INSIDE THE MINDS

Understanding the Legal Issues Behind Executory Contracts in Bankruptcy

Leading Lawyers on Strategies for the Structuring, Drafting, and Execution of Executory Contracts

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Assisting Companies in Reorganization in the Face of Financial Difficulty

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Bankruptcy/financial restructuring lawyers try to help companies reorganize when they are facing financial difficulties or assist companies in recovering monies due to them. Lawyers representing debtors support and guide the companies through the reorganization process. Since a company and its employees are usually not familiar with Chapter 11 and the reorganization process, lawyers often need to educate the company of the rights and powers granted by Chapter 11. Using those rights and powers in the most advantageous manner, the lawyer helps the company effectuate the reorganization to maximize value for all interested parties.

When representing a creditor, the duties of a bankruptcy lawyer are much different. The creditor is generally concerned with one thing: getting its money back as quickly as possible. To help creditors get their money back, bankruptcy lawyers must understand the businesses of both the creditor and the debtor to work within the confines of the Bankruptcy Code to maximize value for the creditor. A bankruptcy lawyer must know what buttons to push and when to push them. The art of bankruptcy law is knowing when to push, where to push, and how hard to push.

Bankruptcy lawyers add the greatest value by building relationships and creating a structure by which a company can continue in business, retain employees, and satisfy the claims of its creditors. Also, it is important to reach consensual agreements in a bankruptcy case, preferably without litigation. Since there are so many complicated issues that can arise during the tenure of a bankruptcy case and the cost of litigation is so high that it can be prohibitive, it is usually helpful to guide a client to reaching an agreement rather than getting mired in endless litigation. Many bankruptcy lawyers ascribe to the theory that the more they litigate, the more clients lose. Some issues that arise in a bankruptcy case simply cannot be resolved in a consensual manner, so litigation is necessary. In those instances, a bankruptcy judge can get involved and either rule on the disputed issue or make rulings that guide the parties to a settlement. On balance, most bankruptcy lawyers and judges try to reach a consensus.

A successful outcome in the context of a bankruptcy case is quite difficult to determine or predict because bankruptcy is about sharing pain. Both debtors and creditors must reach an accommodation where each side shares part of the pain, but on balance the company can continue to operate and pay its debts.

Major Bankruptcy/Financial Restructuring Issues

One of the major issues in bankruptcy law is determining whether certain contracts or agreements are executory contracts under the Bankruptcy Code and what obligations must be cured to have those contracts assumed under a plan of reorganization so that the reorganized company can retain the benefits of those contracts. Most companies have contracts that govern their significant relationships and can be the foundation of a business. Bankruptcy does not change contractual rights but gives a company options to retain (assume) or reject certain contracts. When a debtor elects to retain (assume) a contract, for instance, the debtor must cure all defaults. The issues relating to the cure obligations arise in almost every bankruptcy case.

Another major issue in a bankruptcy case is determining whether certain property or contracts can be included in the bankruptcy estate. The Bankruptcy Code has an expansive definition of property of estate, but there are limitations of whether certain assets are property of the estate or property of a creditor. A company must determine what property it controls in order to reorganize its affairs. In the early stages of a bankruptcy case, there is usually a dispute as to whether certain property is owned by a debtor or whether a lease or contract has expired and can be used by a debtor. There also could be disputes as to whether monies are held in trust and are therefore excluded from a bankruptcy estate. These issues can define the success or failure of a bankruptcy estate. If a company needs certain property, but it is deemed not to be property of the estate, the reorganization may not be successful.

As a bankruptcy case progresses, there are major issues concerning the breadth of the automatic stay, sales, and use of property and financing concerns. Through the bankruptcy process, a company may decide that it has to sell an asset or obtain short-term financing to enable a business to grow. These types of issues have special treatment in the context of a Chapter 11 since the corporate action will necessarily have an effect on creditors and their claims. It is often said that a Chapter 11 debtor is viewed in a fishbowl so that all creditors can raise issues with the corporate actions taken during a Chapter 11 case. Since the corporate action will have an effect on the treatment of claims, creditors or parties in interest will have the right to object and try to block the action if it can hurt the creditor. Sometimes creditors will object to gain a tactical advantage in the bankruptcy process.

The culmination of a Chapter 11 case is the plan of reorganization process. Through the plan process, parties face a variety of issues including distribution to creditors, classification of claims, and whether a non-consensual plan can be confirmed. The plan process is a means by which creditors are paid or the fate of the company is decided. The plan process can take months or years depending upon the level of discontent among the various creditor constituencies.

After the plan process is completed, creditors, a plan trustee, or the reorganized debtor may pursue avoidance actions to recover monies, including preference or fraudulent conveyance litigation. A preference is a transfer of debtor property that occurred within ninety days of bankruptcy. A fraudulent conveyance is a transfer of debtor property for less than reasonably equivalent value. In many bankruptcy cases, there could be thousands of preference cases and litigation regarding those issues. Preference issues are extremely prevalent and occur in almost every bankruptcy case, big and small. Preferences can be viewed as a slap in the face to many creditors because creditors lose money when a company files for bankruptcy protection, and then the same company that did not pay the creditor will sue that creditor to recover additional monies. Fraudulent conveyance claims protect creditors from parties taking advantage of a debtor in the months or years when there are financial difficulties. Both preferences and fraudulent conveyances have the goal of promoting equal distribution among creditors.

The major areas of bankruptcy law are creditor rights, representing a debtor in a bankruptcy case (whether Chapter 7, 11, 12 or 13), representing a trustee or fiduciary, or out-of-court restructuring. Many lawyers can assist in each discipline, but others choose to focus on a particular type of bankruptcy case. It is often difficult for one law firm to represent both creditors and debtors because of conflict issues. Lawyers offer different services to different types of clients. When it comes to creditor rights, lawyers often represent secured and unsecured creditors in all phases of a bankruptcy case from the filing through confirmation; these clients include banks, institutional clients, landlords, and trade creditors. In terms of debtors, attorneys represent corporate clients in Chapter 11 cases or individuals in Chapter 7 or Chapter 13 cases, although there can be certain Chapter 11 cases for individuals. Trustees are represented in both Chapter 11 and Chapter 7 cases. Lawyers also represent clients, both creditors and debtors, out of court.

Since bankruptcies have become a part of the economy, the financial implications for a creditor can be significant as billions of dollars are affected by bankruptcy cases each year. The goal of most attorneys is to maximize value and minimize impact for clients. In each case, the goal of a creditor is usually to obtain the greatest possible recovery in bankruptcy cases. Sometimes, the goal of a creditor client is not to maximize value as other interests are at stake. In certain instances, a creditor may rely on a debtor to produce or deliver a product, and the creditor needs a debtor to remain in business to continue to produce product or to stay afloat long enough to enable the creditor to transition to another source. Other times, a creditor may be a competitor and try to buy the assets of the Chapter 11 debtor to benefit the business of the creditor. In these instances, attorneys must become familiar with their clients' businesses and creatively craft a mechanism to help reach the best result for the client.

During a bankruptcy case, a creditor is sometimes but not always playing offense (i.e., trying to collect the claim). Creditors try to defend their rights when a debtor commences litigation to recover payments from a creditor and lawyers help the clients/creditor strike the proper balance of pushing when necessary and pulling back to avoid exposure. As mentioned above, knowing when to push or pull is of great value.

Attorneys also assist clients in purchasing assets from a debtor. Whether the asset is the entire company, equipment, or leases of nonresidential real property, attorneys understand the protections afforded to buyers of assets and enable clients to take advantage of those benefits. These benefits usually become apparent months or years after a transaction closes when a creditor tries to challenge the sale.

Attorneys also have to rescue their clients from mistakes in not seeking bankruptcy advice. The most common mistake is when clients fail to contact counsel early enough and try to solve the issues on their own. Bankruptcy law is code-based and can be quite complicated and counterintuitive. When a person (no matter how bright) tries to solve financial restructuring issues without the assistance of counsel, that person is bound to make mistakes. In certain instances, those mistakes may be fatal to a company by putting the company in such a bad position that it is impossible to fix the issue. Another major problem is contacting counsel too late. When the problems become too large, a party's options decrease. If a client is experiencing financial difficulties, it is never too early to talk to counsel. There are few clients who have remorse for seeking too much advice, but there are many clients that regret not seeking advice.

When a company faces financial difficulties and does not seek counsel, the company can be placed in a position where restructuring may no longer be possible and the only alternative is to liquidate assets. This process is quite frustrating for a bankruptcy lawyer, who often recognizes the mistakes that were made without the advice of counsel, which could once—but no longer—be remedied. If a debtor negotiates with a bank or lender without the advice of counsel, the company may give up certain rights or claims. With counsel, those rights may not have been waived.

When a creditor negotiates a repayment plan with a debtor without the advice of counsel, the creditor may do more harm than good. That is, a creditor may compel payment from a debtor but only days or weeks after receiving the payment, the creditor may be sued to pay back that payment because of certain rights created by the Bankruptcy Code.

When representing a debtor, the better attorneys never take a company into a bankruptcy case without formulating an end game. Since bankruptcy can be cataclysmic for a company, it is important to develop a strategy to emerge from bankruptcy protection prior to seeking bankruptcy protection. This strategy typically avoids many of the pitfalls that debtors face during a bankruptcy case. There are always going to be pitfalls throughout a Chapter 11 case, but if the company has a strategy from the inception, it will usually be successful.

On the creditor side, attorneys offer experience in handling a bankruptcy case when that lawyer has a keen knowledge of the client's business and provides realistic expectations for the client. Since issues facing creditors are usually not novel, lawyers can avoid future legal situations by developing a strategy to handle the claim at the first sign of financial difficulty. Creditors should not always be reactionary, and there are many times where a creditor may be forced to take an action in the bankruptcy case to achieve a positive result. In these instances, a creditor may have to pick a small battle to win a war.

Within my practice, I have developed a strategy of always focusing on the big picture and the goals of the client. It is easy to be diverted from the primary goals and engage in secondary battles during a bankruptcy case when those battles have little, if any, benefit to the overall restructuring. Attorneys who remain focused on the overall restructuring and try to obtain realistic goals for the client are serving the client as best as possible.

I am most successful when I understand the client's goals and can work to achieve those goals. I work hand in hand with clients and listen to the client's concerns. I find that if I do not listen and understand my client, the results often fall short. When the client and I are on the same page with our strategy and I learn from the client, I generally achieve a successful result.

However, achieving a successful result also requires staying on top of the ever-changing practice area. I find I learn the most when I am representing a client over a long period of time. I learn in this practice that every day I am a day smarter than I was the day before. Also, I learn and benefit from each case, whether the result is positive or negative. There is always room to improve in the practice of law—which is why it is a practice not a science.

Structuring Executory Contracts

Section 365 of the Bankruptcy Code is the section crafted by Congress to resolve issues relating to executory contracts. It is designed to protect not only the interests of the parties to the executory contract in question but also the interests of all of the creditors of the bankruptcy estate. One intent behind 11 U.S.C.S § 365 is to give a debtor time to assume or reject an executory contract, since it is difficult for the debtor to commit itself to assuming or rejecting a contract much before the time for confirmation of a plan. This procedure ensures that the debtor is not in the precarious position of having assumed a contract relying on confirmation of a particular plan, only to find that the plan has been rejected. Another policy goal is to ensure that the non-debtor party to an executory contract receives the benefit of its bargain if it is forced to continue performance after the debtor has filed for bankruptcy. The overall goal of bankruptcy is to permit a financial restructuring of debts, such that Section 365 also has a policy of favoring assumption and assignment of executory contracts and leases to facilitate the overall reorganization. This intent is apparent in the statutes prohibiting ipso facto provisions, anti-assignment clauses, and the provisions enabling assignment to third parties. Section 365 is drafted to not only provide greater protections for a debtor than for a creditor but also provide a balance for both parties' interests.

A further federal bankruptcy policy is to allow a debtor to freely reject executory contracts to provide debtors with the ability to abandon burdensome property and retain beneficial property. In short, the debtor is allowed to go through the inventory of executory contracts and decide which ones it would be beneficial to adhere to and which ones it would be beneficial to reject.

Federal law is not the only relevant set of statutes. State law generally applies to bankruptcy proceedings because property interests are not created by the Federal Constitution, but rather by existing rules or understandings that stem from an independent source such as state law. Law that creates property necessarily defines the legal relationships under which certain parties, or debtors, must discharge obligations to other parties, or creditors. In the context of determining whether a contract is executory, the extent of a party's obligations after another party repudiates its own obligations is a matter of state law. In determining the significance of the remaining obligations under a contract, a court will look to relevant state law. Also, state law principles of contract interpretation and construction apply to issues relating to executory contracts.

Assignment

Assignment can be prevented if the debtor fails to meet the standards for assumption and for assignment. However, provisions in an executory contract or unexpired lease that prohibit, restrict, or condition assignment are not enforceable and may not be used to prevent assumption and assignment. The Bankruptcy Code allows a debtor to assume a contract, assume and assign the contract to a third party, or to reject a contract. If the debtor seeks to assume or assume and assign a contract, the Bankruptcy Code imposes certain restrictions on those actions. These restrictions are threefold:

1. If a contract is in default at the time of the assumption, the debtor must promptly cure or provide adequate assurance that the default will be promptly cured.
2. The debtor must compensate or provide for prompt compensation for the actual pecuniary loss resulting from the default.
3. The debtor must provide adequate assurance of future performance under the contract.

In the case of shopping center leases, the Bankruptcy Code provides specific criteria to determine what constitutes "adequate assurance of future performance." In shopping center leases the debtor must provide adequate assurance of the following four items:

(A) 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 ". . . shall be similar to [that of] the debtor as of the time the Debtor became the lessee under the lease."
(B) That any percentage rent due ". . . will not decline substantially."

(C) 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 will not breach any such provision contained in any other [agreement] relating to such shopping center.
(D) That assumption or assignment ". . . will not disrupt any tenant mix or balance. . .."

A further restriction on assignment is the fact that the proposed assignee must demonstrate adequate assurance of future performance. Generally, adequate assurance of future performance by a proposed assignee requires a showing that the assignee's general financial circumstances and ability to satisfy its obligations under the contract or lease are no less than that of the debtor on the date the petition was filed.

The Bankruptcy Code prohibits assumption of contracts to make loans or extend financial accommodations such as notes, loan agreements or letters of credit. The Bankruptcy Code further prohibits the assignment of executory contracts in cases in which applicable non-bankruptcy law would excuse the other party from accepting performance from someone other than the debtor, unless the other party consents. These non-assignable contracts include personal service contracts.

Executory contracts are assigned upon motion by the debtor upon notice to creditors and parties in interest and a hearing. The debtor first makes a motion to assume, then contracts and moves to have it assigned. If debtors seek to assume or assume and assign the contract, they must advise the contract counterparty of: (a) the amounts that will be paid to cure defaults; (b) the timing of the payments or compensation to cure the defaults; and (c) the possible proposed assignment, the assignee, and financial condition of the assignee. The notice may be a separate pleading or the notice could be embodied in a plan of reorganization.

A court order is required to assign a contract. A contract may also be assigned under a plan of reorganization. Assignment by the debtor or trustee of an assumed executory contract or unexpired lease relieves the trustee and the estate of any liability for any breach of such contract or lease occurring after the assignment.

Assuming Executory Contracts

When a debtor or trustee assumes a contract, it reaffirms its commitment to creditors and parties in interest. The court authorizes the assumption if it is in the best interest of the bankruptcy estate. The entire contract must be assumed or rejected and individual provisions cannot be either included or excluded. Following assumption, the contract becomes a post-bankruptcy obligation that can be enforced against the bankruptcy estate, and damages for breach are accorded priority status.

Generally, the decision to assume an executory contract or lease is governed by the business judgment rule using a benefit/burden approach. Because damages for breach of an assumed contract or lease have priority, creditors generally want assumption (where no assignment is contemplated) to be deferred until confirmation.

In connection with a proposed assumption or assumption and assignment, a debtor provides notice to the affected contract counterparty of the proposed treatment of the contract. If the debtor seeks to assume or assume and assign, the debtor must advise the contract counterparty of: (a) the amounts that will be paid to cure defaults; (b) the timing of the payments or compensation to cure the defaults; and (c) the assignee and the financial condition of the assignee of any proposed assignment. The notice may be a separate pleading or the notice could be embodied in a plan of reorganization.

Rejection

According to 11 U.S.C.S. § 365(g), rejection of a debtor's unexpired lease constitutes a pre-petition breach of the agreement leaving the creditor with potential remedies under applicable state law. The statutory breach of contract simply put the estate in the position of a breaching party to the executory contract. Rejection under the Bankruptcy Code did not divest the estate from the breaching party's rights under the terms of the contract and applicable state law.

A rejection is treated as a breach of contract for purposes of determining the appropriate amount of damages to be awarded as an unsecured, pre-petition claim. While rejection is treated as a breach, it does not completely terminate the contract. Thus, rejection merely frees the estate from the obligation to perform; it does not make the contract disappear. In other words, rejection is not the power to release, revoke, repudiate, void, avoid, cancel, terminate, or even to breach, contract obligations. Rather, rejection is a bankruptcy estate's election to decline a contract or lease asset. It is a decision not to assume, not to obligate the estate on the contract or lease at the price of obtaining the continuing benefits of the non-debtor party's performance. That decision leaves the non-debtor in the same position as all others who have dealt with the debtor, by giving rise to a presumption that the debtor has "breached" (i.e., will not perform) its obligations. The debtor's obligations are unaffected and provide the basis for a claim.

Rejection gives rise to a remedy for breach of contract in the non-debtor party. The claim is treated as a pre-petition claim, affording creditors their proper priority. Under 11 U.S.C.S. §§ 365(g) and 502(g), the date of breach is set as the date immediately prior to the debtor's filing for bankruptcy. The Bankruptcy Code treats rejection as a breach so that the non-debtor party will have a viable claim against the debtor. However, the Bankruptcy Code does not determine parties' rights regarding the contract and subsequent breach. To determine these rights, the court must turn to state law.

To the extent the contract is not otherwise terminated, the non-debtor party may also rely on the breach to exercise any right it may have to terminate because of a breach. Ordinarily, the debtor is required to surrender the property upon rejection, though particular circumstances may call for other action to be taken. Whether the contract is terminated depends on the particular circumstances. However, if the property is surrendered, the contract or lease should also be terminated.

11 U.S.C.S. § 365(n) applies to intellectual property and grants the licensee of intellectual property certain rights not enjoyed by other contracting parties. Specifically, if a trustee rejects an executory contract under 11 U.S.C.S. § 365(a), the licensee of intellectual property may elect either: a) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable non-bankruptcy law, or an agreement made by the licensee with another entity; or (b) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable non-bankruptcy law), as such rights existed immediately before the case commenced, for the duration of such contract; and any period for which such contract may be extended by the licensee as of right under applicable non-bankruptcy law. Any debtor or trustee can reject a debtor's unexpired lease.

For leases of non-residential real property in Chapter 11 cases, a debtor has 120 days which can be extended by an additional ninety days. There is no deadline for executory contracts in Chapter 11 cases. Pursuant to 11 U.S.C.S. § 365(d)(1), if the trustee does not assume or reject an executory contract of the debtor within sixty days after the case is converted to Chapter 7, then such contract is deemed rejected.

A contract generally must be assumed or rejected prior to confirmation of a plan. The assumption or rejection is usually accomplished at or prior to confirmation of a plan. If an executory contract is neither assumed, rejected, nor assigned, then the contract would ride through the proceedings, leaving the non-debtor's claim to survive the bankruptcy as if the bankruptcy had never occurred.

A party may try to insert language concerning assumption or assignment, but those clauses may not be enforceable based on the prohibition of ipso facto clauses in bankruptcy. A clause conditioned upon a bankruptcy is usually not enforceable. On the other hand, if the language is in the contract, it gives the party a right to argue for its enforceability. It may be helpful to add the language, but the client should be aware of the risks involved.

Executory Issues

The determination of whether a contract is executory is one of the most controversial and oft-litigated issues in a bankruptcy case. This uncertainty is because Congress specifically refrained from defining an executory contract for purposes of § 365. The legislative history suggests that a contract is executory where performance remains due, to some extent, by all contracting parties.

Professor Countryman, in two landmark Minnesota Law Review articles in the early 1970s, developed a test for the existence of executory contracts that, at the time, "was a godsend to judges perplexed by the strange results they found in bankruptcy contract cases." Professor Country formulated the material breach test: 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.

This definition has "become the standard test for an executory contract" in bankruptcy. The material breach test is Countryman's effort to ensure that the trustee's right to assume or reject is indeed "an option to be exercised when it will benefit the estate," and which does "not extend to situations where the only effect of its exercise would be to prejudice other creditors of the estate." He explains how the material breach test for an executory contract serves these purposes by comparing the results it achieves when a debtor has both claims and obligations under a contract with the results obtained under the two classes of contracts excluded in his sculpting process. Such a contract, similar to the contract under which the party has fully performed but the bankrupt has not, represents a claim against the estate.

A minority of courts, treating the Countryman test as "helpful but not controlling," hold that the determination of whether a contract is "executory" requires a more "functional" approach, "with an eye towards furthering the policies of the Bankruptcy Code." Under this approach, the question of whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate. This understanding of the nature of the trustee's assume-or-reject option results in a four-step analysis. The trustee must first determine whether the contract gives to the non-debtor party an enforceable interest in property of the debtor that has passed to the estate. The trustee must next consider whether any such interest of the non-debtor is avoidable under the Bankruptcy Code's avoiding powers. If there is no such interest, or if it is avoidable, the trustee must determine whether the estate would benefit more from breach and payment of the resulting claim in bankruptcy dollars, or by performance. Finally, if the non-debtor has an unavoidable interest, the trustee must determine whether, under this circumstance, the estate will benefit most from breach or performance.

There is substantial debate over the appropriateness of the functional approach. Courts that advocate the functional approach claim that the test more accurately reflects "the assume-reject election now codified" in Section 365. In addition, advocates claim that the functional approach "conserves the time and effort that the parties and the court otherwise spend resolving the question of executoriness." Critics contend that the functional approach sidesteps the question of executoriness altogether and therefore ignores the statute's express requirement that the contract be executory. A further criticism is that the "functional analysis" is simply an embodiment of the "business judgment test," which is employed by a bankruptcy court once the contract in question is found to be executory, to determine whether the trustee's decision to reject the contract benefits the estate or general unsecured creditors.

An executory contract evidences a relationship between two parties in which both parties are contractually obligated to deliver goods or services for the benefit of the other. An executory contract has two key characteristics:

1. Each party has obligations under the contract that remain unperformed at the time of the debtor's bankruptcy petition.

2. The nature of each party's unperformed obligations under the contract are of sufficient importance that the party's failure to perform those remaining obligations would constitute a material breach of the contract, thereby excusing the other party from performing its remaining duties.

When companies formulate executory contracts, they may experience several pitfalls. Perhaps the most common problem is the lack of clear termination provisions in executory contracts. Often a creditor wants to have its executory contract terminated prior to bankruptcy to avoid the contract being assumed or assigned and also to excuse the party from performing under the contract. Many contracts do not contain clear termination provisions or clients elect not to exercise the termination provisions prior to the institution of a bankruptcy case. The failure to terminate can force the creditor to continue to perform when the creditor faces added risks during the bankruptcy case, which can prove tremendously difficult. It is usually better for a creditor to get out of a contract prior to bankruptcy.

From the debtors' side, termination is also an important issue ripe for problems. To the extent that debtors need the executory contract to operate its business, they should make sure that the contracts are still executory and the debtor still has rights under the contract. Another pitfall for a debtor is knowing when a contract terminates by its terms. A bankruptcy court cannot revive a contract or write a better contract for the debtor, so a debtor should always be aware of the rights set for in its contracts. A third pitfall for a debtor is failing to recognize the assumption requirements. Since a debtor is required to cure the contract to assume the contract, many debtors may not have the resources to fund an assumption and they may be unable to emerge from bankruptcy protection. Unlike many other creditors, a party to an executory contract is entitled to a prompt cure.

The best way to avoid these pitfalls is through reading and studying the contracts and making sure that the termination provisions are clear and unequivocal.

A rejection is tantamount to a material breach, so if there are provisions in a contract that will survive a material breach, those provisions are still enforceable. The licensee may elect to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property as such rights existed immediately before the case commenced. If a licensee elects to retain its rights, Section 365(n)(2)(B) of the Code requires it to "make all royalty payments due under such contract for the duration of such contract." In addition to the license rights, a covenant not to compete or other restrictive covenants may survive a rejection.

Generally, a debtor cannot force another company to assign, assume, or reject an executory contract. With one exception, there is nothing in 11 U.S.C.S. § 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). Indeed, assumption itself does not guarantee performance by the other party. It simply means that the other party no longer can excuse its refusal to perform based upon the debtor's pre-petition breach. The broad definition of property of the bankruptcy estate encompasses "all legal or equitable interests of the debtor," and includes executory contracts.

A company declaring bankruptcy or restructuring has the ability to assume beneficial contracts or reject burdensome ones. The assignment frees the debtor of its obligations. Upon assumption, the debtor remains liable for all debts and must cure defaults.

Financial Consequences of Rejection

Rejection gives rise to a remedy for breach of contract in the non-debtor party. The claim is treated as a pre-petition claim, affording creditors their proper priority. Under 11 U.S.C.S. §§ 365(g) and 502(g), the date of breach is set as the date immediately prior to the debtor's filing for bankruptcy. The Bankruptcy Code treats rejection as a breach so that the non-debtor party has a viable claim against the debtor. However, the Code does not determine parties' rights regarding the contract and subsequent breach. To determine these rights, the court must turn to state law.

The benefit of an executory contract is that it is subject to assumption in a bankruptcy case. Since assumption requires a cure, a contract counterparty must be paid in full by the debtor. Other benefits include the ability to either reject a burdensome contract or to freely assign a beneficial contract. An executory contract becomes an asset that can be retained, sold, or abandoned as burdensome. An executory contract benefits a company by making sure it gets paid.

There is no set time period for an executory contract. The amount of time remaining on a contract does not affect whether the contract is assigned, assumed, or rejected unless it impacts the determination of what is an executory contract.

The danger of an executory contract is that it may be rejected through a bankruptcy or assigned to a third party over the company's objection. The company loses the ability to control its contract counterparty.

The most confusing aspects of executory contracts include determining whether it is executory or not and what are the cure amounts. These are mixed questions of law and fact and subject to significant disagreement. Interestingly, the law on this topic has changed little over the past ten years. Parties recognize the implications of executory contracts and often modify contracts after an adverse decision. Though, there have been changes in the ways companies do business and draft contracts. Since companies have large and diverse legal departments, when a client faces an adverse decision regarding a contract provision, the attorneys that actually draft the contract may not know, or be aware of, the adverse decision and the reason for the decision. This is the typical one hand does not know what the other is doing. Even if the company is aware of the adverse decision, it could take months or years to fix the problem because there could be hundreds of contracts in existence with the offending provision. I find that companies are not proactive enough when reviewing the bankruptcy implications of their contracts. Since bankruptcy issues are pervasive, I advise my clients to have bankruptcy attorneys review agreements prior to the execution (even on a cursory basis) to understand what will happen if the party to the contract will seek bankruptcy protection. An ounce of prevention could avoid large and many more significant issues by having contracts reviewed by bankruptcy lawyers prior to their execution.

Challenges

When considering contract issues, the bankruptcy field can be described as reactive since bankruptcy courts and attorneys usually dissect or interpret contracts after the rights and duties are scrutinized. Usually corporate financiers and attorneys will create contracts or financial arrangements and bankruptcy attorneys are forced to interpret those agreements. In some industries, bankruptcy courts can be the first courts to interpret and consider these issues. For example, in the telecommunications field, determination of arrangements between telecom providers and customers has been fascinating. Over the past five years, I have considered and advised clients on the interpretation of telecommunications contracts and products to determine whether those arrangements were executory. This analysis affected hundreds of millions of dollars.

During the 1990s as the telecommunications field expanded, many attorneys and financiers developed products and financing arrangements for telecommunications services. When the telecommunications industry imploded in the early 2000s, bankruptcy lawyers had the opportunity to test products that developed and determine how to characterize those products. One of these products was an indefeasible right to use. An indefeasible right to use was a product created for the sale or conveyance of fiber optic cables in the telecommunications industry. It was a vehicle to sell the useful life of cable, but it had characteristics of both a true sale and contractual obligations. In a decision out of the WorldCom bankruptcy case, the U.S. Bankruptcy Court for the Southern District of New York held that an indefeasible right of use (IRU) agreement constituted a property interest in the underlying fiber lines rather than a mere contract or license. The Bankruptcy Court held that the IRU could not be rejected as an executory contract in the bankruptcy case of the grantor of the IRU because the IRU was a property interest and not an executory contract.

The Bankruptcy Court analyzed the IRU by looking at the language of the IRU agreement and noting that "no court has determined the precise legal nature of an IRU." According to the Bankruptcy Court, sections of the agreement implied a sale or at least the transfer of a property interest and repeatedly used the word "exclusive." The Bankruptcy Court rejected the argument that the IRU constituted a license based upon the exclusive nature of the IRU. Rather, the interest of the purchaser of the IRU was closer to an easement or lease, but settled on the concept of a sale for a term of years as the best analogy. The court ultimately determined that the IRU was certainly a property interest rather than a mere contract. This case represents the first reported decision directly addressing the nature of an IRU agreement in bankruptcy and turned on the specific language of the IRU at issue.

In addition to the determination of the executory nature of the newly fashioned products, lawyers were also faced with the determination of whether telecommunication services provided by tariff were executory or not. The battle of whether services provided by tariff are executory continues to this day. I hope to see material performance due on both sides. I feel that if the contract is executory, this would give the debtor options. If the contract is not executory, the debtor lacks options.
Since the telecommunications field has faced significant restructuring, there will be a new industry that will face financial reorganization, and the contracts between the parties will be considered. For example, in the energy business many new products and financing arrangements have to be crafted and negotiated. However, the implications and rights granted by those agreements have yet to be tested. As the automotive industry faces further restructuring, the agreements in that field have also not been tested through a bankruptcy cycle.

As the economy and various industries face their ebbs and flows, the underpinnings of each industry will be tested in a bankruptcy setting. Bankruptcy lawyers and professionals have analyzed industries that have already faced restructuring and will be challenged by industries that will need reorganization. In each of these industries that will face reorganization, it is axiomatic that the contracts that are the foundation of those businesses be tested in a bankruptcy setting. Bankruptcy lawyers will dissect those agreements, and Bankruptcy Court will no doubt be faced with issues relating to the executory nature of the agreement, cure rights, or the effect of rejection, among others. Bankruptcy has truly become part and parcel of the world's economy so that issues relating to executory contracts will always be part of the bankruptcy process.

Andrew H. Sherman is a Member of Sills Cummis Epstein & Gross's Creditors' Rights/Bankruptcy Reorganization Practice Group. He has represented Chapter 11 and Chapter 7 debtors, creditors' committees, secured creditors, banks, insurance companies, landlords, employees and various unsecured creditors in New York, New Jersey, and a variety of jurisdictions across the United States and Canada. Mr. Sherman has been involved in many complex Chapter 11 cases in a number of industries including: telecommunications, real estate, retail, manufacturing, supermarkets, securities, transportation, construction and environmental waste. In addition to Mr. Sherman's bankruptcy experience, he has represented parties and been involved in significant commercial litigation in the New York and New Jersey federal and state courts.

Mr. Sherman had an active role in the following published opinions: In re American Family Enterprises, 256 B.R. 377 (D.N.J. 2000); In re First Interregional Equity Corp., 218 B.R. 377 (Bankr. D.N.J. 1997); In re United Healthcare System, Inc., 1997 WL 176574 (D.N.J. 1997); In re Lazarus Burman Associates, 161 B.R. 891 (Bankr. E.D.N.Y. 1994); In re Arts des Provinces de France, Inc., 153 B.R. 144 (Bankr. S.D.N.Y. 1993); In re Masters, Inc., 149 B.R. 289 (E.D.N.Y. 1992); In re Kenston Management, Inc., 141 B.R. 13 (Bankr. E.D.N.Y. 1992).

Mr. Sherman is a frequent lecturer and author on bankruptcy-related topics.

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Dedication: *I dedicate this chapter to my parents, wife, and children who have supported me and enabled me to gain the knowledge to write this chapter.*

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