

## A. Executory Contracts and Leases

Section 365 of the Bankruptcy Code generally allows a debtor in possession to assume, assign, or reject executory contracts and unexpired leases in the chapter 11 case.<sup>408</sup> The debtor in possession typically makes this determination based on a variety of factors, including whether the contract or lease is above or below market, necessary to its ongoing business operations, and subject to assumption under the Bankruptcy Code. It also may consult with the unsecured creditors' committee on these issues or attempt to renegotiate the contract or lease with the nondebtor party. A debtor in possession's decision to assume, assign, or reject an executory contract or unexpired lease is subject to court approval, certain deadlines, and several other requirements detailed in section 365.<sup>409</sup>

### 1. Definition of Executory Contract

#### *Recommended Principles:*

- The Bankruptcy Code should define the term “*executory contract*” for purposes of section 365 as “a contract under which the obligation 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,” provided that forbearance should not constitute performance. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). The contours of this definition are well developed under the case law and reflect an appropriate balance between the rights of a trustee to assume or reject contracts unilaterally under the Bankruptcy Code and the nondebtor's obligations and rights in those circumstances.

#### *Definition of Executory Contract: Background*

Section 365(a) provides that a debtor in possession,<sup>410</sup> “subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.”<sup>411</sup> The Bankruptcy Code does not define “executory contract,” and the legislative history of section 365 provides little guidance.<sup>412</sup> Accordingly, the court on a case-by-case basis determines whether a particular contract is executory.

Courts traditionally have used what is commonly referred to as the “Countryman” definition of executory contracts.<sup>413</sup> This test was developed by Professor Vern Countryman and defines an

<sup>408</sup> 11 U.S.C. § 365.

<sup>409</sup> See, e.g., *id.* § 365(b) (requirements for assumption); *id.* § 365(c) (contracts not subject to assumption or assignment); *id.* § 365(f) (requirements for assignments).

<sup>410</sup> As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

<sup>411</sup> 11 U.S.C. § 365(a).

<sup>412</sup> H.R. Rep. No. 95-595, at 347 (1977) (“Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.”).

<sup>413</sup> See *In re Baird*, 567 F.3d 1207, 1211 (10th Cir. 2009); *In re Columbia Gas Sys., Inc.*, 50 F.3d 233, 239 (3d Cir. 1995); *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989); *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985); *In re Select-A-Seat Corp.*, 625 F.2d 290, 292 (9th Cir. 1980).

executory contract for bankruptcy purposes as “a contract under which the obligation 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.”<sup>414</sup> Although widely used, courts have recognized limitations and potential inconsistencies in the application of the Countryman test.<sup>415</sup> In addition, the test may not be a good fit for certain kinds of contracts.<sup>416</sup>

Given the noted flaws in the Countryman test, courts have developed alternative approaches to assess executory contracts. For example, some courts use the “functional approach” to evaluate a debtor in possession’s request to assume or reject an executory contract. Under this approach, developed by Professor Jay Westbrook, there is no threshold standard of “executory contract” that the debtor in possession must meet to assume or reject the contract.<sup>417</sup> Rather, the functional approach focuses on whether assumption or rejection would create a benefit for the bankruptcy estate and its creditors. The functional approach recognizes that courts often manipulate the threshold requirement of executory contract in order to produce the desired outcome.<sup>418</sup> Several courts have adopted the functional approach or used it in connection with the Countryman test.<sup>419</sup>

Another alternative approach is commonly referred to as the “exclusionary approach.” This approach is a deviation from the Countryman test and was developed by Michael Andrew.<sup>420</sup> The following are the primary differences between the Countryman test and the exclusionary approach: (i) the concept of executory contract is irrelevant in the rejection context;<sup>421</sup> and (ii) a contract is executory if each party has unperformed obligations, and if the debtor’s nonperformance eliminates its right

414 Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

415 See, e.g., *In re Gen. Dev. Corp.*, 84 F.3d 1364, 1374 (11th Cir. 1996); *In re RoomStore Inc.*, 473 B.R. 107, 111–12 (Bankr. E.D. Va. 2012).

416 Some courts have struggled with the application of the Countryman definition in the context of the following kinds of agreements: options and rights of first refusal; restrictive covenants (covenants not to compete; restrictive covenants on land); oil and gas agreements (e.g., the oil and gas leases themselves and variations thereof, like farmout agreements, and related agreements, like surface use agreements and joint operating agreements); licenses, distributor agreements, and trademark agreements; warranties; rights of first refusal; employment contracts; and severance agreements; arbitration clauses; forum selection clauses; distributor agreements; trademark agreements; and indemnity clauses; and settlement agreements. See, e.g., *Water Ski Mania Estates Homeowners Ass’n v. Hayes* (*In re Hayes*), 2008 Bankr. LEXIS 4668, at \*31–32 (B.A.P. 9th Cir. Mar. 31, 2008) (“[A]lthough restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. Although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting § 365.”) (citation omitted); *Frontier Energy, LLC v. Aurora Energy, Ltd.* (*In re Aurora Oil & Gas Corp.*), 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) (“The court’s conclusion that the [oil and gas leases] qualify as ‘leases’ within the meaning of Section 365 makes it unnecessary to consider whether the [oil and gas leases] meet either the functional test or Countryman definition for executory contracts. Given the confusion in the case law, it is also improvident to opine on the question.”) (citations omitted); *In re Bergt*, 241 B.R. 17, 29–31 (Bankr. D. Alaska 1999) (discussing the application of the Countryman test in recent case law to options); *Bronner v. Chenoweth-Massie, P’ship* (*In re Nat’l Fin. Realty Trust*), 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998) (“The contingent nature of the obligations arising from an option agreement make them quite distinguishable from the typical contract. This distinction has puzzled many courts, resulting in two distinct lines of cases. The first line of cases, while recognizing the contingent nature of the obligations arising under option agreements, and while also expressly acknowledging that they are unilateral contracts until exercised, have nevertheless engaged in what could be described as analytical gymnastics to arrive at a finding that they are nonetheless executory contracts.”) (citations omitted); *Cohen v. Drexel Burnham Lambert Grp., Inc.* (*In re Drexel Burnham Lambert Grp., Inc.*), 138 B.R. 687, 699 (Bankr. S.D.N.Y. 1992) (“Our readings persuade us that in each case, use of the Countryman test was neither necessary nor determinative. It was, rather, merely window dressing for results determined in the first instance by resort to another, sometimes unspecified criterion.”) (analyzing case law regarding application of Countryman test to employment agreements). See also *infra* note 424.

417 Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 282–85 (1989).

418 *Id.* at 287.

419 See, e.g., *Route 21 Assoc. of Belleville, Inc., v. MHC, Inc.*, 486 B.R. 75 (S.D.N.Y. 2012); *In re Majestic Capital, Ltd.*, 463 B.R. 289, 300 (Bankr. S.D.N.Y. 2012).

420 Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding “Rejection,”* 59 U. Colo. L. Rev. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991).

421 Andrew, *Executory Contracts in Bankruptcy*, *supra* note 420, at 894.

to the other party's performance.<sup>422</sup> Although courts have not adopted this approach, they have considered its factors in applying other tests.<sup>423</sup>

### *Definition of Executory Contract: Recommendations and Findings*

The Commission conducted an in-depth review of the literature and case law on executoriness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoriness issue and the attendant uncertainty and expense. The focus of the executoriness inquiry is whether each party has significant unperformed obligations under the contract.<sup>424</sup> The Commissioners discussed examples of contracts when this issue may be of particular concern, such as options, covenants not to compete, and oil and gas leases.<sup>425</sup> Although executoriness is not necessarily a bright-line determination, the Commissioners generally agreed that courts resolve this issue fairly or parties are able to negotiate a resolution.

The Commission also considered the possibility of eliminating the concept of executoriness from the Bankruptcy Code. Both the advisory committee and the 1997 NBRC endorsed this position.<sup>426</sup> The Commissioners debated at length the potential utility to this approach. They discussed the meaningful benefits to refocusing contract disputes on the merits of the proposed assumption or rejection rather than extensive litigation on executoriness. The Commissioners supporting this approach emphasized the value to such a clean solution: with the distraction of executoriness off the table, parties could devote more attention on their rights, obligations, and remedies under the contract. Many Commissioners found the simplicity of this approach attractive.

Further deliberations about the elimination proposal revealed, however, the potential of unintended consequences of such a dramatic shift in a fundamental bankruptcy principle. The Commissioners noted the common law origins of the executoriness requirement of section 365,<sup>427</sup> and they also

<sup>422</sup> *Id.* at 893.

<sup>423</sup> See, e.g., *In re Family Snacks, Inc.*, 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001).

<sup>424</sup> The Seventh Circuit Court of Appeals explained:

The Bankruptcy Code's legislative history states that the term "executory contract" "generally includes contracts on which performance is due to some extent on both sides." A common definition, which this court has cited with approval, states that a contract is executory for bankruptcy purposes where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material breach excusing the performance of the other."

*In re Crippin*, 877 F.2d 594, 596 (7th Cir. 1989). See also *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054, 1060 (3d Cir. 1988) ("The [Bankruptcy] Code does not define the term executory contract, however, courts have generally employed what has become known as the 'Countryman' definition of an executory contract, i.e., a contract under which the obligations of both the bankrupt and the other party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation omitted).

<sup>425</sup> See, e.g., *COR Route 5 Co., LLC v. Penn Traffic Co.* (*In re Penn Traffic Co.*), 524 F.3d 373, 380 (2d Cir. 2008) ("While some courts have held that options contracts under which the optionee fully paid its price for the option to buy property before the debtor filed for bankruptcy are not executory (because no performance is due from the optionor unless the option is exercised), . . . others treat such contracts as executory.") (citing conflicting case law) (citations omitted); *Powell v. Anadarko E&P Co., L.P.* (*In re Powell*), 482 B.R. 873, 877-78 (Bankr. M.D. Pa. 2012) ("Some courts have assumed that an oil and gas lease is an executory contract. Other courts have considered an oil and gas lease a transfer of an interest in real property and therefore not an executory contract.") (citing conflicting case law) (citations omitted); *In re Teligent, Inc.*, 268 B.R. 723, 730-31 (Bankr. S.D.N.Y. 2001) ("As a rule, Delaware law treats the covenant not to compete and the reciprocal promise to pay as material. As a result, the failure to make payment will discharge the obligation not to compete. . . . Where the covenant is given in connection with the sale of a business, it is even more likely to be deemed material. A covenant not to compete is often included in a contract to sell a business to protect the purchaser and allow him to enjoy the built-up good will.")

<sup>426</sup> See NBRC Report, *supra* note 37, at 21 ("Title 11 should be amended to delete all references to 'executory' in section 365 and related provisions, and 'executoriness' should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.")

<sup>427</sup> See *In re Austin Dev. Co.*, 19 F.3d 1077, 1081 (5th Cir. 1994) ("Section 365 derives from § 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's

perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executory concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.

The Commissioners also discussed the functional approach to determining executory, but most perceived the test to be unfair toward counterparties and too heavily weighted in favor of the interests of the debtor and the estate. The Commissioners acknowledged the potential value of allowing a debtor in possession to assume or reject any contract that would provide a benefit to the estate. As with the elimination proposal, however, the Commissioners were concerned about diminishing the rights of the nondebtor counterparties under the contracts. Subjecting any contract to section 365 primarily, if not solely, for the benefit of the estate imposed a greater burden on nondebtor parties than necessary to achieve a fair result for the estate in a chapter 11 case.

On balance, the Commission voted to adopt the Countryman test and to recommend its express incorporation into the Bankruptcy Code. The Commission found that, although imperfect, the Countryman test strikes an appropriate balance between the rights of debtors in possession and nondebtor counterparties to a contract. If the parties have material unperformed obligations, it is fair and reasonable to allow a debtor to choose to assume, assign, or reject such an agreement under section 365. The Commission also determined that many of the potentially challenging issues under the Countryman test have been resolved by the courts and that this case law is a valuable resource that would guide the implementation of the codified standard.

## 2. General Rights of Private Parties to Executory Contracts and Unexpired Leases

### *Recommended Principles:*

- A nondebtor party to an executory contract or unexpired lease with the debtor should be required to continue to perform under such contract or lease after the petition date, provided that the trustee needs such continued performance and pays for any products or services delivered after the petition date on a timely basis as required by the contract or lease. In paying for such products or services, however, the trustee should not be subject to any modifications or rate changes in the contract or lease triggered by the debtor's bankruptcy filing, insolvency, or prepetition default.
- Except as provided in section 365(d)(3) of the Bankruptcy Code (and the principles for that section, *see* Section V.A.6, *Real Property Leases*) and in section 365(d)(5) of the Bankruptcy Code, the trustee does not otherwise have an

leases or executory contracts or to 'reject' them if they were economically burdensome to the estate.”).

obligation to perform, or to cure any defaults, under such contract or lease prior to the assumption of that contract or lease under section 365(a). The nondebtor party should be permitted to compel the trustee to perform other postpetition obligations under the contract or lease if the court determines, after notice and a hearing, that the harm to the nondebtor party resulting from the trustee's nonperformance significantly outweighs the benefit to the estate derived from such nonperformance. The court should limit the trustee's performance obligation to that which is necessary to mitigate the harm to the nondebtor party pending assumption or rejection. The nondebtor party should bear the burden of proof in any such hearing.

- The trustee should not be required to cure nonmonetary defaults that occur prior to the assumption of the executory contract or unexpired lease and that are impossible for the debtor to cure at the time of the proposed assumption under section 365(a) and (b).
- These principles governing the rights of parties to executory contracts and unexpired leases are intended to apply only to contracts and leases between private parties and should not affect the debtor's contracts or leases with any state or federal governments.

### ***General Rights of Private Parties to Executory Contracts and Unexpired Leases: Background***

In most chapter 11 cases, the debtor in possession<sup>428</sup> does not make its decision to assume, assign, or reject executory contracts and unexpired leases on, or even shortly after, the petition date. As such, there is a gap period between the petition date and the treatment decision under section 365. The Bankruptcy Code requires the debtor in possession to perform timely obligations arising under nonresidential real property leases, certain personal property leases,<sup>429</sup> and intellectual property licenses,<sup>430</sup> but does not otherwise address performance during the gap period.<sup>431</sup> In light of this silence, "most courts agree that before an executory contract is assumed or rejected under § 365(a), that contract continues to exist, enforceable by the debtor in possession, but not enforceable against the debtor in possession."<sup>432</sup>

<sup>428</sup> As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

<sup>429</sup> 11 U.S.C. § 365(d)(5). This provision for personal property leases applies only in chapter 11 cases. *Id.* If the case is initially filed under chapter 11 and later converted to chapter 7, section 365(d)(5) will no longer apply. 3 Collier on Bankruptcy ¶ 365.04[2][c].

<sup>430</sup> 11 U.S.C. § 365(n).

<sup>431</sup> *Id.* § 365(d)(3). The court "may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period." *Id.*

<sup>432</sup> See, e.g., *In re Nat'l Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (collecting cases). See also Howard C. Buschman III, *Benefits and Burdens: Postpetition Performance of Unassumed Executory Contracts*, 5 Bankr. Dev. J. 341, 343 (1988) (citing Douglas Bordewick & Vern Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors*, 57 Am. Bankr. L.J. 239, 332 (1983)); 2 Collier on Bankruptcy ¶ 365.03, 365-28, 365-29 (15th ed. 1988); 8 Collier on Bankruptcy ¶ 3.15(6) at 204 (14th ed. 1978).

Courts generally justify this one-sided performance requirement by emphasizing the importance of the breathing spell created by the automatic stay for the debtor in possession,<sup>433</sup> and the severe consequences that may result from a rushed or premature decision to assume, assign, or reject an executory contract or unexpired lease.<sup>434</sup> They also acknowledge the burden such one-sided performance may impose on the nondebtor party, but on balance find in favor of the estate. The nondebtor party may seek to compel performance or a treatment decision by the debtor in possession under section 365, and it frequently requests an administrative claim under section 503(b)(3) for any postpetition obligations that the debtor in possession fails to perform.<sup>435</sup>

Once a debtor in possession decides to assume an executory contract or unexpired lease, section 365(b) requires the debtor in possession to cure or provide adequate assurance of a prompt cure of any defaults under the contract or lease. Section 365(b)(1) indicates that nonmonetary defaults that are impossible to cure under unexpired leases for nonresidential real property do not require cure, “except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph.”<sup>436</sup> Section 365(b)(2) further provides that a debtor in possession’s general cure obligations under section 365(b)(1) do not apply to “the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.”<sup>437</sup> Some courts have interpreted section 365 to preclude the assumption of executory contracts and unexpired leases (other than real property leases) if non-curable historical nonmonetary defaults exist under the contract or lease.<sup>438</sup>

### ***General Rights of Private Parties to Executory Contracts and Unexpired Leases: Recommendations and Findings***

The chapter 11 filing can have significant negative implications for a nondebtor party’s business. Accordingly, the Commission carefully scrutinized the postpetition needs of a debtor in possession with respect to executory contracts and unexpired leases. The Commissioners discussed the importance of a reliable, steady supply of goods and services used in the debtor’s business to the debtor in possession’s reorganization efforts. They also acknowledged that nondebtor parties frequently threaten to stop providing goods or services unless the debtor in possession satisfies certain conditions. Although the Commissioners understood the nondebtor party’s desire for more

433 See, e.g., *In re Cont’l Energy Assocs. Ltd. P’ship*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) (“Not only does this saddle an ailing company with an additional burden which it is unlikely to overcome, it pressures the Debtor to surrender the ‘breathing space’ normally allowed to it to consider the assumption or rejection of the contract.”).

434 11 U.S.C. § 365(g)(2). Post-assumption rejection is treated as a breach at the time of rejection (*i.e.*, postpetition). *Id.* Where a contract or lease is assumed in a chapter 11 case that is later converted to a chapter 7 and then the contract or lease is rejected in the chapter 7 case, the rejection would be treated as having occurred immediately before the date of conversion. 1 Collier Handbook for Trustees & Debtors in Possession ¶ 14.07 (2012).

435 11 U.S.C. § 503(b). The extent of the nondebtor party’s administrative claim, however, may be limited by the court under the “benefit to the estate” standard of section 503(b). See *Mason v. Official Comm. of Unsecured Creditors (In re FBI Distrib. Corp.)*, 330 F.3d 36, 42–43 (1st Cir. 2003) (“[T]he nondebtor party will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate.”); *In re Nat’l Steel Corp.*, 316 B.R. 287, 301 (Bankr. N.D. Ill. 2004) (“Claims under § 503(b)(1)(A) are to be measured by the benefit received by the estate rather than the cost incurred by a claimant.”).

436 11 U.S.C. § 365(b)(1).

437 *Id.* § 365(b)(2).

438 See, e.g., *In re Carterhouse, Inc.*, 94 B.R. 271, 273 (Bankr. D. Conn. 1988) (holding that section 365(b)(1) “extends to nonmonetary as well as monetary breaches”).

certainty and for some kind of adequate assurance, they found the general principles underlying the postpetition performance requirements to be sound.

Reflecting on the circumstances of nondebtor parties in these cases, however, the Commissioners considered various ways to mitigate the burden imposed by the general postpetition performance requirement. They did not believe that the debtor in possession should be required to provide adequate protection under section 361 of the Bankruptcy Code or to cure any historical defaults prior to assumption or rejection of the contract or lease. They also rejected full performance of the contract or lease by the debtor in possession, agreeing with courts that hold such a requirement undercuts the value of the automatic stay in the debtor in possession's reorganization efforts.

The Commissioners debated the feasibility of requiring the debtor in possession to pay for goods and services actually provided to the debtor in possession postpetition in accordance with the terms of the contract or lease. Some Commissioners commented that the debtor in possession may not have the liquidity to meet this standard on an immediate postpetition basis, while others indicated that the debtor in possession's needs in this respect could be factored into the postpetition financing budget.<sup>439</sup> The Commissioners stressed the need for any such payment obligation to be limited to those goods and services needed by, and provided to, the debtor in possession postpetition and that the nondebtor party should not be able to enforce more onerous payment terms from, or demand any other type of performance of, the debtor in possession pending assumption or rejection of the contract or lease.<sup>440</sup> The terms of the prepetition contract or lease should govern the timing and amount of the debtor in possession's postpetition payment obligations, unless the parties mutually agree to more beneficial terms for the estate.

The Commissioners also analyzed the circumstances under which nondebtor parties should be able to seek to compel full or greater postpetition performance by the debtor in possession under the contract or lease. The Commissioners generally believed that nondebtor parties should have this option, but that the standard of proof should be stringent and that the nondebtor party should bear the burden of proof, particularly in light of the Commission's recommendation to require some postpetition payment by the debtor in possession. The Commission ultimately determined that this standard was an appropriate balance and recommended the joint proposal of requiring payment solely for goods or services provided to the debtor in possession postpetition and placing a high evidentiary burden on the nondebtor party that seeks to compel further or other postpetition performance. The Commissioners also discussed the potential impact of these provisions on government contracts. In light of the different and varied interests that may be implicated by government contracts, the Commission agreed that these contracts be excluded from the recommended principles governing postpetition performance of executory contracts and unexpired leases and that such principles be limited to the rights of private parties to executory contracts and unexpired leases with a debtor.

439 Some of the Commissioners proposed incorporating an "adequate assurance" concept similar to Section 2-609 of the Uniform Commercial Code, but others believed that this would provide too much leverage for counterparties in terms of holdup value.

440 *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3-4 (June 4, 2013) (stating that retailers are failing because of the reluctance of trade creditors to extend credit on reasonable terms and the difficulty of obtaining DIP and exit financing to support reorganization), available at Commission website, *supra* note 55; *id.* at 5 (citing the January 2013 Senior Loan Officer Opinion Survey on Bank Practices from the Federal Reserve which indicates that DIP lending is tight and trade vendors are unwilling to extend credit except on onerous terms).

Finally, the Commissioners addressed the continued confusion in the case law concerning a debtor in possession's obligation to cure historical nonmonetary defaults in order to assume the executory contract or unexpired lease. The Commissioners acknowledged that the BAPCPA Amendments to the Bankruptcy Code clarified this issue for real property leases, but that ambiguity remained for other kinds of leases and executory contracts. The Commissioners debated whether certain kinds of historical nonmonetary defaults were so central to a contract's or lease's purpose that their nonperformance should bar assumption. On balance, the Commission determined that, with respect to all executory contracts and unexpired leases, a debtor in possession should not be required to cure nonmonetary defaults occurring prior to the assumption decision that are impossible to cure at the time of assumption under section 365(b) of the Bankruptcy Code.

### 3. Rejection of Executory Contracts and Unexpired Leases

#### *Recommended Principles:*

- The rejection of an executory contract or unexpired lease should continue to constitute a breach of the contract or lease as of the time immediately preceding the commencement of the case under section 365(g) of the Bankruptcy Code. The trustee's rejection of an executory contract or unexpired lease should not, however, entitle the nonbreaching, nondebtor party to a right of specific performance or to retain possession or use of any property of the debtor or the estate.
- A nonbreaching, nondebtor party should be able to retain possession or continue to use property of the debtor or the estate if expressly authorized by a section of the Bankruptcy Code (*e.g.*, section 365(n)).
- If the nondebtor party to an executory contract or unexpired lease breaches the executory contract or unexpired lease prior to the trustee's assumption or rejection decision, the trustee may treat such contract or lease as breached and exercise any rights or remedies it may have under the contract or lease or applicable nonbankruptcy law.

#### *Rejection of Executory Contracts and Unexpired Leases: Background*

A debtor in possession<sup>441</sup> may reject (*i.e.*, disavow) most executory contracts and unexpired leases under section 365(a) of the Bankruptcy Code. A debtor in possession's decision to reject an executory contract or unexpired lease generally relieves the debtor in possession of further performance obligations under the contract or lease. Courts, however, have differed on whether rejection terminates the contract or lease or, rather, constitutes a breach by the debtor in possession of such contract or lease.

<sup>441</sup> As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.



Section 365(g) of the Bankruptcy Code specifically provides that rejection “constitutes a breach of such contract or lease.” As such, section 365(g) answers the initial question concerning the effect of rejection and expressly equates rejection with a breach of the contract or lease by the debtor.<sup>442</sup> In some cases, that determination may end the inquiry, but in other cases, questions still remain regarding what rights the nondebtor party may pursue under the contract or lease or under applicable nonbankruptcy law because of the debtor’s breach. As explained by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,

[w]hat § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party’s rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. . . . The debtor’s unfulfilled obligations are converted to damages; . . . But nothing about this process implies that any rights of the other contracting party have been vaporized.<sup>443</sup>

Courts and commentators agree that rejection gives the nondebtor party a right to assert monetary damages against the debtor in possession, which is deemed a prepetition claim against the estate.<sup>444</sup> They also generally agree that the nondebtor party cannot compel continued performance by the debtor in possession, unless otherwise specifically permitted by section 365.<sup>445</sup> They do not, however, agree whether the nondebtor party can enforce equitable remedies against the debtor in possession that such party otherwise would be able to assert under applicable nonbankruptcy law.<sup>446</sup> The court’s perspective on this issue can have significant implications for the estate.

### ***Rejection of Executory Contracts and Unexpired Leases: Recommendations and Findings***

The Commission focused a substantial amount of time on the concept of rejection and whether a debtor in possession’s decision to reject an executory contract or unexpired lease should trigger a breach or termination of such contract or lease. The Commissioners discussed the language of section 365 and specifically contrasted it with the chapter 5 avoiding powers of the debtor in possession. Congress did not intend section 365 to operate as an avoiding power that would allow a debtor in possession to terminate or unwind prepetition agreements or completely extinguish the rights of the nondebtor counterparty to an agreement. Such a result would be contrary to the language and structure of the Bankruptcy Code and well-settled federal policy that state law generally determines

442 See, e.g., *Sunbeam Prod., Inc. v. Chi. Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012), cert. denied, 133 S. Ct. 790 (2012). Both the National Bankruptcy Conference’s Bankruptcy Code Review Project in 1993 and the NBRC in 1997 expressly considered the question of whether rejection should result in termination and provided a negative answer. A.L.I.-A.B.A., Bankruptcy Reform Circa 1993 183–87 (Nat’l Bankr. Conf. 1993); NBRC Report, *supra* note 37, § 2.4.1.

443 *Sunbeam Prod., Inc. v. Chi. Am. Mfg. LLC*, 686 F.3d 372, 377 (7th Cir. 2012), cert. denied, 133 S. Ct. 790 (2012).

444 11 U.S.C. § 365(g)(1).

445 See, e.g., *In re Walnut Assocs.*, 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992) (“[N]on-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor’s general unsecured creditors. . . . [U]nless specific performance is available to the non-debtor party under applicable state law, the debtor cannot be compelled to render its performances required under the contract. However, if state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.”).

446 See, e.g., *Abboud v. Ground Round, Inc.* (*In re Ground Round, Inc.*), 335 B.R. 253 (B.A.P. 1st Cir. 2005) (“[A] party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under applicable state law.”); *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (same with respect to covenant not to compete). *But see, e.g., In re Register*, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989) (refusing to enforce covenant not to compete in rejected sale agreement). See also *Route 21 Assoc. of Belleville, Inc. v. MHC, Inc.*, 486 B.R. 75 (S.D.N.Y. 2012) (injunctive relief could be reduced to monetary claim).

property rights in bankruptcy.<sup>447</sup> The Commission voted to reinforce the principle that rejection of an executory contract or unexpired lease constitutes a breach, not a termination, of such contract or lease.

The Commissioners fully vetted the potential consequences of equating rejection with breach of the applicable contract or lease, using various examples to explore the nuances and variances in possible results. In analyzing these scenarios, the Commissioners worked to balance the state law rights and interests of the nondebtor party with the federal interests that are central to the reorganization efforts of a debtor in possession. These federal interests include equal treatment of all similarly situated creditors, automatic stay of actions based on prepetition transactions and relationships with the debtor, and the ability of the debtor in possession to reject burdensome contracts and leases to facilitate its reorganization.<sup>448</sup>

The Commission considered the rejection of different kinds of contracts and leases, and identified the competing interests of the debtor in possession and the nondebtor, and the needs of the estate, following rejection. For example, the debtor in possession, on behalf of the estate, needs (i) any property that may be held by the nondebtor party to be returned; (ii) the ability to use such property free from restraints or limitations; and (iii) relief from any performance obligations under the contract or lease. Congress was aware of these needs and carefully balanced them against the interests of the nondebtor party. In specific instances when the interests of the nondebtor party outweigh the needs of the debtor in possession, Congress specified the nondebtor party's rights upon rejection. Specifically, these exceptions arise in the context of certain real property leases, timeshares, and intellectual property licenses.<sup>449</sup>

The Commission agreed that, other than the exceptions already made by Congress, the nondebtor party to the rejected contract or lease should be required to immediately return the debtor's property to the debtor in possession and should not be able to enforce any equitable or injunctive relief against, or otherwise require performance by, the debtor in possession. In addition to the factors previously noted, the Commissioners pointed to section 542 in support of requiring the counterparty to return personal property to the estate upon rejection.<sup>450</sup> They also believed that allowing the nondebtor party to enforce equitable or injunctive relief against the debtor in possession would elevate the rights of such counterparty beyond those of other similarly situated prepetition creditors. Indeed, general unsecured creditors typically are not entitled to relief from the automatic stay or to take actions affecting the debtor in possession's postpetition business operations, despite the terms of the creditors' prepetition contracts or applicable nonbankruptcy law. Accordingly, the Commission

447 "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner v. United States*, 440 U.S. 48, 54 (1979).

448 *See, e.g., In re Am. Suzuki Motor Corp.*, 494 B.R. 466, 477 (Bankr. C.D. Cal. 2013) ("The purpose of contract rejection under section 365 is to permit the debtor to receive the economic benefits necessary for reorganization (which includes liquidation under chapter 11) for the ultimate benefit of the estate and its creditors. State legislatively imposed buyback requirements, fair market value awards and treble-damages penalties are superimposed onto the normal contract damage remedy provisions under state common or statutory law. While Florida and many other states believe that their public policy should provide special protections for the economic interest of local car dealerships, in the area of federal bankruptcy law those remedies run counter to the federal policy of bankruptcy reorganization and are therefore preempted."); *In re PPI Enters. (U.S.), Inc.*, 228 B.R. 339, 344-45 (Bankr. D. Del. 1998) ("In enacting the Bankruptcy Code, Congress made a determination that an eligible debtor should have the opportunity to avail itself of a number of Code provisions which adversely alter creditors' contractual and nonbankruptcy law rights."): *Id.*

449 11 U.S.C. § 365(h), (i), (n).

450 *Id.* § 542(a) ("[A]n entity . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."): *Id.*