

## Where do we go from here? Consequences of rejecting contracts

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Section 365 of the Bankruptcy Code governs the assumption and rejection of executory contracts<sup>1</sup> and unexpired leases. It is an area of the law which has famously been described by one commentator as a “brambled filled thicket” wherein “lurks a hopelessly convoluted and contradictory jurisprudence,” and by another as “psychedelic.”<sup>2</sup> Few would likely find these characterizations unfair.

Particularly confusing are the rights and remedies available for non-debtor parties to executory contracts or unexpired leases following rejection of such agreement by the trustee or debtor-in-possession, especially with respect to the right to compel specific performance. “Rejection” is a term which has no counterpart outside of bankruptcy law, and the Bankruptcy Code does not fully delineate the consequences of rejection. Not surprisingly, the courts have, at times, struggled to apply the abstract concept of rejection to real-world scenarios, resulting in inconsistent impact of the rejection statute.

### OVERVIEW

Rejection of an executory contract may be accomplished through a motion to reject under Section 365(a) or through a plan of reorganization in Chapter 11 and Chapter 13 proceedings.<sup>3</sup> In determining whether a

proposed rejection should be approved, most courts apply a “business judgment test,” approving the proposed rejection as long as the trustee or debtor-in-possession can demonstrate that rejection would benefit the estate.<sup>4</sup>

Pursuant to Section 365(g)(1), rejection of an executory contract or unexpired lease is deemed to constitute a breach of the agreement immediately before the petition date. The purpose of the “relation back”



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provision of Section 365(g)(1) is to make clear that the non-debtor party to the rejected contract or lease is simply a general unsecured creditor. Section 502(g)(1) provides similarly, “[a] claim arising from the rejection ... of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed ... or disallowed...the same as if such claim had arisen before the date of the filing of the petition.”<sup>5</sup>

Rejection of an executory contract or unexpired lease, however, does not cause the contract to magically disappear. Rejection does not terminate the agreement or affect the parties’ substantive rights thereunder; rather, rejection merely means that the bankruptcy estate itself has breached the agreement.<sup>6</sup>

Rejection of an executory contract or unexpired lease in most circumstances will entitle the non-debtor party to a claim for damages against the bankruptcy estate. The monetary claim is expressed in a proof of claim, which is subject to objection.

The ultimate dividend paid from the bankruptcy estate on account of a monetary claim for rejection damages is dependent on the economics of each bankruptcy case. The question arises as to what remedies other than monetary damages, if any, are available to the non-debtor party upon the debtor’s rejection.

### THRESHOLD ISSUES

In determining what remedies are available to a non-debtor party following rejection of an executory contract by a debtor-in-possession or trustee, a threshold issue is whether the



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subject agreement is an “executory” contract at all. If an agreement is not executory, it is merely an asset or obligation of the debtor’s estate, and it cannot be assumed or rejected.

*Unsecured Creditors’ Committee v. Southmark Corp.* (In re Robert Helms Constr. and Dev. Co.), 139 F.3d 702 (9th Cir. 1998), provides an interesting illustration of the consequences of this threshold question. The case has been frequently cited by the courts with both approval and criticism. The agreement at issue in *Helms* was an option agreement entered into between Southmark Corp. and Double Diamond Ranch LP.

filed, based upon the reasoning set forth in *Helms*.<sup>7</sup>

Other courts have reached opposite results, holding that an option or right of refusal is an executory contract until the expiration of the contingency period, regardless of whether exercised by the holder pre-petition. This was the holding of the 4th Circuit in the frequently cited *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985).

The *Lubrizol* court said, “until the time has expired, during which an event triggering a contingent duty may occur, the contingent

- Leases of real property where the debtor is a lessor.
- Contracts to purchase real property or timeshare interests where the debtor is the seller and the buyer is in possession of the property.
- Intellectual property licenses where the debtor is the licensor.

These statutory provisions expressly allow the non-debtor parties to such agreements to retain specific performance rights, albeit modified, notwithstanding rejection.

Pursuant to Section 365(h), if a trustee or debtor-in-possession rejects an unexpired lease of real property, under which the debtor is the lessor, the non-debtor lessee has the right to either:

- Treat the lease as terminated and assert a claim for damages; or
- Retain its rights under the lease for the balance of the term (including rights relating to the amount and timing of payment of rent, right to use, possession, subletting and assignment) and for any enforceable renewal period.<sup>12</sup>

If the lessee remains in possession, however, rejection relieves the lessor of ancillary duties of the lease (i.e., heating, cleaning services or trash disposal) except to the extent the lessor would be obligated to continue performing such obligations under applicable non-bankruptcy law. The lessee is, in turn, given the right to offset against future rent all damages caused by the debtor’s or trustee’s non-performance of any obligations under the agreement after the date of rejection.

With respect to rejected contracts to purchase real property and timeshare interests in which the debtor is the seller and the purchaser is in possession, Section 365(i) provides similar rights to the purchaser. The purchaser has the right to either treat the contract as terminated and assert a claim for damages, or remain in possession and continue making payments under the contract, upon completion of which the trustee must deliver title. As with lessees, the purchaser may offset damages caused by the debtor’s or trustee’s non-performance of any obligation after the date of rejection, but the purchaser may not assert an affirmative claim against the estate for such damages.

Finally, the rights of intellectual property licensees under rejected executory contracts

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The agreement was in connection with Southmark’s sale of a property to Double Diamond, pursuant to which Southmark was provided an option to buy part of the property back. Southmark subsequently filed bankruptcy without having exercised its repurchase option and confirmed a plan of reorganization providing that all contracts not specified therein were deemed rejected. The option was not specified therein. Double Diamond then filed bankruptcy as well, and the creditors’ committee sought to sell the property free and clear of Southmark’s option, considering it no longer valid because it had been deemed rejected in the Southmark bankruptcy.

While remanding the case for further findings, the 9th U.S. Circuit Court of Appeals held that an option agreement which was not in the process of being exercised at the time of the debtor’s bankruptcy filing was not an executory contract. In reaching its ruling, the court focused on whether the option required further performance from each party at the time the bankruptcy petition was filed.

In the case of unexercised options, the court determined that the answer was typically no, as the holder of the option need not exercise the option and, absent being exercised, the option would ordinarily lapse without breach. Following suit in *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999), the Bankruptcy Court for the District of Alaska held that a right of first refusal was, similarly, not an executory contract. That is, unless there was a sale pending when the bankruptcy was

obligations represent a continuing duty to stand ready to perform if the contingency occurs.”<sup>8</sup> Other courts have reached the same holding, based on this and other rationales.<sup>9</sup>

A second important threshold issue that has been the topic of substantial debate is what constitutes the “agreement” at issue. An executory contract or lease may not be assumed or rejected in part; the trustee or debtor-in-possession must either assume all obligations and benefits under the agreement or reject the agreement in its entirety.<sup>10</sup>

While the courts have applied different tests and relied upon different factors in determining whether a contract is severable, the basic question is how intimately bound the provision at issue is to the rest of the contract. The issue of severability has frequently been litigated in connection with covenants not to compete and options contained within larger agreements. While the courts have generally found these provisions to be non-severable, they have sometimes held them to be specifically enforceable, notwithstanding rejection of the non-divisible agreement as a whole.<sup>11</sup>

### **SPECIAL TYPES OF AGREEMENTS PROVIDED FOR IN SECTIONS 365(H), (I) AND (N)**

Section 365 contains provisions detailing the rights and obligations of the parties upon rejection with respect to three types of executory contracts and leases:

are governed by Section 365(n). This occurs when the debtor is the licensor of a right to “intellectual property,” defined in Section 101(35A) to include patents, copyrights and trade secrets but not trademarks.

Similar to Sections 365(h) and (i), Section 365(n) gives the licensee the right to either treat the contract as terminated or retain its rights pursuant to the agreement for the duration of the contract and any renewal term. If the licensee opts to retain its contractual rights, they will include the right to use the intellectual property, any rights regarding exclusivity and any rights under a supplementary agreement to the contract. These will include agreements of the licensee with the debtor and third parties, regardless of whether they are rejected by the debtor or trustee.<sup>13</sup>

The licensee does not have the right to seek specific performance of other obligations by

Neither the Bankruptcy Code nor the case law offers clear guidance as to whether, and in what circumstances, specific performance remains available to the non-debtor party following rejection of an executory agreement type not specified in Sections 365(h), (i) and (n). The Bankruptcy Code does not directly address the matter, and the case law is inconsistent.

Some courts have held, often without discussion, that rejection of an executory contract limits the non-debtor party to money damages without exception.<sup>14</sup> Cases discussing the basis for such a conclusion have often looked toward Congress’ intent in enacting Section 365(g)- to provide a mechanism for the estate to be relieved of burdensome obligations as the debtor attempts a reorganization.<sup>15</sup> Others have said allowing a non-debtor to compel specific performance from a debtor following

applicable state law.” Therefore, the panel examined whether the landlord would be entitled to specific performance of the provision under Pennsylvania law. Under Pennsylvania law, which is consistent with the law in most states, specific performance is available only in situations where no adequate remedy exists, such as when no method can accurately ascertain the amount of damages.

As the Pennsylvania Supreme Court had taken prior judicial notice that liquor licenses were limited in number and not readily available, and were therefore “unique assets,” the panel found that specific performance was an available remedy. The panel said the retransfer provision was specifically enforceable, notwithstanding the debtor’s rejection of the lease.

Such analysis has also been employed by courts in deciding whether specific performance is available to the non-debtor party to a rejected contract containing non-compete provisions, although the approaches and results have not been consistent.<sup>18</sup>

A related approach employed by courts is to examine whether the breach caused by rejection results in a “claim” that is dischargeable in bankruptcy. Under this approach, the non-debtor party is entitled to specific performance only if the breach caused by rejection gives rise to an obligation that is not a “claim” within the meaning of the Bankruptcy Code and capable of discharge.

Pursuant to Section 101(5)(B), a “claim” includes “the right to an equitable remedy for breach of performance if such right gives rise to a right of payment,” whether such right is non-contingent, contingent, matured, unmatured, disputed or undisputed. An equitable remedy will, in turn, give rise to a right of payment when money damages is a “viable alternative.”<sup>19</sup>

For example, in *Route 21 Associates of Belleville Inc. v. MHC Inc.*, 486 B.R. 75 (S.D.N.Y. 2012), the issue before the court was a purchaser’s right to specific performance from the debtor of certain environmental remediation work pursuant to a settlement agreement which the debtor had rejected. As the purchaser’s right to specific performance could be easily monetized in the form of reimbursement for the costs incurred by having the property remediated, the court found the purchaser’s remedy of specific performance was a “claim” dischargeable in bankruptcy.<sup>20</sup>

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the licensor, though. In addition, the licensee is required to make all royalty payments as and when due under the contract. Furthermore, in contrast to Sections 365(h) and (i), under Section 365(n), the licensee is deemed to have waived any rights to set-off for damages or an administrative claim.

### AGREEMENTS NOT SPECIFICALLY PROVIDED FOR IN SECTION 365.

While the rights and remedies of a non-debtor party with respect to the executory contracts and leases specified in Sections 365(h), (i) and (n) are delineated, the rights with respect to other executory agreements are less clear.

Ordinarily, giving a monetary claim for damages to the non-debtor party for a breach is sufficient. Parties to contracts containing options, rights of first refusal, non-compete covenants, or requiring other special obligations from the debtor, may seek to compel performance of those provisions, notwithstanding rejection. The question then arises as to the enforceability of those provisions upon rejection.

rejection would be to prefer that party over other equally deserving creditors, which the “relation back” provision of Section 365(g) does not intend.<sup>16</sup>

Other courts have instead viewed the issue as one of state law. These courts have held that a debtor cannot be compelled to render specific performance under an executory contract or lease following rejection, unless specific performance would be available to the non-debtor party under applicable state law.<sup>17</sup>

For example, this was the approach taken by the 1st Circuit Bankruptcy Appellate Panel in the much discussed *Abboud v. Ground Round Inc. (In re Ground Round)*, 335 B.R. 253 (B.A.P. 1st Cir. 2005). Therein, the panel held that the landlord was entitled to compel performance of a provision in its lease, requiring the debtor to transfer its liquor license back to the landlord upon terminating the lease, notwithstanding the debtor rejecting the lease.

The panel said, “a party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under

In contrast, in *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001), the court found enforceable a covenant not to compete provision within a sale contract, notwithstanding rejection. The court reasoned that the covenant required nothing of the debtor other than to refrain from conduct and was, therefore, not a “claim” subject to discharge.

Other courts have reached opposite results, however, with respect to non-compete agreements, using the same approach. For example, in *In re Register*, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989), the court found a similar covenant in a rejected franchise agreement was not enforceable. Using the “claim analysis,” the court came to this conclusion because a value could be determined for the injury incurred for a breach of the covenant.<sup>21</sup>

## CONCLUSION

While this discussion only skims the surface with respect to non-monetary issues arising with the rejection of executory contracts and leases under the Bankruptcy Code, it demonstrates the confusion and inconsistency that typifies this area of the law. While there have been calls for statutory reform, and a complete overhaul of Section 365, such calls have been left largely unanswered. In dealing with current rejection issues, a practitioner’s best course is to search the case law as assiduously as possible in hopes of garnering a sense of the applicable law in the applicable jurisdictions.

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## NOTES

<sup>1</sup> The term “executory contract” is not defined in the Bankruptcy Code. However, the so-called “Countryman definition” has been touted with much approval. Pursuant to professor Vern Countryman, a contract is executory if “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.” Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439, 466 (1973).

<sup>2</sup> *Cohen v. Drexel Burnham Lambert Group (In re Drexel Burnham Lambert Group)*, 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (quoting Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991); Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 228 (1989)).

<sup>3</sup> In Chapter 7 cases, an executory contract or lease of residential or personal property not assumed within 60 days of the order of relief —

unless extended for cause — is automatically deemed rejected, pursuant to Section 365(d)(1).

<sup>4</sup> See, e.g., *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095 (2d Cir. 1993); *In re Bildisco*, 682 F.2d 72, 79 (3d Cir. 1982), *aff’d sub nom.*, *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984).

<sup>5</sup> See also 11 U.S.C. § 101(10) (defining “creditor” to include any entity that has a claim of the type specified in 11 U.S.C. § 502(g)).

<sup>6</sup> See, e.g., *Aboud v. Ground Round Inc. (In re Ground Round)*, 335 B.R. 253, 261 (B.A.P. 1st Cir. 2005); *Sir Speedy Inc. v. Morse*, 335 B.R. 657, 659 (D. Mass. 2000); *In re Flagstaff Realty Assocs.*, 60 F.3d 1031, 1034 (3d Cir. 1995); *Drexel Burnham*, 138 B.R. at 708.

<sup>7</sup> See also *Gouevia v. Tazbir*, 37 F.3d 295, 298-99 (7th Cir. 1994) (reciprocal land covenant restricting use of property was not executory contract as it required no affirmative performance in the future and instead constituted an interest in property); *BNY Capital Funding v. US Airways.*, 345 B.R. 549, 553 (E.D. Va. 2006) (unilateral option contract was not an executory contract as debtor optionor had no unperformed obligations under the option and any future obligations were contingent upon its exercise of the option); *In re Plascencia*, 354 B.R. 774, 779-80 (Bankr. E.D. Va. 2006) (unexercised right of first refusal not an executory contract).

<sup>8</sup> 756 F.2d at 1046.

<sup>9</sup> See *In re CB Holding Corp.*, 448 B.R. 684, 689 (Bankr. D. Del. 2011) (finding right of first refusal is executory, stating that the majority of courts have held the same and rejecting the *Bergt* decision); *In re Roomstore*, 473 B.R. 107 (Bankr. E.D. Va. 2012) (declining to follow *Helms* and finding option to buy debtor’s membership interest under buy-sell agreement at defined price an executory contract); *In re Hardie*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989) (contingency of obligation under unexercised option did not prevent option from being executory); *In re G-N Partners*, 48 B.R. 462, 465-66 (Bankr. D. Minn. 1985) (fact that real estate purchase option agreement did not require the debtor to purchase the property did not mean that its right to purchase was not “executory” at time debtor filed his petition); *In re Coordinated Fin. Planning Corp.*, 65 B.R. 711, 713 (B.A.P. 9th Cir. 1986) (characterizing right of first refusal as a covenant running with the land but finding that same was nonetheless an executory contract subject to rejection); *In re Fleishman*, 138 B.R. 641, 646-47 (Bankr. D. Mass. 1992) (finding right of first refusal was a personal contract and not a covenant running with the land and therefore was subject to rejection).

<sup>10</sup> See, e.g., *Stewart Title Guar. Co. v. Old Republic Nat’l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996).

<sup>11</sup> *CB Holding*, 448 B.R. 684 (finding landlord’s right of first refusal to purchase liquor license upon termination of lease not severable from lease agreement); *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (covenant not to compete in sale agreement not severable); *In re Rovine Corp.*, 6 B.R. 661 (Bankr. W.D. Tenn. 1980) (finding covenant not to compete in franchise agreement not severable); *In re*

*JRT Inc.*, 121 B.R. 313, 323 (Bankr. W.D. Mich. 1990) (same); *Sir Speedy*, 256 B.R. 657 (same).

<sup>12</sup> The protections of Section 365(h) were extended to purchasers of timeshare interests whose terms had commenced via the Bankruptcy Amendments and Federal Judgeship Act of 1984.

<sup>13</sup> In enacting Section 365(n), Congress effectively overruled the 4th Circuit’s decision in *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985) with respect to “intellectual property” contract licenses. In *Lubrizol* the court had held that the debtor was permitted to reject an technology licensing agreement under which it was the licensor and that upon rejection, the licensee’s right to use the license was terminated.

<sup>14</sup> See *In re Kaonohi Ohana Ltd.*, 873 F.2d 1302, 1306 n. 5 (9th Cir. 1989) (“specific performance of a rejected executory contract cannot be required”); *In re Waldron*, 36 B.R. 633, 642 n. 4, *rev’d on other grounds*, 785 F.2d 936 (Bankr. S.D. Fla. 1984) (“The Code does not permit specific performance resulting from the rejection of an executory contract.”); *Midway Motor Lodge of Elk Grove v. Innkeeper’s Telemangement & Equip. Corp.*, 54 F.3d 406, 407 (7th Cir. 1995) (“Rejection avoids specific performance, but the debtor assumes a financial obligation equivalent to damages for breach of contract.”); *Roomstore*, 473 B.R. at 116 (because movant’s option to purchase debtor’s membership interest in company was an executory contract which debtor had rejected, motion for relief from stay to exercise option must be denied because “rejection of the contract takes that option away”); *CB Holding*, 448 B.R. at 689-90 (debtor’s rejection of its restaurant lease deprived landlord of right to exercise first refusal right to purchase liquor license, rejecting *Ground Round*).

<sup>15</sup> See *Lubrizol*, 756 F.2d at 1048 (“the legislative history of 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party”); *Rovine Corp.*, 6 B.R. at 666 (“[Section 365 was] intended to solve the problem of assumption of liabilities, i.e. excusing or requiring future specific performance by the debtor depending upon assumption or rejection.”). It is noted that the 7th Circuit recently directly took aim at, and rejected, *Lubrizol* in the highly publicized decision in *Sunbeam Products v. Chicago American Manufacturing*, 686 F.3d 372 (7th Cir. 2012). *Sunbeam* held that the trustee’s rejection of a trademark license agreement did not terminate the licensee’s rights to use the debtor’s trademarks in the sale of its product.

<sup>16</sup> *In re A.J. Lane & Co.*, 107 B.R. 435, 439 (Bankr. D. Mass. 1989); *In re Norquist*, 43 B.R. 224 (Bankr. E.D. Wash. 1984); *In re Jolly*, 574 F.2d 349 (6th Cir. 1978).

<sup>17</sup> See *In re Yasin*, 179 B.R. 43, 49-50 (Bankr. S.D.N.Y. 1995) (“Under Section 365, rejection constitutes a statutory breach, but does not repudiate or terminate the lease. The parties must, therefore, resort to state law to determine their rights as a result of the breach.”); *In re West Chestnut Realty of Haverford Inc.*, 177 B.R. 501, 506 (Bankr. E.D. Pa. 1995) (“The measure of the damages of a party to a rejected executory contract is a question of state law. Such damages are not necessarily limited exclusively to monetary damages. ... If state law does