a contract is executory, courts focus on whether the debtor and the other party to the contract had significant obligations to perform prior to the filing of the bankruptcy petition. If performance remains due on only one side, the contract is not executory. *In re Hawker Beechcraft, Inc*., 486 B.R. 264, 276 (Bankr. S.D.N.Y. 2013). If all that remains to be done under the contract is for the debtor to pay the creditor money, the contract is not executory. *In re Computer Utilization, Inc.*, 508 F.2d 673, 675 (5th Cir. 1975); *In re Cornwall Hill Realty, Inc.*, 128 B.R. 378, 381 (Bankr. S.D.N.Y. 1991).

B. ASSUMPTION AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

1. **Debtor's Options**

Under Section 365 of the Bankruptcy Code, a trustee or debtor-in-possession has the power to:

a) ***reject*** an executory contract or unexpired lease;

b) ***assume and retain*** an unexpired lease or executory contract; or

c) ***assume and assign*** an unexpired lease or executory contract (even if the lease or contract at issue prohibits assignment).

The decision to assume or reject is subject to court approval, and contracts and leases must be assumed *cum onere*, that is, as they are, with all benefits and burdens – generally, a contract (or lease) may not be assumed in part and rejected in part. *Bildisco*, 465 U.S. 513, 531-32 (1984); *In re National Gypsum Co.*, 208 F.3d 498, 506 (5th Cir. 2000). In addition, this right to assume or reject may not be waived by prepetition agreement. *Hayhoe v. Cole (In re Cole),* 226 B.R. 647, 651–52 (B.A.P. 9th Cir. 1998); *In re Trans World Airlines, Inc.*, 261 B.R. 103 (Bankr. D. Del. 2001).

2. **Court Approval**

In most instances, a trustee's decision to assume or reject an executory contract or unexpired lease is subject to the approval of the bankruptcy court. Section 365(a) ("the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"). *See Pacific Shores Development, LLC v. At Home Corp. (In re At Home Corp.)*, 392 F.3d 1064, 1065 (9th Cir. 2004); *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.)*, 67 F.3d 1021, 1025 (1st Cir. 1995) (court approval is a condition precedent to a rejection of a non-residential lease); *In re Frontier Props., Inc.*, 979 F.2d 1358 (9th Cir. 1992) (court approval of stipulation providing for the assumption of a lease satisfies requirement that an assumption or rejection be approved by the court); *In re MF Global Holdings Ltd.*, 466 B.R. 239 (Bankr. S.D.N.Y. 2012) (establishing procedures for rejection of executory contracts); *Duke Realty Ltd P'ship v. N. Metro Mill Work Distribs., Inc. (In re Manis Lumber Co.)*, 2009 Bankr. LEXIS 506 (Bankr. N.D. Ga. Feb. 6, 2009) (courts generally agree that rejection requires bankruptcy court approval).

However, when an *individual* chapter 7 debtor seeks to assume an unexpired lease of *personal property* under Section 365(p), courts have held that judicial approval is unnecessary. *In re Farley*, 451 B.R. 235, 241 (Bankr. E.D.N.Y. 2011) (court will not enter order approving or disapproving debtor's lease assumption under Section 365(p)); *In re Mortensen*, 444 B.R. 225, 230 (Bankr. E.D.N.Y. 2011) (court not required to approve a lease assumption under Section 365(p)); *In re Gaylor*, 379 B.R. 413 (Bankr. D. Conn. 2007) (same); *In re Walker*, No. 06–11514C–7G, 2007 WL 1297112 (Bankr. M.D.N.C. 2007) (same). Assumption by the individual debtor removes the lease and its associated liabilities from the debtor's bankruptcy estate. Therefore, Section 365(p) sets forth a process by which the debtor may directly negotiate with its creditor and assume a lease for personal property without judicial involvement.

3. **Timing of Assumption or Rejection**

The time within which the trustee or debtor in possession must assume or reject a contract or lease varies according to the type of agreement at issue and the chapter of the Bankruptcy Code under which the debtor's case is proceeding.

a) *Leases of Residential Real Property* vs. *Non-residential Real Property*

Different timing rules apply to the assumption and rejection of leases of residential real property as opposed to leases of non-residential real property.

Although the Bankruptcy Code does not explicitly define the term "***residential real property***," courts have found that, if the intent of the lease is that people reside on the property in question, the lease is one of residential real property, even if the property is not actually being used as

a residence at the time. *See In re Historical Locust St. Dev. Assocs.*, 246 B.R. 218, 220 (Bankr. E.D. Pa. 2000) (lease of real property to be used as a parking lot for a building containing 16 residential units was a residential lease); *In re Lippman*, 122 B.R. 206, 207 (Bankr. S.D.N.Y. 1990) (leases for three apartments, one of which was occupied by the debtor, one of which was sublet, and one of which was vacant, were residential leases); *In re Independence Village, Inc.*, 52 B.R. 715, 720-22 (Bankr. E.D. Mich. 1985) (lease for a life-care facility for the elderly was a residential lease); *In re Terrace Apts., Ltd.*, 107 B.R. 382, 383-84 (Bankr. N.D. Ga. 1989) (lease for low-cost military housing was a residential lease); *In re Care Givers, Inc.*, 113 B.R. 263, 265-68 (Bankr. N.D. Tex. 1989) (six leases for nursing homes were residential leases).

Conversely, however, the fact that real property is actually being used as a residence by someone is not necessarily determinative – for example, in a case where the use of the property as a residence is not legal. *See In re Michael H. Clement Corp.*, 430 B.R. 549 (Bankr. N.D. Cal. 2009) (lease was non-residential, where property was located in heavy industrial zone and property could not legally be used as residence, though debtor's principal and his family actually lived on property).

1) **Applicable Deadlines Regarding Leases of Residential Real Property and of Personal Property: Sections 365(d)(1) & 365(d)(2)**

In chapter 7 of the Bankruptcy Code: An unexpired lease of residential real property or of personal property is deemed rejected if it is not timely assumed within 60 days after the entry of the order for relief. Section 365(d)(1). The court may extend this time period for cause, but only if it fixes the new time period within the original 60-day deadline. When deciding whether to grant an extension of time, courts often consider several factors, including

(a) whether the rent has been or is being paid;

(b) whether the lease is a primary asset of the estate;

(c) the potential prejudice to the landlord from non-compensable damages;

(d) whether the landlord would receive a windfall;

(e) the size and complexity of the case; and

(f) whether the trustee or debtor-in-possession has had a reasonable period of time to analyze the estate and formulate a plan for reorganization.

See, e.g., S. St. Seaport Ltd. P'ship v. Burger Boys, Inc. (In re Burger Boys, Inc.), 94 F.3d 755, 761 (2d Cir. 1996); *Escondido Mission Village L.P. v. Best Prods. Co.*, 137 B.R. 114 (S.D.N.Y. 1992); *In re 611 Sixth Ave. Corp.*, 191 B.R. 295 (Bankr. S.D.N.Y. 1996) (including additional factors); *In re Columbus One Parcel Servs., Inc.*, 138 B.R. 194 (Bankr. S.D. Ohio 1992); *In re Muir Training Techs, Inc.*, 120 B.R. 154 (Bankr. S.D. Cal. 1990).

Generally, if the trustee fails to act within the 60-day period, the court may not extend the deadline. However, some courts have held that the doctrines of waiver and estoppel create exceptions to this rule in unusual cases. *In re Food Barn Stores, Inc.*, 174 B.R. 1010, 1014 (Bankr. W.D. Mo. 1994) (doctrines of waiver and estoppel are available in an unusual case to bar a landlord from asserting a deemed rejection by operation of Section 365(d)(4)); *In re THW Enters., Inc.*, 89 B.R. 351 (Bankr. S.D.N.Y. 1988).

Where a bankruptcy case is converted from one chapter of the Bankruptcy Code to another, the 60-day deadline begins to run from the date of conversion, if the time to assume has not yet expired – this is because the order for conversion is treated as a new order for relief under Section 348(a). *Carrico v. Tompkins (In re Tompkins)*, 95 B.R. 722, 724 (B.A.P. 9th Cir. 1989). But the period will not start anew if the 60-day period has expired prior to conversion from chapter 7 to another chapter. *Affordable Efficiencies v. Bane (In re Bane)*, 228 B.R. 835, 841 (Bankr. W.D. Va. 1998).

In chapters 9, 11, 12, and 13 of the Bankruptcy Code: For all other chapters, a lease of residential real property or of personal property may be assumed or rejected at any time prior to confirmation of a plan. But the court may set an earlier deadline on the request of any party. Section 365(d)(2).

2) **Applicable Deadlines Regarding Leases of Non-Residential Real Property: Section 365(d)(4) – applicable to all chapters of the Bankruptcy Code**

The Bankruptcy Code deems a lease of ***non-residential real property*** to be rejected, regardless of chapter, unless the debtor assumes the lease **within 120 days after the date of entry of the order for relief** (in a voluntary bankruptcy case, the date of the order for relief is the same as the date of the filing of the bankruptcy petition). Section 365(d)(4)(A).

The court may extend that period, without the landlord's consent, for a maximum of 90 days only (*i.e.*, to a maximum total of 210

days after the date of the order for relief); however, **any further extensions beyond that 210-day period require the prior written approval of the landlord**. Section 365(d)(4)(B). Moreover, the Bankruptcy Code, on its face, leaves the decision to consent or not to the landlord's sole discretion; therefore, landlords may negotiate for consideration from the debtor in exchange for consent to extensions of time beyond the 210-day period described above, such as advance payment of rent and/or taxes and other charges for the extension period. Although the landlord is not, in theory, required to be 'reasonable," the bankruptcy court need not approve terms that impose heavy financial burdens or risks on the debtor's estate.

Section 365(d)(4)(B) was added to the Bankruptcy Code in 2005. Before the enactment of the 2005 amendments, courts had discretion to grant repeated extensions of the period for assumption of leases of non-residential real property, through the confirmation of a plan of reorganization (which could be months or years after the commencement of the bankruptcy case). Some commentators have criticized the 2005 amendments that enacted the 210-day that is now the law, arguing that, in concert with other amendments enacted at the same time, the provision is unnecessarily protective of landlords, impairs significantly the ability of a debtor to extract value from its leaseholds for the benefit of its creditors, and has effectively doomed retail bankruptcy cases to being quick sales of assets for the primary benefit of secured lenders. For a more detailed explication of this position, see, for example, Lawrence C. Gottlieb, *The Disappearance of Retail Reorganizations under the Amended Section 365(d)(4)* (2013).

b) *Notice*

1) Generally, requests for approval of assumption or rejection of a contract or lease are made by motion to the bankruptcy court and must be noticed to the other party to the subject contract or lease, other parties in interest as the bankruptcy court may direct, and (except in chapter 9 cases) to the United States Trustee. *See* Fed. R. Bankr. P. 6006(a), 6006(c). However, a separate motion is not required as to a contract or lease that is to be assumed or rejected under a plan of reorganization, although proper notice of the intent to assume or reject is still required. *Century Indemnity Co v. NGC Settlement Trust (In re National Gypsum Co.)*, 208 F.3d 498, 513 (5th Cir. 2000).

2) Subject to Fed. R. Bankr. P. 6006(e) and 6006(f), a trustee may seek to assume or reject multiple contracts and/or leases in a single motion.

3) Motions to assume or assign contracts and leases may not be granted during the first 21 days after the filing of the bankruptcy petition, *except* to avoid irreparable harm. Fed. R. Bankr. P. 6003(c). This limitation does not apply to motions to *reject* contracts and leases.

4. **Rejection: Prerequisites and Effect**

a) *General Standard: The Business Judgment Rule*

Most courts apply the business judgment rule when deciding whether to approve the decision to reject a contract or lease. *Cor 5 Route Co. v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 383 (2d Cir. 2008); *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir. 1985); *In re Old Carco LLC*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009); *In re Pilgrim's Pride Corp.*, 403 B.R. 413 (Bankr. N.D. Tex. 2009). A minority of courts have held that an executory contract must impose some loss or detriment upon the bankruptcy estate for the trustee to reject it. *In re Jackson Brewing Co.*, 567 F.2d 618 (5th Cir. 1978) ; *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951); *In re Vidicom Sys., Inc.*, 7 C.B.C. 568 (S.D.N.Y. 1975); *American Brake Shoe & Foundry Co. v. New York Rys. Co.*, 278 F. 842 (S.D.N.Y. 1922). Most courts, however, have rejected this view, finding that the profitability of the contract is not determinative. *See e.g., Group Inst. Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 318 U.S. 523 (1943) (equating executory contracts with unexpired leases for assumption and rejection purposes, court stated that the question whether a lease should be rejected and, if not, on what terms it should be assumed, is one of business judgment); *In re Tilco, Inc.*, 558 F.2d 1369, 1372 (10th Cir. 1977) (under the business judgment rule, the production of substantial net revenue in the past is not determinative).

Under the business judgment standard, the court's role is largely one of "an overseer of the wisdom with which the bankruptcy estate's property is being managed by the trustee or debtor-in-possession" rather than "as an arbiter of disputes between creditors and the estate." *Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095 (2d Cir. 1993). Thus, unless there is bad faith or gross abuse of discretion, most courts will approve the decision to assume or reject. *In re Health Science Products, Inc.*, 191 B.R. 895, 909 n.15 (Bankr. N.D. Ala. 1995) (citing *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir.1985)).

The Ninth Circuit has adopted the most expansive view of the business judgment rule, holding that bankruptcy courts should presume that the debtor-in-possession "acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate," and rejection should be approved unless the decision

"is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, whim, or caprice." *In re Pomona Valley Medical Group*, 476 F.3d 665, 670 (9th Cir. 2007).

b) *Minority Rule: "Balancing of the Equities"*

A minority of courts employ a "balancing of the equities" test rather than the traditional business judgment rule. These courts consider whether rejection or assumption would disproportionately harm the non-debtor party and compare that potential harm to any benefit that may accrue to the debtor's general unsecured creditors from assumption or rejection. *In re Washington Capital Aviation & Leasing*, 156 B.R. 167, 172 (Bankr. E.D. Va.1993)*; In re Monarch Tool & Mfg. Co.*, 114 B.R. 134 (Bankr. S.D. Ohio 1990)*; In re Logical Software, Inc.*, 66 B.R. 683 (Bankr. D. Mass.1986).

c) *Special case: Rejection of Collective Bargaining Agreements in Chapter 11 cases – Section 1113.*

An exception to the ordinary business judgment standard for approval of a trustee's decision to reject an executory contract involves collective bargaining agreements. Rejection of these agreements **in chapter 11 cases only** is governed by a more stringent test, which is codified in Bankruptcy Code Section 1113.

1) Pursuant to Section 1113, before a debtor files a motion to reject a collective bargaining agreement, the debtor ***must***:

   (a) make a postpetition effort to renegotiate the contract with the union;

   (b) act in good faith in negotiations with the union; and

   (c) make an open and full disclosure to the union of the debtor's financial situation.

2) The bankruptcy court shall grant the motion only if it is satisfied that:

   (a) the debtor made a good faith effort to renegotiate the contract;

   (b) the union has rejected the proposed modifications to the agreement without good cause; and

   (c) the balancing of the equities weighs in favor of allowing the debtor to reject the agreement.

3) Section 1113 applies only in chapter 11 cases; the process described above is not required in a chapter 7 liquidation or in chapter 9, which governs the bankruptcy reorganization of municipalities.

d) *Effect of Rejection*

Rejection relieves both the debtor and the non-debtor party of their respective obligations under the rejected executory contract or unexpired lease. In most instances, rejection is treated as a breach of the contract or lease rather than a termination.

1) **Timing**

The time as of which the contract or lease is deemed breached depends upon whether (A) the contract or lease was previously assumed prior to rejection and (B) whether the bankruptcy case has been converted from its original chapter to a different chapter, pursuant to Sections 1112, 1208, or 1307:

– If the contract or lease has not previously been assumed under Section 365 or under a plan confirmed under chapter 9, 11, 12, or 13, it is treated as breached immediately before the date of the filing of the bankruptcy petition. Section 365(g)(1).

– If the contract or lease has been assumed under a plan of reorganization confirmed under chapter 9, 11, 12, or 13, it is treated as breached at the time of rejection, *unless* the case has been converted under Sections 1112, 1208, or 1307. Section 365(g)(2)(A).

– If the contract or lease was assumed prior to conversion, and then rejected, it is treated as breached immediately *before* the date of conversion. Section 365(g)(2)(B)(i).

– If the contract or lease was assumed after conversion, and then rejected, it is treated as breached at the time of rejection. Section 365(g)(2)(B)(ii).

2) **Priority of Rejection Damages Claim**

As described above, rejection of a contract or lease that was not previously assumed by the trustee or debtor in possession is treated as breach of the contract or lease that occurred immediately before the filing of the bankruptcy petition. Section 365(g)(1). The non-debtor party to the rejected agreement is therefore deemed to hold

a *prepetition* general unsecured claim for the damages caused by the breach.

However, if the lease or contract was previously assumed and is subsequently rejected, it is treated as breached at the time of the rejection, unless the case was converted under Sections 1112, 1208, or 1307. Section 365(g)(2)(A). Either way, the non-debtor party will have a postpetition claim for damages that will likely be entitled to administrative expense priority under Section 503(b); however, pursuant to Section 365(g)(2), if a case is converted from chapter 11, 12, or 13 to chapter 7, the claim will be an administrative expense of the superseded case rather than of the chapter 7 case. Section 365(g)(2). *In re Frontier Props., Inc.*, 979 F.2d 1358 (9th Cir. 1992); *In re Norwegian Health Spa, Inc.*, 79 B.R. 507 (Bankr. N.D. Ga. 1987); *In re Multech Corp.*, 47 B.R. 747 (Bankr. N.D. Iowa 1985).

e) *"Retroactive" Rejection*

The effective date of the rejection of a lease of ***non-residential real property*** is particularly important, because, under Section 365(d)(3), the landlord is entitled to its contractual rent until court approval of the rejection. Some courts have held that, where the equities in a particular case so dictate, a court may use its equitable powers to order that rejection of a lease be deemed effective as of the filing date of the motion to reject, rather than upon the later date of the order granting the motion. *See, e.g.*, *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.)*, 67 F.3d 1021, 1028 (1st Cir. 1995). Debtors seek such relief to avoid paying postpetition rent and charges for the period after the motion to reject is filed, but before the court enters its order approving the rejection. Landlords, however, may object to retroactive rejection, because, during that same period, while the debtor seeks to avoid paying postpetition rent, the landlord does not have unfettered control over the leased premises and is unable to re-let the premises; the debtor-tenant controls the timing of rejection, but seeks to avoid paying the cost of that control, by asking the court for a retroactive rejection date.

5. **Assumption: Prerequisites and Effect**

In lieu of rejection, the trustee or debtor in possession may choose to assume an executory contract or unexpired lease – thereby binding the debtor in possession to the terms of the contract or lease going forward and after the close of the bankruptcy case – unless another provision of Section 365 prohibits assumption. If there has been a default under the contract or lease – whether prepetition or postpetition – the lease or contract may not be assumed unless the default is cured as required by the Bankruptcy Code. Section 365(b)(1)(A)-(C).

a) *Cure – Sections 365(b)(1)(A) and 365(b)(1)(B)*

Section 365(b)(1) sets out three requirements that must be met before the trustee, debtor-in-possession, or debtor may assume a contract or lease.

1) The trustee must either cure the default or provide adequate assurance that the default will be promptly cured. Section 365(b)(1)(A).

2) The trustee must compensate or provide adequate assurance that he will promptly compensate the other party for any pecuniary loss resulting from the default. Section 365(b)(1)(B).

3) The trustee must provide adequate assurance of future performance under the contract or lease being assumed. Section 365(b)(1)(C).

b) *Adequate Assurance of Future Performance – Sections 365(b)(1)(C) and 365(b)(3)*

The Bankruptcy Code provides no general definition of what constitutes "adequate assurance" of future performance under a contract or lease. Adequate assurance of future performance may be provided by showing the credit-worthiness of the debtor (if the debtor is keeping the contract or lease) or of the proposed assignee and its ability to perform the assigned contract. A demonstrated intent to set aside money for cure payments, or other non-speculative demonstrations of intent to pay, can also establish adequate assurance of future performance. Other factors courts may consider are: (1) whether the financial terms of the agreement are at or below the prevailing rate; (2) the general outlook in the debtor's industry; (3) a plan that would earmark money exclusively for the non-debtor party to the agreement; (4) evidence of profitability; (5) the presence of a security deposit; (6) the presence of a guarantee; and (7) the debtor's payment history. *In re M. Fine Lumber Co.*, 383 B.R. 565, 573 (Bankr. E.D.N.Y. 2008) (assumption of lease of non-residential real property).

Factors that courts consider relevant to the "promptness" of delayed payments of cure amounts or of pecuniary losses resulting from defaults include: (i) historical economic performance of the debtor; (ii) level of prejudice or injury to the non-debtor party arising from past defaults; (iii) inequitable conduct by the non-debtor party; and (iv) the term of the contract or lease in question (*i.e.*, the longer the term of the assumed contract or lease, the longer the cure period that a court may find permissible).

For a discussion of the standards applicable to establishing adequate assurance of future performance and promptness, as well as other case citations, see *In Tama Beef Packing Inc.*, 277 B.R. 407 (Bankr. N.D. Iowa 2002); *In re Embers 86th St., Inc.*, 184 B.R. 892 (Bankr. S.D.N.Y. 1995).

c) *Shopping Center Leases: Section 365(b)(3)*

Although the Bankruptcy Code provides no *generally* applicable definition of "adequate assurance of future performance" under a contract or lease proposed to be assumed by a trustee, it does provide specifics in the particular context of the proposed assumption of a lease of non-residential real property at a ***shopping center***.

The term "*shopping center*" is not defined in the Bankruptcy Code, but should be strictly construed. *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1087 (3d Cir. 1990); *In re Goldblatt Bros., Inc.*, 766 F.2d 1136, 1140-41 (7th Cir. 1985) (physical criteria are significant, but never determinative); *Androse Associates of Allaire, LLC v. Great Atlantic & Pacific Tea Co. (In re Great Atlantic & Pacific Tea Co.),* 472 B.R. 666, 677 (S.D.N.Y. 2012). Some of the most important characteristics courts look to are: (1) multiple leases held by a single landlord (2) that are leased to commercial retailers, with (3) the presence of a common parking area. *In re Ames Dep't Stores, Inc.*, 348 B.R. 91 (Bankr. S.D.N.Y. 2006). Other features courts look for include joint advertising, a master lease, fixed hours of operation for all stores, and common areas. *See, e.g., In re Joshua Slocum, Ltd.*, 922 F.2d 1081 (3d Cir. 1990); *In re Goldblatt Bros., Inc.*, 766 F.2d 1136 (7th Cir. 1985).

Under Section 365(b)(3), in order to assume a shopping center lease, the trustee or debtor in possession must – in addition to curing any defaults under the lease, as described above – provide adequate assurance:

1) of the source of rent and other consideration due under such lease, 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;

2) that any percentage rent due under such lease will not decline substantially;

3) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and that assumption or assignment of such lease will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and,

4) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

Moreover, under Section 102(3), the term "includes" is not limiting, meaning that the bankruptcy court has discretion to impose additional requirements, not specifically enumerated in Section 365(b)(3), before finding that the requirement of "adequate assurance of future performance" has been met.

6. **Assignment**

a) *Assignment Generally*

Section 365 of the Bankruptcy Code provides that in addition to assuming a contract for its own reorganization, a debtor may assign an assumed executory contract or unexpired lease to a third party.

1) **Relation of Assignment of Contracts and Leases to Sales of <u>Property of the Bankruptcy Estate Under Section 363</u>**

(a) ***Typical Terms***. Sale agreements providing for the sale of a debtor's business assets pursuant to Section 363 often include provisions requiring the assumption and assignment of contracts or leases in connection with the sale. In connection with the sale process, a court may approve procedures for the assumption and assignment of contracts. Typical terms addressed in a sale agreement or related procedures may include:

i. <u>Designation of Contracts to be Assumed and Assigned</u>. The sale agreement may include a schedule of contracts to be assumed and assigned, and/or it may permit the purchaser to designate such contracts or additional contracts by a date certain. The contract designation deadline may be before or after the sale approval hearing, up to (or, in some cases, after) the closing date. The assumption and assignment of such contracts typically is conditioned on the closing of the related sale. The purchaser also may have the right to remove contracts from the list of contracts to be assigned, including if disputes arise with the counterparty regarding the right to assign the contract or any "cure" amount to be paid in connection with the assignment. Contracts not assigned to a buyer may later be rejected by the debtor if, for example, it has sold the entirety of its related business operations, and, therefore, has no further use for remaining contracts and leases not assigned to the purchaser.

ii. Cure. Section 365(b) requires a debtor to cure outstanding defaults (including payment defaults) as a condition to assuming a contract. Under a sale agreement, a purchaser may agree to assume or share in the obligation to make such "cure" payments.

iii. Contingent Liabilities. The sale agreement may or may not specify other obligations related to contracts that the purchaser is willing to assume (such as warranty obligations and other contingent liabilities).

iv. Adequate Assurance. As described above in these Materials, adequate assurance of future performance under the assigned contract or lease must be established as a prerequisite to assumption and assignment; the burden of making that showing is, ultimately, the debtor's, although, in practice, the purchaser will have to provide whatever information is necessary to establish such adequate assurance. A showing based on the general financial wherewithal of the purchaser may be sufficient. However, under certain contracts, it may be appropriate for a purchaser to provide additional assurances that it can fully perform the contract (such as if non-monetary terms are material to the contract).

(b) ***Procedures for Assignments in Connection with Sales***. A court may approve procedures for notice requirements and objection deadlines for the assignment of contracts in connection with a sale. These procedures may include:

i. Form of Notice. Traditionally, notice of proposed assignments was provided through written mailings. However, in more recent cases, courts have approved notice procedures that allow for the use of web sites to post schedules identifying contracts to be assumed and assigned. Even where notice of a proposed assignment is mailed in hard copy to a counterparty, the notice may be in the form of a schedule of contracts to be assigned.

ii. Notice Period. The sale agreement may require a shorter notice period for assumption and assignment than ordinarily provided under Section 365.

iii. Designation Procedures. A counterparty should confirm if a purchaser is given the right to designate (or un-designate) contracts to be assumed and assigned after an initial sale notice date, and the manner in which such changes will be noticed. These procedures will address: (1) when the purchaser must make designations of contracts it wishes to assume and assign, (2) the timing and form of notice that will be provided to counterparties and (3) the deadline by which counterparties must object to the assumption and assignment.

iv. Objection Deadlines. Deadlines may be established for a counterparty to object to different aspects of the assignment of the contract, including a deadline for challenging the showing of adequate assurance of future performance of the contract or lease; the right generally to assign the contract or lease, and the determination of the cure amount owed in connection with such an assumption and assignment.

In an auction process – where the identity of the proposed purchaser/assignee will not be known ahead of time – the auction sale procedures may include additional deadlines (possibly very short ones) for the assertion of supplemental objections to the assignment of a contract, if the winning bidder at the auction has not previously provided appropriate information to non-debtor counterparties to contracts and leases targeted for assumption and assignment to the purchaser/assignee.

(c) ***Types of Objections***. Although the process under which a debtor's assets are sold under Section 363 is often accelerated, as compared to the usual contract assumption and assignment process under Section 365, there are multiple points at which a non-debtor counterparty may object and be heard:

i. Objection to Assumption and Assignment Procedures. A party should review any initial procedures to determine if the proposed procedures provide for adequate notice and time to formulate

and file objections to the proposed assignment of an agreement.

ii. Objection to Adequate Assurance. A non-debtor contract counterparty may file an objection to the ability of a proposed purchaser to perform under an assigned contract generally. In particular, if a contract contains requirements that a purchaser may not be able to satisfy, a counterparty may want to identify such requirements for the debtor and proposed buyer promptly, whether by way of formal objection or other means, so that all of the parties can consider the merits of such concerns and whether there is a way to address them. Such issues may be considered by a debtor in comparing the value of alternative bids received for the same assets.

iii. Objection to Cure Amount. A separate deadline may be established to resolve disputes regarding a proposed cure amount to be paid under a contract. If a counterparty is aware of substantial amounts owed by a debtor, the counterparty may consider informing the debtor of such obligations so that the purchaser and any alternative bidder can account for such obligations in the event an auction is held.

b) *Anti-Assignment Clauses*

1) Sections 365(f)(1) and 365(f)(2) protect the debtor's power to assign an executory contract, as opposed to merely assuming it; Section 365(f) provides:

> (1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.
>
> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if –
>
> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

2) Section 365(f)(3) prevents the non-debtor party from terminating the contract because of such an assignment:

> Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease . . . on account of an assignment of such contract or lease, such contract [or] lease . . . may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

3) Section 365(f) operates even if the executory contract contains a prohibition on assignment, and even if applicable non-bankruptcy law prohibits assignment. Moreover, the section overrides such anti-assignment clauses or non-bankruptcy law even when they are not tied to particular "*ipso facto*" events [*discussed in these Materials below*]. For example, a contract clause that simply provides "Party A may not assign its rights hereunder" is invalidated, even though the clause is not triggered by Party A's financial condition, bankruptcy filing, or the like.

4) Courts may build outward from Section 365(f)'s express provisions in order to protect the debtor's ability to reorganize. For example, in *In re Jamesway Corp.*, 201 B.R. 73 (Bankr. S.D.N.Y. 1996), the debtor was the lessee of retail space. The lease agreement provided that the debtor must pay the landlord 50% of any profits from any future sublease. During the chapter 11 proceeding, the debtor moved to sublet the space under terms that would result in a profit to the estate, and the court refused to enforce the profit-sharing provision. *Id.* at 74-76, 79. It was arguable whether the profit-sharing provision fell within the literal terms of Section 365(f)(1), but the court nonetheless held that the statute represented a policy judgment that required invalidation of the provision:

> [Section] 365 reflects the clear Congressional policy of assisting the debtor to realize the equity in all of its assets . . . . In furtherance of Congressional policy favoring the assumption and assignment of

> unexpired leases as a means of assisting the debtor in its reorganization or liquidation efforts, we interpret § 365(f)(1) to invalidate provisions restricting, conditioning or prohibiting debtor's right to assign the subject lease.

Id. at 77-78 (citations omitted).

c) *Assignability Based upon Applicable Law Generally*

1) Section 365(c)(1) provides in relevant part that the debtor "may not assume or assign" an executory contract if "applicable law" excuses the non-debtor party "from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession," and if the non-debtor party "does not consent to such assumption or assignment."

2) Assignability under "applicable law" is the standard (see above), which includes state or federal statutes and the common law of contracts.

3) As a practical matter, important types of contracts that thereby become non-assumable include:

(a) Those under which the debtor is obligated to perform personal services or act in a fiduciary capacity. *See, e.g.*, Restatement (Second) of Contracts § 317(2)(a) (providing that a contract is assignable unless, among other things, the assignment would "materially increase the burden or risk imposed on [the obligor] by his contract, or materially impair his chance of obtaining return performance").

(b) Those under which the non-debtor is obligated to make a loan to the debtor. See Section 365(c)(2) (debtor may not assume executory contract to "make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor"). *Cf.* Section 365(e)(2)(B) (making the invalidation of *ipso facto* clauses under Section 365(e)(1) [*discussed below in these Materials*] inapplicable to the same classes of contracts).

(c) Contracts between the debtor and state or federal government bodies.

i. Contracts with the federal government are non-assignable as a matter of statute. "No [government] contract . . . or any interest therein, shall be

transferred by the party to whom such contract is given to any other party and any such transfer shall cause the annulment of the contract **. . .** transferred, so far as the United States is concerned." 41 U.S.C. § 15 (2006).

ii. For a discussion of non-assignability of government contracts under state law, *see e.g., Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re Allentown Ambassadors, Inc.),* 361 B.R. 422 (Bankr. E.D. Pa. 2007) (considering North Carolina's limited liability company act).

(d) Apparent conflict between Sections 365(c)(1) and 365(f)(1)

Note that courts and commentators have long struggled with an apparent conflict between Section 365(c)(1) and Section 365(f)(1). Under subsection (c)(1), applicable anti-assignment law is of course to be recognized, while under subsection (f)(1) it is to be disregarded. *See, e.g., In re Catapult Entertainment, Inc.*, 165 F.3d at 752; *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984); Michelle Morgan Harner *et al., Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 Am. Bankr. Inst. L. Rev. 187 (2005); Michael J. Kelly, *Recognizing the Breadth of Non-Assignable Contracts in Bankruptcy: Enforcement of Nonbankruptcy Law as Bankruptcy Policy*, 16 Am. Bankr. Inst. L. Rev. 321 (2008).

(e) "***Hypothetical***" and "***actual***" tests for assumption of contracts.

i. The so-called "hypothetical" test emerged from an asserted plain reading of Section 365(c). Proponents of the "hypothetical" test argue that the statutory language makes the debtor's power to assume a contract or lease contingent on whether the debtor has the power, hypothetically, to assign the same contract or lease, even if the debtor itself is the party that would be performing after assumption and no actual assignment of the contract or lease to a third party is contemplated.

In *In re West Electronics, Inc.*, 852 F.2d 79 (3d Cir. 1988), the leading case under the "hypothetical" test, the debtor was a military contractor seeking to

assume its contract to supply missile launcher components to the U.S. Air Force. The court denied the debtor's motion to assume, even though no assignment was contemplated.

ii. A growing number of courts have developed the competing "actual" test, in which the assignability of the contract is irrelevant to assumption, unless the debtor actually seeks to assign the contract to a third party.

Under this line of analysis, on the facts of *West Electronics*, the fact that the debtor would have been unable to assign the missile launcher component contract would not have interfered with the debtor's own assumption of the contract. As with executory contracts in general, the debtor would have had the power to assume the contract and thereby benefit from its mix of rights and obligations in the furtherance of its reorganization.

(f) Competing authorities.

i. The First Circuit seemingly adopted the "actual" test in *Summit Investment & Development Corp. v. Leroux*, 69 F.3d 608, 612-13 (1st Cir. 1995), though this was in the context of the non-debtor's motion to terminate under Section 365(e)(2) rather than the debtor's motion to assume notwithstanding Section 365(c)(1). The Fifth Circuit reached a comparable holding in *Bonneville Power Administration v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006). The First Circuit later confirmed its adherence to the "actual" test under Section 365(c)(1) in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *abrogated by Hardemon v. City of Boston*, No. 97-2010, 1998 WL 148382 (1st Cir. Apr. 6, 1998).

ii. For a case reaching a result consistent with the actual test by means of a questionable construction of "trustee" in Section 365(c), see *In re Footstar, Inc.*, 323 B.R. 566 (S.D.N.Y. 2005).

iii. *See also Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992); *In re Aerobox Composite Structures, L.L.C.*, 373 B.R. 135, 142

(Bankr. D.N.M. 2007); *Cajun Elec. Members Comm. v. Mabey (In re Cajun Elec. Power Coop., Inc.)*, 230 B.R. 693 (Bankr. M.D. La. 1999); *In re GP Express Airlines, Inc.*, 200 B.R. 222 (Bankr. D. Neb. 1996); *In re Am. Ship Bldg. Co.*, 164 B.R. 358 (Bankr. M.D. Fla. 1994); *In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990); *In re Hartec Enters., Inc.*, 117 B.R. 865 (Bankr. W.D. Tex. 1990), *vacated on other grounds*, 130 B.R. 929 (W.D. Tex. 1991).

iv. For commentary, *see, e.g.*, Daniel J. Bussel & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts*, 74 Am. Bankr. L.J. 321 (2000); Harner *et al.*, *supra*; Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 Am. Bankr. L.J. 95 (1996); Kuney, *Restructuring Dilemmas for the High Technology Licensee: Will "Plain Meaning" Bring Order to the Chaotic Bankruptcy Law for Assumption and Assignment of Technology Licenses?*, 44 Gonz. L. Rev. 123 (2008); Jason A. Nagi, *Section 365 of the Bankruptcy Code: When the Words Get in the Way*, 105 Com. L.J. 413 (2000); Kristin Schroeder Simpson, *Fifth Circuit's Executory Contracts Standards Deconstructed: The Mirant Lessons*, 26 Miss. C.L. Rev. 225 (2007).

(g) Note the First Circuit's regrettably wooden application of the actual test in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997). In that case, the court applied the "actual" test in a way that permitted assumption of a license agreement even though the debtor had been taken over by a competitor of the non-debtor licensor. If free enough to adopt the "actual" test in principle, the court should also have been free enough to limit it in the circumstances of that case, whether as a matter of contract construction or of bankruptcy policy.

d) *Ipso Facto* Clauses

1) "*Ipso facto* clause" is a non-statutory shorthand label for a category of contractual provisions that, in essence, would provide for the debtor's rights under the contract to terminate upon the filing of bankruptcy or related events.

(a) Specifically, Section 365(e)(1) refers to a "provision" in the contract "that is conditioned on" any of the following:

i. the insolvency or financial condition of the debtor at any time before the closing of the case;

ii. the commencement of a case under this title; or

iii. the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(b) The central operative importance of an *ipso facto* clause is described in Section 365(e)(1):

> **an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of [such a provision].**

Section 365(e)(1). Thus, a non-debtor party cannot undermine in advance the debtor-to-be's power to assume a contract, simply by utilizing a clause that provides for the debtor's contract rights to be pulled out from under its feet upon its filing of bankruptcy (or upon the other enumerated conditions).

(c) Termination clauses triggered by specified events may be perfectly enforceable as a matter of state law, as a matter of freedom of contract. But the Bankruptcy Code supersedes that enforceability.

(d) This superseding of contractual termination provisions embodies a strong federal policy, namely, protecting the debtor's power to assume. In a reorganization proceeding, the power to assume is integral to preserving the debtor's going concern value, and in a liquidation proceeding the power to assume helps to maximize the return to the debtor's creditors in general. A single creditor, the non-debtor, is prevented from exiting its relationship with the debtor, so that the other creditors' relationships with the debtor can be better rehabilitated. Bankruptcy is a sharing of pain, and the invalidation of *ipso facto* clauses is a mechanism by which the Code mandates that sharing.

(e) Those courts that employ the "*actual,*" rather than the

"hypothetical," test for determining whether a contract is assumable by a debtor may also be seen as furthering the policy of protecting the power of a debtor to assume a contract. The "actual" test can be viewed as a type of "de facto *ipso facto* clause," *i.e.*, a judicial invention that extends the principle of invalidating *ipso facto* clauses so as to protect the debtor's power to reorganize.

i. See, for example, *In re GP Express Airlines, Inc.*, 368 F.3d 720 (7th Cir. 2004), in which the debtor was a small airline seeking to assume its contracts with Continental Airlines and, in the course of granting the debtor's motion based on the "actual" test, the court explicitly considered and embraced the Bankruptcy Code's pro-reorganization policy.

ii. The court in *GP Express* wrote, "To bar GP Express from assuming its executory contract with Continental would … impair a successful reorganization…. If the rigid interpretation of *West Electronics* [*discussed above in these Materials*] prevails, bankruptcy reorganizations will be defeated when debtors in possession cannot succeed to their pre-bankruptcy contracts. In terms of the classic example of non-assignable contracts, a bankrupt artist should be permitted to complete the portrait." … "[S]ections 363(1), 365(e), and 541(c), indicate that the Bankruptcy Code will not enforce provisions in private agreements or under nonbankruptcy law which terminate a debtor's interest in property or an executory contract merely because of a bankruptcy filing…. Under [the "hypothetical" test], section 365(c)(1) provides for the termination of a debtor's property interest in a contract merely because of the filing of a bankruptcy petition. This result is directly at odds with the anti-*ipso facto* provisions of the Code. My conclusion that section 365(c)(1) does not bar assumption of contracts by the debtor in possession is consistent with other provisions of the Bankruptcy Code which decline to enforce forfeiture provisions in private contracts."

(f) One can also see the invalidation of *ipso facto* clauses as a common-sense limitation on (i) the *cum onere* principle (*i.e.*, that a contract must be assumed "with its burdens") and (ii) the Bankruptcy Code's baseline respect for non-

bankruptcy entitlements. If the federal bankruptcy policy of empowering the debtor to assume contracts and leases is to have any realistic force, then contract drafters must not be permitted to readily render that policy nugatory.

This is all the more true in light of the pre-bankruptcy bargaining posture of the debtor-to-be who, as a result of natural negotiation dynamics, has little or no incentive to resist the inclusion of a "termination-on-bankruptcy" clause. The Code does not allow a few boilerplate drops of prepetition ink to disrupt its own important and express goals.

2) Section 365(e)(1) is expressly overridden for certain capital markets transactions:

(a) Section 555 (for securities contracts);

(b) Section 556 (for commodities contracts);

(c) Section 559 (for repo agreements);

(d) Section 560 (for swap agreements);

(e) Section 561 (for master netting agreements and across certain types of contracts).

i. However, see the order entered by the bankruptcy court in *In re Lehman Bros. Holdings, Inc.*, Bankr. Case No. 08-13555, Docket No. 5209, in which the court appears to have restricted the ability of non-debtor swap counterparty Metavante Corporation to exercise certain remedies under its ISDA Master Netting Agreement with a Lehman debtor-affiliate.

3) **Sibling Provisions to *Ipso Facto* Clauses**

(a) Section 365(b)(2) – This subsection provides that no cure or compensation need be given for the breach of a provision relating to the typical *ipso facto* events.

(b) Section 541(c)(1)(B) – This provision invalidates any provision "in an agreement, transfer instrument, or applicable nonbankruptcy law" that (a) is conditioned on the same three typical *ipso facto* events and (b) "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."

i. As a result, property that would otherwise be excluded from property of the estate is instead included, and this section, like its counterpart in Section 365, burdens a single third party in the service of facilitating the debtor's reorganization or of maximizing recovery by the debtor's creditors.

ii. For example, suppose that Seller has a contract with Buyer that, in addition to reserving a security interest for Seller, provides that if Buyer files for bankruptcy, then Buyer forfeits the purchased equipment or so much of it as has not yet been paid for. Section 541(c)(1)(B) prevents this contracted-for forfeiture from occurring, by invalidating the condition and including the equipment as property of the bankruptcy estate, so that the equipment is available to the debtor/buyer for use in its reorganization or for distribution to its creditors in a liquidation.

(c) Section 363(l) – This provision protects the debtor's power to use property during the pendency of the case.

(d) Section 545(1) – This section permits a debtor to "avoid" (*i.e.*, nullify) a statutory lien attaching to property of the estate.

4) Again, each of the above provisions is designed to protect the debtor's overall prospects of reorganization by preventing particular non-debtors from declining to shoulder their share of the harm stemming from the debtor's insolvency. One creditor – the drafter of the *ipso facto* clause – is harmed, so that the body of creditors as a whole will benefit. In Thomas Jackson's words, the non-debtor's rights under an *ipso facto* clause are "the type of rights that bankruptcy law is justified in ignoring because they may be destructive of the collective weal in bankruptcy."

e) Other issues and judicial analyses that arise under Section 365 and that may be understood through application of the policy underlying *ipso facto* clauses include:

1) financial accommodations and "incidentality," Section 365(e)(2)(B);

2) nonmonetary defaults and (im)materiality, Section 365(b)(1)(A), and

3) cross-default clauses and (lack of) substantial connectedness, Section 365(b)(1).

For a discussion of these topics, see Andrea Coles-Bjerre, *Ipso Facto: The Pattern of Non-Assumable Contracts in Bankruptcy*, 40 New Mexico L. Rev. 77 (2010).

C. SPECIAL ISSUES REGARDING CERTAIN LEASES

1. **Debtor as Lessor of Real Property**

a) If the debtor is a ***lessor*** of real property and rejects its lease, the non-debtor tenant may elect (Section 365(h)(1)):

1) **to treat the lease as terminated**, if the debtor-landlord's rejection of the lease amounts to such a breach as would permit the tenant to treat the lease as terminated under

(a) the terms of the lease;

(b) applicable non-bankruptcy law; or

(c) the terms of any agreement made by the tenant; *or*

2) if the term of the lease has commenced, **to remain in possession of the premises**, offsetting from its rent any damages caused by the rejection.

(a) Offset against future rent is the non-debtor tenant's sole remedy for damages caused by the rejection, if the tenant elects to remain in possession; that tenant may not assert rejection damages against the estate.

(b) The rights retained by the non-debtor tenant include the right to sublet and to assign and the right to quiet enjoyment of the premises.

(c) Applied against debtor-lessors of real property, "possession" encompasses subletting and assignment. Therefore, a debtor-landlord may not reject a lease and expel the lessee's subtenant if the primary lessee chooses to remain "in possession." Section 365(h)(1).

i. However, in *Precision Industries, Inc. v. Qualitech Steel SBQ LLC*, 327 F.3d 537 (7th Cir. 2003), a debtor-landlord sold property of the estate under Section 363 free and clear of its tenant's leasehold

interest, and the tenant was unable to enforce its possessory rights under Section 365(h).

The key issues in *Qualitech* may well have been (A) that the tenant had received notice of the sale and had neither objected to the sale nor sought any of the protections the Bankruptcy Code might have authorized (such as adequate protection of its interest in the leasehold) and (B) that the tenant had conceded in its briefing that Section 363(f) permitted the sale of the underlying property free and clear of its leasehold interest.

A tenant of real property that a debtor-landlord is seeking to sell should consider challenging at least item (B) above, and should also consider, pursuant to item (A) above, whether the notice provided, if any, truly informed the tenant of the intended effect of the sale on its leasehold rights.

3) The tenant may retain its rights under the rejected lease for:

(a) the remainder of the original term of the lease; *plus*

(b) any renewal or extension periods the tenant has a right to enforce under applicable non-bankruptcy law.

2. **Payment Obligations of Debtor-Tenant Under Lease of Non-Residential Real Property**

a) Pending assumption or rejection of *nonresidential real property leases*, the debtor must stay current on all of its obligations that arise thereunder **from and after the date of the entry of the order for relief**. If the debtor does not, the landlord receives an administrative claim for the full amount due postpetition under the lease.

b) Although the usual standard for granting a claim administrative-priority status under Section 503(b)(1) of the Bankruptcy Code requires that the bankruptcy estate have used the creditor's property or otherwise derived some benefit in exchange for incurring liability for the claim, the majority of courts hold that **a landlord is entitled to an administrative priority claim for unpaid postpetition rent, *whether or not* the debtor actually used the leased premises or otherwise benefited from the lease**. *See, e.g.*, *In re Pacific-Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994). However, a minority of courts have held that Section 365(d)(3) does not abrogate the requirements of Section 503(b)(1) and that, therefore, the amount of the administrative claim must be determined under the "benefit

to the estate" standard. *See, e.g., In re Burival*, 406 B.R. 548, 557 (B.A.P. 8th Cir. 2009).

c) However, as a practical matter, and notwithstanding the language of the Bankruptcy Code requiring debtors to remain current postpetition, many courts will not force a debtor to pay postpetition rent immediately, even on a landlord's motion, if the court believes that such immediate payment will jeopardize the debtor's reorganization.

d) The automatic stay bars pursuit of the debtor-tenant for prepetition rent arrearages. However, a landlord may pursue its debtor-tenant for *postpetition* rent arrearages, but still *may not sue the tenant outside of bankruptcy court* or *act against the premises or against the tenant's property* without a prior bankruptcy court order.

e) *Real estate taxes*:

1) The majority view of the courts is that the debtor need only pay real estate taxes under a lease **that accrue postpetition**, effectively requiring a proration of real estate tax obligations between prepetition and postpetition periods. *See, e.g., In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998); *Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934 (S.D.N.Y. 1997); *Child World, Inc. v. The Campbell/ Massachusetts Trust (In re Child World, Inc.)*, 161 B.R. 571 (S.D.N.Y. 1993); *In re Consolidated Indus. Corp.*, 234 B.R. 84 (Bankr. N.D. Ind. 1999); *Santa Ana Best Plaza, Ltd. v. Best Products Co., Inc. (In re Best Products Co., Inc.)*, 206 B.R. 404 (Bankr. E.D. Va. 1997); *In re Victory Markets, Inc.*, 196 B.R. 6 (Bankr. N.D.N.Y. 1996).

2) However, some decisions hold that, if an obligation to pay real estate taxes arises under the lease postpetition (*e.g.*, because that is when the landlord bills the tenant for the taxes), the *entire amount* is a postpetition obligation to be paid immediately under Section 365(d)(3) of the Bankruptcy Code, even if some taxes are on account of prepetition periods. *See, e.g., Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205 (3d Cir. 2001); *Inland's Monthly Income Fund, L.P. v. Duckwall-Alco Stores, Inc. (In re Duckwall-Alco Stores, Inc.)*, 150 B.R. 965 (D. Kan. 1993); *In re R.H. Macy & Co., Inc.*, 152 B.R. 869 (Bankr. S.D.N.Y. 1993), *aff'd*, No. 93 Civ. 4414, 1994 WL 482948 (S.D.N.Y. Feb. 23, 1994).

f) *Rent Proration/"Stub Rent"*

1) The issue of rent proration resembles the issue of real estate tax payments described immediately above. It arises generally in the following contexts:

(a) Rent is due in advance on the first of the month. The debtor files its bankruptcy case after the first of the month, and the landlord seeks payment of rent for the period from the filing date through the end of the month as priority, postpetition rent immediately due and payable (this is the amount most often referred to as "stub rent").

(b) Rent is due in advance on the first of the month. The debtor rejects the lease after the first of the month and proposes to pay currently only prorated rent from the first of the month through the rejection date.

2) In the situation described in (1)(b) immediately above, the Sixth and Seventh Circuits, using reasoning similar to the Third Circuit's reasoning in *Montgomery Ward* (cited above) regarding real estate taxes, have held that the debtor must pay the full month's rent when due under Section 365(d)(3) if the obligation came due on the first day of the month, even if the debtor rejected before the end of the month. *HA-LO Indus., Inc. v. Centerpoint Properties Trust*, 342 F.3d 794 (7th Cir. 2003); *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986 (6th Cir. 2000); *see also In re Comdisco, Inc.*, 272 B.R. 671 (Bankr. N.D. Ill. 2002).

However, the reasoning of these cases also suggests that, in the situation described above regarding "stub" rent for the month during which the case is commenced (as described in (1)(a), above), the debtor need not immediately pay "stub rent" under Section 365(d)(3) for the postpetition portion of the month in which it commences its bankruptcy case. Several courts have so held, although the holdings may leave open the possibility that the landlord would be entitled to be paid the stub rent as an ordinary administrative expense under Code §503(b). *See, e.g., In re DVI, Inc.*, 308 B.R. 703 (Bankr. D. Del. 2004); *In re UAL Corp.*, 291 B.R. 121 (Bankr. N.D. Ill. 2003); *In re HQ Global Holdings, Inc.*, 282 B.R. 169 (Bankr. D. Del. 2002).

3. **Limitation on Allowed Amount of Landlord's Claim Arising from Rejection of Unexpired Lease of Non-Residential Real Property – Section 502(b)(6)**

a) *Policy Background*. Leases of real property (especially nonresidential real property, like retail space) can typically run for years, or even decades, after the debtor-tenant's petition date. Upon the debtor breaching such a lease by rejecting it, a landlord could assert a damages claim in the tenant's bankruptcy for the entire rent reserved under such leases, sometimes millions of dollars.

Congress determined that it was not equitable for landlords to be able to so dilute the claims of other unsecured creditors, especially in light of the fact that they will likely be able to re-let the premises at issue and mitigate those damages to some extent.

b) Congress's solution is Section 502(b)(6), which caps the landlord's prepetition claim for actual damages pursuant to an arbitrary formula.

c) The landlord's claim arising from the debtor's rejection of a lease of real property is deemed to be a general, nonpriority, unsecured claim arising immediately prior to the petition date. Sections 365(g)(1) and 502(g).

d) The Section 502(b)(6) formula.

1) **Damages Arising from Prepetition Arrearages:** The landlord may include in its claim the full amount of any prepetition rent arrearages, without limitation or cap, but "without acceleration." Section 502(b)(6)(B).

(a) The "without acceleration" language is meant to avoid the effect of a lease provision that permits a landlord to declare all rent reserved under the lease for the entire lease term due and owing upon breach.

(b) Therefore, the landlord is entitled to include in its claim, as prepetition arrearages, only the actual amounts that remain unpaid prior to the petition date, rather than the entire, accelerated rent reserved under the lease.

2) **Damages Arising from the Rejection/Termination of the Lease:** In addition to actual prepetition arrearages, the landlord may include in its claim an amount that reflects the damage it sustains as a result of the debtor's rejection of the lease[1]; these damages

[1] The Bankruptcy Code actually uses the word "termination" instead of "rejection," even though the Bankruptcy Code states that rejection constitutes a *breach* of a lease or contract (Section 365(g)) and does not use the word "termination." However, rejection does immediately terminate a debtor's *possessory rights* under a lease of real property and its obligation to continue timely payment of rent under Section

will primarily be the loss of the future rents the debtor would have paid under the lease, but may also include, for example, the cost of re-letting the premises; the cost of a build-out for a new tenant, and the failure to recoup the full amount of any tenant allowance provided to the rejecting debtor by the landlord as incentive to the debtor to enter into a long-term lease.

(a) **GENERAL RULE**: This element of the landlord's claim is capped pursuant to a formula decided upon by the drafters of the Bankruptcy Code; the landlord may add to its claim for prepetition arrearages whichever of the following two amounts is the ***lesser***: (I) the landlord's actual damages arising from the breach of the lease, as such damages would be calculated under state law and (II) the greater of:

i. one year's "rent reserved" under the lease; or

ii. 15% of the total rent reserved under the lease, with the calculation of "total rent reserved" beginning on the earlier of:

(A) the petition date; and

(B) the date the debtor surrendered (or the landlord repossessed) the premises; provided, however,

iii. that the 15% amount can never be greater than the absolute maximum cap of three years' rent.

(b) **NOTE:** The majority view is that the "15%" alternative refers to *15% of the total rent reserved under the lease* from the earlier of the two dates mentioned above; however, a minority of courts have held that the "15%" alternative refers to an amount equal to (i) periodic rent, at the contract rate in effect as of the earlier of the two dates described above, multiplied by (ii) a *period of time* equal to *15% of the time period* remaining under the lease from the earlier of those two start dates through the end date of the lease.

i. There is no difference between the majority and minority views, so long as monthly rent is flat over the term of the lease. If, however, rent and charges

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365(d)(3), so, it may be convenient to think of a rejection as a type of termination for purposes of calculating a landlord's claim under Section 502(b)(6).

increase over time, the minority view deprives the landlord of the benefit of any large upticks contained in the later months of the lease.

ii. *Calculating "Rent Reserved" Under a Lease*: Because the amount of a landlord's capped claim is determined by reference to a number described as "rent reserved" – either 15% of the total "rent reserved" over the term of the lease, or the amount of "rent reserved" paid each month, multiplied by 15% of the number of months remaining in the lease – it is important to know what elements are included in the "rent reserved" number.

One influential judicial definition of "rent" requires that any charge included as rent for the purpose of the Section 502(b)(6) calculation must be:

(A) either (I) designated as "rent" or "additional rent" in the lease or (II) otherwise be the tenant's obligation under the lease;

(B) be related to the value of the property or of the lease thereon; *and*

(C) be properly classifiable as rent, because it is fixed, regular, or periodic.

See In re McSheridan, 184 B.R. 91 (B.A.P. 9th Cir. 1995) (overruled to a limited extent by *El Toro* (cited below)).

(c) If the landlord's actual damages (total future rent it lost as a result of the debtor's breaching the lease, less any mitigation from re-letting of the premises) are less than one year's rent, the landlord may add the entire amount of those actual damages to its claim.

(d) Conversely, if the landlord's actual damages arising from the rejection/termination of a lease exceed the capped amount allowable under Section 502(b)(6), that capped amount is intended to compensate the landlord for all of those rejection/termination-related damages, even if some elements of those damages (for example, re-letting costs or inability to recover a tenant allowance) are not includible in the "rent reserved" figure to which the cap is applied and are therefore "lost."

3) **Other Damages:** Damages that do not arise from the rejection/termination of the lease (like the cost of repairing physical damage to the premises) are not subject to the cap of Section 502(b)(6) and may be included dollar-for-dollar in the landlord's claim in their entirety. *See In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007) (overruling *McSheridan* to the extent *McSheridan* was meant to suggest that tort damage claims unrelated to the rejection/termination of a lease of real property are subject to the cap of Section 502(b)(6)).

4) **Special Rule Regarding Rejection of Leases Previously Assumed in the Same Bankruptcy Case:** If a debtor assumes, but then later rejects in the same case, a lease of non-residential real property, the landlord has a priority claim for nearly all monetary obligations accruing under the lease for the ***two (2) years*** after either the rejection of the lease or the turnover of the premises (whichever is *later*); this claim is reduced only for amounts actually received or to be received from any non-debtor (such as a successor tenant or a guarantor).

4. **Personal Property Leases: Section 365(d)(5)**

a) Unlike Section 365(d)(3) – which applies in ***all*** chapters of the Bankruptcy Code and requires timely performance of the debtor-tenant's obligations beginning at the entry of the order for relief – Section 365(d)(5) applies ***only in Chapter 11 cases*** and requires timely performance of all obligations ***beginning on the 61st day after*** the entry of the order for relief.

b) This temporal distinction means that the status of the obligations owed under a personal property lease during the first 60 days of a bankruptcy case differs from the status of obligations arising after that 60th day.

1) Generally, courts grant administrative priority status – without requiring the usual showing of actual use of the leased property or actual benefit to the estate under Section 503(b)(1) – to all unperformed obligations under a lease of personal property that arise ***from and after the 61st day after entry of the order for relief*** (the date of commencement of a voluntary bankruptcy case), until the personal property lease is assumed or rejected.

(a) This is the same standard applied under Section 365(d)(3) to all obligations under a lease of non-residential **real** property arising immediately from and after the entry of the order for relief (that is, with no 60-day "grace period" for the trustee), until the real property lease is assumed or rejected.

(b) However Section 365(d)(5) allows the bankruptcy court to adjust the obligations of the debtor under a personal property lease based solely on the equities of the case, while Section 365(d)(3) does not contain an analogous adjustment option regarding leases of non-residential real property.

2) Under Section 365(d)(5), for obligations arising under personal property leases in chapter 11 ***during the first 60 days after entry of the order for relief***, there must be a showing of actual use or benefit to the estate before the court will grant the claim administrative expense priority. *See, e.g.*, *In re Pettingill Enters.*, 486 B.R. 524, 534 (Bankr. D.N.M. 2013) (disallowing administrative expense during that portion of first 59 days in which equipment was out of service); *In re Double G Trucking of the Arlatex, Inc.*, 442 B.R. 684 (Bankr. W.D. Ark. 2010) (disallowing administrative expense for lease of tractor that was inoperable during the 60-day period); *In re Wyoming Sand & Stone Co.*, 393 B.R. 359 (Bankr. M.D. Pa. 2008); *In re Food Etc., L.L.C.*, 281 B.R. 82 (Bankr. S.D. Ala. 2001).

D. RIGHTS AND CLAIMS OF NON-DEBTOR PARTIES TO EXECUTORY CONTRACTS

1. Introduction

An often-troubling issue for suppliers who are parties to a long-term supply contract with a debtor is whether such contract is an executory contract. Assuming such a contract is deemed executory, the issue is whether the supplier, who usually is owed money for goods or services provided prepetition and may be very concerned about the debtor's ability to pay postpetition, must continue to perform under its supply contract after the petition date pending assumption or rejection of that contract by the debtor. Unfortunately, the respective obligations of debtors and non-debtors to executory contracts pending assumption or rejection are not clearly defined in the Bankruptcy Code, and the case law on point is often inconsistent and confusing. As discussed below, courts have dealt with these issues in a variety of ways, attempting to balance a debtor's need to obtain goods and services on credit postpetition against a supplier's right to be reasonably assured that it will be compensated by the debtor for providing such goods or services.

2. Executory Contracts are Enforceable by Debtor But Not Against Debtor

The Bankruptcy Code is silent on the rights and obligations of non-debtor parties to an executory contract between the filing of the petition and the time of assumption or rejection. *In re National Steel Corp.,* 316 B.R. 287, 305 (Bankr.

N.D. Ill. 2004). Rather, the statute simply provides that in a case under chapter 11, the debtor may assume or reject an executory contract:

> at any time before the confirmation of the plan but the court, on the request of any party to such contract or lease, may order the [debtor] to determine within a specified period of time whether to assume or reject such contract or lease.

Section 365(d)(2).

It is generally accepted that an executory contract remains in effect pending assumption or rejection by a debtor. *See e.g., Pub. Serv. Co. of N.H.*, 884 F.2d 11, 14 (1st Cir. 1989). According to the Supreme Court, prior to assumption or rejection, the contract is enforceable by, but not against, the debtor. *See e.g., NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984). It is not at all clear what the Supreme Court meant, but this language has since found its way into virtually every executory contract opinion. *See e.g., National Steel Corp.*, 316 B.R. at 305; *see also* Gregg, John T., *Compelling Nondebtor Suppliers to Perform Under Executory Contracts,* 27 Am. Bankr. Inst. J. 20 (2008).

Thus, the oft-stated rule is that the non-debtor party to an executory contract must generally continue to perform its obligations under the contract prior to assumption or rejection, but the debtor is not bound by the provisions of the contract unless the contract is subsequently assumed. *See e.g., In re Pittsburgh-Canfield Corp.*, 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002) (non-debtor party "cannot unilaterally elect to cease performance on executory contract prior to assumption or rejection"); *In re El Paso Refinery, L.P.*, 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996); *In re Rhodes Inc.*, 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005); *In re Boling Group, LLC*, 2002 WL 31812671 *6 (Bankr. M.D.N.C. Dec. 13, 2002); *Matter of Travelot Co.*, 286 B.R. 462, 466 (Bankr. N.D. Ga. 2002); *but see In re Lucre*, 339 B.R. 648, 657 (Bankr. W.D. Mich. 2006) ("There is nothing in § 365 that permits the trustee or debtor-in possession to compel performance from the other party prior to actually assuming that contract pursuant to § 365(a)").

The rationale for permitting the debtor to enforce the contract, but not have it enforced against it, is that such relief is part of the breathing spell contemplated by the Bankruptcy Code, during which the debtor may determine which contracts it wishes to assign and which it wishes to reject. This breathing spell is set forth both in Section 365(d)(2) of the Bankruptcy Code, and also in various subsections of Section 362 of the Bankruptcy Code which creates an automatic stay. Specifically, Section 362(a)(3) of the Bankruptcy Code prohibits a creditor that has a prepetition claim from taking action to obtain possession of property of a debtor's estate or property from the debtor's estate. Similarly, Section 362(a)(6) prevents a creditor from taking action to collect or recover its prepetition claim against the debtor.

Relying on these sections of the Bankruptcy Code, courts have found that executory contracts are property of the estate entitled to the protection of the automatic stay that cannot be terminated by the non-debtor party, at least not without first obtaining stay relief. *See LaMonica v. North of England Protecting and Indemnity Ass'n, Ltd. and UK P & I Club (In re Probulk, Inc.)*, 407 B.R. 56, 61-62 (Bankr. S.D.N.Y. 2009) ("Section 362(a)(3) prevents a party to a contract from terminating the contract or taking action to deem the contract terminated after the bankruptcy case has commenced without seeking relief from the stay…."); *In re Coast Trading Company Inc.*, 26 B.R. 737 (Bankr. D. Or. 1982) (opining that cancellation of a contract under which the debtor was to sell corn to its purchaser was prohibited under Section 362(a) as an "act to obtain possession of property of the estate."); *In re Plastech Engineered Prods., Inc.*, 382 B.R. 90 (Bankr. E.D. Mich. 2008); *In re Computer Communications,* 824 F.2d 725 (9th Cir, 1987); *In re West Electronics Inc.,* 852 F.2d 79, 82 (3d Cir. 1988).

Recognizing the debtor's need to obtain goods and services during this breathing spell, some courts have issued injunctions in favor of the debtor to ensure performance by non-debtor parties. *See e.g., In re Continental Energy Assocs. Ltd. P'ship.*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) (agreeing to issue injunction in favor of debtor enforcing executory contract *but* requiring the debtor to continue to make postpetition payments to the non-debtor party in accordance with the terms of the contract); *Matter of Whitcomb & Keller Mortgage Co. Inc.*, 715 F.2d 375, 378-80 (7th Cir. 1983) (injunction appropriate to compel performance where non-debtor would not be prejudiced based on certain stipulated protections provided to non-debtor). Like any injunction, of course, the moving party must demonstrate that it would suffer irreparable injury as a result of the non-debtor party's refusal to perform. Moreover, in deciding whether to grant an injunction, courts often consider the non-debtor party's interests in enforcing performance. For example, in *In re Continental Energy Assocs. Ltd. P'ship.*, the court indicated that the debtor would itself be required to perform pending assumption or rejection, stating that: "there is ample authority for the proposition that, pending assumption or rejection, the debtor may elect to enforce the contract *thereby being required to pay for the reasonable value of the materials or services supplied…*." *In re Continental Energy Assocs. Ltd. P'ship.*, 178 B.R. at 408-09 (emphasis added).

3. **Debtor Must Pay for Benefits Received Prior to Assumption or Rejection**

Where a debtor postpones assumption or rejection, but continues to receive benefits under the contract, courts generally agree that "the [debtor] is obligated to pay for the reasonable value of those services … which depending on the circumstances of a particular contract, may be what is specified in the contract…." *NLRB v. Bildisco & Bildisco,* 465 U.S. at 531; *see also In re Tabernash Meadows, LLC,* 2005 Bankr. LEXIS 210, *28-31 (Bankr. D. Colo. February 15, 2005). Such amounts are generally allowed and paid as an administrative expense under Section 503 of the Bankruptcy Code. *See id.*; *see also In re FBI Distribution Corp.,* 330 F.3d 36, 42-44 (1st Cir. 2003) (where non-

debtor induced by debtor to render performance under executory contract pending assumption or rejection, non-debtor entitled to administrative expense if consideration supplied postpetition benefits the estate); *but see In re Continental Energy Assocs. Ltd. P'ship.*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) (stating that language in *Bildisco* was dictum and is not controlling). The amount of the administrative expense is generally measured by reference to the contract itself, assuming such contract was negotiated at arm's length. *Id.*

In order to qualify as an administrative expense, however, the court must find that the goods and services provided by the supplier benefitted the estate. *Id.* Moreover, the provision of an administrative expense provides limited comfort to a supplier if the debtor's estate is administratively insolvent. As one court noted:

> Anyone who is remotely familiar with Chapter 11 cases and the Debtor-in-Possession post-commencement status frequently is painfully aware that the recognition of a postpetition claim as a cost of administration is a pyrrhic victory, if a victory at all. It is a well-known fact that the mortality rate in Chapter 11 cases is quite high and in an aborted Chapter 11 case, which is later converted to a Chapter 7 case, the cost of administrative items incurred in the Chapter 11 case are subordinated to the costs of administration items incurred in the liquidation phase of the case.

In re JW Aluminum Co., 200 B.R. 64, 67 (Bankr. M.D. Fla. 1996).

Accordingly, commentators have argued that the protection provided by Section 503 of the Bankruptcy Code is insufficient. *See e.g.*, Wolf-Smith, Risa Lynn, *Must Suppliers Continue to Supply on Credit During the Slide into Bankruptcy? Heck No!*, 28 Am. Bankr. Inst. J. 26 (2009); Nathan, Bruce & Cargill, Scott, *Compelling Postpetition Trade Credit: Navigating Uncharted Waters*, 28 Am. Bankr. Inst. J. 34 (2009). A variety of arguments can be asserted by non-debtor parties to try to enhance their rights.

4. **What Non-Debtor Parties Can Do to Protect their Interests**

a) *Demand for Adequate Protection*

Some courts have found that a non-debtor party's interest in an executory contract or lease is "an interest of an entity in property" entitled to adequate protection under Section 361 of the Bankruptcy Code. *See e.g., In the Matter of Braniff Airways, Inc.*, 783 F.2d 1283, 1286 (5th Cir. 1986); *In re Matter of Whitcomb & Keller Mort. Co.*, 715 F.2d 375, 379 (7th Cir. 1983); *In re Attorneys Office Management, Inc.*, 29 B.R. 96, 98-99 (Bankr. C.D. Cal. 1983); *In re Castle Tool Specialty Co.*, 22 B.R. 44, 45-46 (E.D. Penn. 1982). If adequate protection is required, Section 361(3) specifically provides that an administrative expense claim under

Section 503(b)(1) of the Bankruptcy Code is not sufficient adequate protection and, thus, something else is required.

Most courts have rejected this view however, *see e.g., In re Wheeling-Pittsburgh Steel Corp.*, 54 B.R. 385, 390-91 (W.D. Penn. 1985); *In re Café Partners/Washington 1983 L.P.*, 81 B.R. 175, 179-81 (Bankr. D. D.C. 1988), noting that Section 365 of the Bankruptcy Code is not listed in the introductory sentence to Section 361 which identifies where adequate protection is applicable ("When adequate protection is required under sections 362, 363, or 364 of this title of an interest of an entity in property….").

b) *Consider UCC Remedies*

The Uniform Commercial Code ("UCC") provides a number of potential remedies for suppliers who provide goods (but not services) to a debtor. Collectively, these provisions reflect the unfairness of forcing a seller to sell goods on credit when the buyer is manifestly unable to perform its part of the bargain.

First, under UCC § 2-609, a supplier under an executory contract for the sale of goods has the right to demand in writing adequate assurance of performance from the debtor when it has reasonable grounds for insecurity about the counterparty's ability to perform. That section provides:

1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

2) Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.

3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance.

4) After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

UCC § 2-609. Thus, outside of bankruptcy, UCC § 2-609 permits the non-debtor party to cease performance if the debtor fails to timely provide adequate assurance of due performance.

What constitutes "reasonable" grounds for insecurity and "adequate" assurance is defined by commercial standards and is generally a question of fact. *See e.g., Brisbin v. Superior Valve Co.,* 398 F.3d 279, 286 (3d Cir. 2005) (holding that supplier's demands for adequate assurance and grounds for insecurity were reasonable, given that buyer had not yet begun full-time production on contractually obligated projects over a year after contracts were signed and buyer offered supplier little to no feedback on project status). Official Comment 1 to UCC § 2-609 provides:

> The section rests on the recognition of the fact that the essential purpose of a contract between commercial men is actual performance … and that a continuing sense of reliance and security that the promised performance will be forthcoming when due is an important feature of the bargain. If either the willingness or the ability of a party to perform declines materially between the time of contracting and the time for performance, the other party is threatened with the loss of a substantial part of what he has bargained for. A seller needs protection not merely against having to deliver on credit to a shaky buyer, but also against having to procure and manufacture the goods, perhaps turning down other customers. Once he has been given reason to believe that the buyer's performance has become uncertain, it is an undue hardship to force him to continue his own performance.

UCC § 2-609, Official Comment 1. Outside of bankruptcy, courts have held that a payment default by the debtor alone qualifies as reasonable grounds for insecurity giving rise to the seller's right to demand adequate assurance of due performance. *See Reich v. Republic of Ghana*, 2002 WL 142610 at *4 (S.D.N.Y. Jan. 31, 2002) (citing *Hornell Brewing Co., Inc. v. Spry,* 664 N.Y.S.2d 698, 703 (N.Y. Sup. Ct. 1997) ("Reasonable grounds for insecurity can arise from the sole fact that a buyer has fallen behind in his account with the seller")); *Kunian v. Dev. Corp. of America,* 334 A.2d 427, 433 (1973) (holding that seller had reasonable grounds for insecurity when seller failed to pay amounts due under outstanding invoices). Bankruptcy, in and of itself, however, does not constitute reasonable grounds for insecurity for purposes of UCC § 2-609. *See In re Beeche Systems Corp.,* 164 B.R. 12, 16-17 (N.D.N.Y 1994).

Two UCC provisions also permit a supplier to stop delivery in certain circumstances where the debtor is insolvent[2] or has failed to timely pay its obligations to the vendor. First, UCC § 2-702 allows a vendor to refuse delivery except in return for cash payments by providing that "[w]here the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract." UCC § 2-702(1). Withholding delivery in such a manner amounts to a suspension of performance, not a termination of the contract. *See* UCC § 2-702, Official Comment 1 ("Where stoppage occurs for insecurity it is merely a suspension of performance").

Courts have suggested that UCC § 2-702(1) remains available as a remedy for suppliers postpetition. *See e.g., In re Coserv LLC*, 273 B.R. 487, 494-95 (Bankr. N.D. Tex. 2002) (noting that "mechanisms such as … payment on delivery [and] payment in advance" can help alleviate the financial strain that a buyer's bankruptcy filing may put on a vendor."); *Morrison Industries LP v. Hiross Inc. (In re Morrison Industries LP)*, 175 B.R. 5, 6 (Bankr. W.D.N.Y. 1994); *Cargill Inc. v. Trico Steel Co. LLC (In re Trico Steel Co. LLC)*, 282 B.R. 318 (Bankr. D. Del. 2002).

Second, UCC § 2-705(1) allows a vendor to stop delivery in process, providing that:

> The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent and may stop delivery of carload, truckload, planeload or larger shipments of express or freight when the buyer repudiates or fails to make a payment due before delivery or if for any other reason the seller has a right to withhold or reclaim the goods.

UCC § 2-05(1). Despite the Bankruptcy Code's general prohibition against contract modification or termination, some courts have allowed a vendor to exercise its UCC stoppage rights postpetition. For example, in *National Sugar Refining Co. v. C. Czarnikow Inc.*, 27 B.R. 565, (S.D.N.Y. 1983), the United States District Court for the Southern District of New York refused to find an automatic stay violation when a vendor exercised its stoppage rights, stating:

> We are of the opinion, however, that [the vendor] was not required under Code § 362(a) to seek relief from the stay prior to exercising its right of stoppage. As a practical matter, establishing as a prerequisite to such exercise an application for relief would in many instances effectively

[2] Under the UCC, a buyer can be deemed insolvent using either a balance-sheet test or an inability to pay debts as they come due test. UCC § 1-201(23).

> deny to the seller the right of stoppage, in light of the often short period between the filing of the petition and actual or constructive delivery of the goods during which the right must be exercised.

Id. at 572-73. The court reasoned that the vendor was neither terminating its contractual relationship with the debtor, nor modifying the terms of the contract but, rather, merely suspending its own performance pending assumption or rejection by the debtor. *Id.* at 574; *see also Cargill, Inc. v. Trico Steel Co. LLC (In re Trico Steel Co. LLC),* 282 B.R. 318 (Bankr. D. Del. 2002), *affirmed by J.P. Morgan Chase Bank v. Cargill Inc. (In re Trico Steel Co. LLC),* 302 B.R. 489, 494 (D. Del. 2003) (holding that a vendor's exercise of its stoppage rights was appropriate even though exercised postpetition); *In re Kellstrom Indus. Inc.*, 282 B.R. 787 (Bankr. D. Del. 2002) (seller's right to stop delivery of foods still in its possession, upon discovery of buyer's insolvency, was not impaired by passage of title to buyer).

c) *Demanding Cash on Delivery or in Advance*

Upon the filing of a bankruptcy case, a vendor may threaten to withhold performance absent payment by the debtor in advance or on delivery notwithstanding the terms of their supply agreement. In response to such a threat, a debtor may threaten to sue the supplier for breach of contract and/or violation of the automatic stay. The debtor may ask the court to find that the non-performing supplier has willfully violated the automatic stay and seek actual and punitive damages, sanctions and/or costs. In anticipation of such an argument by the debtor, the best course of action for a supplier is often to file a motion seeking stay relief.

In cases where a debtor has sought to compel a prepetition supplier to ship goods postpetition, courts have protected the supplier by requiring cash in advance. For example, in *In re Kellstrom Indus., Inc.*, 282 B.R. 787 (Bankr. D. Del. 2002), the supplier stopped delivery of goods despite the fact that the debtor already had legal title to goods which the debtor sought to sell pursuant to Section 363 of the Bankruptcy Code. The bankruptcy court held that passage of title as part of the contract did not eliminate or impair the supplier's right to stop delivery of parts under UCC § 2-702 and UCC § 2-705. *Id.* at 791. However, the court allowed the debtor to sell the goods provided that adequate protection was afforded to the supplier. The court required that "the sale of Parts free and clear of [supplier's] right to withhold and stop delivery be conditioned upon full payment in cash for all of the Parts to be delivered under the Agreement." *Id.* at 794; *see also Ike Kempner & Bros., Inc. v. U.S. Shore Corp. (In re Ike Kempner & Bros.),* 4 B.R. 31, 32-33 (Bankr. E.D. Ark. 1980) (bankruptcy court ordered a supplier to continue to ship product subject to a prepetition contract conditioned on debtor paying supplier prior to

shipment); *Sportfame of Ohio, Inc. v. Wilson Sporting Goods, Co. (In re Sportfame of Ohio, Inc.)*, 40 B.R. 47, 48 (Bankr. N.D. Ohio 1984) (bankruptcy court ordered the supplier to resume shipping but required the debtor to pay cash either in advance or upon receipt of the goods).

d) *Shortening Time for Assumption or Rejection*

Perhaps the most prudent course of action for a non-debtor party to an executory contract who believes that the debtor's delay in assuming or rejecting an executory contract is prejudicial to its interests is for the non-debtor party to file a motion to compel assumption or rejection, or shorten the time period for the debtor to make its election. *See e.g., Pub Serv. Co.*, 884 F.2d at 15-16. Section 365(d)(2) of the Bankruptcy Code expressly authorizes such action, providing:

> The trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan *but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease*.

Section 365(d)(2) (emphasis added). In filing such a request, the supplier should ask for adequate assurance of future performance before the shortened deadline. *See e.g., Matter of Travelot Co.*, 286 B.R. 462 (Bankr. S.D. Ga. 2002) (debtor would be required, before expiration of shortened deadline to deposit with court cash sufficient to cure defaults, both pre- and postpetition).

In determining whether a debtor must elect to assume or reject an executory contract prior to plan confirmation, "the bankruptcy court essentially balances the interests of the bankruptcy estate and its creditors against the interests of the movant." *In re EnCap Golf Holdings, LLC*, 2008 WL 5955350 at *3 (Bankr. D. N.J. Dec. 24, 2008). Courts examine multiple factors in determining whether to shorten the period of assumption or rejection, including: (i) the importance of the contract to the debtor's business or reorganization, (ii) the debtor's failure or ability to satisfy postpetition obligations, (iii) the nature of the interest at stake, (iv) the balance of hurt to the litigants and the good to be achieved, (v) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan, (vi) the safeguards afforded the litigants, (vii) the damages the non-debtor will suffer beyond compensation available under the Bankruptcy Code, (viii) whether there is a need for judicial determination as to whether an executory contract exists, (ix) whether a debtor's exclusive period to file a plan and solicit acceptances thereof has been terminated, (x) whether the

action to be taken is in derogation of Congress' scheme, and (xi) the purpose of chapter 11, which is to permit successful rehabilitation. *In re Dana Corp.*, 350 B.R. 144, 147 (Bankr. S.D.N.Y. 2006); *see also In re Adelphia Communications Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003) (compelling debtors to assume or reject prepetition contract within 90 days); *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002) (setting a 4-month time period for the debtors to assume or reject prepetition contract). No one factor is controlling and the analysis is conducted on a case-by-case basis.

The benefit to filing such a motion is that it tees up the issues related to the debtor's performance under the contract sooner rather than later and within the confines of the Bankruptcy Code. Moreover, for the contract to be assumed, the debtor must, among other things, provide adequate assurance of future performance under Section 365(b)(1) of the Bankruptcy Code. *See* Section 365(b)(1)(C) ("if there has been a default in an executory contract … of the debtor, the [debtor] may not assume such contract … unless, at the time of assumption of such contract…, the [debtor] provides adequate assurance of future performance under such contract."). The downside is that a hearing before the court on such a motion may not be granted for over a month, and any deadline for assumption or rejection likely would be at least another month or two later. Moreover, courts are often reluctant to force the debtor to make its assumption or rejection decisions early in the case. As such, the supplier should include in any such motion a discussion of the factors identified above, and why such factors weigh in favor of the supplier.

e) *Case Studies* – <u>In re Visteon Corporation</u> *and* <u>In re Lucre Inc.</u>

Good examples of suppliers aggressively pursuing their rights in this situation can be found in the bankruptcy cases of Visteon Corporation and Lucre, Inc. First, in the Visteon bankruptcy case, a supplier that had entered into a contract for the sale of goods to the debtor on credit filed a motion seeking adequate assurance of performance or, alternatively, assumption or rejection of the contract. *See Panasonic Automotive Systems Company of America's Motion for an Order Under Michigan Uniform Commercial Code § 2-609 and 11 U.S.C. §§ 105(a) and 365(d) Compelling the Debtors to (i) Provide Adequate Assurance of Performance or (ii) Assume or Reject the Pre-Petition Contract* [Case No. 09-11786, Doc No. 275].

In that case, the Visteon debtors had threatened to seek damages from the supplier for breach of contract and automatic stay violations unless the supplier rendered performance under the prepetition contract. The contract provided for the delivery of goods (historically, in the amount of $600,000 per week) on trade credit terms of approximately 55 days. In the motion, the supplier asserted that it had justifiably refused to accede to the

debtors' threats as agreeing to ship would result in the supplier assuming the risk of the debtors' administrative insolvency. The supplier stated, however, that it was willing to continue to provide postpetition goods to the debtors under cash-in-advance payment terms or, alternatively, if the debtors provided the supplier with an irrevocable stand-by letter of credit to secure the debtors' payment obligations.

In the motion, the supplier invoked its adequate assurance rights under UCC § 2-609, noting that in addition to the debtors' prepetition payment default, it had substantial grounds for insecurity postpetition warranting adequate assurance. Specifically, the supplier noted that the debtors: (i) had admitted that they were insolvent, (ii) had no debtor in possession financing or any other long-term source of working capital with which to finance the continuation of their business, and (iii) had only a limited right to use cash collateral. Accordingly, the supplier argued, there is no assurance that it would be paid for any of the goods delivered postpetition. The supplier further argued that its refusal to deliver goods postpetition was justified, relying on, among other things, UCC §§ 2-609, 2-702, and 2-705, and asserted that such state law rights survive the bankruptcy filing. Alternatively, the supplier argued that the debtors should be compelled to assume or reject the contract under Section 365(d)(2), which would entitle the supplier to adequate assurance of future performance under Section 365(b)(1).

Ultimately the parties settled and the supplier's motion was withdrawn. While it is mere speculation as to how the court would have ruled on the motion, it does appear that the motion impacted the debtor's decision-making process, ultimately resulting in a settlement that the supplier could live with.

In another case, *In re Lucre Inc.*, 339 B.R. 648 (Bankr. W.D. Mich. 2006), *aff'd on other grounds*, 471 F. Supp. 845 (W.D. Mich. 2007), the non-debtor party to an executory supply contract moved for relief from the automatic stay so that it could: (i) attempt to dissolve state court injunctions preventing it from discontinuing services, and (ii) safely withhold future performance under its contract. *Id.* at 650. Importantly, the non-debtor party asserted that the debtor had materially breached the executory contract prepetition. *Id.* at 652.

The debtor argued that because the executory contract became property of the debtor's estate, the non-debtor party was subject to the automatic stay such that it was required to perform. *Id.* at 653. According to the court, however, Section 541 of the Bankruptcy Code transfers only the interests the debtor has in property as of the petition date. *Id.* at 655. The court explained that unless the Bankruptcy Code itself provides greater or different rights under an executory contract, a debtor is subject to the rights under the agreement as of the date of the petition. *Id.* If the

Bankruptcy Code is silent, the court found, "the debtor is subject to the same laws and regulations as those that had constrained the debtor pre-petition." *Id.* The court explained:

> A bankruptcy estate does not engage in these activities in a vacuum. Rather its activities are proscribed by the very same laws as those which regulate the activities of other legal entities which own property and which engage in business transactions. The only difference is that the outcome of activities which involve a bankruptcy estate may also be affected by the Bankruptcy Code itself. Consequently, it is incorrect to consider bankruptcy matters as being governed exclusively by the Bankruptcy Code and whatever "common law" the courts may have enacted in conjunction with that Code. Instead, the Bankruptcy Code should be treated as simply a filter which must be used when a bankruptcy petition is filed to reassess an already existing framework of laws and regulations.

Id. (citing *In re Macomb Occupational Health Care, LLC,* 300 B.R. 270, 283 n. 11 (Bankr. E.D. Mich. 2003)).

Noting that the debtor had defaulted under the executory contract prepetition and, thus, was subject to the non-debtor's UCC rights to withhold performance, the court stated: "The question then is what, if any, section of the Bankruptcy Code empowers [the debtor] to compel [the non-debtor party] to continue performance under the [executory contract] notwithstanding [the debtor's] alleged pre-petition breach of the agreements." *Id.*

The court was not persuaded by the interpretation of Sections 362 and 365 employed by other courts, noting that:

> Unfortunately, the courts have tended to read into § 365 more than that section actually provides. Section 365 is in fact simply a conglomeration of various rules relating to the post-petition *assumption and rejection* of executory contracts and unexpired leases.

Id. at 655 (emphasis added). The court found that the only provision of Section 365 that deals with compelling performance of a non-debtor party is Section 365(b)(4), which deals exclusively with an unexpired lease of the debtor upon the occurrence of a default. *Id.* at 657. That subsection, the court stated, "proves by exception that the rule that a trustee or DIP cannot otherwise demand performance from the party to the contract when the debtor's prepetition breach under the contract remains uncured." *Id.* at 658. In other words, the court reasoned, "there is no reason for including

Section 365(b)(4) in the Bankruptcy Code if, as [the debtor] would have it, prepetition defaults are irrelevant to begin with." *Id.*

The court also rejected the debtor's argument that any refusal to perform by the non-debtor party would violate the automatic stay provision in Section 362(a)(6) (prohibiting any "act to collect, assess, or recover a claim") because the non-debtor party's reason for withholding performance on C.O.D. terms was to collect on the sizable prepetition debt owed to it by the debtor. *Id.* The court suggested that the non-debtor party could be reluctant to perform for a variety of reasons other than non-payment of the prepetition amount including, among other things, concern about the debtor's ability to perform postpetition, a better offer from a competitor or it simply does not do business with chapter 11 debtors. *Id.* Of course, the court stated, "the other party to an executory contract may ultimately have no choice but to perform under the contract if the debtor, as debtor-in-possession, cures the pre-petition default and otherwise meets the requirements for assumption under Section 365." *Id.* However, the court continued, that advantage can only be regained by the debtor if the executory contract is in fact assumed: "[u]ntil that point, the advantage remains with the other party." *Id.* The court further reasoned that, since Section 362(a)(6) only stays an "act to collect, assess, or recover a claim," the non-debtor party's *inaction* in refusing to perform postpetition did not run afoul of the automatic stay. *Id.*

Finally, turning again to the prepetition material breach, the court noted that what was really at issue was whether the debtor could demand postpetition services from the non-debtor party notwithstanding its prepetition breach of the agreement. *Id.* at 660. "The mere commencement of the bankruptcy case and the attendant imposition of the automatic stay," the court found, "do not by themselves empower a debtor … to compel from the other party to an executory contract performance the day after the commencement of the bankruptcy case when the debtor had no right to compel that performance the day before." *Id.*

The court recognized that the non-debtor party's refusal to perform could have a catastrophic result with respect to the debtor's efforts to reorganize, stating "[b]ankruptcy judges and practitioners alike are uneasy whenever a party advocates a position which, if accepted, would interfere with the debtor's ability to reorganize." *Id.* at 661. Nonetheless, the court explained, not all debtors are guaranteed success under chapter 11. Instead, "[a]ll that Congress has done is to set up a system within which all debtors can try." *Id.*

Although it is undeniably a minority view, *In re Lucre* stands for the proposition that the automatic stay does not preclude the non-debtor from refusing to perform postpetition where the debtor had breached the contract prior to the bankruptcy. As discussed previously, in order to

highlight any prepetition breaches, suppliers should be diligent in pursuing their UCC and contractual rights whenever, and as soon as, possible.

5. **Conclusions Regarding the Enforcement of the Rights of a Non-Debtor Party to an Executory Contract**

There are a variety of arguments available to non-debtor parties to executory contracts during the period between the petition date and confirmation where such parties are concerned about the debtor's willingness or ability to perform its side of the deal. In most cases, however, any action that a non-debtor party takes should be accompanied by a motion for relief from stay so that it does not run afoul of Section 362 of the Bankruptcy Code.

E. LICENSES OF INTELLECTUAL PROPERTY

1. ***Lubrizol*, Section 365(n), and *Sunbeam* – Rights of Licensees of Intellectual Property in the Bankruptcy Cases of Their Licensors**

Section 365(n) provides special protections to a licensee in the event a debtor rejects an executory contract under which the debtor is a licensor of a right to "intellectual property." Upon such rejection, the licensee may elect either to seek a prepetition claim for damages based on the rejection, or to retain its rights to the intellectual property as they existed immediately prior to the bankruptcy filing.

Note that the Bankruptcy Code definition of "***intellectual property***" includes patents, but not trademarks. Section 101(35A).

a) *The leading pre-365(n) case* – Lubrizol:

Section 365(n) was enacted in reaction to *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), in which the Fourth Circuit court held that a debtor could strip a licensee's intellectual property rights through the rejection of a license agreement. At issue in *Lubrizol* was a "nonexclusive license to utilize a metal coating process technology" granted by the debtor (RMF) to Lubrizol. Lubrizol had not begun to use the process when, after filing its chapter 11 petition, RMF moved to reject the license.

The Fourth Circuit held that (a) the technology license was executory and therefore subject to rejection, and (b) the effect of rejection was to terminate the licensee's rights in the licensed intellectual property.[3] Using

[3] The bankruptcy court had granted RMF's motion to reject, finding the contract executory because each party had ongoing, albeit contingent, material liabilities, and holding that rejection was in the best interests of the estate because it would effect a termination of Lubrizol's rights in the process and thereby allow the debtor to sell or license the process free of Lubrizol's license. *In re Richmond Metal Finishers, Inc.*, 34 B.R. 521 (Bankr. E.D. Va. 1983). The district court reversed, finding RMF's continuing obligations to be *de minimis* and the license therefore non-executory, and finding no benefit to the estate

the *Countryman* test, the court found the license to be executory because mutual material obligations existed between the parties: on the one hand, RMF had "continuing core obligations of notice and forbearance" (to notify Lubrizol of other licenses and forbear from licensing at different rates without adjusting Lubrizol's rates) and, on the other hand, Lubrizol had an obligation to "deliver written quarterly sales reports and keep books of account" subject to an accounting by RMF.[4] The court then upheld the rejection, which it determined would "strip[] Lubrizol of its rights in the process and facilitate further licensing," as being in the best interests of the estate. *Lubrizol*, 756 F.2d at 1047.

b) *Enactment of Section 365(n)*:

In response to *Lubrizol*, Congress enacted Section 365(n), to protect licensees of "intellectual property" in the event of a contract rejection. However, in defining the term *intellectual property*, Congress notably excluded **trademarks**. *See* Section 101(35A). The omission of trademarks was intentional, and legislative history shows that Congress believed that further study of trademarks was needed, because trademark licensing agreements generally included provisions regarding "control of the quality of the products or services sold" that were beyond the scope of the statute. S. Rep. No. 100-505, 5, *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204

c) *Developments in protection of trademark licenses*

In recent years, courts have grappled with determining the consequences of rejecting trademark licenses in a bankruptcy. Most courts historically assumed the omission of trademark licenses from Section 365(n) meant that the rejection of a trademark license operates to strip the licensee of its rights in the trademark, focusing instead on whether a trademark license was executory and therefore could be rejected, and, until recently, many of those courts found the trademark licenses at issue to be executory. *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) (authorizing rejection of executory trademark license and finding that rejection terminates licensee's rights in the license); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) (same); *Raima UK Ltd., v Centura Software Corp. (In re Centura Software Corp.)*, 281

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because Lubrizol's "nonexclusive property right" in the process would survive rejection. *In re Richmond Metal Finishers, Inc.*, 38 B.R. 341 (E.D. Va. 1984).

[4] The court appears to have misapplied legislative history in finding that Lubrizol's ongoing royalty payment obligations to debtor RMF were relevant to the executoriness analysis. The court cited to legislative history that said that where the only obligation left on a note was the debtor's obligation to repay, the contract generally would not be executory. H. R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5693, 6303-04. However, the only ongoing obligation to pay in the *Lubrizol* license was Lubrizol's duty, not RMF's. *See, e.g., In re Teligent, Inc.*, 268 B.R. 723, 732 (Bankr. S.D.N.Y. 2001).

B.R. 660, 673-75 (Bankr. N.D. Cal. 2002) (same). However, in the last five years, three circuit decisions have reached results favoring trademark licensee rights. Two of these decisions, *Exide* and *Interstate Bakeries*, determined that the trademark licenses at issue were not executory because any continuing performance under the licenses were not material when compared to the entirety of the integrated agreements. The third, *Sunbeam*, held that the rejection of a trademark license did not terminate the licensee's rights in the trademark.

1) ***Exide***: The license under review in *In re Exide Techs*., 607 F.3d 957 (2d Cir. 2010), was a trademark license granted in connection with a prepetition sale by the debtor (Exide) of substantially all of its industrial battery business to EnerSys Delaware Inc. EnerSys was granted a "perpetual, exclusive, royalty-free license to use the Exide trademark." Exide sought rejection of its agreement with EnerSys in order to terminate the trademark license and allow Exide to reenter the battery business.

   The bankruptcy and district courts found the trademark license was executory and permitted its rejection.[5] The Third Circuit reversed, finding the trademark agreement was integrated with the related sale agreements and that EnerSys had substantially performed its obligations as a licensee and counterparty under the integrated agreement, where EnerSys had already paid the full $135 million purchase price, assumed liabilities in connection with the business and operated under the Exide Agreement for ten years. Applying the same *Countryman* test that the *Lubrizol* court had in reaching the opposite result, the court determined that, under New York law (which governed the Exide Agreement), a "material breach" qualifying an unperformed obligation as executory must be "a breach which is so substantial as to defeat the purpose of the entire transaction," and that no material breach can occur if the breaching party has already "substantially performed" under the contract. *Id.*

[5] *In re Exide Techs.*, 340 B.R. 222 (Bankr. D. Del. 2006); *In re Exide Techs.*, No. 02-11125 (KJC), 2008 WL 522516 (D. Del. Feb. 27, 2008). The bankruptcy court found nearly all of the following to be material unperformed obligations: "(1) Exide must refrain from suing EnerSys for trademark infringement for the use of the Exide mark . . . ; (2) EnerSys must refrain from using the Exide mark outside of the industrial battery business . . . ; (3) Exide must refrain from using the Exide mark within the industrial battery business . . . ; (4) EnerSys must maintain a minimum level of quality for its products that contain the Exide mark . . . ; 5) Exide must make payments into a pension plan maintained for the benefit of its employees . . . ; (6) Exide must maintain the registration of the Exide mark . . . ; (7) Exide and EnerSys must indemnify each other from and against certain costs, losses, liabilities, damages, lawsuits, claims, etc . . . ; and (8) Exide and EnerSys must cooperate with one another after the closing of the Agreement in order to effectuate certain provisions contained therein." *Id.* at 230.

at 962 (citing *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 895 (2d Cir. 1975)).[6]

Because it found that the Exide Agreement was not executory, the Third Circuit did not reach the issue of what effect rejection would have on EnerSys' rights in the trademark. However, one judge concurred in the decision, finding the agreement to be executory but concluding that a trademark license could not be stripped through rejection by the debtor.

2) ***Interstate Bakeries***: The procedural history of *Interstate Bakeries*, which was recently decided *en banc*, tells largely the same story as *Exide*'s. *See Lewis Bros. Bakeries, Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 2014 WL 2535294 (8th Cir. June 6, 2014) ("*Interstate II*"). At issue in *Interstate Bakeries* was a trademark license agreement granted by the debtor (Interstate Bakeries) to Lewis Brothers Bakeries, Inc. ("LBB") as part of a $20 million sale of certain of Interstate Bakeries' businesses in certain territories, entered into as a result of a U.S. Department of Justice antitrust divestiture decree. The license agreement granted LBB a "perpetual, royalty-free, assignable, transferable, exclusive" license to use those brands and trademarks in the relevant territories. Following Interstate Bakeries' bankruptcy filing, LBB commenced an adversary proceeding in bankruptcy court for a declaratory judgment that the license was not executory.

As the *Exide* lower courts had done, the bankruptcy court focused solely on the license agreement and found that there were material continuing obligations thereunder, including, as in *Exide*, mutual obligations to maintain the quality of goods produced using the trademarks. *In re Interstate Bakeries Corp.*, 2010 WL 2332142 (Bankr. W.D. Mo. June 4, 2010). Relying on the *Exide* lower court decisions (which had not yet been reversed), the bankruptcy court therefore found the license agreement to be executory.

On appeal, although both the district court and the Eighth Circuit rendered their respective decisions after the Third Circuit's reversal in *Exide* came down, both appellate courts affirmed the bankruptcy court decision, distinguishing *Exide* on the basis that, unlike in *Exide*, the *Interstate Bakeries* license agreement

[6] The court went on to lay out factors to be considered to determine whether there had been substantial performance: "Several factors must be considered, including the ratio of the performance already rendered to that unperformed, the quantitative character of the default, the degree to which the purpose of the contract has been frustrated, the willfulness of the default, and the extent to which the aggrieved party has already received the substantial benefit of the promised performance." *Id.* at 963 (quoting *Hadden v. Consol. Edison Co. of New York, Inc.*, 34 N.Y.2d 88, 96 (1974)).

expressly provided that LBB's failure to maintain quality standards would constitute a "material breach" of the agreement. *In re Interstate Bakeries Corp.,* 447 B.R. 879 (W.D. Mo. 2011); *In re Interstate Bakeries Corp.,* 690 F.3d 1069 (8th Cir. 2012) ("*Interstate I*"). While basing its analysis on the *Countryman* test like the *Exide* court had, the Eighth Circuit in *Interstate I* did not consider whether the quality standards maintenance obligation was material if the license were viewed as integrated with the asset sale agreement.[7]

LBB moved for rehearing *en banc* on the basis of (1) the conflict between *Interstate I* and *Exide*; (2) the "exceptional[] importance" of the issue for the structuring of intellectual property transactions, and (3) Judge Colloton's dissent.[8] The Eighth Circuit invited the Federal Trade Commission to file an amicus brief, which the Commission did, presenting "the government's views on the proper application of the executory contract doctrine . . . to contracts that implement antitrust divestiture decrees" and expressing concern that allowing a debtor to reject, and thereby terminate, a license that had been granted as part of an antitrust decree would thwart the remedial purpose of such decrees.[9] The Eighth Circuit granted the motion for rehearing and vacated *Interstate I*.

On rehearing *en banc*, the Eighth Circuit reversed the district court, holding that the trademark license agreement was not executory. *Interstate II,* 2014 WL 2535294 at *7. The *Interstate II* panel (1) found that the license agreement was a single integrated contract with the asset purchase agreement, (2) adopted the "doctrine of substantial performance" used by the *Exide* court as part of the *Countryman* test, and (3) held that both parties had substantially performed their obligations under the integrated agreement (including the payment by LBB of the full $20 million purchase price and the transfer of all of the tangible assets under the purchase agreement from Interstate Bakeries to LBB). *Id.* at *5-7. In comparison to the obligations that had been performed under the integrated agreement, the panel found that the remaining

[7] In a lengthy dissent, *In re Interstate Bakeries Corp.*, 690 F.3d at 107, Judge Colloton maintained that the executoriness analysis should have been made by looking at the license and asset sale agreement as a single, integrated contract and that, in that context, as in *Exide*, the alleged ongoing obligations were relatively minor.

[8] Appellants' Petition for Rehearing En Banc, *In re Interstate Bakeries Corp.*, No. 11-1850 (8th Cir. filed Jan. 2, 2013.)

[9] Brief for the United States and the Federal Trade Commission as Amici Curiae in Support of Rehearing, *In re Interstate Bakeries Corp.*, No. 11-1850 (8th Cir. filed May 31, 2013).

obligations, including the quality standards maintenance provision, were "relatively minor and do not relate to the central purpose of the agreement to sell" the business operations to LBB "[w]hen considered in the context of the entire agreement." *Id.* at *7.

The *Interstate II* panel found "useful guidance on analogous facts in" *Exide*, and aligned itself with that decision in making its holding that the license agreement is not executory "[f]or similar reasons." *Id.* Because it found the agreement not to be executory, the *Interstate II* panel declined to address whether "rejection of a trademark-licensing agreement terminates the licensee's rights to use the trademark," although it noted the *Sunbeam* decision on the issue (discussed below) and Judge Ambro's concurrence in *Exide* and their disagreement with *Lubrizol*. *Id.* at *7 n. 2.[10]

3) ***Sunbeam***: In *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir.), *cert. denied*, 133 S. Ct. 790 (2012), the Seventh Circuit squarely addressed the issue that the *Exide* and *Interstate II* courts declined to decide and, in a departure from the weight of authorities on the issue, held that rejection of a trademark license does **not** terminate the licensee's rights in the trademark.

The license at issue in *Sunbeam* related to a contract under which Chicago American Manufacturing ("CAM") manufactured the debtor's (Lakewood Engineering & Manufacturing Co.) box fans. Under the contract, CAM had the right to practice Lakewood's patents and put its trademarks on the fans. Moreover, CAM contracted with Lakewood to be allowed to sell the completed fans for its own account if Lakewood failed to purchase them. Shortly after execution of the agreement, Lakewood's creditors commenced an involuntary chapter 7 bankruptcy against Lakewood. The chapter 7 trustee rejected Lakewood's contract with CAM and sold Lakewood's business to Sunbeam. Despite the rejection, CAM continued to manufacture and sell Lakewood-branded fans. Sunbeam litigated to seek a determination that the effect of Lakewood's rejection of the contract was to terminate CAM's right to sell fans bearing Lakewood's trademarks.[11]

[10] Three of the judges on the panel filed a separate opinion that dissented from most of the majority's decision and agreed with the lower courts that LBB's quality control obligation, which had been made explicitly "material" in the agreement, was material. *Id.* at *8-9.

[11] Although the Seventh Circuit characterized the adversary proceeding as commenced by Sunbeam (d/b/a "Jarden"), 686 F.3d at 374, it appears, from the recitation of facts by the bankruptcy court, that the Lakewood chapter 7 trustee actually commenced the adversary proceeding when the trustee was considering attempting to re-enter the box-fan business on Lakewood's account, and that Sunbeam

Both the bankruptcy court and the Seventh Circuit on direct appeal agreed with Judge Ambro's concurring opinion in *Exide*. *Exide*, 607 F.3d at 964. In his concurrence, Judge Ambro criticized the *Exide* bankruptcy and district courts for imputing that Congress's omission of trademarks from the protection of Section 365(n) indicated a codification of *Lubrizol*'s holding that rejection otherwise terminated a counterparty's rights. Judge Ambro argued that "'it is simply more freight than negative inference will bear' to read rejection of a trademark license to effect the same result as termination." *Id.* at 967 (quoting Michael T. Andrew, *Executory Contracts Revisited*, 62 U. Colo. L. Rev. 1, 11 (1991)). Judge Ambro stated that the purpose of Section 365 was "merely to free … the estate from the obligation to perform," and that courts should not let licensors use Section 365 to "take back trademark right[s they] bargained away." *Id.*

The *Sunbeam* bankruptcy court agreed with Judge Ambro and found no negative inference in Section 365(n), noting that "rejection . . . does not make the contract disappear."[12] The bankruptcy court found that on the filing date, Lakewood's estate only took such interest in the trademark license as Lakewood held prepetition, and held that equity required allowing CAM to continue using the Lakewood marks. *Id.*

The Seventh Circuit affirmed but disagreed with the bankruptcy court's reliance on equity rather than on the Bankruptcy Code, stating that "[t]here are hundreds of bankruptcy judges, who have many different ideas about what is equitable in any given situation." *Sunbeam*, 686 F.3d at 375. The court found that Section 365, "by classifying rejection as breach[,] . . . establish[es] that, in bankruptcy, as outside of it, the other party's rights remain in place." *Id.* at 377. The court found that while rejection does not entitle a counterparty to specific performance and that unfulfilled obligations are converted to damages that would be realized at a discount, "nothing about this process implies that any rights of the other contracting party [are] vaporized." *Id.* The court noted that the Bankruptcy Code expressly provides trustees with a means of eliminating rights in certain circumstances – in its avoiding powers, not rejection – and that where a trustee uses Section 365(a) to reject a contract, it "is not the functional equivalent of a rescission" and does not "render[] void the contract." *Id.* The

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intervened after purchasing Lakewood's business. *See Szilagyi v. Chicago Am. Mfg., LLC (In re Lakewood Eng'g & Mfg. Co., Inc.)*, 459 B.R. 306, 324 (Bankr. N.D. Ill. 2011).

[12] *Szilagyi*, 459 B.R. at 345 (quoting *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group., Inc.*), 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992)).

court therefore held that "the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights." *Id.* at 378.

The Seventh Circuit in *Sunbeam* expressly rejected *Lubrizol* (with no judge of the circuit favoring a rehearing *en banc*). Indeed, in stating that it disagreed with *Lubrizol*, the court noted that "[s]cholars uniformly criticize *Lubrizol*, concluding that it confuses rejection with the use of an avoiding power." *Id.* at 377. In addition, by finding that, under the Bankruptcy Code, rejection does not eliminate licensees' rights in the trademarks, the court rendered irrelevant *Exide*'s and *Interstate Bakeries*' examination of executoriness.

Conclusion: *Exide*, *Interstate II* and *Sunbeam* appear to represent a developing trend among the circuits away from permitting debtors to use the bankruptcy process to recapture trademark rights that they previously bargained away. Even if the Seventh Circuit ultimately stands alone in finding that rejection under Section 365 does not eliminate a counterparty's rights in a trademark, *Exide* and *Interstate II* indicate that at least some courts will impose a high (perhaps unattainable) standard for finding trademark license agreements executory when such licenses are a part of larger asset sales.

2. **The *Qimonda* Case – Protecting U.S Licensees of U.S. Patents Owned by Insolvent Foreign Licensors**

In December 2013, in *Jaffé v. Samsung Electronics Co. (In re Qimonda AG)*, No. 12-1802, 2013 WL 6388591 (4th Cir. Dec. 3, 2013), the Fourth Circuit addressed the first impression issue of whether a bankruptcy court need recognize, in a chapter 15 proceeding, the termination of licenses in a foreign proceeding, where the governing foreign insolvency law did not preserve the rights of licensees that are protected by Section 365(n) of the Bankruptcy Code.

Qimonda AG, a German manufacturer of semiconductor memory devices, filed for insolvency in Germany in January 2009. Dr. Michael Jaffé, as insolvency administrator and the estate fiduciary, filed an application in the U.S. bankruptcy court under chapter 15 for recognition of the German proceedings. Qimonda's principal assets consisted of its patent portfolio, including a significant number of U.S. patents, which were subject to broad non-exclusive cross-licensing agreements with its competitors.[13]

[13] Such patent cross-licensing agreements are commonly used to reduce any risk of "hold-up" claims, *i.e.*, the ability of the owner of an infringed patent to extract significantly higher royalties after the fact than would have been agreed to upfront. Such risks particularly exist in the semiconductor industry, where the vast array of overlapping intellectual property incorporated into each semiconductor product brings a

Dr. Jaffé, as insolvency administrator, sought to monetize the patents by re-licensing them and declared, pursuant to German insolvency law, the cross-license agreements to be unenforceable – in effect, "rejecting" them. The German Insolvency Code allows a debtor to decide not to continue performing the debtor's executory contracts; however, unlike Section 365(n) of the Bankruptcy Code, it includes no carve-out for the intellectual property rights of a non-debtor licensee.

In considering whether to respect and enforce the termination of the patent licenses under German law, the U.S. bankruptcy court first considered which country's laws determined the issue. It held that German insolvency law controlled the issue of whether to enforce the patent cross-license agreements, noting that the chapter 15 proceeding should "supplement, but not supplant, the German proceeding." *In re Qimonda AG,* 2009 WL 4060083 at *2 (Bankr. E.D. Va. Nov. 19, 2009). Several of the patent licensees appealed to the district court on the basis that the license terminations would deny the licensees of U.S. patents the protections of Section 365(n) of the Bankruptcy Code, namely, the ability of counterparties of rejected contracts to continue to exercise their rights to intellectual property provided under the rejected contracts. The district court remanded, with instructions to the bankruptcy court to consider (1) whether the interests of the creditors were sufficiently protected as required by Section 1522(a) of the Bankruptcy Code, and (2) whether circumventing the protections of Section 365(n) is manifestly contrary to the public policy of the United States pursuant to Section 1506 of the Bankruptcy Code. *In re Qimonda AG Bankr. Litig.,* 433 B.R. 547, 557-58, 567-71 (E.D. Va. 2010).

On remand, the bankruptcy court determined that the protections in Section 365(n) should apply to any termination of licenses of U.S. patents by the Qimonda estate. *In re Qimonda AG,* 462 B.R. 165 (Bankr. E.D. Va. 2011). First, the bankruptcy court found that Section 1522(a) of the Bankruptcy Code required that it balance the interests of the estate's creditors and the debtor.[14] Section 1522(a) provides that a bankruptcy court may grant certain relief to a foreign representative under chapter 15, including the administration of the debtor's U.S. assets, only after it has established that the interests of creditors are sufficiently protected. Before the hearing, Dr. Jaffé promised to re-license the patents to the licensees at a reasonable and non-discriminatory (RAND) rate. Nevertheless, the bankruptcy court determined that the loss in value to the Qimonda estate from an inability to re-license the patents was outweighed by the risk created to the investments the licensees had made in their products and fabrication facilities. *Id.* at 180-83.

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greater risk of infringement of patents owned by numerous third parties. Cross-licenses allow parties to expend large upfront costs to begin the fabrication process with less risk of hold-up claims.

[14] Section 1522(a) of the Bankruptcy Code provides: "The court may grant relief under section 1519 or 1521 …only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Second, the bankruptcy court held that allowing the Qimonda estate to cancel the licenses of the U.S. patents violated Section 1506 of the Bankruptcy Code, because it would be manifestly contrary to the public policy of the United States to enforce such termination.[15] The bankruptcy court found the intellectual property protections in Section 365(n) to be of great public importance and held that cancellation without those protections would slow innovation in the U.S. semiconductor industry. *Id.* at 184-85.

The Fourth Circuit Court of Appeals affirmed the decision on direct appeal. First, the Fourth Circuit agreed with the bankruptcy court that Section 1522(a) requires a bankruptcy court to undertake a balancing analysis that considers the interests of the estate's creditors and the debtor. *Jaffé v. Samsung Electronics Co. (In re Qimonda AG),* 2013 WL 6388591, at *11. The Fourth Circuit rejected the argument that Section 1522(a) provided creditors with procedural protections only and not with protection from the substantive effects of the law of the foreign bankruptcy forum, as well as the argument that the limited public policy protections of Section 1506 were the only exceptions in which a bankruptcy court did not have to defer to foreign substantive law. Instead, the Fourth Circuit held that when granting discretionary relief under chapter 15, a court must consider whether creditors are sufficiently protected from the effects of imposing foreign law. *Id.* at *12.

The Fourth Circuit also found reasonable (although a close question) the bankruptcy court's balancing analysis under Section 1522 and conclusion that any gains to the estate from re-licensing the U.S. patents did not justify the costs to the licensees. The court noted the hold-up risk facing the licensees who already invested in their technology and manufacturing processes in reliance on the design freedom provided by the cross-licenses. In the face of such costs to the licensees, the court found that Dr. Jaffé's commitment to re-license the patents – even at RAND rates – did not sufficiently protect the licensees' interests from the cancellation of the licenses. *Id.* at *13-14.[16]

On the basis that it had resolved the appeal under Section 1522(a), the Fourth Circuit did not find it necessary to address the bankruptcy court's determination that recognition of the termination of the licenses was also barred by Section 1506 as manifestly contrary to public policy. The Fourth Circuit did, however, note that protecting the licensees' rights also furthered the public policy interests underlying the intellectual property protections "inherent in and manifested by section 365(n)." *Id.* at *15-16. The court thus left unanswered the question of

[15] Section 1506 of the Bankruptcy Code provides: "Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

[16] In addition, the bankruptcy court had questioned whether a re-licensing agreement really would provide meaningful protection if Qimonda could sell the patents to a German entity who, in a subsequent bankruptcy, could once again terminate the licenses and sue the licensees for infringement. *Id.* at *14.

whether, if a court were to find the balancing of interests analysis under Section 1522(a) to weigh in the opposite direction, it still would not enforce the cancellation of licenses of U.S. patents on the basis that it was manifestly contrary to U.S. public policy.

Although that question was left open, the *Qimonda* decision marks a further recognition by courts of the importance of protecting intellectual property licensees from debtor-licensors trying to use the bankruptcy process to eliminate licensees' rights to the intellectual property, and ensuring that licensees can continue to rely on their interest in the intellectual property even where the licensor is insolvent. *Qimonda* closed off a licensor's ability, at least in the Fourth Circuit, to take advantage of the laws of foreign insolvency regimes to bypass licensees' Section 365(n) rights. A current proposal before the U.S. Senate, H.R. 3309, would codify, and expand upon, *Qimonda*, by applying Section 365(n) automatically in every Chapter 15 proceeding.[17]

F. LIMITED LIABILITY COMPANY AND PARTNERSHIP AGREEMENTS

1. **Is the LLC Operating Agreement or Partnership Agreement Executory?**

a) This question can arise in the bankruptcy of either the entity or the member/partner and, since the test of executoriness looks at both parties' obligations, the question should be answered the same way in either case.

b) The entity's obligations include making distributions and complying with the exercise of powers. The member/partner's obligations include contributing capital in the event of a call, and perhaps management. Many of the clauses affecting the member/partner may be powers rather than obligations.

c) The majority view appears to be that partnership agreements are executory contracts;. *See, e.g.*, *Breeton v. Catron (In re Catron)*, 158 B.R. 629, 634 (E.D. Va. 1993) (collecting cases for majority view), *aff'd*, 25 F.3d 1038 (4th Cir. 1994).

d) Courts are divided regarding the status of LLC operating agreements. *Contrast Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re Allentown Ambassadors, Inc.)*, 361 B.R. 422 (Bankr. E.D. Pa. 2007) and *In re Daugherty Constr., Inc.*, 118 B.R. 607 (Bankr. D. Neb. 1995) (each finding an LLC operating agreement to be executory contract) *with In re Capital Acquisitions and Mgmt. Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006) and *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005) (each finding that LLC operating agreement at issue was not an executory contract).

[17] Innovation Act, H.R. 3309, 113th Cong. § 6(d)(1) (2013).

2. **If the Agreement Is Executory, May a Bankrupt Member/Partner Assume It?**

a) The member/partner's executory obligations, assumed here to exist, may very well be non-assumable under Section 365(c)(1)(A) (see above) and "applicable law" on the grounds that they are personal in nature.

b) However this obstacle to assumption should apply only in jurisdictions adhering to the so-called "hypothetical test" for assumption of a contract (described elsewhere in these Materials).

3. **In the Bankruptcy of a Member/Partner, Which Interests in the Entity Become Property of the Member/Partner's Bankruptcy Estate?**

a) State law (whether the organic statute and/or the operating or partnership agreement) generally provides that the bankruptcy of a member/partner disassociates the member/partner. It also provides that transferees acquire only an economic rather than a governance interest, absent the consent of other member/partners.

1) UCC Article 9 is generally not to the contrary. LLC and partnership interests are usually "general intangibles" rather than investment property under Article 9, and UCC §§ 9-406 and 9-408 do override certain anti-assignment provisions in general intangibles, but only those that would run to the benefit of the entity itself, rather than other member/partners.

2) However, Section 541(c)(1) of the Bankruptcy Code – a "sibling" anti-*ipso facto* provision noted in these Materials – provides that:

> an interest of the debtor becomes property of the estate . . . notwithstanding any provision in an agreement . . . or applicable nonbankruptcy law –
>
> > … that restricts or conditions transfer of such interest by the debtor; or
> >
> > … that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

Applying this Bankruptcy Code provision would result in the governance interest, too, becoming property of the estate. A

majority of the cases, though, decline to apply Section 541(c) to a debtor's governance interests in an LLC, reasoning instead that the estate's property interests are determined by state law. *See, e.g.*, *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000).

b) Rights of first refusal conferred by the LLC operating agreement on other members should not be invalidated by Section 363(*l*), at least in the ordinary case in which they are triggered by any transfer and not just one effectuated by bankruptcy. *See In re The IT Group, Inc., Co.*, 302 B.R. 483 (D. Del. 2003); *In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632, 637-38 (Bankr. N.D. Ill. 2006).

PANELIST BIOGRAPHIES

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CHRISTOPHER COMBEST — MODERATOR

Christopher Combest is a partner in Quarles & Brady's Commercial Bankruptcy, Restructuring and Creditors' Rights Group in Chicago and is co-chair of the Executory Contracts Subcommittee of the American Bar Association's Business Bankruptcy Committee. In addition to work for creditors and debtors in a variety of insolvency situations, his practice encompasses secured transactions under Article 9 of the Uniform Commercial Code and issues arising from asset securitizations. He represents commercial landlords, equipment lessors, debtors, trustees, receivers, secured and unsecured creditors, manufacturers, defendants in bankruptcy avoidance actions, and purchasers of assets out of bankruptcy estates

Chris is a 1982 graduate of Yale College and a 1994 graduate of Yale Law School. In a previous life, he earned an M.F.A. degree in acting from the University of Washington in Seattle.

Chris's speaking engagements have included presentations to the National Conference of Bankruptcy Judges; the Turnaround Management Association, the Commercial Mortgage Attorneys' Association; the Business Bankruptcy, Uniform Commercial Code, and Commercial Financial Services Committees of the American Bar Association; the National Business Institute, and the Diocesan Fiscal Management Conference. He has co-taught a course on real estate in bankruptcy as an adjunct professor in the LLM program at John Marshall Law School in Chicago. His articles on legal topics have appeared in *Business Law Today*, BNA's *Bankruptcy Law Reporter, The Practical Lawyer*, and *The Journal of Corporate Renewal*, and in publications of the American Bar Association, The Practising Law Institute, and the Illinois Institute for Continuing Legal Education.

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ASHLEY CHAMPION

Ashley Champion serves as a judicial law clerk to the Honorable Katharine Samson in the Bankruptcy Court for the Southern District of Mississippi. She graduated *magna cum laude* from Georgia State University College of Law, where she served as Articles Editor for the Georgia State Law Review. While in law school, Ashley interned for the Honorable Mary Grace Diehl in the Bankruptcy Court for the Northern District of Georgia, as well as in the Office of the United States Trustee. Ashley received the second-place award in the 2013 American Bankruptcy Institute law student writing competition for her article entitled *Use it or Lose it: Waiver of Article III Adjudication in a Post-Stem World*, which was published in the June 2013 Bankruptcy Litigation Committee Newsletter. Her other publications include: Ashley Champion & Jessica Gabel, *Social Networks and Ethical Chaos: Professional Responsibility Issues in Consumer Bankruptcy Cases*, in Best Of ABI 2012: The Year In Consumer Bankruptcy 262 (2012); Ashley Champion & Kimberly Reeves, *The Problem of Too Much Culpability*, AM. BANKR. INST. J., July 2012, at 56; and Jessica D. Gabel & Ashley D. Chainpion, *Regulating the Science of Forensic Evidence: A Broken System Requires a New Federal Agency*, 90 TEX. L. REV. *See Also* 19 (2011). Ashley has two forthcoming articles that will be published this year in the Norton Journal of Bankruptcy Law and Practice. She is a member of the Georgia bar, the American Bankruptcy Institute, and the American Bar Association. She is also currently serving as a Faculty Committee Member of the American Board of Certification.

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ANDREA COLES-BJERRE

Andrea Coles-Bjerre is Associate Professor of Law and Faculty Director of the Business Law Program at the University of Oregon School of Law. She teaches and writes in the fields of bankruptcy and civil procedure and received the Orlando J. Hollis Award for Excellence in Teaching. She received her B.A., *magna cum laude*, from Barnard College in 1984 and her J.D. from Brooklyn Law School in 1987. After finishing law school, Professor Coles-Bjerre clerked for two years for U.S. Bankruptcy Judge Jerome Feller, E.D.N.Y. She practiced for six years with the law firm of Milbank, Tweed, Hadley & McCloy in New York, where she was the lead associate in a variety of complex Chapter 11 and other insolvency matters, including representation of an investor group that acquired New York City's Rockefeller Center, and the institutional noteholders in the reorganization of the Phar-Mor chain of drugstores (one of history's more notorious bankruptcy fraud cases). She has been a member of the Oregon faculty since 1996. She is a peer reviewer for the American Bankruptcy Law Journal and has been a visiting faculty member at Brooklyn Law School. Her most recent article, *Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy*, appears in the New Mexico Law Review, Volume 40.

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HON. CAROL A. DOYLE

The Honorable Carol A. Doyle is a judge on the United States Bankruptcy Court for the Northern District of Illinois, sitting in Chicago. From July 1, 2007, through June 30, 2011, Judge Doyle served as Chief Judge of that Court. She is currently serving her second 14-year term as a bankruptcy judge. Prior to her appointment to the bench, Judge Doyle spent 14 years at Sidley & Austin LLP, concentrating on business and environmental litigation. She served as law clerk to the Honorable John A. Nordberg of the United States District Court for the Northern District of Illinois from 1982 to 1985. Judge Doyle earned her Bachelor of Business Administration, with distinction, from the University of Iowa and her J.D., with distinction, from the Loyola University Chicago School of Law.

U.S. Bankruptcy Court
Northern District of Illinois
Chicago, IL

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PAUL R. HAGE

Paul R. Hage is a partner in the insolvency & reorganization practice group at Jaffe Raitt Heuer & Weiss, P.C. He specializes in representing debtors, secured and unsecured creditors, unsecured creditors' committees, asset purchasers and trustees in reorganizations, liquidations and other insolvency proceedings nationwide. Paul earned his Bachelor's degree from James Madison College at Michigan State University and his J.D. from Loyola University Chicago School of Law. He earned his LL.M. in Bankruptcy from St. John's University School of Law. Paul frequently writes and speaks on bankruptcy issues for the American Bar Association Business Bankruptcy Committee, the American Bankruptcy Institute, Norton Institutes and the Turnaround Management Association.

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LISA M. SCHWEITZER

Lisa Schweitzer is a partner of Cleary Gottlieb Steen & Hamilton LLP based in the New York office. Ms. Schweitzer's practice focuses on financial restructuring, bankruptcy, insolvency and commercial litigation. Ms. Schweitzer has extensive experience advising corporate debtors, individual creditors and strategic investors in both U.S. Chapter 11 proceedings and restructurings in other jurisdictions in North America, Europe and Asia. Ms. Schweitzer also has represented several companies seeking to acquire distressed assets in bankruptcy proceedings.

Ms. Schweitzer advises clients on a broad range of matters in some of the most high-profile bankruptcy matters, with particular expertise in sale, intellectual property and cross-jurisdictional issues. She is currently lead U.S. restructuring counsel to Nortel Networks Inc. and affiliates in their U.S. Chapter 11 proceedings, including serving as counsel to the U.S. Nortel estate, in a groundbreaking cross-border trial in Toronto and Wilmington courts concerning a dispute with Canadian and European estates regarding the allocation of sale proceeds and intercompany claims. She also represented Nortel in nearly $7.5 billion of asset sales. In addition, Ms. Schweitzer advises creditors in restructuring cases, including the recent restructurings of Vitro and Maxcom Telecomunicaciones. Ms. Schweitzer also represented Barclays Capital in its acquisition of Lehman Brothers' North American investment banking and capital markets assets, and a $450 million debtor-in-possession financing facility provided to Lehman.

Ms. Schweitzer was honored in 2012 as a "Dealmaker of the Year" and in 2011 as a "Dealmaker in the Spotlight" by *The American Lawyer*. She is recognized as a leading bankruptcy and restructuring lawyer by *Chambers USA, The Legal 500 U.S., IFLR 1000: The Guide to the World's Leading Financial Law Firms, The International Who's Who of Business Lawyers* and *The International Who's Who of Insolvency & Restructuring Lawyers.* Additionally, Ms. Schweitzer was shortlisted for Euromoney's LMG Americas Women in Business Law Awards in 2013 and 2014 for insolvency and restructuring.

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Jill Walters is an attorney in Poyner Spruill LLP's Raleigh, North Carolina office and practices in the areas of Creditors' Rights, Bankruptcy and NCAA compliance. She regularly represents secured and unsecured creditors in Chapter 7, 11, 12, and 13 bankruptcy cases in all three North Carolina bankruptcy districts and also represents banks and other lenders in collection and claim and delivery actions throughout the state. Jill is a member of the Bankruptcy Section of the North Carolina Bar Association and serves on the Board of Directors for the International Women's Insolvency & Restructuring Confederation – Carolinas Network.

Jill received her B.A. from Lake Forest College, and her J.D. from Michigan State University.

Before joining Poyner Spruill in 2008, Jill was a Staff Attorney for the United States Bankruptcy Administrator for the Eastern District of North Carolina.

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