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Executory Contracts and Unexpired Leases

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§8.1 I. INTRODUCTION

At the time the bankruptcy case is filed, the debtor may be a party to contracts with continuing performance obligations on both sides. For individual debtors, such contracts may include real property leases, installment land sale contracts, motor vehicle leases, installment payment contracts for furniture, appliances, and other household goods, insurance contracts, club memberships, and various kinds of service contracts. For business debtors, such contracts may include real property and equipment leases, motor vehicle leases, franchise agreements, licensing agreements, manufacturing and other outsourcing agreements, warehousing and distributing agreements, sales contracts, employment contracts, commission agreements, and many kinds of service contracts. From the debtor's standpoint, continuance of the contract during and after bankruptcy may be either beneficial or detrimental to the estate or the debtor. The Bankruptcy Code

therefore gives the trustee, the debtor in possession, and, in some situations, an individual debtor, the right to assume or reject executory contracts and unexpired leases. See 11 USC §365.

II. DEFINITION OF EXECUTORY CONTRACT

§8.2 A. “Executory Contract” Defined

The Bankruptcy Code does not define “executory contract.” Most courts, including those in the Ninth Circuit, apply the “Countryman” definition:

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 performance of the other.

Countryman, *Executory Contracts in Bankruptcy*, 57 Minn L Rev 439, 446 (1973). See *Unsecured Creditors’ Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702, 705 n7. Although the issues of contract construction and breach are governed by state law, the issue of whether a contract is executory is one of federal law. *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492.

Unexpired leases are a subset of executory contracts. An unexpired lease may concern either real property or personal property. Leases of real property “include any rental agreement to use real property.” 11 USC §365(m). Section 365 of the Bankruptcy Code applies equally to all executory contracts and unexpired leases, except as expressly provided in the statute. Certain subsections of §365 apply exclusively to unexpired leases of real property (see 11 USC §365(b)(1), (b)(3), (d)(3)-(4), (h)(1)), while other subsections apply exclusively to unexpired leases of personal property (see 11 USC §365(d)(5), (p)).

B. Contracts Not Within Definition

§8.3 1. Financing Agreements

Some contracts that appear to be executory contracts or unexpired leases may in fact be secured or unsecured financing agreements. The most common examples are installment sales or rent-to-own contracts, as well as finance leases. *Pacific Express, Inc. v Teknekron*

Infoswitch Corp. (In re Pacific Express, Inc.) (9th Cir 1986) 780 F2d 1482 (equipment lease characterized as installment sale, not executory, because seller's performance substantially complete on delivery of equipment); *In re Crummie* (Bankr ND Cal 1996) 194 BR 230 (retail automobile installment sales contract not executory). The analysis may be affected by applicable state statutes. For example, the Karmette Rental-Purchase Act (CC §§1812.620-1812.649) provides that certain personal property leases of consumer goods are "true" leases, not retail installment sales contracts, consumer credit contracts, or security agreements. Thus, personal property leases within the scope of that Act may be subject to 11 USC §365. See also Com C §1203 (criteria to distinguish secured loans from leases); *Duke Energy Royal, LLC v Pillowtex Corp. (In re Pillowtex, Inc.)* (3d Cir 2003) 349 F3d 711 (transaction was financed sale, not equipment lease, when lease term was same as useful life of equipment and no residual value remained for "lessor"); *In re Grubbs Constr. Co.* (Bankr MD Fla 2005) 319 BR 698 (same). Courts generally apply state law to determine whether a lease is a disguised financing or a true lease, provided that the state law does not attempt to defeat federal policy by elevating the form of the "lease" over the economic substance of the transaction. See *United Airlines, Inc. v HSBC Bank USA, N.A.* (7th Cir 2005) 416 F3d 609, 615.

Some courts considering sale-leaseback transactions involving the issuance of municipal bonds and the execution of leases, as well as other lease agreements, have analyzed the transaction in accordance with federal law as embodied in 11 USC §§502(b)(6) and 365, together with the legislative history of §502(b)(6). These courts have looked to the "economic realities" of the situation to determine the character of the agreement. See, e.g., *City of San Francisco Mkt. Corp. v Walsh (In re Moreggia & Sons, Inc.)* (9th Cir 1988) 852 F2d 1179; *Liona Corp. v PCH Assocs. (In re PCH Assocs.)* (2d Cir 1986) 804 F2d 193; *City of Olathe v KAR Dev. Assocs. (In re KAR Dev. Assocs.)* (D Kan 1995) 180 BR 629 (only damages from rejection of true lease are subject to cap under §502(b)(6); true lease determination is to be made with reference to economic realities test). In contrast, the Seventh Circuit recently opined that courts should apply state law to determine how to characterize a purported lease, unless it appears that state law is designed to defeat federal policy by ignoring the economic substance of the transaction and elevating document form over substance. *United Airlines, Inc.*

v HSBC Bank USA, N.A. (7th Cir 2005) 416 F3d 609, 615 (applying California law to characterize lease of San Francisco facility as financing transaction). In several related appeals, the court found it appropriate to apply state law in order to recharacterize leases of airport facilities as financings, materially reducing the airline tenant's liabilities. See also *Martin Bros. Toolmakers, Inc. v Industrial Dev. Bd (In re Martin Bros. Toolmakers, Inc.)* (11th Cir 1986) 796 F2d 1435.

The distinction between financing arrangements and executory contracts is important. The rights of a lender to receive payments and enforce a lien on collateral are markedly different from those of a lessor who owns and may repossess property on default under a lease. Most important, a trustee cannot permanently alter a lessor's payment rights and at the same time retain possession of the leased goods or premises. See, e.g., 11 USC §365(d)(3) (requiring postpetition performance of all real property lease obligations pending assumption or rejection); 11 USC §365(d)(5) (requiring performance of certain personal property lease obligations pending assumption or rejection); 11 USC §365(b)(1) (conditioning assumption of lease on cure of defaults and adequate assurance of future performance); 11 USC §1124 (defining impairment of claims to include failure to pay amounts to cure or compensate for damages caused by defaults, as required by 11 USC §365(b)). See §8.21 (concerning requirement that trustee assume or reject entire lease). By contrast, a trustee may retain possession of a secured lender's collateral yet modify the lender's repayment rights. See, e.g., 11 USC §§1123(b)(5), 1322(b)(2) (reorganization plans may modify the rights of all holders of secured claims, except those secured only by a lien on the debtor's principal residence). Moreover, a trustee may set aside a lien that is not properly perfected or is otherwise unenforceable. See 11 USC §544; §6.31. A secured lender thus may become unsecured, while the trustee retains the putative collateral free and clear of any claim or lien in favor of the lender.

For a discussion of the distinction between real property leases and financing arrangements, see §13.28. See also §15.16.

§8.4 2. Option Agreements

In the Ninth Circuit, the Countryman test applies to option agreements. *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert*

L. Helms Constr. & Dev. Co.) (9th Cir 1998) 139 F3d 702, 705. Under this approach, an option is likely to be executory if the optionee, before the bankruptcy petition was filed, had announced its intent to exercise, but had not fully exercised, its rights under the option agreement. In this situation, both the optionor and the optionee would have obligations to perform in each other's favor. If, however, as of the petition date, the optionee has not announced its intent to exercise the option, the optionor has no performance obligations under the agreement, and the option agreement is not executory. In the latter situation, the option is an asset of the optionee and is the basis of a claim against the optionor, but nothing more. 139 F3d at 706.

If the option creates an enforceable property right under state law, it may be enforceable as such in the debtor-optionor's bankruptcy case. See *In re Bergt* (Bankr D Alaska 1999) 241 BR 17 (right of first refusal is similar to option and is not necessarily terminated by rejection). See also *In re Koneta* (Bankr D Az 2006) 357 BR 540 (real property purchase option recorded in real property records, and therefore enforceable under Arizona law, would be enforceable against optionor as debtor in bankruptcy).

III. ASSUMPTION OR REJECTION OF EXECUTORY CONTRACT

§8.5 A. Who Assumes or Rejects

In Chapter 7 cases, the trustee has the power to assume or reject executory contracts and unexpired leases of the debtor. *Dean v Tele-gadis (In re Dean)* (Bankr WD Penn 2004) 317 BR 482 (only trustee in Chapter 7 case has assumption powers). Additionally, 11 USC §365(p)(2), added by BAPCPA, permits the debtor, with the creditor's consent, to assume personal property leases that the trustee either has rejected or failed timely to assume. See 11 USC §365(p)(2). In Chapter 11 cases, only the debtor in possession, or the Chapter 11 trustee, if one has been appointed, has the power to assume or reject executory contracts and unexpired leases. In Chapter 13 cases, either the Chapter 13 trustee or the debtor may exercise the power to assume or reject. 11 USC §1322(b)(7). As a result, some executory contracts that are not assumable by a Chapter 7 trustee or Chapter 11 debtor in possession may be assumed in a Chapter 13 case. See §8.29. In this chapter, unless otherwise indicated, the

word “trustee” denotes the person with the power to assume or reject under the applicable Bankruptcy Code relief chapter.

§8.6 B. Assumption or Rejection Permitted

Under 11 USC §365(a), the trustee, “subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” On assumption, the contract or lease becomes property of the estate, to be performed in full in accordance with all of its terms. *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492. See also *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276, 1280; §8.47. On rejection, the estate is relieved of its performance obligations under the contract or lease. Rejection, however, constitutes a material breach and gives the other party to the contract a prepetition claim for damages. See 11 USC §365(g); §§8.48-8.51.

The trustee’s power to assume is limited by 11 USC §365(b), concerning assumption after defaults have occurred, and 11 USC §365(c), concerning contracts that cannot be assumed. After assuming the contract, the trustee, subject to certain conditions, may assign it to a third party. 11 USC §365(f). In this way, even if the estate is not in a position to enjoy the benefits of the contract or lease, it can profit from selling it, or at least avoid incurring rejection damages.

§8.7 C. Bankruptcy Code §365 Inapplicable to Contracts and Leases Terminated Prepetition

Title 11 USC §365 applies only to contracts or leases that both (1) have not been terminated under applicable nonbankruptcy law before commencement of the debtor’s bankruptcy case, and (2) have not expired by their own terms after the petition date. See *In re National Steel Corp.* (Bankr ND Ill 2004) 316 BR 287. Whether a lease or contract terminated prepetition is a question of state law. *Vanderpark Props. v Buchbinder (In re Windmill Farms, Inc.)* (9th Cir 1988) 841 F2d 1467, 1469; *In re Beck* (Bankr D Haw 1980) 5 BR 169, 171 (debtor could not assume beauty salon license that licensor terminated prepetition under nonbankruptcy law). Whether a contract is executory, however, is a question of federal law. *Otto*

Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.) (9th Cir 1991) 950 F2d 1492, 1494.

NOTE► Many California real property leases permit a lessor, on the lessee's breach of a lease and abandonment of premises, either to (1) terminate the lessee's right of possession, or (2) elect to have the lease continue in effect and to enforce all rights and remedies under the lease, including the recovery of rent as it comes due. Compare CC §1951.2 (what lessor may recover from lessee on termination of lease) with CC §1951.4 (lessor's rights and remedies on continuation of lease). If a lessor is exercising its rights to continue the lease under CC §1951.4 at the commencement of the lessee's bankruptcy case, the lease likely will be "unexpired" for purposes of 11 USC §365 and subject to assumption in the bankruptcy case. For further discussion of landlords' rights in bankruptcy cases, see §§13.28-13.47.

D. Timing of Assumption or Rejection

§8.8 1. Chapter 7

In Chapter 7 cases, the trustee is deemed to have rejected all executory contracts and unexpired leases of personal or residential property that are not, within 60 days after the entry of the order for relief, the subject of a motion for assumption, rejection, or extension of the deadline for assumption or rejection. 11 USC §365(d)(1).

NOTE► The date of entry of the order for relief is the petition date in voluntary cases and, in involuntary cases, the date an involuntary petition is approved and the order for relief is entered. See §2.9. For convenience, the date of the order for relief is referred to in this chapter as the "petition date."

If an actual or deemed rejection of a personal property lease occurs, the debtor appears to have an unlimited time to notify the lessor of the debtor's desire to assume the rejected lease. However, it is possible that the debtor's obligations under 11 USC §521(a)(6)—added by BAPCPA—will be construed to require an individual Chapter 7 debtor to give notice of any intention to assume (if the opportunity to assume arises) within 45 days after the first meeting of creditors. In any event, giving notice within that timeframe will prevent the

bankruptcy filing from constituting a default under the subject lease, and it is probable that a creditor will be more likely to agree to an assumption if the debtor sends its notice sooner rather than later. See 11 USC §365(d)(1), (p)(2). For nonresidential real property leases, the BAPCPA amended 11 USC §365(d)(4) to significantly change the treatment of such leases under all chapters of the Bankruptcy Code. See §8.9.

If a trustee is prohibited from assuming or assigning an executory contract or unexpired lease under §365(c), the lease may be terminated under 11 USC §365(e)(2). That subsection permits enforcement of contract clauses providing for termination on an event of bankruptcy if applicable law prohibits assumption by the trustee. See §§8.29–8.40 for discussion of prohibitions on assumption of certain executory contracts.

2. Chapters 11 and 13

§8.9 a. Nonresidential Real Property Leases

In all cases under the Bankruptcy Code, leases of nonresidential real property are deemed rejected unless a motion to assume, reject, or extend the initial deadline is filed (and, in some circuits other than the Ninth, the order on the motion is entered) within the earlier of (1) 120 days after the petition date, and (2) the date a plan confirmation order is entered. 11 USC §365(d)(4). The trustee may request a 90-day extension for cause from the bankruptcy court. However, the order granting such extension must be entered before the initial 120-day period elapses. *In re Tubular Technols., LLC* (Bankr D SC 2006) 348 BR 699. In order to obtain an extension beyond the additional 90-day period, the trustee must obtain the consent of the landlord. 11 USC §365(d)(4)(B)(ii). In cases filed before October 17, 2005, former 11 USC §365(d)(4) provided a shorter period (60 days) within which to file a motion to assume, reject, or extend the deadline to make the decision. However, the court, on a modest showing of cause, typically would extend the deadline through plan confirmation to permit the debtor sufficient time to formulate its reorganization plan and the plan's treatment of leases. Thus, under the BAPCPA, nonresidential real property leases are subject to automatic rejection unless assumed by the debtor within the statutory period. The debtor-tenant has a maximum of 7 months to make its assumption decision, but only if it is able,

during the first 120 days, to show cause for granting the statutorily-permitted 90-day extension. See §8.11.

PRACTICE TIP▶ Amended §365(d)(4) materially alters the dynamics of a Chapter 11 case in which nonresidential real property leases are an important asset of the debtor's estate. For example, in large retail cases, the debtor will need to engage in significant prebankruptcy planning to evaluate the performance of each location and whether each lease is above or below market, and to time the bankruptcy filing so that the debtor can obtain optimal results from the holiday shopping season. Tightened restrictions on extensions of the assumption deadline also increase the leverage of commercial landlords in dealing with troubled lessees. It may be possible for the debtor to pay the lessor a fee in exchange for consent to an extension of the deadline. Such payment may be outside of the debtor's ordinary course of business, however, and may require court approval under 11 USC §363(b).

§8.10 b. Other Executory Contracts and Leases

Bankruptcy Code §365(d)(2) permits the trustee in a Chapter 11 or 13 case to assume or reject any other type of executory contract or unexpired lease at any time before plan confirmation. 11 USC §365(d)(2). Historically, courts allowed some executory contracts and unexpired leases (other than nonresidential real property leases) that were not addressed by motion during the case or in the Chapter 11 or 13 plan to "ride through" the bankruptcy case unaffected. See §8.10A for further discussion of the concept of "ride through."

In cases under Chapter 11 and Chapter 13, a court has the discretion, on motion of the nondebtor contracting party, to shorten the period for assumption or rejection and require the trustee to make its decision by a date certain. 11 USC §365(d)(2); *In re Resource Technol. Corp.* (Bankr ND Ill 2000) 254 BR 215, 227 (court exercised discretion to require prompt assumption or rejection because plan proposal relied on assumption and creditors were entitled to know whether plan could proceed or alternative action would be required in debtor's case).

A court considering a motion to shorten the assumption/rejection period should analyze four factors in order to determine what constitutes a "reasonable time":

- (1) The extent of likely noncompensable damage the nondebtor party will suffer;
- (2) The importance of the contract to the debtor's operations;
- (3) The amount of time the debtor reasonably needs to appraise its financial situation and the potential contribution of its assets to a plan; and
- (4) The pendency of the debtor's plan exclusivity period.

See *Zions Credit Corp. v Rebel Rents, Inc. (In re Rebel Rents, Inc.)* (Bankr CD Cal 2003) 291 BR 520, 530.

When equity permits, a court may deny a motion to compel the debtor to assume or reject, and thus may allow the contract to ride through the case. *In re Hernandez* (Bankr D Ariz 2002) 287 BR 795, 803 (after considering four equitable factors, court denied motion to compel rejection and permitted debtors to amend plan to delete references to subject contract, thereby causing ride-through).

PRACTICE TIP ▶ In addition to moving for an order to expedite the trustee's decision, a real property lessor may seek relief from the automatic stay, under 11 USC §362(d), in order to exercise its state law remedies. See §§9.12–9.18. A lessor of personal property generally cannot seek relief from stay and should instead move for an order under 11 USC §363(e), prohibiting or conditioning the continued use and lease of the property “as is necessary to provide adequate protection of” the lessor's interest in the property. See §6.61.

§8.10A 3. Ride-Through

In cases under Chapter 11 or 13, if an executory contract or lease (other than one concerning personal property) is not addressed in the confirmed plan, or is one that 11 USC §365(c) prohibits the trustee from assuming (see §8.29), then the contract or lease may be deemed to have continued in force, unaffected by the bankruptcy case. This concept of “ride-through” arises most often in Chapter 11 cases. See, e.g., *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238, 254 n19 (recognizing that executory contract, and nondebtor party's claims thereunder, may “ride through” bankruptcy), citing *Century Indem. Co. v NGC Settlement Trust (In re National Gypsum Co.)* (5th Cir 2000) 208 F3d 498, 504 n4, cert denied (2000) 531 US 871, citing *Federal's*

Inc. v Edemontan Inv. Co. (6th Cir 1977) 555 F2d 577, 579 (executory contract that is not assumed or rejected will “ride through the case and be binding on the debtor even after a discharge is granted”); *In re Parkwood Realty Corp.* (Bankr WD Wash 1993) 157 BR 687, 690 (shareholders’ agreement not rejected by plan boilerplate remained binding on debtor after plan confirmation); *In re JZ, LLC* (BAP 9th Cir, June 18, 2007, No. ID-07-1011-KMoR) 2007 Bankr Lexis 2293 (debtor’s failure to schedule executory contract does not bar application of “ride through” doctrine). In Chapter 7 cases, ride-through may apply to nonassumable contracts, such as individual debtors’ employment contracts.

Ride-through is distinct from assumption in that the subject contract does not benefit from Bankruptcy Code protections such as the voiding of ipso facto provisions and prohibitions against assignment, or the grant of a reasonable period of time in which to cure defaults regardless of the contract’s default provisions. *In re Hernandez* (Bankr D Ariz 2002) 287 BR 795, 800 (carefully analyzing and adopting ride-through doctrine in Chapter 11 case).

In cases in which the debtor is an individual, any personal property lease not assumed in a confirmed plan (or, presumably, under an order entered earlier in the case) will be deemed rejected as of the conclusion of the confirmation hearing, and applicable stays under 11 USC §§362 and 1301 will terminate automatically with respect to the leased property. 11 USC §365(p)(3). The narrow scope of this provision added by the BAPCPA arguably validates the concept of ride-through with respect to other executory contracts.

E. Motion to Assume, Reject, or Extend Election Period

§8.11 1. When to File Motion

The BAPCPA has sharply curtailed a trustee’s ability to obtain an extension of time to assume or reject a lease of nonresidential real property. The initial deadline to file a motion to assume, reject, or extend the deadline is the earlier of the date 120 days after the petition date or the date the plan confirmation order is entered. 11 USC §365(d)(4)(A). See §8.9. Absent landlord consent, the court may grant only one 90-day extension of the deadline to assume or reject. As a consequence, a debtor may be forced to assume the lease prematurely in the course of its reorganization, and may

ultimately default. This result is somewhat mitigated by BAPCPA provisions that limit the amount of a landlord's administrative claim under a nonresidential real property lease that was assumed and then later rejected postpetition to the amount of rent due for the 2-year period following the later of the rejection date and the date of the actual turnover of the premises. See 11 USC §503(b)(7) for precise claim calculation provisions. The remainder of the landlord's rent claim is unsecured, subject to the cap in 11 USC §502(b)(6). See §§13.30-13.35.

In a case filed before October 17, 2005, to prevent automatic rejection of a contract or lease, the motion to assume, reject, or extend the election period had to be *filed* within the 60-day period. However, the order granting the motion could be entered after expiration of the 60-day period and would relate back to the date the motion was filed. Further, multiple extensions of the deadline could be granted as long as each extension motion was filed before the end of the election period. See, e.g., *Willamette Waterfront, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.)* (9th Cir 1989) 875 F2d 1380, 1384.

It is expected that the same rules will continue to apply in the Ninth Circuit with respect to the 60-day and 120-day deadlines effective in Chapter 11 and Chapter 13 cases filed on or after October 17, 2005. In Chapter 7 cases, however, it appears that extension orders relating to all executory contracts and leases (except of nonresidential real property) must be entered within 60 days after the petition date. It is likely that applicable orders regarding assumption also will be required within that time. Similarly, with respect to nonresidential real property leases in a case under any chapter of the Bankruptcy Code, 11 USC §365(d)(4)(B) now requires *entry* of the extension order before the lapse of the 120-day period. *In re Tubular Technols., LLC* (Bankr D SC 2006) 348 BR 699. Outside the Ninth Circuit, many courts have required all orders granting either assumption or extension to be actually *entered* before the election period lapses. See, e.g., *DeBartolo Prop. Mgmt. v Devan* (D Md 1996) 194 BR 46, 51.

To obtain an extension of the deadline in a case filed before October 17, 2005, the movant must show "cause." See generally *Willamette Waterfront, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.)* (BAP 9th Cir 1988) 88 BR 231, 236, *aff'd* (9th Cir 1989) 875 F2d 1380, *cert denied* (1993) 510 US 865 (enumerating

factors relevant to whether cause exists to extend election period, including importance of lease as estate asset, complexity of case, number of leases, and ongoing payments to landlord). Other considerations include whether a plan has been filed or is in the process of being negotiated and whether the trustee is continuing to perform its postpetition obligations under the lease or contract.

Title 11 USC §365(d)(4) as amended by BAPCPA affords substantial leverage to commercial landlords, and it remains to be seen whether courts will approve motions to extend the deadline if the debtor has paid a fee to purchase the landlord's consent. It also remains to be seen whether courts will permit debtors to reject leases of nonresidential real property prospectively, e.g., obtain an order in September providing for rejection to be effective on January 31 of the following year, so that a debtor can remain in place and conduct its retail business through the post-holiday sales before closing the location.

Motions concerning assumption, rejection, or modification of the election period should be made under Fed R Bankr P 6006 and 9014.

§8.12 2. Forfeiture May Result From Failure to Act Timely

It is imperative that a debtor act promptly to accurately identify all unexpired leases of nonresidential real property and all other executory contracts and unexpired leases on Schedule G (see App D-5), as required by Fed R Bankr P 1007, so that the trustee can take appropriate action for each such lease or contract.

It is also imperative that the trustee act promptly to preserve its rights under 11 USC §365(d)(1) or (d)(4) regarding such leases and contracts. *Carrico v Tompkins (In re Tompkins)* (BAP 9th Cir 1989) 95 BR 722, 724. Failure to make a timely motion to assume or to extend the time period for assumption will result in rejection, which constitutes a breach and may result in the forfeiture of rights under the affected lease or contract. When a real property lease is deemed rejected by operation of §365(d)(4), the landlord has the absolute right to compel turnover of the premises. *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885, cert denied (2000) 528 US 1135. Under 11 USC §365(d)(4), this right is enforced automatically, because the trustee is required to “immedi-

ately surrender” to the lessor the nonresidential real property that was the subject of the deemed-rejected lease. Moreover, the court does not have the power to revive a contract after it is deemed rejected. *Carrico v Tompkins (In re Tompkins)*, *supra*.

A trustee may try to avoid forfeiture by contending that the subject lease is not a “true lease,” but a financing or other arrangement. There is a body of case law that examines the “economic realities” of arrangements that appear to be leases of nonresidential real property to determine whether the parties actually intended to or did create a true lessor-lessee relationship. See *City of San Francisco Mkt. Corp. v Walsh (In re Moreggia & Sons)* (9th Cir 1988) 852 F2d 1179 (agreement was not true lease when “lessee” had significant possessory interest and minimal obligations to lessor). A similar analysis is appropriate for leases of residential real property and personal property.

PRACTICE TIP ▶ Debtors should work closely with their bankruptcy trustees to prevent the forfeiture by the trustee’s inaction of contracts and leases that debtors believe to be of value. Parties whose interests may be adversely affected by forfeiture, such as a debtor’s sublessee or a lender secured by a leasehold mortgage, should be alert to bankruptcy case filings and take steps to protect their interests in the case. The most prudent way to protect such interests is to enter into subrogation and attornment agreements with the lessor, or comparable agreements in the context of other executory contracts, *before* bankruptcy.

Failure to promptly reject leases and contracts that have no value to the estate also can be costly. Amounts coming due under such agreements may be afforded administrative priority and constitute a drain on the estate. See 11 USC §§365(d)(3), 503(b)(1).

§8.13 3. Court Approval

Court approval is required for every assumption of an executory contract or unexpired lease by a trustee or debtor in possession. Bankruptcy Code §365(p)(2), however, does not require court approval of the assumption of a personal property lease by a Chapter 7 debtor. See *In re Rogers* (Bankr D SC 2007) 359 BR 591. Court approval also is required for all rejections, except those that occur automatically by operation of the Bankruptcy Code. See 11

USC §365(d)(1), (d)(4). Approval may be obtained in the form of an order granting a motion or approving a stipulation regarding assumption or rejection. *Elliott v Four Seasons Props. (In re Frontier Props.)* (9th Cir 1992) 979 F2d 1358. The order providing for assumption or rejection also may be incorporated into an order confirming a Chapter 11 or Chapter 13 plan. See 11 USC §§1123(b)(2), 1322(b)(7). See generally chaps 11-12. If the order is included in the plan confirmation order, the nondebtor contracting party must be served with the plan and a specific notice stating the intent to assume or reject and setting forth the amount and proposed terms of any cure of defaults or compensation for damages caused by default. *Century Indem. Co. v NGC Settlement Trust (In re National Gypsum Co.)* (5th Cir 2000) 208 F3d 498, cert denied (2000) 531 US 871. See also *Dataprose, Inc. v Amerivision Communications, Inc. (In re Amerivision Communications, Inc.)* (BAP 10th Cir 2006) 349 BR 718 (boilerplate provisions in plan, coupled with assumption schedule, provided sufficient notice to nondebtor party of rejection of lease).

Although rejection historically has been effective only after entry of an order or after expiration of the applicable statutory period (as extended by any court order), courts increasingly permit rejection to be effective retroactive to the date of the rejection motion, if the trustee's intentions to reject are clear, even without a formal surrender of the leased premises. See *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064; *Stonebriar Mall Ltd. Partnership v CCI Wireless, LLC (In re CCI Wireless, LLC)* (D Colo 2003) 297 BR 133, 138 (retroactive lease rejection permissible because plain language of §365 silent as to effective date of rejection; effectiveness not conditioned on prior entry of rejection order).

PRACTICE TIP ► A debtor may be able to reduce administrative expenses by unequivocally manifesting its intent to reject as early in the case as possible, as this will increase the probability of obtaining a retroactive rejection order. In addition, precedent allowing retroactive rejection may be used to allow debtors to comply with the new statutory deadlines yet remain in possession of premises they intend to reject by rejecting prospectively, *i.e.*, effective as of a date after expiration of the applicable statutory assumption/rejection period.

§8.14 F. Business Judgment Rule

The “business judgment” test applies to every decision to assume or reject a contract. To satisfy this test, the trustee must demonstrate that its chosen course of action reflects its reasonable business judgment and thus promotes the interests of the bankruptcy estate. *Agarwal v Pomona Valley Med. Group, Inc. (In re Pomona Valley Med. Group, Inc.)* (9th Cir 2007) 476 F3d 665, 670; *Durkin v Bendor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276. A court may not substitute its own business judgment, or that of other parties in interest, for that of the trustee or debtor in possession. *Orion Pictures Corp. v Showtime Networks, Inc. (In re Orion Pictures Corp.)* (2d Cir 1993) 4 F3d 1095, 1098, cert dismissed (1994) 511 US 1026.

“Good faith” may be viewed as a corollary of the business judgment rule. Several courts have declined to grant a motion to reject a contract if the debtor did not appear to have financial problems, but was instead trying to minimize the cost of breach or avoid the obligation of specific performance. See *Dressler v Seeley Co. (In re Silberkraus)* (Bankr CD Cal 2000) 253 BR 890, 906, aff’d (9th Cir 2003) 336 F3d 864 (creditor’s motion to convert case to Chapter 7 was granted; debtor’s Chapter 11 case was filed in bad faith to avoid entry of judgment for specific performance of executory real property sales agreement); *In re Southern Cal. Sound Sys.* (Bankr SD Cal 1987) 69 BR 893 (debtor had filed its petition in bad faith, solely to get out of a bad contract; motion to reject exclusive licensing contract denied). Compare *In re Liberate Technols.* (Bankr ND Cal 2004) 314 BR 206, 218 (bad faith for solvent debtors to file Chapter 11 solely to take advantage of 11 USC §502(b)(6) cap on landlord damages at a time when debtors were not facing any level of financial distress) and *NMSBPCSLDHB, L.P. v Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)* (3d Cir 2004) 384 F3d 108, 128 (same) with *In re Chameleon Sys., Inc.* (Bankr ND Cal 2004) 306 BR 666, 669 (not bad faith for debtor to file Chapter 11 for sole purpose of rejecting lease and enjoying benefit of §502(b)(6) cap on landlord damages).

G. Conditions to Assumption

§8.15 1. Before Default

If there are no defaults under an executory contract or unexpired

lease, the trustee normally will be permitted to assume the agreement simply by satisfying the “business judgment” test.

§8.16 2. After Default

If defaults have occurred under an executory contract or unexpired lease—other than a breach of a covenant relating to the debtor’s financial condition, the commencement of a bankruptcy case, or the satisfaction of any penalty provision relating to the debtor’s failure to perform nonmonetary obligations under the contract or lease (see 11 USC §365(b)(2); §8.18)—11 USC §365(b)(1) requires the trustee to clear three additional hurdles before the court will authorize assumption. Court approval will be denied unless the trustee satisfies all of the following requirements:

- Cures, or provides adequate assurance that the trustee will promptly cure, such default (11 USC §365(b)(1)(A)) (except in the circumstances discussed below);
- Compensates, or provides adequate assurance that the trustee will promptly compensate, the nondebtor contracting party for any actual pecuniary loss to that party resulting from such default (11 USC §365(b)(1)(B)); and
- Provides adequate assurance of future performance under the contract or lease (11 USC §365(b)(1)(C)).

Litigation often arises over the existence of a default and the adequacy of proposed cure payments and compensation for pecuniary loss, as well as whether the trustee has adequately demonstrated its ability to perform in the future.

Post-BAPCPA, the trustee is no longer required to cure nonpenalty, nonmonetary defaults under unexpired real property leases, except to the extent that the defaults can be cured by providing nonmonetary performance after the trustee’s assumption. 11 USC §365(b)(1)(A). If the nonmonetary default arises from a failure to operate in accordance with the lease terms, then the default must be cured by operating in accordance with the lease after assumption and the pecuniary losses resulting from nonoperation must be compensated in accordance with 11 USC §365(b)(1)(B). The trustee is required, however, to cure nonmonetary defaults before assuming personal property leases or other executory contracts, and likely will be

unable to assume any lease or contract under which the default in question is not curable, e.g., when a debtor has breached a franchise contract by closing its business for too many consecutive days. In situations where a real property lease and an operating agreement are tightly intertwined, a debtor who has incurably defaulted under its operating agreement may be precluded from assuming the related lease.

§8.17 3. Cure

“Cure” requires payment of all delinquent amounts due under the contract or lease to be assumed. The cure payment is calculated at the nondefault rate (see 11 USC §365(b)(2)(D); *Worthington v General Motors Corp. (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029), and may include postpetition attorneys’ fees of the nondebtor party (*In re Crown Books* (Bankr D Del 2001) 269 BR 12), but only to the extent that attorney fees are recoverable under the assumed contract or lease, or under applicable nonbankruptcy law. *In re Rowland* (ED Pa 2003) 292 BR 815, 819. Although the statutory language requires “prompt” payment, courts may allow cure payments to be made over a period of time, depending on the facts and circumstances of each case. Compare *In re New Valley Shopping Ctr., LP* (Bankr D Kan 2001) 260 BR 10, 26 (permitting two-year stretch-out of cure payments) with *In re Uniq Shoes Corp.* (Bankr SD Fla 2004) 316 BR 748, 752 (finding proposed four-year payment period not “prompt”).

As a corollary to the requirement that payment defaults be cured as a condition to assumption, prepetition payments made during the applicable preference period on account of an assumed lease or executory contract are not avoidable under 11 USC §547(b). *Alvarado v Walsh (In re LCO Enters.)* (9th Cir 1993) 12 F3d 938, 943.

Under 11 USC §365(p)(2)(A), a Chapter 7 debtor seeking to assume a rejected lease of personal property must negotiate the cure amount directly with the lessor. This negotiation is not subject to the automatic stay and apparently will not be subject to bankruptcy court oversight.

PRACTICE TIP ► It may be advisable for Chapter 7 debtors who desire to assume their personal property leases to arrange for the trustee to do so in the bankruptcy case and to obtain an order authorizing contemporaneous assignment to the debtor.

Although potentially more costly, this approach will reduce a lessor's ability to refuse to consent to lease assumption, and should prevent the lessor from overreaching in calculating the cure amount.

Creditors who are not vigilant may be estopped from seeking damages if they fail to appear in the bankruptcy case and oppose a motion that seeks (a) an order permitting assumption and (b) findings that there are no existing defaults that must be cured, and no damage payments that are due as a condition to assumption, or that a nominal proffered cure amount is appropriate. If an order is entered finding that no cure is due, the nondebtor party may be found to have waived its right to a cure. See *Manus v NRG Energy, Inc. (In re O'Brien Env'tl Energy)* (3d Cir 1999) 188 F3d 116. A trustee hoping to obtain the benefit of such a waiver should give explicit notice of the relief sought. See *Folger Adam Sec. v DeMatteis/MacGregor JV* (3d Cir 2000) 209 F3d 252 (no waiver of defenses when asset sale notice not explicit that waiver could result). Compare *In re Rascon* (ND Cal 2005) 321 BR 48 (when notice and plan provided creditor due process, plan confirmation order effectively reduced allowed amount of secured claim to value of collateral) with *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405 (plan confirmation order not binding to reduce allowed amount of tax lien when due process notice requirements not satisfied).

PRACTICE TIP ▶ Debtors have become very aggressive in attempting to minimize their obligation to cure defaults by filing motions to assume that assert that no or minimal defaults exist, and leaving it to the lessor to recognize the issues raised, object to the motion, and allege and prove the amounts of the cure claim.

§8.18 a. Not Necessary to Cure Certain Defaults

To facilitate the assumption of desirable contracts and leases, 11 USC §365(b)(2) permits a trustee to assume a contract or lease without first curing defaults relating to (1) the commencement of the bankruptcy case, (2) the appointment of a receiver, trustee, or custodian for the debtor, or (3) the insolvency or financial condition of the debtor. These so-called ipso facto provisions generally are

not enforceable in bankruptcy. See 11 USC §365(e)(1); §8.59. Additionally, 11 USC §365(b)(2)(D) allows the trustee to cure without paying penalty rates or penalty provisions relating to the debtor's or trustee's failure to satisfy nonmonetary obligations.

§8.19 b. Noncurable Defaults May Prevent Assumption

Before enactment of BAPCPA, 11 USC §365(b)(2)(D) was held not to excuse performance of material nonmonetary obligations, notwithstanding that the failure to perform may not be curable and may preclude assumption of the affected agreement. For example, automobile dealership agreements customarily provide that the dealer's failure to conduct ordinary business operations ("going dark") for a number of consecutive days (e.g., seven) entitles the manufacturer to terminate the agreement. State statutes, such as Veh C §3060(a)(2), contain similar provisions. *General Motors Corp. v Worthington (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029, held that 11 USC §365(b)(2)(D) does not relieve the debtor or trustee from complying with such provisions. At least one bankruptcy court in the Ninth Circuit criticized *Claremont* as inconsistent with prior Ninth Circuit rulings that plans under Chapter 11 or 13 can cure all defaults. *Bank of America, N.A. v Garcia (In re Garcia)* (Bankr D Ariz 2002) 276 BR 627, 636 (analyzing prior case law to effect that "cure" has consistent meaning throughout Bankruptcy Code, and that 11 USC §§1123(a) and 1322(b) permit a plan to provide for cure of any default), citing *Great Western Bank & Trust v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338. More recently, the First Circuit rejected the *Claremont* approach, reasoning that requiring the debtor to cure any nonmonetary default would undermine the basic goal of promoting the rehabilitation of the debtor in order to maximize the value of the estate for the benefit of debtor and creditors. *Eagle Ins. Co. v BankVest Capital Corp. (In re BankVest Capital Corp.)* (1st Cir 2004) 360 F3d 291, 300, cert denied (2004) 542 US 919. A New York bankruptcy court, in *In re New Breed Realty Enters.* (Bankr ED NY 2002) 278 BR 314, 321, adopted a compromise approach, agreeing with the *Claremont* analysis of §365(b)(2)(D), but holding that the court had discretion to deny enforcement of the provisions

concerning nonmonetary performance when the creditor failed to show that it had suffered substantial economic detriment, and enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets.

Title 11 USC §365(b)(1)(A), as amended by BAPCPA, affords some relief from the *Claremont* approach, but only with respect to nonmonetary defaults under real property leases. The amended statute excuses the cure of “a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption.” 11 USC §365(b)(1)(A). The amended section further provides that nonmonetary defaults relating to “a failure to operate in accordance with a nonresidential real property lease” (e.g., “going dark”) 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 [11 USC §365(b)(1)(B)].” 11 USC §365(b)(1)(A).

Amended §365(b)(1)(A) offers some relief to a trustee in its capacity as a tenant but does not appear to enable the trustee to assume non-real-estate-related leases or contracts under which noncurable nonmonetary defaults have occurred, such as a dealership agreement that the debtor violated by “going dark” for too many consecutive days. Indeed, the restriction of the new provisions to real property leases might be construed as an indication of congressional intent to adopt *Claremont* and prohibit a trustee from assuming an executory contract or unexpired lease of personal property under which incurable nonmonetary defaults have occurred.

For further analysis of amended §365(b)(1)(A) and (b)(2)(D) in relation to the *Claremont* and *BankVest* cases, see *Brown & Ahern, 2005 Bankruptcy Reform Legislation With Analysis* (Thomson West 2005) 99-102.

§8.20 4. Adequate Assurance of Future Performance

“Adequate assurance of future performance” (see 11 USC §365(b)(1)(C)) generally requires a trustee to provide enough information for a court to find that assumption would not alter the material economic expectations of the nondebtor party to the contract. See *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records*

& Tapes, Inc.) (BAP 9th Cir 1985) 51 BR 583, 589 (assumption and assignment permissible when they “do not interfere, in any significant way, with the primary economic expectations of a lessor or with existing property uses”). See also *In re Martin Paint Stores* (Bankr SD NY 1996) 199 BR 258, 261, aff’d (SD NY 1997) 207 BR 57 (11 USC §365(b)(3) is intended to protect landlord’s economic expectations). In addition, if a debtor tenant has defaulted under a shopping center lease, a trustee must meet the minimum standards specified by 11 USC §365(b)(3) for “adequate assurance of future performance” under a shopping center lease. These standards include assurances of (a) continued performance of payment obligations, including no substantial decline in percentage rents generated by the tenant, and (b) compliance with all lease covenants and restrictions, including those on radius, location, use, exclusivity, and tenant mix.

H. Requirements for Assumption or Rejection

§8.21 1. Entire Lease or Contract

The trustee must assume or reject an executory contract or unexpired lease in its entirety, with all its burdens, and cannot assume the beneficial elements of the contract while rejecting its burdensome elements. *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574, 575. The effect of this rule may vary depending on the court’s determination as to what constitutes a single executory contract or unexpired lease. Much of the litigation under 11 USC §365 has focused on the question of what constitutes “the contract.” Courts have ruled that a single document may contain a number of severable agreements. Courts have also found that in certain circumstances multiple documents may constitute a single contract.

§8.22 2. Severability

Contract rights are determined by state law. See *Butner v U.S.* (1979) 440 US 48, 59 L Ed 2d 136, 99 S Ct 914. In general, the following factors are relevant to any severability analysis under state law: (1) whether the nature and purpose of the agreements within the one document are distinct, (2) whether there is separate and distinct consideration for each agreement, and (3) whether the

obligations of each party to the instrument are interdependent or interrelated. *Byrd v Gardinier (In re Gardinier, Inc.)* (11th Cir 1987) 831 F2d 974, 976, cert denied (1988) 488 US 853. See also *Hudson v Wylie* (9th Cir 1957) 242 F2d 435, 446, cert denied (1957) 355 US 828. In the Ninth Circuit,

[s]everability is determined by the intent and actions of the contracting parties . . . whether a contract is entire or severable generally is a question of intention, to be determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted.

Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.) (9th Cir 1991) 950 F2d 1492, 1496, citing *Christian v Christian* (1977) 396 NYS2d 817, 856, 365 NE2d 849. As a practical matter, a contract should be severable only when a party's failure to perform one promise would not defeat the purpose of, or excuse the other party's performance under, the entire agreement.

§8.23 3. Integration

When several documents are found to constitute a single agreement, the trustee is required to assume or reject the entire group without "cherry-picking" among the constituent documents. Courts analyze the integration of multiple documents much as they do the severability of provisions of a single document, by focusing on the parties' intent, as evidenced by the language and substance of the agreement. *Moore v Pollock (In re Pollock)* (BAP 9th Cir 1992) 139 BR 938, 940. Multiple agreements contained in multiple documents may be construed as a single contract even if not expressly integrated. *Dimond v U.S. (In re Steen)* (9th Cir 1975) 509 F2d 1398, 1402 (court integrated two documents after considering timing, parties, size of transaction, and interrelationship of agreements). See CC §1642. See also *Pieco, Inc. v Atlantic Computer Sys. (In re Atlantic Computer Sys.)* (SD NY 1994) 173 BR 844, 850 (collecting extensive list of cases regarding integration of multiple documents into one contract). See also *In re Oregon Arena Corp.* (D Or, Feb. 28, 2006, No. 304-31605-e1p11) 2006 US Dist Lexis 10042 (contemporaneously executed agreements that included extensive cross-references and encompassed same subject matter construed as one integrated agreement to be assumed or rejected in its entirety).

To facilitate reorganization, a court may refuse to approve integration of several related contracts. For example, when a debtor had purchased a business and, in connection with the purchase, had leased three business locations from the seller, the court permitted the debtor to assume or reject each lease independently of the others. *In re Plitt Amusement Co.* (Bankr CD Cal 1999) 233 BR 837, 847. See also *Jewell v Beeler (In re Stanton)* (BAP 9th Cir 2000) 248 BR 823, aff'd (9th Cir 2002) 303 F3d 939 (disapproving aggregation of deed of trust with contemporaneously executed factoring agreement and guaranty).

4. Severable Portions of Apparently Executory Contracts

§8.24 a. Nonexecutory Obligations

Some courts have held that an apparently executory contract was in fact not executory for purposes of 11 USC §365, but rather was an amalgam of executory and nonexecutory obligations, and that the latter obligations would not be affected by rejection of the executory elements of the contract. *Stewart Title Guar. Co. v Old Republic Nat'l Title Ins. Co.* (5th Cir 1996) 83 F3d 735, 741 (“only the executory portions of the document are subject to rejection ... the executed portions of the contract remain intact, and property rights acquired under the contract prior to filing become property of the estate [despite] rejection of the unperformed obligations of the contract”). This approach effectively results in severance of the contract and enables the trustee to enjoy the benefit of the nonexecutory portion of the contract, while separately assuming or rejecting its executory portions.

§8.25 b. Obligations Required by Public Policy

In a few cases, courts have found that certain obligations could not be rejected as a matter of public policy. For example, the debtor landlord in *Saravia v 1736 18th St. N.W., Ltd. Partnership* (DC Cir 1988) 844 F2d 823, 824, rejected its tenants' leases, and accordingly was released from performing the landlord's obligations under those leases. Nonetheless, the court held that the landlord was required by the public housing laws, which promote public health, safety, and welfare, to continue to maintain the property and to

provide basic utility and other services to its residential tenants. 844 F2d at 826.

§8.26 c. Obligations Arising Under State Law

One provision of the Judicial Code, 28 USC §959(b), may offer nondebtor contract parties additional support for enforcement of certain agreements, including those relating to compliance with zoning or environmental laws. Section 959(b) provides, in pertinent part, that:

[A] trustee, . . . including a debtor in possession, shall manage and operate the property in his possession [in such capacity] according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

See *Baker & Drake, Inc. v Public Serv. Comm'n of Nev. (In re Baker & Drake, Inc.)* (9th Cir 1994) 35 F3d 1348 (bankruptcy code did not preempt valid state regulation of taxicabs).

§8.27 d. Homeowner Association Fees

Applicable state laws vary, but the usual result of bankruptcy court analysis is that condominium or homeowners' association fees relate to the maintenance and upkeep of common areas, which necessarily confer a benefit on the owner, and that, as long as the owner continues to hold title, the owner (as well as the unit) is liable for the association fee. *In re Lenz* (Bankr D Colo 1988) 90 BR 458, aff'd (D Colo 1990) 110 BR 523. In 1994, §523(a)(16) was added to the Bankruptcy Code to prohibit the discharge of postpetition obligations incurred while the debtor occupies or receives rent for the use of its premises. See §10.13.

As amended by the BAPCPA, Bankr C §523(a)(16) expands the scope of the discharge exception to encompass all postpetition fees or assessments relating to the debtor's ownership interest in a condominium unit, cooperative corporation share, or lot in a homeowners association "for as long as the debtor or the trustee has a legal, equitable, or possessory ownership interest" in the applicable unit, corporation, or lot. The amended section also clarifies that it does not affect the dischargeability of such fees or assessments to the

extent they arise before the petition date in a pending or subsequent bankruptcy case.

§8.28 e. Real Property Covenants Likely to Be Executory Contracts in California

The fact that an executory contract creates rights affecting real property does not necessarily insulate those rights against rejection, as illustrated by *Steffan v McMillan (In re Coordinated Fin. Planning Corp.)* (BAP 9th Cir 1986) 65 BR 711. The Chapter 7 debtor in *Steffan v McMillan* was a joint owner of real property in California. The recorded memorandum of ownership established the mutual rights of first refusal between the debtor and its co-owner in the event of any sale. 65 BR at 712. The court found that the right of first refusal was a covenant that ran with the land under CC §1468. Nonetheless, the court held that the covenant was contractual in nature, not merely an attribute of the real property, and was an executory contract as a matter of federal law. The trustee therefore was permitted to reject the right of first refusal and sell the property to a third party. The jilted co-owner was granted a lien against the property to secure repayment of amounts it paid for the right of first refusal. 65 BR at 713; see 11 USC §365(j). Compare *Steffan v McMillan* with *In re Bergt* (Bankr D Alaska 1999) 241 BR 17 (right of first refusal was not an executory contract subject to rejection).

§8.29 5. Prohibitions on Assumption of Certain Contracts

Bankruptcy Code §365(c) identifies three categories of contracts that either cannot be assumed or can be assumed only with the prior consent of the nondebtor party. 11 USC §365(c)(1)–(3). The prohibition in 11 USC §365(c)(1) applies to many common types of contracts. See §§8.30–8.40.

a. Applicable Law Prohibits Assumption or Assignment Without Nondebtor's Consent

§8.30 (1) Generally

Bankruptcy Code §365(c)(1) prohibits the trustee from assuming

or assigning a contract when (a) applicable state or federal nonbankruptcy law excuses the nondebtor party “from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession” regardless of whether the contract actually contains explicit restrictive language, and (b) the nondebtor party does not consent. 11 USC §365(c)(1). A contract provision restricting assignment does not alone impair a trustee’s right to assume or reject. *Everex Sys. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673.

Section 365(c)(1) is widely accepted as giving effect to state laws prohibiting the assignment of “personal” contracts, *i.e.*, when the personal attributes of the individual contract party are material. See, *e.g.*, *Rieser v Dayton Country Club Co. (In re Magness)* (6th Cir 1992) 972 F2d 689, 695 (debtor’s golf membership in country club was personal contract, which trustee could not assume and assign). In the Ninth Circuit, §365(c)(1) has also been found to encompass the California Vehicle Code and federal patent law. See *Ford Motor Co. v Claremont Acquisition Corp. (In re Claremont Acquisition Corp.)* (CD Cal 1995) 186 BR 977, 980, *aff’d General Motors Corp. v Worthington (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029 (§365(c)(1) encompasses Vehicle Code provisions prohibiting assignment of dealership contracts in absence of manufacturer’s reasonable consent); *Everex Sys. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673, 679 (nonexclusive patent license is personal and nonassignable under federal law and, under §365(c)(1), cannot be assumed and assigned in licensee’s bankruptcy case without licensor’s consent). But see *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404 (criticizing *Everex* for applying federal, rather than state, law to determine assignability of patent license).

Some courts permit a debtor in possession to assume a contract as long as it has no actual intent to assign the contract to a third party (which would not be permitted absent consent). See *Institut Pasteur v Cambridge Biotech Corp.* (1st Cir 1997) 104 F3d 489, cert denied (1997) 521 US 1120. See also *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566, 573 (permitting Chapter 11 debtor in possession to assume contract, notwithstanding §365(c)(1) prohibitions). In the Ninth Circuit, however, if a contract is governed by a law described in 11 USC §365(c)(1)(A), neither a trustee nor a debtor in possession can assume the contract without the nondebtor’s

consent, regardless of the actual intent of the debtor or debtor in possession to perform, rather than assign, the contract. *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747, cert denied (1999) 528 US 924 (debtor in possession could not assume patent license over objection of patentor, because identity of licensee is material to licensor and federal patent law prohibits assignment of license without patentor's consent). See also *RCI Tech. Corp. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257, 267 ("or" does not mean "and"; separate nondebtor consent required for each of assumption and assignment).

(2) Contracts Subject to 11 USC §365(c)(1)

§8.31 (a) Personal Services Contracts

Personal services contracts are within the scope of 11 USC §365(c)(1). In Chapter 11 cases filed on or after October 17, 2005, in which the debtor is an individual, property of the estate includes earnings from services rendered after the petition date but before the case is dismissed, converted, or closed. 11 USC §1115(a). In these cases, a debtor in possession in the Ninth Circuit would not be able to assume the contract without the employer's consent, but probably would simply keep working and let the contract "ride through" the case. In cases filed before October 17, 2005, if the contract is for the employment of an individual debtor, amounts payable for services performed by the debtor after the petition date do not become property of the estate. See §6.16. Thus, the trustee has little reason to seek to assume such a contract.

Some individual debtors may file bankruptcy petitions in the hope of rejecting personal services contracts (such as artists' exclusive recording or performance contracts) and freeing themselves from the constraints of noncompetition clauses in the contracts. Whether or not a bankruptcy court will permit rejection generally reflects the court's perception of whether the debtor has legitimate financial problems or is merely trying to avoid the effects of an ill-considered contract. Most courts permit the trustee reject a personal services contract, including any noncompetition covenants, if there is a legitimate bankruptcy purpose. See *Delightful Music Ltd. v Taylor (In re Taylor)* (3d Cir 1990) 913 F2d 102 (debtor with financial problems permitted to reject exclusive recording contract). But see *In re Car-*

rere (Bankr CD Cal 1986) 64 BR 156 (contract between debtor and third party “that is based upon the personal service or skill of the debtor” does not become property of Chapter 7 or Chapter 11 estate and is therefore not subject to rejection in cases under Chapter 7 or 11).

If the only reason for the bankruptcy filing was to terminate an employment contract, the nondebtor party to the contract may seek to dismiss the case as having been filed in bad faith. Dismissal under these circumstances is contemplated by 11 USC §707(b) as amended by BAPCPA, which provides for dismissal of a case filed by an individual Chapter 7 debtor with primarily consumer debts if the court determines that granting the debtor relief under Chapter 7 would be an abuse of the provisions of Chapter 7. Amended §707(b) requires the court to consider “the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor). . . .” 11 USC §707(b)(3)(B). See generally §§9.60-9.64 for further discussion of dismissal of bankruptcy cases.

Individuals with whom a debtor has contracts also may seek to prevent the debtor from assuming the agreements on the grounds that they are personal services contracts. This ploy is not assured of success. See *In re Health Plan of the Redwoods* (Bankr ND Cal 2002) 286 BR 407 (HMO could assume contracts with physicians to provide services to members of HMO because such contracts did not involve personal, sui generis relationships between HMO and doctors).

§8.32 (b) Automobile Dealership Contracts

California and many other states provide statutory protection to both automobile manufacturers and dealers in connection with many aspects of their relationships. Vehicle Code §11713.3(e) sets forth a typical provision that balances the needs of dealers to be able to sell their franchises with the needs of manufacturers to retain control over who is representing their products to the public:

There shall be no transfer or assignment of the dealer’s franchise without the consent of the manufacturer or distributor, which consent shall not be unreasonably withheld.

Bankruptcy courts generally uphold this provision as within the scope of 11 USC §365(c)(1), and the focus of litigation is whether the

manufacturer is reasonable in withholding its consent to the proposed assignee. See *Ford Motor Co. v Claremont Acquisition Corp.* (*In re Claremont Acquisition Corp.*) (CD Cal 1995) 186 BR 977, 984, *aff'd General Motors Corp. v Worthington* (*In re Claremont Acquisition Corp.*) (9th Cir 1997) 113 F3d 1029; *In re Van Ness Auto Plaza, Inc.* (Bankr ND Cal 1990) 120 BR 545, 547. In any event, if defaults have occurred, the trustee will have to satisfy the cure, compensation, and adequate assurance of future performance requirements of 11 USC §365(b)(1). The trustee may not be able to assume the contract at all if noncurable defaults have occurred. See §8.19.

§8.33 (c) Other Franchise Agreements

There is little authority on the assignment of franchise agreements, such as those covering retail or restaurant operations, but it seems that they should be subject to assumption by a trustee in a California bankruptcy case. Even trustees of petroleum franchisees (*i.e.*, gas station operators) should be able to assume (and later assign) their franchise agreements. Under Bus & P C §21148, a petroleum franchisor must consent to a transfer of the franchise unless the franchisor demonstrates certain facts, as specified in the statute, to support its nonconsent. In any event, the statute gives the franchisor a right of first refusal to purchase the franchise from the franchisee on the same terms as those of the proposed assignment. But see *In re Adelpia Communications Corp.* (Bankr SD NY 2007) 359 BR 65 (municipal ordinances restricting transfer of cable franchise agreements were enacted to protect public and were sufficient to bar assignment of debtor's franchise agreement).

§8.34 (d) Patent Licenses

A trustee cannot assume a patent license without consent of the licensor. *Perlman v Catapult Entertainment, Inc.* (*In re Catapult Entertainment, Inc.*) (9th Cir 1999) 165 F3d 747, cert denied (1999) 528 US 924 (consent required for assumption of nonexclusive patent license); *In re Hernandez* (Bankr D Ariz 2002) 285 BR 435, 439 (no assumption of any patent license without licensor's consent). Although no statute limits the assignment of patent licenses, the restriction flows from the application of federal common law, as analyzed in *Everex Sys. v Cadtrak Corp.* (*In re CFLC, Inc.*) (9th Cir 1996) 89 F3d 673, 679. The CFLC court found that a fundamen-

tal policy of federal patent law is to reward investors with an exclusive right to use or license their invention for a period of years. Further, under federal law, such licenses are personal and cannot be assigned unless the patent owner consents or the license expressly permits assignment. The restriction on assignment protects the patent owner's interest in knowing each licensee, and assuring, among other things, that competitors do not obtain the license. 89 F3d at 679. The *CFLC* court ruled that the debtor in possession could not assume and assign the nonexclusive patent license. The court in *Catapult* later ruled that assumption was prohibited even in situations in which no assignment was intended.

§8.35 (e) Copyrights

Under an analysis similar to that relating to patents, bankruptcy courts have found that trustees cannot assign copyright licenses without the licensor's consent. *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237. The Ninth Circuit Court of Appeals, in a nonbankruptcy case, similarly has determined that the holder of an exclusive copyright license cannot transfer its rights under the license without the licensor's consent. *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774, 780. Thus a trustee in the Ninth Circuit probably would not be able to assume a copyright license over the licensor's objection.

§8.36 (f) Trademarks

Federal law does not appear to protect trademarks in the same manner as patents and copyrights. (Interestingly, they are excluded from the Bankruptcy Code's definition of "intellectual property." 11 USC §101(35A). Although bankruptcy courts have allowed the assignment of trademark licenses (see *In re Rooster, Inc.* (Bankr ED Pa 1989) 100 BR 228), one Ninth Circuit court has held that trademarks are personal and nonassignable without consent of the licensor, and therefore cannot be assumed in bankruptcy without the licensor's consent. *N.C.P. Mktg. Group v Blanks (In re N.C.P. Mktg. Group)* (D Nev 2005) 337 BR 230. See also *Miller v Glenn Miller Productions* (CD Cal 2004) 318 F Supp 2d 923, 938 ("copyright and trademark licensors share a common retained interest in the ownership of their intellectual property—an interest that would

be severely diminished if a licensee were allowed to sub-license without the licensor's express permission").

§8.37 (g) Partnership and LLC Agreements

The laws of most states, including California, permit partners and LLC members to encumber or assign the economic attributes of their partnership or LLC membership interests. See *Northrop Grumman Tech. Servs., Inc. v The Shaw Group, Inc. (In re ItGroup, Inc.)* (D Del 2003) 302 BR 483. See also Corp C §§15672, 16502, 17301. Those laws generally do not permit partners or LLC members to assign their entire partner or membership interests without consent of the other partners or members. See Corp C §§15674(a), 16503, 17301. Therefore, if the partner's or member's identity is important (which is usually true for a general partner or managing member), the bankruptcy trustee of such partner or member probably will not be permitted to become a full partner or LLC member without consent of the other partners or members. See *Broyhill v DeLuca (In re DeLuca)* (Bankr ED Va 1996) 194 BR 65 (LLC operating agreement was nonassumable personal services contract of managing member; debtors in possession could not assume management interest and related duties and responsibilities, but did succeed to right to share in profits, losses, and distributions allocable to their membership interest). But see *In re Daugherty Constr.* (Bankr D Neb 1995) 188 BR 607, 611 (LLC Articles of Organization and Operating Agreement constitute executory contracts that debtor may attempt to assume under §365, notwithstanding provisions that purport to terminate debtor's interest on commencement of bankruptcy case).

§8.38 (h) Government Contracts

Many contracts with the federal government are governed by the Nonassignment Act (41 USC §15). This Act prohibits the transfer of a government contract from the original contractor to another party and further provides that "any such transfer shall cause the annulment of the contract or order transferred." Bankruptcy Code §365(c)(1) prohibits a trustee from assuming such contracts without the government's consent. *In re West Electronics, Inc.* (3d Cir 1988) 852 F2d 79, 82 (Nonassignment Act precluded assumption over government's objection; bankruptcy court should have granted government's motion for relief from stay to permit termination of con-

tract); *U.S. v TechDyn Sys. Corp. (In re TechDyn Sys. Corp.)* (Bankr ED Va 1999) 235 BR 857, 863 (relief from stay granted if government opposed debtor's assumption of contracts that were subject to 41 USC §15).

§8.38A b. Relief From Stay for Nonassumable Contracts

Nondebtor parties often seek relief from the automatic stay to terminate contracts, such as patent or copyright licenses, that cannot be assumed in bankruptcy over the nondebtor's objection. Some courts, however, have been reluctant to grant motions for relief from stay on this basis, because the debtor's circumstances can change during the case and the nondebtor party may decide to give its consent after all.

PRACTICE TIP ► If applicable law prevents assignment, a trustee or debtor in possession may be able to retain its contract rights by arguing that the subject contract is not executory and therefore is an estate asset.

§8.39 c. No Assumption of Financing Agreements

Bankruptcy Code §365(c)(2) prohibits the assumption of any contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor." 11 USC §365(c)(2). The prohibition in §365(c)(2) applies whether or not the contract itself contains any prohibitions, as long as the contract concerns the making of a loan or financial accommodation. In the Ninth Circuit, the prohibition against assumption of a financial accommodation contract is absolute, regardless of the consent of the nondebtor party. *Transamerica Commercial Fin. Corp. v Citibank (In re Sun Runner Marine, Inc.)* (9th Cir 1991) 945 F2d 1089, 1093. If a trustee or debtor in possession wishes to obtain financing during a bankruptcy case, Bankruptcy Code §364 establishes the standards for doing so. See §12.36.

Section 365(c)(2) protects lenders from having to make postpetition loan advances on the same terms that were applicable before the debtor's bankruptcy filing. This section encompasses contracts that provide for an extension of credit as a material element and

therefore are unassumable. See *In re Whiteprize, LLC* (Bankr D Ariz 2002) 275 BR 868, 873 (debtor could not assume land sale contracts that provided for sellers to provide long-term carryback financing). Section 365(c)(2) is construed narrowly, however, and does not apply to a contract when the extension of credit is incidental to the primary purpose of the agreement. *In re United Airlines, Inc.* (7th Cir 2004) 368 F3d 720, 725 (merchant's credit card-processing agreement was assumable executory contract, not "financial accommodation," as primary purpose was provision of service to debtor); *In re Neuhoff Farms, Inc.* (Bankr ED NC 2000) 258 BR 343; *In re Emerald Forest Constr.* (Bankr D Mont 1998) 226 BR 659. See also *United Sur. & Indem. Co. v Maxon Engineering Servs., Inc.* (*In re Maxon Engineering Servs., Inc.*) (Bankr D Puerto Rico 2005) 324 BR 429 (payment and performance bonds were not executory contracts and were not unassumable financial accommodations; debtor paid all premiums prepetition, and its only continuing obligation was performance of underlying construction contracts, nonperformance of which would trigger, not excuse, surety's performance obligations).

§8.40 d. No Assumption of Terminated Commercial Real Estate Leases; Other Terminated Contracts

Although 11 USC §365(c)(3) is redundant of the rule that §365 applies only to *executory* contracts and *unexpired* leases (see §8.1), the shopping center lobby caused §365(c)(3) to be added in order to preclude the assumption of any lease of nonresidential real property that terminated under applicable nonbankruptcy law before the petition date. 11 USC §365(c)(3). It should not be inferred from the exclusion of personal property and residential leases in §365(c)(3) that such leases or any other contracts can be assumed after a prepetition termination. Although landlords usually should obtain relief from the automatic stay before evicting tenants whose residential leases terminated before bankruptcy, courts have held that the stay does not apply to prevent eviction if the landlord actually obtained an unlawful detainer judgment before the bankruptcy petition was filed. *Marquand v Smith (In re Smith)* (Bankr CD Cal 1989) 105 BR 50; *Lee v Baca* (1999) 73 CA4th 1116, 86 CR2d 913. This rule is consistent with 11 USC §362(c)(1), which provides that the

automatic stay does not apply to acts against property that has ceased to be property of the estate. See §9.5.

As a precaution, however, landlords holding prebankruptcy unlawful detainer judgments customarily seek, and bankruptcy courts commonly grant, expedited relief from the automatic stay. Similar relief has been sought by and granted to landlords who filed unlawful detainer complaints but did not obtain judgments before the tenant filed its bankruptcy petition. This practice has been incorporated into 11 USC §362(b) by the BAPCPA, which, in cases filed on or after October 17, 2005, excepts from the automatic stay any action for eviction or unlawful detainer or similar proceeding by a lessor that obtained a prebankruptcy judgment of possession against the debtor-tenant of residential real property. 11 USC §362(b)(22), (l)(4). Title 11 USC §362(l) provides such a tenant the opportunity to obtain the protection of the automatic stay by (1) filing with the petition and serving on the lessor a statement that, under applicable nonbankruptcy law, the tenant could remain in possession by curing the entire monetary default; (2) depositing with the bankruptcy clerk an amount equal to the sum of all rent that will come due in the first 30 days of the case; and (3) filing and serving a further certification that the entire monetary default has in fact been cured. 11 USC §362(l)(1)-(2). The lessor may object to the foregoing certifications and obtain a hearing within 10 days. 11 USC §362(l)(3). If the objection is sustained, the automatic stay immediately will cease to apply. To enable the court and the parties to determine the applicability of 11 USC §362(b)(22), debtors will be required to indicate on their petitions the existence of any adverse judgment of possession concerning the residential real property where the tenant resides, the name and address of the lessor who obtained the judgment, whether postjudgment monetary cure is available, and whether 30 days' rent has been posted.

Further, if a residential landlord has commenced a prepetition eviction action based on endangerment of, or illegal use of controlled substances on, the premises, or if the landlord files with the court and serves on the debtor a certification that the debtor has been involved in such activities within the preceding 30 days, the automatic stay will cease to apply to the premises and any related eviction action 15 days after service of the certification. 11 USC §362(b)(23), (m). The debtor can preserve the automatic stay by filing and serving, within the 15-day period, an objection to the lessor's certification

and by providing satisfactory evidence, at or before a hearing to be held within 10 days after the filing of the objection, that the alleged prohibited situation did not exist or has been remedied. 11 USC §362(m)(2).

For further discussion of landlords' rights in bankruptcy cases, see §§13.28-13.47.

IV. PERFORMANCE PENDING ASSUMPTION OR REJECTION

§8.41 A. Performance by Nondebtor Party

Nondebtor parties to executory contracts and unexpired leases normally are required to continue to provide goods and services and otherwise perform under those agreements after the commencement of the bankruptcy case as if no case had been filed. See, e.g., *In re Coast Trading Co.* (Bankr D Or 1982) 26 BR 737, 741 (nondebtor party cannot repudiate executory contract; remedies are limited to seeking order shortening time for debtor to assume or reject contract, or seeking relief from automatic stay to terminate contract). This is so even if the contract includes a clause making bankruptcy or insolvency an event of default. 11 USC §365(e). See §8.59. A nondebtor party that desires to terminate such a lease or contract, even one that cannot be assumed in the bankruptcy case (see §§8.29-8.40), must first obtain relief from the automatic stay. *Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725. A nondebtor party also may seek relief from stay in order to be excused from performance or to obtain clarification of the debtor's postpetition payment obligations or other related relief. See *In re Lucre, Inc.* (Bankr WD Mich 2006) 339 BR 648 (granting relief from stay for nondebtor party and holding that debtor could not compel nondebtor party to continue performance under contract).

To the extent that the debtor requires the nondebtor party to perform its obligations under the contract during the debtor's bankruptcy case but before the debtor has assumed the contract, the amounts payable to the nondebtor usually will be found to be actual and necessary costs and expenses of preserving the estate, and will be treated as an administrative priority claim. 11 USC §503(b)(1). See §7.10. The estate, however, is required to pay only the reasonable value of goods and services received postpetition, which may be

less than what is specified in the contract. *In re Bryant Universal Roofing, Inc.* (Bankr D Ariz 1998) 218 BR 948, 956 (contract is “persuasive but not binding guide to a determination of the appropriate amount” of nondebtor’s administrative claim for services provided postpetition).

Bankruptcy Code §365(b)(4) provides special relief for lessors. If there has been a default under an unexpired lease, the trustee cannot require the lessor to provide goods or supplies incidental to the lease unless the trustee compensates the lessor for such goods and services in accordance with the lease terms. 11 USC §365(b)(4). Moreover, by operation of 11 USC §365(d)(3) and (5) (and former 11 USC §365(d)(10)), lessors of *commercial* real or personal property are entitled to payment of all amounts due under the lease from the petition date (if real property) or from 60 days after the petition date (if personal property) pending assumption or rejection, regardless of the effect on the estate. See §§8.43-8.44.

The nondebtor party should obtain a bankruptcy court order authorizing the trustee to incur and pay postpetition obligations under the contract. This step is particularly important for an obligation that is not simple trade debt, because the obligation may be viewed as not “in the ordinary course” of the debtor’s business, and therefore as one requiring prior court approval under 11 USC §364. To determine whether a transaction is “ordinary course,” courts examine two factors: (1) whether it is common for entities in the same business as the debtor, and (2) whether it subjects the debtor’s creditors to economic risks different from those they reasonably expected when they extended credit to the debtor. *Burlington N. R.R. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700. Obtaining a court order also is important if any secured creditor asserts a security interest in the debtor’s cash flow (see 11 USC §363(a); §§12.35, 15.8). If there is no court order and the secured creditor has not consented to the use of its cash collateral to pay the nondebtor party’s claim, the claim may not be paid, because the trustee may not have any other source of funds.

§8.42 B. Performance by Debtor

Bankruptcy Code §365 contains specific requirements concerning a trustee’s performance under unexpired commercial real and personal property leases pending assumption or rejection (see 11 USC

§365(d)(3) and (5), and former 11 USC §365(d)(10)) but does not impose performance requirements with respect to other executory contracts. If a trustee ceases to perform its obligations under an executory contract or a noncommercial lease during a bankruptcy case, the nondebtor party's principal recourse is to seek an order compelling assumption or rejection by a date certain under 11 USC §365(d)(2), granting relief from the automatic stay under 11 USC §362(d) (see §§9.12-9.18), or granting adequate protection under 11 USC §363(e) (see §9.14).

In cases filed before October 17, 2005, personal property lessors were limited to seeking adequate protection and could not seek stay relief under §362(d)(2). Under the BAPCPA, however, such lessors receive greater protection. Sections 362(h) and (p) require that individual debtor-lessees indicate their intentions to assume a personal property lease. Section 362(h) might be construed to incorporate the 30-day deadline of 11 USC §521(a)(2), even if a lease rather than a security interest is at issue (although in this author's view such an interpretation would be incorrect because §521(a)(2) applies only to security interests). Accordingly, it is possible that courts will require an individual debtor to deliver his or her statement of intention to assume the lease within 30 days after the first meeting of creditors, regardless of whether the trustee has made the required assumption decision under 11 USC §365(d)(1) or (2). Moreover, unless otherwise ordered by the court, Chapter 13 debtors are required to make payments, beginning no later than 30 days after the petition date, at the lease rate, of that portion of the lease rental that comes due after the petition date, 11 USC §1326(a)(1). Additionally, within 60 days after the petition date, Chapter 13 debtors are required to provide proof of insurance of the leased property, 11 USC §1326(a)(4).

C. Additional Performance Requirements of Trustee: Commercial Leases

§8.43 1. Leases of Nonresidential Real Property

Pending assumption or rejection, the trustee must perform all of the debtor's obligations as lessee under a lease of nonresidential real property, except any obligation to cure defaults triggered by so-called ipso facto clauses or to satisfy any penalty rates or penalty provisions relating to defaults arising from the failure of the debtor

to perform nonmonetary obligations (see 11 USC §365(b)(2), (e)(1)), to the extent that such obligations arise after the petition date. 11 USC §365(d)(3). These obligations include payment of *all* amounts due under the lease, including rent, interest, late fees, common area charges, percentage rents, real estate taxes, and any items termed “additional” or “further” rent, regardless of the fair and reasonable value of the trustee’s use of the leased property. Compare *Cukierman v Uecker (In re Cukierman)* (9th Cir 2001) 265 F3d 846 and *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401 (postpetition, prerejection rent obligation constitutes “an administrative claim for the full amount of the rent accrued during that period, regardless of the actual value conferred by the lease upon the estate”) with *TreeSource Indus., Inc. v Midway Engineered Wood Prods., Inc. (In re TreeSource Indus.)* (9th Cir 2004) 363 F3d 994, 998 (claim based on debtor’s failure to restore premises following rejection of lease arose immediately prior to petition date and was not postpetition administrative claim). See §8.48. The filing of a rejection motion, however, may terminate the accrual of postpetition obligations as of the date the rejection motion is filed. See *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064.

NOTE► Bankruptcy Code §365(d)(3) does not apply to postpetition performance of a debtor’s obligations as *lessor*; it applies only to its obligations as *lessee*. *Einstein/Noah Bagel Corp. v Smith (In re BCE W., LP)* (BAP 9th Cir 2001) 264 BR 578, 583, *aff’d* (9th Cir 2003) 319 F3d 1166.

Courts usually prorate leasehold obligations that are payable postpetition but accrue in part prepetition. *El Paso Props. Corp. v Gonzales (In re Furr’s Supermarkets, Inc.)* (BAP 10th Cir 2002) 283 BR 60 (court analyzed competing approaches of 7th and 3d Circuits and adopted 7th Circuit’s proration approach); *In re Handy Andy Home Improvement Ctrs.* (7th Cir 1998) 144 F3d 1125 (articulating and adopting proration approach, in which only obligations *accruing* postpetition are within 11 USC §365(d)(3)); *In re National Refractories & Minerals Corp.* (Bankr ND Cal 2003) 297 BR 614, 620 (postpetition, prerejection physical or environmental damage to leased premises would result in administrative claim). But see *Centerpoint Props. v Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)* (3d Cir 2001) 268 F3d 205 (rejecting proration ap-

proach and adopting performance date approach; holding that entire amount of taxes payable to landlord postpetition under lease terms had administrative priority, regardless of when tax liability of debtor to landlord (or of landlord to taxing authority) accrued). Similarly, obligations for rent under 11 USC §365(d)(3) normally are prorated based on the actual number of days of occupancy. *In re Travel 2000, Inc.* (Bankr WD Mich 2001) 264 BR 444. The Sixth Circuit, however, has held a trustee liable under §365(d)(3) for payment of an entire month's rent in a case in which the rent was due on the first day of the month and the trustee rejected the lease on the second day. *Koenig Sporting Goods, Inc. v Morse Road Co. (In re Koenig Sporting Goods, Inc.)* (6th Cir 2000) 203 F3d 986, 989; *HA-LO Indus. v CenterPoint Props. Trust* (7th Cir 2003) 342 F3d 794, 799 (adopting *Koenig* approach and distinguishing rent obligations, which accrued entirely postpetition, from *Handy Andy* tax obligations, which accrued both pre- and postpetition but were billed only postpetition).

An Illinois bankruptcy court ruled that §365(d)(3) did not apply to postpetition rent that accrued between payment dates specified in the lease, when the debtor filed its petition several days after the payment due date, but that rent accruing between the petition date and the next scheduled payment date (known as "stub rent") was entitled to administrative priority under §503(b)(1). *In re UAL Corp.* (Bankr ND Ill 2003) 291 BR 121, 127. A debtor cannot challenge the lease rate for payments under §365(d)(3), but may argue that stub rent claims that are accorded general administrative status are subject to challenge to the extent that the lease rate exceeds current market rates. *Orland Holdings, LLC v Rhodes, Inc. (In re Rhodes, Inc.)* (Bankr ND Ga, Nov. 17, 2005, No. 04-78434) 2005 Bankr Lexis 2688.

A trustee may obtain a court order permitting it to delay performance under a lease of nonresidential real property for up to 60 days after the petition date, but no longer. 11 USC §365(d)(3).

California bankruptcy courts generally view the landlord's right under 11 USC §365(d)(3) as a right to receive immediate payment of postpetition rent unless the debtor is unable to pay all administrative claims. *In re Tandem Group, Inc.* (Bankr CD Cal 1986) 61 BR 738, 741. The majority view is that §365(d)(3) does not confer superpriority status on the landlord's claim. *In re LPM Corp.* (Bankr SD Cal 2000) 253 BR 914, 919, aff'd (9th Cir 2002) 300 F3d

1134. At least one bankruptcy court outside California has adopted the view that *some* claims under §365(d)(3) may be entitled to superpriority status. *In re Pudgie's Dev.* (Bankr SD NY 1998) 223 BR 421, 427, aff'd (SD NY 1999) 239 BR 688. In any event, claims that arise under §365(d)(3) in a Chapter 11 case will be subordinate to administrative expenses that accrue after the case is converted to Chapter 7. *Temecula v LPM Corp. (In re LPM Corp.)* (9th Cir 2002) 300 F3d 1134, 1137. See 11 USC §726(b).

PRACTICE TIP ▶ If a trustee under a commercial lease is not making the required postpetition payments, the landlord has several options: (a) move to compel payment of rent; (b) move to compel surrender of the premises; and (c) move to convert the case to a Chapter 7 case. *In re LPM Corp.* (Bankr SD Cal 2000) 253 BR 914, 918, aff'd (9th Cir 2002) 300 F3d 1134.

For further discussion of landlords' rights in bankruptcy cases, see §§13.28-13.47.

§8.44 2. Commercial Personal Property Leases in Chapter 11

Lessors of personal property *other than consumer goods* (which are defined in 11 USC §365(d)(5) (former §365(d)(10)) as goods "leased to an individual primarily for personal, family, or household purposes") receive protection under §365(d)(5) similar to that afforded commercial landlords under §365(d)(3), but only in Chapter 11 cases. See 11 USC §365(d)(5). See *CIT Communications Fin. Corp. v Midway Airlines Corp. (In re Midway Airlines Corp.)* (4th Cir 2005) 406 F3d 229, 235. Section 365(d)(5), however, only requires the trustee to perform leasehold obligations first arising on or after 60 days after the petition date, giving the trustee a two-month grace period. In addition, §365(d)(5) contains an escape clause: Before assuming or rejecting a commercial personal property lease, a trustee may seek an order "based on the equities of the case" modifying its performance and payment obligations under the lease.

In cases filed before October 17, 2005 under Chapters 7 and 13 or involving consumer goods, the personal property lessor's remedies are limited to seeking payment of postpetition sums as an administrative claim under 11 USC §503(b) (see §7.10), seeking adequate

protection of its interests (see §§6.61, 9.14), and seeking an order shortening the time for the assumption or rejection of the subject contract (see §8.11). With respect to cases filed on or after October 17, 2005, see §8.42.

§8.45 3. No Waiver of Lessor's Rights

Acceptance by a lessor of the trustee's performance under 11 USC §§365(d)(3) or (d)(5) does not constitute a waiver of the lessor's rights under 11 USC §§365(b) and 365(f). 11 USC §365(d)(3), (d)(5); *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885, 888, cert denied (2000) 528 US 1135. See also §13.38.

§8.46 D. Additional Performance Requirements of Trustee Under Intellectual Property Licenses

If the debtor is a licensor under an executory intellectual property license that has not yet been rejected and the nondebtor licensee makes a written request, the trustee is required to perform the debtor's obligations under the license agreement. In the alternative, the trustee may deliver to the licensee the subject intellectual property held by the trustee. 11 USC §§101(35A), 365(n)(4)(A). Further, on the licensee's written request, the trustee, pending rejection, is prohibited from interfering with the rights of the licensee as provided in the agreement, including any right to obtain the subject intellectual property from another person. 11 USC §365(n)(4)(B).

V. EFFECT OF ASSUMPTION OR REJECTION

§8.47 A. General Effect of Assumption

On assumption, an executory contract or unexpired lease becomes a postpetition asset and a liability of the bankruptcy estate, and the trustee (or its assignee) is required to perform all of its payment and other obligations as if no bankruptcy case were pending. All of the debtor's obligations under the assumed agreement become obligations of the bankruptcy estate with administrative priority under 11 USC §503(b)(1). See §7.10. After assuming an executory contract or unexpired lease, a trustee may assign it to a third person, subject to the limitations of 11 USC §365(f). See §§8.60-8.64.

B. General Effect of Rejection

§8.48 1. Damage Claim

Rejection results in a breach of the subject agreement and gives rise to a damage claim payable in the bankruptcy case. See 11 USC §365(g). On rejection, a nondebtor party usually will have a general unsecured claim for damages resulting from rejection and also may have a secured claim in an amount up to the amount of any security deposit received from the debtor, as well as rights of offset or recoupment with respect to amounts owed by the nondebtor to the debtor. The nondebtor party also may have an administrative priority claim for goods provided or services rendered to or on behalf of the trustee, under the contract, during the bankruptcy case up to the rejection date. See 11 USC §503(b).

Section 365(g) provides rules for calculating when the breach of a rejected contract is deemed to occur. Generally, rejection of a contract that has not been assumed is deemed to be a prepetition breach, giving rise to a prepetition claim. See *Bank of Montreal v American HomePatient, Inc. (In re American HomePatient, Inc.)* (6th Cir 2005) 414 F3d 614, 620 (rejection of contract gave rise to breach deemed to occur immediately before petition date, notwithstanding state law to contrary). If a contract was assumed during the bankruptcy case, however, the subsequent rejection is a postpetition breach, and gives rise to an administrative claim for all amounts payable under the assumed contract. *Nostas Assocs. v Costich (In re Klein Sleep Prods.)* (2d Cir 1996) 78 F3d 18. See also *Elliott v Four Seasons Prods. (In re Frontier Prods.)* (9th Cir 1992) 979 F2d 1358, 1367.

The BAPCPA amended 11 USC §503(b)(7) to limit the administrative claim for damages under an assumed but later rejected lease of nonresidential real property to the amount payable under the lease, exclusive of penalties, for the 2-year period following the later of the rejection date and the date the premises actually are delivered to the landlord. The balance of the unpaid rent is treated as a general unsecured claim subject to the cap imposed by 11 USC §502(b)(6).

Rejection of a contract does not automatically result in allowance of a claim for damages in favor of the nondebtor party. If the court finds that the rejected contract was not enforceable under applicable nonbankruptcy law prior to rejection, the nondebtor will not have any allowable claim for rejection damages. *Durkin v Benedor Corp.*

(*In re G.I. Indus.*) (9th Cir 2000) 204 F3d 1276, 1280. Similarly, rejection does not abrogate any obligation of the nondebtor party under applicable nonbankruptcy law to mitigate damages. In cases in which 11 USC §503(b)(7) applies, however, the administrative claim for two-years' rent will not be subject to "reduction or setoff for any reason whatsoever except for sums actually received or to be received from any entity other than the debtor." 11 USC §503(b)(7).

As written, these provisions do not appear to require the lessor to seek to mitigate its damages or contemplate that its administrative rejection claim would be reduced for failure to mitigate. Courts nonetheless may try to import the mitigation requirements often imposed on lessors under applicable nonbankruptcy law and often applied to limit landlords' prepetition claims, but application of such mitigation requirements to an administrative rejection claim now appears to be inconsistent with the statute and should not be permitted. The statute does provide, however, that if the lessor enters into a new lease of the premises, the amounts paid or payable under the new lease will be taken into account in setting the lessor's allowed administrative claim. At least one court has given a debtor credit for payments that were agreed to under a replacement equipment lease, even though the new lessee defaulted during the pendency of the bankruptcy case (and prior to the determination of the lessor's claim), so that the replacement lessee's rent was not likely "to be received" by the landlord. See *Giant Eagle, Inc. v Phar-Mor, Inc.* (ND Ohio, July 31, 2006, No. 04:06CV0432) 2006 US Dist Lexis 52485 (debtor not liable for rent that would have come due under rejected equipment lease despite default by lessee under new lease; despite new lessee's breach, terms of new lease applied to mitigate damages in debtor's bankruptcy case). Although the case concerned an equipment lease, it is possible that a court would take a similar approach with respect to an unexpired, real estate lease. As a result, not only is mitigation arguably not required in this context, it actually may impose a potential risk in situations where the new tenant fails to make the payments required by the new "mitigating" lease.

§8.49 2. Limitations on Rejection Damages

Damage claims may be limited in some respects. For example,

any administrative claim arising from the nondebtor's postpetition performance under an executory contract, other than a commercial lease of real or personal property, is limited to an amount equal to the fair value conferred on the bankruptcy estate. See 11 USC §503(b). But see discussion in §8.43 regarding stub rent. See also 11 USC §1326(a) regarding required postpetition payments to personal property lessors. In addition, 11 USC §502, concerning the allowance of claims or interests, limits the claims of certain creditors.

§8.50 3. Landlords' Claims

Bankruptcy Code §502(b)(6) limits the claim of a real property lessor for damages arising from rejection of its lease (in addition to any damages existing on the petition date, before rejection, plus any administrative claim) to an amount equal to the "rent reserved by such lease" for the greater of (1) one year, and (2) 15 percent of the rent for the remaining term of the lease, not to exceed three years. 11 USC §502(b)(6). The actual elements of "rent" have been the subject of extensive litigation. The term has been construed narrowly in the Ninth Circuit but more broadly by other courts. Compare *Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91, 96, with *In re Best Prods.* (Bankr ED Va 1998) 229 BR 673, 678. See also *Wall St. Plaza, LLC v JSJF Corp. (In re JSJF Corp.)* (BAP 9th Cir 2006) 344 BR 94 (landlord may add attorney fees awarded in state court in prepetition litigation to cap under §502(b)(6)). In addition, as discussed in §8.48, if an assumed lease of nonresidential real property is thereafter rejected, the administrative claim for the term remaining at the time of rejection is capped at two years' rent. 11 USC §503(b)(7). This limitation does not apply in cases filed before October 17, 2005, if the lease was assumed in the bankruptcy case before it was rejected. *Nostas Assocs. v Costich (In re Klein Sleep Prods.)* (2d Cir 1996) 78 F3d 18. For further discussion of landlords' claims in bankruptcy cases, see §§7.53, 13.28–13.38. See also California Landlord-Tenant Practice, chap 14 (2d ed Cal CEB 1997).

§8.51 4. Employees' Claims

Bankruptcy Code §502(b)(7) limits the claim of an employee for damages arising from rejection of his or her employment contract (in addition to damages existing on the petition date, before rejection,

plus any administrative claim) to an amount equal to one year's compensation. 11 USC §502(b)(7). The claim should be calculated as of the petition date, without reference to any prepetition severance payments or pre- or postpetition payments by co-obligors or letter-of-credit issuers. *Young v Condor Sys., Inc. (In re Condor Sys., Inc.)* (BAP 9th Cir 2003) 296 BR 5, 19. The allowed amount of the claim may be reduced as a result of such payments, however, if the payor's right to repayment is secured by property of the bankruptcy estate. *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295, 300.

§8.52 C. Termination

Rejection of an executory contract or unexpired lease constitutes a breach, but does not terminate or rescind the contract or lease. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc.)* (9th Cir 2006) 439 F3d 558, 563 ("While rejection of a lease prevents the debtor from obtaining future benefits of the lease (such as ongoing possession of leased premises), it does not rescind the lease or defeat any pending claims or defenses that the debtor had in regard to that lease"). See also *In re Aslan* (Bankr CD Cal 1986) 65 BR 826, 829, aff'd (9th Cir 1990) 909 F2d 367. In any event, in the Ninth Circuit, rejection terminates all of the debtor's performance obligations, and the nondebtor's only remedy is a claim for damages. *Kaonohi Ohana, Ltd. v Sutherland (In re Kaonohi Ohana, Ltd.)* (9th Cir 1989) 873 F2d 1302, 1306 (dismissal of specific performance complaint against debtor was correct because specific performance is not available as remedy for rejection of executory contract). See also *TPG of Scottsdale, LLC v Scott Desert Shadows, LLC (In re Scott Desert Shadows, LLC)* (Bankr D Ariz, Apr. 14, 2006, No. 05-14892-PHX-CGC) 2006 Bankr Lexis 1220 (claim for reformation cannot lie when underlying contract has been rejected); *Dunkley v Rega Props. (In re Rega Props.)* (9th Cir 1990) 894 F2d 1136, 1140. But see *Abboud v Ground Round, Inc. (In re Ground Round, Inc.)* (BAP 1st Cir 2005) 335 BR 253, 261 (rejection of lease did not terminate landlord's specific performance right to require debtor to retransfer liquor license to landlord).

Current Ninth Circuit law thus precludes specific performance, including enforcement of negative covenants, as a remedy for a trustee's rejection of an executory contract or unexpired lease, regard-

less of whether the contract or state law provides the right to injunctive relief. It should be noted, however, that the Bankruptcy Code provides modified specific performance rights to certain real property lessees or purchasers, and intellectual property licensees, under rejected agreements. See 11 USC §365(h)-(i), (n).

Some bankruptcy court decisions have distinguished between rejection and termination:

[R]ejection of an executory contract or lease under Section 365 does not result in the termination or extinguishment of the covenants, rights or remedies created by the executory contract or lease, or, of any property interests appurtenant to the executory contract or lease.

CASC Corp. v Milner II (In re Locke) (Bankr CD Cal 1995) 180 BR 245, 263 (mortgagee's interest in debtor tenant's leasehold survived debtor's rejection of lease). See also *Eastover Bank for Sav. v Sowashee Venture (In re Austin Dev. Co.)* (5th Cir 1994) 19 F3d 1077, 1082, cert denied (1994) 513 US 874 (rejection is just "power to breach," and does not result in repudiation or termination of contract); *McLaughlin v Walnut Props., Inc.* (2004) 119 CA4th 293, 14 CR3d 369 (same). See also *Selby's Market, Inc. v PCT (In re Fleming Cos., Inc.)* (D Del, Mar. 16, 2007, No. 05-749-SLR) 2007 US Dist Lexis 18739 (arbitration clause survives rejection of executory contract). Under this analysis, most claims resulting from rejection are quantified in monetary terms and paid as prepetition claims, but specific performance would be available as a remedy in appropriate circumstances. However, at this juncture, a party claiming a possessory interest in leased premises through a debtor has no greater rights than the debtor, unless that party is in contractual privity with the nondebtor party to the lease and is likely to lose its possessory rights on the trustee's rejection of the lease. See *Syufy Enters. v City of Oakland* (2002) 104 CA4th 869, 128 CR2d 808 (subtenant's possessory interest was terminated when debtor tenant's possessory interest was terminated by deemed rejection of commercial lease in bankruptcy case).

PRACTICE TIP ► A lender or subtenant who wants to enter into a leasehold mortgage or a sublease with a potential debtor-tenant should, at the time of contracting with the tenant, enter into a nondisturbance and attornment or other appropriate agreement with the tenant's landlord, in order to establish direct privity

of contract around the tenant, thus creating rights between the nontenant parties that will survive the tenant's bankruptcy case.

§8.53 D. Abandonment

Some courts outside of the Ninth Circuit have ruled that rejection results in abandonment, not termination, of a rejected contract. See, e.g., *B. N. Realty Assocs. v Lichtenstein* (SD NY 1999) 238 BR 249. But see *Thompson-Mendez v St. Charles Olde Court Partnership, LLC (In re Thompson-Mendez)* (Bankr D MD 2005) 321 BR 814 (deemed rejection of residential lease did not result in abandonment or termination, nor did it make contract disappear; absent formal abandonment under 11 USC §554 or filing of motion for relief from stay, landlord's ejectment action violated automatic stay).

The Ninth Circuit has not expressly adopted this abandonment theory. Instead, although there is some disagreement over whether rejection terminates a lease or contract or merely results in a breach, bankruptcy courts in the Ninth Circuit have found that rejection of a real property lease terminates a debtor's possessory rights: The debtor cannot remain in possession of the premises after termination of the lease. *CASC Corp. v Milner II (In re Locke)* (Bankr CD Cal 1995) 180 BR 245. One bankruptcy court in the Southern District of California left open the possibility that a property subject to a rejected lease of personal property would revert to the debtor-lessee, and the lessor's rights would then be subject to applicable nonbankruptcy law. The lessor then would have to obtain relief from the automatic stay before pursuing its rights. *Blackburn v Security Pac. Credit Corp. (In re Blackburn)* (Bankr SD Cal 1988) 88 BR 273. *Blackburn*, however, has been undercut by BAPCPA, which added 11 USC §365(p). Section 365(p) clarifies that, in cases filed on or after October 17, 2005 in which the debtor is an individual, personal property subject to a lease that is deemed rejected ceases to be property of the estate and ceases to be protected by the automatic stay as of the rejection date.

PRACTICE TIP ▶ A Chapter 7 debtor wishing to preserve its rights under an executory contract or unexpired lease without assuming liability for prepetition defaults (which are dischargeable unless assumed) should attempt to have the trustee file a notice of intent to abandon the subject lease under 11 USC §554 before expiration of the deadline under 11 USC §365(d)(1)

or (d)(4). See §§6.69–6.70. In cases filed after October 17, 2005, however, this tactic will be of no avail for leases of personal property, and a debtor who wishes to retain the property will have to negotiate with the lessor to assume the lease in accordance with 11 USC §365(p)(2).

VI. POSTREJECTION PROTECTION FOR NONDEBTOR PARTIES

§8.54 A. Real Property Lessees

A debtor-lessor's rejection of an unexpired real property lease can be catastrophic for the nondebtor lessee. To minimize the lessee's damages, 11 USC §365(h)(1) prevents the automatic eviction of lessees on rejection and provides them with an option. A lessee can accept the rejection as terminating the lease, move out, and assert a claim for damages in the bankruptcy case. 11 USC §365(h)(1)(A)(i). Alternatively, the lessee can retain all of its rights under the lease (including possessory rights and rights relating to rental payments) for the duration of the lease, including all extension periods. 11 USC §365(h)(1)(A)(ii). A lessee that elects the second option can reduce its rent payments under the lease by offsetting amounts equal to all damages caused by the debtor's nonperformance after rejection. Such a lessee can also assert a claim for damages arising from the debtor's nonperformance before the rejection date but cannot seek an affirmative recovery for damages arising from and after the rejection date. 11 USC §365(h)(1)(B). Despite this apparent protection, a lessee who elects to remain in possession after rejection may lose its possessory rights if the trustee sells the property free and clear of interests, in accordance with 11 USC §363(f). *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel)* (7th Cir 2003) 327 F3d 537. Other courts hold that a trustee's sale of the property pursuant to 11 USC §363(f) does not terminate a tenant's leasehold interest. *In re Haskell L.P.* (Bankr D Mass 2005) 321 BR 1; *In re Churchill Props. III, L.P.* (Bankr ND Ill 1996) 197 BR 283.

PRACTICE TIP ► A tenant who elects to remain in possession after rejection of its lease should monitor the case and oppose any sale motion that does not adequately protect such tenant's interests. See 11 USC §363(e)–(f).

§8.55 B. Timeshare Interest Purchasers

A nondebtor purchaser of a timeshare interest may either accept rejection as terminating the timeshare plan or elect to retain its interests under the plan. In the latter situation, the nondebtor purchaser may offset damages caused by the trustee's nonperformance after rejection against payments due to the trustee under the timeshare plan. The nondebtor purchaser may also assert a claim for prerejection damages but cannot seek affirmative recovery from the bankruptcy estate of postrejection damages. 11 USC §365(h)(2).

§8.56 C. Purchasers in Possession

A nondebtor party to an executory contract to purchase real property or a timeshare interest who is *in possession* of the subject property may either accept rejection as terminating the contract, or elect to continue to perform under the contract and compel limited specific performance by the trustee. 11 USC §365(i). See *In re Maier* (Bankr WD NY 1991) 127 BR 325, 327. In the latter event, the purchaser can offset damages caused by the trustee's nonperformance after rejection against the purchaser's payment obligations but cannot assert a claim for postrejection damages against the bankruptcy estate. 11 USC §365(i)(2)(A). If the purchaser elects to perform, the trustee is required to deliver title in accordance with, but not otherwise to perform under, the purchase agreement. 11 USC §365(i)(2)(B).

§8.57 D. Purchasers' Liens

A purchaser who is not in possession of the subject property is not entitled to elect to perform and compel delivery of title. However, any such purchaser, and any purchaser in possession who elects to remove itself from the property and accept rejection as terminating the contract, has a lien on the debtor's interest in the subject property in an amount equal to the amount of the purchase price paid by the purchaser. 11 USC §365(j).

§8.58 E. Intellectual Property Licensees

If a licensor of intellectual property files a bankruptcy case, the filing can wreak havoc on the licensee's business if its business operations depend on the licensed intellectual property. The Bankruptcy Code balances the needs of the nondebtor licensee with those

of the debtor licensor by permitting the licensee either to accept rejection as terminating the license or to retain its rights under the license for the remainder of its term. 11 USC §365(n)(1). If the licensee elects to retain its rights, the licensee is required to make all royalty payments required by the contract, without offset of any prepetition or postpetition damages. In addition, the licensee is deemed to waive all rights to assert an administrative claim for postpetition performance under the contract. 11 USC §365(n)(2). In exchange, on the licensee's written request, the trustee must provide to the licensee all of the licensed intellectual property held by the trustee, and the trustee must not interfere with the licensee's rights under the contract. 11 USC §365(n)(3). The trustee is also required to honor any exclusivity provision in the license but is not otherwise required to perform obligations of the licensor under the agreement. 11 USC §365(n)(2)(B).

NOTE ➤ It is important to note that trademarks are not included within the Bankruptcy Code definition of intellectual property, and trademark licensees thus do not enjoy the protections of §365. *Raima UK Ltd. v Centura Software Corp. (In re Centura Software)* (Bankr ND Cal 2002) 281 BR 660, 670. See 11 USC §101(35A) (definition of "intellectual property").

§8.59 VII. THE ANTI-IPSO FACTO PROVISION

Many contracts include clauses that are intended to terminate or modify the rights of a party in the event of the party's bankruptcy, insolvency, prebankruptcy receivership, or similar event. Bankruptcy Code §365(e)(1) prevents the enforcement of these ipso facto clauses in most cases. See 11 USC §365(e)(1). The purpose of the anti-ipso facto provision of §365(e)(1) is to enable the estate to realize the full value of the debtor's contract rights for the benefit of the debtor's creditors. *Spieker Props., LP v MFM The SPFC Liquidating Trust (In re Southern Pac. Funding Corp.)* (9th Cir 2001) 268 F3d 712.

Bankruptcy Code §365(e)(2) provides that §365(e)(1) does not apply to contracts that a trustee cannot assume. Section 365(e)(2) parallels and preserves the limitations on assumption found in 11 USC §365(c). *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747, 753 n6, cert denied (1999) 528 US 924. These contracts include ones that cannot be assumed or assigned as a matter of applicable nonbankruptcy law

without consent of the nondebtor party, regardless of whether the contract prohibits assumption or assignment. 11 USC §365(c)(1). See §§8.30-8.38. These also include financial accommodation contracts. 11 USC §365(c)(2). See §8.39.

If a contract described in 11 USC §365(e)(2) provides for termination on an event of bankruptcy, the contract's ipso facto clause will be given effect. In these cases, the court should grant relief from the automatic stay to permit the nondebtor party to terminate the contract. *In re West Electronics, Inc.* (3d Cir 1988) 852 F2d 79, 82 (Anti-Assignment Act precluded assumption over government's objection; bankruptcy court should have granted government's motion for relief from stay to permit termination of contract). But see *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238, 248 (no relief from stay to enforce Anti-Assignment Act ipso facto clause against debtor in possession when no prohibited "transfer" of contract to third parties occurred). Some courts have declined to grant such relief early in the case, in the belief that the nondebtor party may change its mind during the case, as long as the interests of that party are adequately protected in the interim. See also §8.38.

§8.60 VIII. ASSIGNMENT UNDER 11 USC §365(f)

The Bankruptcy Code recognizes assumption and assignment of executory contracts and unexpired leases as important means of promoting reorganization and maximizing the value of the debtor's estate. Section 365(f)(1) facilitates assumption and assignment by permitting the trustee to assign most contracts that the trustee can assume. 11 USC §365(f)(1). Section 365(f)(1) abrogates contractual antiassignment language and permits assumption and assignment without consent of the nondebtor party. However, §365(f)(1) does not override 11 USC §365(c)(1). Thus, at least in the Ninth Circuit, if applicable nonbankruptcy law provides that a contract cannot be assigned without the nondebtor's consent, both assumption and assignment are conditioned on that consent.

Section 365(f)(1) also nullifies contract terms that, although not expressly prohibiting assignment, impose undue burdens on or create economic hurdles to assignment. For example, *South Coast Plaza v Standor Jewelers W., Inc. (In re Standor Jewelers W., Inc.)* (BAP 9th Cir 1991) 129 BR 200, held that a lease provision that condi-

tioned the tenant's assignment of the lease on payment to the landlord of 75 percent of the amount by which the lease value had appreciated (effectively capturing the bulk of any premium that might be paid to the tenant by its assignee), although arguably valid under California law, was rendered invalid and unenforceable in the tenant's bankruptcy case by operation of §365(f)(1). Similarly, under §365(f)(1), the court may disregard cross-default provisions that restrict a trustee's ability to cure defaults and assume and assign the main contract. *In re Sambo's Restaurants, Inc.* (Bankr CD Cal 1982) 24 BR 755. Further, the court may disregard a "change of ownership" provision that serves to deny a trustee's assignee the full economic benefit of ownership of properties that it bought from the bankruptcy estate. *Crow Winthrop Dev. LP v Jamboree LLC (In re Crow Winthrop Operating Partnership)* (9th Cir 2001) 241 F3d 1121.

An antiassignment clause that has been rendered inoperative in bankruptcy by §365(f)(1) may be reactivated after the contract is assumed by a third party. For example, in *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574, 576, the court refused to enforce a lease covenant providing for an increase in rent to the current market rate on the trustee's assignment of the lease, but it ruled that the trustee's assignee would take the lease subject to the escalation clause and that the escalation would take effect on the assignee's subsequent assignment of the lease.

§8.61 A. Conditions to Assignment

There are two principal conditions to assignment of an executory contract or unexpired lease under 11 USC §365(f)(2): First, the trustee must assume the contract or lease under 11 USC §365(a) or (b). 11 USC §365(f)(2)(A). If a cure payment is necessary, 11 USC §365(b)(1) requires the trustee to make it, although the trustee and the assignee should decide in advance of assignment who will bear the cost of the payment.

Second, the nondebtor party must be given adequate assurance of performance by the assignee. 11 USC §365(f)(2)(B). This rule generally requires the assignee to provide financial and operating information showing that it is likely to be able to perform and protect the nondebtor's financial expectations under the assigned contract. See *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1985) 51 BR 583, 589 (assump-

tion and assignment permissible if they “do not interfere, in any significant way, with the primary economic expectations of a lessor or with existing property uses”). See also *In re Martin Paint Stores* (Bankr SD NY 1996) 199 BR 258, 261, aff’d (SD NY 1997) 207 BR 57 (11 USC §365(b)(3) is intended to protect landlord’s economic expectations). If an unexpired lease of real property is being assigned, the lessor may require the assignee to deliver a security deposit in the amount the landlord would require if the assignee were the initial tenant under a new lease. 11 USC §365(l).

§8.62 B. Additional Conditions to Assignment of Shopping Center Leases

In addition to satisfying the two conditions described in §8.61, an assignee of a debtor-lessee’s shopping center lease must provide adequate assurance that (1) its financial condition and operating performance will be similar to those of the debtor and any guarantors at the commencement of the lease, (2) it will generate the same level of percentage rents as the debtor, (3) it will comply with special shopping-center-related covenants in the lease, and (4) it will not disrupt the tenant mix or balance of the shopping center. 11 USC §365(b)(3). The multi-factor test set forth in *In re Joshua Slocum Ltd.* (3d Cir 1991) 922 F2d 1081, 1087, is regularly used by courts in determining whether premises are a “shopping center” under §365(b)(3) and evaluates whether the following are present:

(a) A combination of leases; (b) All leases held by a single landlord; (c) All tenants engaged in the commercial retail distribution of goods; (d) The presence of a common parking area; (e) The purposeful development of the premises as a shopping center; (f) The existence of a master lease; (g) The existence of fixed hours during which all stores are open; (h) The existence of joint advertising; (j) Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases; (k) The existence of percentage rent provisions in the leases; (l) The right of the tenants to terminate their leases if the anchor tenant terminates its lease; (m) Joint participation by tenants in trash removal and other maintenance; (n) The existence of a tenant mix; and (o) The contiguity of the stores.

A shopping center may be found to exist when only some of these factors are present. The court noted, quoting Collier, that “the most important characteristic will be a combination of leases held

by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area.” 922 F2d at 1087, citing 3 Collier on Bankruptcy ¶1365.05[5].

Prior to the enactment of the BAPCPA, there was a circuit split concerning whether the specific restrictions on assignability of shopping center leases contained in §365(b)(3) overrode the more liberal assignment requirements set forth in §365(f)(1). Compare *Trak Auto Corp. v West Town Center, LLC (In re Trak Auto Corp)*. (4th Cir 2004) 367 F3d 237, 244 (specific requirements of §365(b)(3)(C) trump general provisions of §365(f)(1); auto parts retailer therefore could not assign use-restricted shopping center lease to apparel retailer) with *In re Rickel Home Ctrs.* (D Del 1998) 240 BR 826 (§365(f)(1) controls). Section 365(f)(1) was amended to make explicit that the general power to assign leases set forth in §365(f)(1) is subject to restrictions on assignment of shopping center leases contained in §365(b)(3).

The restrictions in §365(b)(3)(C) mandating compliance with special shopping center-related covenants in any lease, financing agreement, or master agreement relating to shopping centers have been interpreted to encompass any conditions, covenants, or restrictions applicable to a common interest development. See *In re Three A's Holdings, LLC* (Bankr D Del, Mar. 5, 2007, No. 06-10886) 2007 Bankr Lexis 820 (applying California law to prohibit assignment pursuant to §365(b)(C)(3) to a pharmacy where the pharmacy's use of the premises was not explicitly authorized under the CC&Rs of the local business improvement district). Further, the court in *Three A's* held that standing to enforce §365(b)(C)(3) was not restricted to the lessor, and that the owners' association could enforce the use restrictions.

§8.63 C. Assignment Procedures

An assignment may be accomplished by a motion for approval of the assumption and assignment under 11 USC §365(f), preferably combined with a motion for approval of a sale under 11 USC §363. These motions are governed by Fed R Bankr P 9014 and, respectively, Fed R Bankr P 6004 and 6006. The advantage of framing the motion under both sections is that 11 USC §363(m) provides the assignee with protections not available under §365. The assignment cannot be done by a sale motion alone, however. Until the contract

has been assumed, it is not property of the estate capable of being sold by the trustee.

§8.64 D. Trustee's Liability After Assignment

The trustee is not liable for any breach that occurs under a lease or contract after it has been assigned to a third party. 11 USC §365(k). This is true even if the nondebtor party has relied on the contract with the breaching assignee to mitigate the damages under the debtor's lease (and reduce the nondebtor's claim against the debtor). See *In re Phar-Mor, Inc.* (Bankr ND Ohio 2006) 336 BR 326, 335, aff'd (ED Ohio, July 31, 2006, No. 04:06CV0432) 2006 US Dist Lexis 52485 ("To allow the Lessors to recover from both [the new lessee] and Debtor . . . would put Lessors in a better position than they were in under the original leases with Debtor"). Although assignees often remain as secondary obligors under agreements assigned outside of bankruptcy, an assignment made under a bankruptcy court order acts as a release of any obligation for future payment or performance that might otherwise survive the assignment as a matter of applicable nonbankruptcy law.

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