

# **EXECUTORY CONTRACTS UNDER BANKRUPTCY CODE SECTION 365**

**By**

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## EXECUTORY CONTRACTS

Section 365 of the Bankruptcy Code authorizes the trustee or debtor in possession to reject, assume, or assign executory contracts and unexpired leases. The power is of primary importance in chapter 11 reorganization cases; sometimes it is important as well in chapter 7, and 13. This memorandum provides a general overview of the law governing executory contracts under Section 365 of the Bankruptcy Code.

### **I. TREATMENT OF EXECUTORY CONTRACTS IN BANKRUPTCY - GENERALLY**

An executory contract is generally “[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 performance of the other.”<sup>1</sup>

A debtor<sup>2</sup> has three options with regard to an unexpired executory contract upon the filing of a bankruptcy petition: (i) reject the contract; (ii) assume and perform under the contract; or (iii) assume and assign the contract to a third party who will perform under the contract.<sup>3</sup> As a general rule, bankruptcy voids a provision in an executory contract that prohibits or conditions the debtor’s ability to assign its rights and obligations.<sup>4</sup>

The general rule is that an executory contract may not be assumed in part and rejected in part. Thus, a debtor (or third-party assignee, in the case of an assignment) seeking to assume or reject an executory contract must assume or reject the contract in its entirety. Courts, however, will permit limited modification of an executory contract to exclude from the assumption of a contract such contract’s ipso facto clauses or bankruptcy termination clauses. Further, courts have allowed debtors to assume parts of an executory contract while rejecting other parts if the court determines that the contract is not in actuality a single contract but rather two separate agreements. A court, however, will not normally characterize a contract as divisible unless the parties’ intent regarding divisibility is clear.

### **II. ASSUMPTION, REJECTION, OR ASSIGNMENT OF EXECUTORY CONTRACTS**

Section 365 of the Bankruptcy Code gives the debtor the option of assuming or rejecting an executory contract. If the debtor elects to keep the contract in existence, the estate would be entitled to receive the other party’s performance and be liable for the obligations undertaken by

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<sup>1</sup> Countryman, Executory License Agreements in Bankruptcy, 57 Minn. L. Rev. 439, 446 (1973).

<sup>2</sup> In a chapter 11 case, the debtor often remains as the debtor in possession, and a trustee usually is not appointed. Although this memo uses the term “debtor”, a trustee would have the same rights as a debtor to assume, reject, or assign an executory contract.

<sup>3</sup> See 11 U.S.C. § 365.

<sup>4</sup> See 11 U.S.C. § 365(f)(1).

the debtor. The performance due by the estate qualifies as an administrative expense and is thus entitled to priority.<sup>5</sup>

The debtor's election to reject the contract constitutes a breach that is treated as a prepetition breach by the debtor.<sup>6</sup> The other party to the contract becomes a creditor, and its claim for damages for breach of contract is classed as a general unsecured prepetition claim.<sup>7</sup> It is paid in the bankruptcy distribution at whatever fractional rate is due to such claims. Generally, the measure of damages is determined by applicable nonbankruptcy law; the Bankruptcy Code itself, however, limits the allowability of the general unsecured prepetition claim of a lessor under a rejected or breached lease of real estate and that of an employee under a terminated employment contract.<sup>8</sup>

If the estate first assumes a contract and later rejects it, the rejection is the estate's breach and the other party's damages are treated as an administrative expense.<sup>9</sup> These damages are measured at the time of rejection or, if a chapter 11 or 13 case was converted to chapter 7 between assumption and rejection, at the time of conversion.

#### **A. Procedure and Standards for Assumption or Rejection**

In a case under chapter 11 or 13, the debtor has until plan confirmation (which could be several months or even more than a year) to decide which option to select, although the court may require an earlier decision.<sup>10</sup> In a case under chapter 7, the debtor (more accurately, the trustee) has sixty days from the petition date unless it obtains an extension.<sup>11</sup> Until an option is selected, the debtor must perform its post-petition obligations under the contract.

An affirmative decision to assume or reject must be approved by the court following a motion by the debtor on notice. However, if the contract is deemed rejected because of the debtor's failure to act within the prescribed period, the rejection is automatic and does not require court approval.<sup>12</sup>

The most widely accepted standard for the court's approval of the debtor's decision to assume or reject is the business judgment rule. The court will not interfere with the debtor's decision if it was based on a good faith, reasonable business judgment that appears beneficial to

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<sup>5</sup> See 11 U.S.C. § 507(a)(1).

<sup>6</sup> See 11 U.S.C. § 365(g)(1).

<sup>7</sup> See 11 U.S.C. § 502(g).

<sup>8</sup> See 11 U.S.C. § 502(b)(6).

<sup>9</sup> See 11 U.S.C. § 365(g)(2).

<sup>10</sup> See 11 U.S.C. § 365(d)(2).

<sup>11</sup> See 11 U.S.C. § 365(d)(1).

<sup>12</sup> See 11 U.S.C. § 365(d)(1).

the estate. It is extremely difficult, if not unobtainable, for the non-debtor party to the contract to challenge a debtor's decision to reject a contract.

### **B. Interim Performance**

In some limited cases, performance may be suspended on both sides pending the debtor's decision to assume or reject. However, in most cases, the contracts involve continuing performance by the non-debtor party in the period before the decision is made and there is nothing in Section 365 of the Bankruptcy Code that allows the non-debtor party to withhold performance pending the estate's decision to assume or reject the contract.

If there is continuing performance and the contract is ultimately rejected, the general, albeit theoretical, rule is that the other party is entitled to compensation, payable as an administrative expense, for the reasonable value of any benefit received. Reasonable value may be less than the contract rate, and it is only payable to the extent that the estate was actually enriched. As a practical matter, the value of the performance rendered by the non-debtor party or the benefit realized by the estate during the interim period is almost always measured by the contracted rate, unless there is some readily defined market for the benefit, such as in the case of a commodities contract.

### **C. Assumption of Contracts in Default**

To assume a contract that is in default, the debtor must comply with Section 365(b)(1) of the Bankruptcy Code by curing the default, compensating for any loss caused by it, and giving the party adequate assurance of future performance under the contract. The question of whether there has been a default is determined with reference to the contract terms and non-bankruptcy law.

Under Section 365(b)(2) of the Bankruptcy Code, two types of default need not be cured. First, if the default is simply the violation of an ipso facto clause, the default really cannot be cured without the debtor dismissing the bankruptcy case and becoming solvent. Second, if the default consists of the failure to pay a penalty rate or it consists of some non-monetary default (for example, the debtor's failure to keep a business open during the hours specified in the contract), cure for that default is not needed for assumption.

As for adequate assurance of performance, it is generally left to the court to evaluate the debtor's proposals for rectifying the breach and assuring future performance.<sup>13</sup> The concept of adequate assurance of future performance is taken from Section 2.609 of the Uniform Commercial Code, which entitles a party to a sales agreement to demand such assurances when there are grounds for insecurity about the other party's ability to perform. Both under the Uniform Commercial Code, and in Section 365(b)(1)(c) of the Bankruptcy Code, assurance is provided by showing that resources are likely to be available for the discharge of the contractual obligations and performance appears to be commercially feasible.

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<sup>13</sup> Section 365(b)(3) of the Bankruptcy Code goes to some length in expressing what is required for adequate assurance of performance in connection with leases of premises in shopping centers.

#### **D. Non-assumable Contracts**

Section 365(c) of the Bankruptcy Code denotes three types of executory contracts that may not be assumed. The bar on assumption arises as a matter of law and does not depend on the existence or absence of a clause in the contract forbidding or restricting assignment.

First, in the absence of consent by the other party, the Bankruptcy Code prevents the assumption of a contract if applicable law excuses the other party from accepting performance from or rendering performance to someone other than the debtor.<sup>14</sup> The Bankruptcy Code therefore respects the rights of non-transferability under non-bankruptcy law and enables the other party to resist assumption by the estate if transfer of the contract could have been prevented outside of bankruptcy.

Second, the Bankruptcy Code forbids the debtor from assuming a contract to make a loan, to extend other debt financing or financial accommodations to the debtor, or to issue a security of the debtor.<sup>15</sup> Limited in its scope, it does not cover all credit transactions but is confined to loan and financing contracts. Courts construe Section 365(c)(2) of the Bankruptcy Code strictly and refuse to extend it to contracts whose primary purpose is not the provision of a loan or financing.

Third, the estate may not assume a lease of nonresidential real property that had been terminated under non-bankruptcy law prior to the order for relief.<sup>16</sup>

#### **E. Bankruptcy Termination or Ipso Facto Clauses**

A provision in a contract that allows the non-debtor to declare default or to terminate the contract on the grounds of the insolvency, financial condition, or bankruptcy of the debtor is ineffective in bankruptcy. This reflects the general policy of preventing states or private parties from undermining the bankruptcy process through laws or contractual terms that are designed to take effect on bankruptcy.

A contract may provide grounds for termination other than the bankruptcy or financial condition of the debtor. If valid in non-bankruptcy law, termination rights not based on an ipso facto clause are effective against the estate.<sup>17</sup> Note, however, that if all steps for termination have not been taken by the nondebtor party prior to the bankruptcy case filing, further steps toward termination are subject to the automatic stay.

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<sup>14</sup> See 11 U.S.C. § 365(c)(1).

<sup>15</sup> See 11 U.S.C. § 365(c)(2).

<sup>16</sup> See 11 U.S.C. § 365(c)(3).

<sup>17</sup> However, Section 365(b) of the Bankruptcy Code permits the estate to cure defaults, so termination on grounds of default is subject to the estate's right to cure.

## **F. Assigning the Executory Contract**

The debtor may be unwilling or unable to take on the burden of performance even though the contract is advantageous. In this situation, the debtor may assume the contract and then sell it to someone else. The buyer of the contract takes an assignment of it, including both the assignment of the debtor's rights and a delegation of its duties.

Generally speaking, though some exceptions may apply, if the contract is of a kind that would not have been assumable by the debtor, then the debtor cannot assume and assign it to a third party.<sup>18</sup>

Before a contract can be assigned, the debtor must first assume the contract. As explained above, this means that the debtor must cure defaults under the contract and give adequate assurance of future performance. In the case of a contract that will be assigned to a third party, it is the assignee that must demonstrate adequate assurance of future performance. This is intended to protect the non-debtor party from being forced into a contractual relationship with someone who is financially unstable or otherwise unlikely to provide a performance that conforms to the contract. Once a contract is assigned by the debtor, the non-debtor party has no recourse against the estate if the assignee breaches. Upon assignment, the estate is relieved of all liability for post-assignment breaches.<sup>19</sup>

## **III. SPECIAL ISSUES / SITUATIONS**

### **A. The Debtor as Landlord or as Contract Vendor of Real Estate**

If the debtor rejects an unexpired lease of real property under which the debtor is the lessor, the lessee may treat the lease as terminated by the rejection and file a claim for damages or may elect to retain the rights under the lease for the remainder of the term and for any renewal or extension period, including the right to possession at the rent provided in the lease and any right to sublet, assign, or hypothecate the leasehold.<sup>20</sup> A lessee who chooses to retain its rights may, as the exclusive remedy for the breach, offset damages caused by the debtor's nonperformance against rent coming due after the rejection.<sup>21</sup>

Similarly, a buyer in possession under an executory contract for the sale of real estate from a debtor-vendor is protected by an option given in Section 365(i). If the debtor rejects, the buyer may treat the contract as terminated and assert a claim for damages or may, as the exclusive remedy for the breach, elect to remain in possession with the right to offset his

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<sup>18</sup> See 11 U.S.C. § 365(c) and (f).

<sup>19</sup> See 11 U.S.C. § 365(k).

<sup>20</sup> See 11 U.S.C. § 365(h)(1)(A).

<sup>21</sup> See 11 U.S.C. § 365(h)(1)(B).

damages against payments coming due under the contract. When the contract payments are completed or satisfied, the land purchaser is entitled to delivery of title.<sup>22</sup> A land contract buyer who is not in possession or who chooses to treat the rejection as a termination of the contract is given a lien on the property to secure the return of whatever part of the purchase price he has paid.<sup>23</sup>

#### **B. The Debtor as Licensor of Intellectual Property**

Section 365(n) of the Bankruptcy Code gives a licensee of intellectual property from the debtor a measure of protection against rejection of the license. Intellectual property is defined in Section 101(35A) to mean copyrights, patents and applications thereof, and trade secrets, but not tradenames, trademarks, or related rights. If the debtor rejects a licensing contract, the licensee may either treat the rejection as a termination of the contract and assert a damage claim, or may retain the rights under the license and continue to make royalty payments, waiving any right to setoff for damages resulting from the rejection and any administrative expense claim resulting from the licensee's performance under the license. Moreover, during the "limbo" period before rejection, the debtor must continue performance of the debtor's obligations under the license agreement if requested by the licensee to do so.

### **IV. SELECTED AMENDMENTS TO SECTION 365 UNDER THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005**

#### **A. Time to Assume or Reject Nonresidential Real Property Leases**

Under Section 365(d)(4) of the pre-amendment Bankruptcy Code, a debtor had 60 days after the order for relief to decide whether to assume or reject a nonresidential real property lease. A failure to assume within that time period meant that the lease was deemed rejected. The amendments lengthens this 60-day period to the earlier of 120 days after the order for relief or the date of the entry of an order confirming a plan. However, Section 365(d)(4)(B) of the amended Bankruptcy Code limits non-consensual extensions of the 120-day period to only one 90-day extension. This contrasts sharply with the practice in many jurisdictions under the pre-amendment Bankruptcy Code, under which it is common for extensions to be granted until the confirmation of a chapter 11 plan.

#### **B. Claim Status for Lessors of Nonresidential Real Property**

New Section 503(b)(7) of the amended Bankruptcy Code provides lessors of nonresidential real property with administrative expense status for damages under an assumed

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<sup>22</sup> See 11 U.S.C. § 365(i)(2)(B).

<sup>23</sup> See 11 U.S.C. § 365(j).

nonresidential real property lease that is subsequently rejected, but such status is limited to two years of obligations under the lease (excluding those obligations arising from or relating to a failure to operate or a penalty provision), measured from the later of the rejection date or the actual turnover of the premises. This priority is provided without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor. New Section 503(b)(7) further provides that the claim for remaining sums due for the balance of the term of the lease will be a claim under (and, therefore, subject to the cap contained in) Section 502(b)(6). This contrasts with the current state of the law in which rejection or breach of an assumed contract would give rise to an uncapped administrative expense for damages.

### C. Nonmonetary Defaults

Under the pre-amendment Bankruptcy Code, there is disagreement among courts as to whether Section 365(b)(2)(D)—which states that the debtor need not satisfy “any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease” to assume such executory contract or lease—requires debtors to cure nonmonetary defaults before being able to assume executory contracts. The Ninth Circuit, in In re Claremont Acquisition Corp., 113 F.3d 1029 (9<sup>th</sup> Cir. 1997), took the position that “penalty rate or provision” was to be read as “penalty rate or penalty provision”—a reading whereby a debtor would be required to cure non-monetary defaults, other than those that were penalty provisions relating to non-monetary defaults. As a practical matter, because many nonmonetary defaults are by their nature historical facts and therefore incurable, a debtor’s breach of a nonmonetary obligation will disable it from assuming a lease or executory contract. Indeed, this was the result in Claremont Acquisition. The First Circuit, however, reached the opposite conclusion in In re Bankvest Capital Corp., 360 F.3d 291 (1<sup>st</sup> Cir. 2004), holding that a debtor need not cure any nonmonetary default, whether or not in the nature of a penalty. But Congress did not agree.

Section 365(b)(2)(D) of the amended Bankruptcy Code essentially codifies the holding of Claremont Acquisition. New Section 365(b)(2)(D) contains the word “penalty” before “provision,” clarifying that as to executory contracts and leases of personal property, a debtor need not satisfy any “penalty rate or penalty provision” relating to a failure to perform its nonmonetary obligations. Nonetheless, the nonmonetary defaults themselves must be cured before a debtor may assume an executory contract or personal property lease.

The amended Bankruptcy Code treats real property leases differently, however. Section 365(b)(1)(A) of the amended Bankruptcy Code provides that, with respect to an unexpired lease of real property, a debtor need not cure a nonmonetary default “if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption.” That section goes on to provide that “if [the nonmonetary 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.” In other words, historical nonmonetary defaults (such as failure to comply with

going-dark clauses) need not be cured; all that is required is that the debtor comply with such nonmonetary obligations after it assumes the lease and compensate its counterparty, as part of the cure amount, for any losses suffered as a result of its having breached its nonmonetary obligations.