LAWYERING ON BEHALF OF THE NON-DEBTOR PARTY IN ANTICIPATION, AND DURING THE COURSE, OF AN EXECUTORY CONTRACT COUNTERPARTY'S CHAPTER 11 BANKRUPTCY CASE

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I. INTRODUCTION: LAWYERING FOR THE NON-DEBTOR PARTY IN THE EXECUTORY-CONTRACT CONTEXT OF BANKRUPTCY

The Texas economy is said to be fairly strong today, having weathered the latest recession better than most other states, and Chapter 11 filings are near historic lows.[1] While they may not need Chapter 11 bankruptcy relief themselves, most Texas business firms will, nevertheless, from time to time, encounter a situation in which the Bankruptcy Code (particularly one section of it) is highly relevant, indeed directly applicable, to them: when a contract counterparty files a Chapter 11 case. This article presents that context, beginning with the general rules of executory contracts under Bankruptcy Code section 365, then identifies six problems, risks, losses, or issues faced by the non-debtor, and makes strategic and practical suggestions, both before a counterparty files and during its Chapter 11 case, for "lawyering" those problems by corporate counsel on behalf of the company or by the outside attorney on behalf of the client.

"Lawyering" is a term that, over the past half century, has skyrocketed into the vocabulary of lawyers, judges, and legal scholars. Brian Garner, a premier legal lexicographer had defined "lawyering" as "a neutral term to describe what [lawyers] do."[2] But as commonly used by attorneys, there is nothing "neutral" about the term "lawyering," and that definition does not explain what it is that lawyers "do". Diving deeper into the history of the term and

1. Mark Curriden, Business Bankruptcies in Texas Plummet – For Now, DALLAS MORNING NEWS, May 29, 2013, http://www.dallasnews.com/business/headlines/20130528-business-bankruptcies-in-texas-plummet—for-now.ece.

2. BRIAN GARNER, DICTIONARY OF MODERN LEGAL USAGE 332 (1987) (defining "lawyer" and "lawyering").

based on the cause-and-effect results flowing from the relationship of agent and principal: "lawyering" is the work of an agent, i.e., an attorney, who, in serving his or her principal, the client, "invokes and manipulates, or advises about, the dispute-resolving or transaction-effectuating processes of the legal system for the purpose of solving a problem or causing a desired change in, or preserving, the status quo for his or her principal."[3] The essence of "lawyering" is, in short, *finding a way to accomplish the desired result for the client.*

For simplicity, this article is limited to the scenario of a contract counterparty filing a case under Chapter 11, the business reorganization chapter of the Bankruptcy Code (the "Code"),[4] rather than any other chapter of the Code, and the adverse counterparty becoming a debtor in possession (that is, with no trustee being appointed in the case). This presentation is limited to the fundamental principles of Code section 365 applicable to commercial executory contracts and does not address the unique rules found in various provisions of the Code governing executory contracts in such specialized situations as real property[5] and equipment[6] leases, intellectual property agreements,[7] collective bargaining agreements,[8] aircraft and vessel leases,[9] forward contracts,[10] commodity contracts,[11] and derivatives.

The Code and the companion Bankruptcy Rules (the "Rules") provide only limited protections for the non-debtor party to an executory contract (the "non-debtor") when the other party (the "debtor" or the "counterparty") files a Chapter 11 case, so the opportunity for, indeed the necessity of, creative and effective lawyering is elevated here. With some imagination and diligence, the non-debtor's counsel may be able to "lawyer"–that is, to find a way to accomplish–a good, or at least a better, result for the company or the client in this difficult and frequently unpleasant situation.

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3. Josiah M. Daniel, III, *A Proposed Definition of the Term "Lawyering,"* 101 LAW LIBR. J. 207, 215 (2009). In the newest edition of the leading legal dictionary, Garner adopted substantially the author's definition. BLACK'S LAW DICTIONARY 1022 (10th ed. 2014) (defining "lawyering").

4. *See*, 11 U.S.C. §§ 1101-74 (2012).

5. *See generally, id.* § 365(d)(3), (4).

6. *Id.* § 365(d)(1), (2) & (5).

7. *Id.* §§ 101(35A), 365(n).

8. *Id.* § 1113.

9. *Id.* § 1110.

10. *Id.* §§ 101(25), 556.

11. *Id.* §§ 761(4), 556.

II. OVERVIEW OF THE LAW OF EXECUTORY CONTRACTS UNDER CODE SECTION 365

The ability to assume (and retain) or to reject (and be freed from) executory contracts is a key restructuring power of a Chapter 11 debtor.[12] The Code does not define "executory contract"; nor has the Supreme Court delineated the precise contours of the term, although in a 1984 case the Court recognized the core concept of "mutuality of obligations" in stating that an executory contract is a contract "on which performance remains due to some extent on both sides."[13] That is shorthand for the "Countryman definition," the often-cited, more detailed definition crafted in 1973 by Professor Vern Countryman and the one to which the legislative history of Code section 365 refers[14]: "a contract under which the obligation of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[15] The Fifth Circuit Court of Appeals[16] and most other appellate courts[17] have adopted the Countryman definition.[18]

In contrast, a contract that has been fully performed on one

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12. COLLIER'S HANDBOOK FOR TRUSTEES AND DEBTORS IN POSSESSION ¶ 21.08 ("Bad contracts are often at the heart of the debtor's woes and rejection offers quick and easy relief. . . .Although rejection creates a damage claim, it will. . . .usually end up being satisfied at less than full value."). *See also id.* ¶ 25.04 ("The debtor in possession's right" to assume or reject contracts "can be one of its most potent rehabilitation tools.").

13. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522-23 n.6 (1984).

14. *See* H.R. REP. NO. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6573; S. REP. NO. 95-989, at 58 (1978).

15. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 446 (1973).

16. Phoenix Exploration, Inc. v. Yaquinto (*In re* Murexco Petroleum, Inc.), 15 F.3d 60, 62-63 (5th Cir. 1994) ("[A]n agreement is executory if at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing the performance of the other party."). *See also* Unsecured Creditors' Comm. v. Gen. Homes Corp. (*In re* Gen. Homes Corp.), 199 B.R. 148, 150 (S.D. Tex. 1996); *In re* Placid Oil Co., 72 B.R. 135, 137 (Bankr. N.D. Tex. 1987).

17. *See, e.g.*, Enter. Energy Corp. v. United States (*In re* Columbia Gas Sys., Inc.), 50 F.3d 233, 239 (3d Cir. 1995); Unsecured Creditors' Comm. v. Southmark Corp. (*In re* Robert Helms Constr. & Dev. Co.), 139 F.3d 702, 705 (9th Cir. 1998); Mitchell v. Streets (*In re* Streets & Bears Farm P'ship), 882 F.2d 233, 235 (7th Cir. 1989); Draper v. Draper, 790 F.2d 52, 54 (8th Cir. 1986); Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045 (4th Cir. 1985).

18. An alternative test called the "functional approach" has been posited by other law professors and has been adopted by a few courts. Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 264 (1989). This test asks whether assumption or rejection would be helpful or useful for the debtor. *Id.*

side or the other is an "executed" or "non-executory" contract.[19] Unlike an executory contract, an executed contract is not eligible for assumption or rejection by the debtor.[20] Rather, if a contract is fully performed by the debtor, but under performed by the non-debtor, then the obligation owed by the non-debtor to the debtor simply becomes an asset of the bankruptcy estate.[21] On the other hand, if a contract is fully performed by the non-debtor party but under performed by the debtor, then the obligation owed becomes a claim by the non-debtor party against the debtor's estate.[22]

From the moment the debtor files its Chapter 11 petition, bankruptcy law affects the executory contracts to which a debtor is a party in profound ways. First, the automatic stay of Code section 362(a), which springs instantaneously into effect upon the filing of a bankruptcy petition, forbids the filing of a suit outside the bankruptcy proceeding or the enforcement of a judgment, any act to obtain or exercise control over property of the debtor's estate, and (with immaterial exceptions)[23] any other act to collect a prepetition claim against the debtor.[24] Section 362(a)'s stay also prevents the non-debtor party from unilaterally terminating an executory contract with the debtor or exercising any other contract remedy or right against the debtor.[25] Modifying or terminating the automatic stay to permit such enforcement activity requires the non-debtor party to file a motion and to establish "cause" for such relief.[26] The automatic stay ensures orderly distribution of assets and affords the debtor "breathing

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19. *In re* Cent. Ill. Energy, L.L.C., 482 B.R. 772, 787 (Bankr. C.D. Ill. 2012) *aff'd sub nom.*, Rafool v. Evans, 497 B.R. 312 (C.D. Ill. 2013).

20. Lycoming Engines v. Superior Air Parts, Inc. (*In re* Superior Air Parts, Inc.), 486 B.R. 728 (Bankr. N.D. Tex. 2012).

21. *In re Columbia Gas Sys., Inc.*, 50 F.3d at 239; *see* 3 COLLIER ON BANKRUPTCY ¶ 365.02 (16th ed., rev. 2013).

22. *See* 3 COLLIER ON BANKRUPTCY ¶ 365.02; *see also In re Columbia Gas Sys., Inc.*, 50 F.3d at 239; Commercial Union Ins. Co. v. Texscan Corp. (*In re* Texscan Corp.), 976 F.2d 1269, 1272-73 (9th Cir. 1992).

23. 11 U.S.C. § 362(b) (criminal action, civil action concerning child custody, the establishment of paternity, etc.).

24. *Id.* § 362(a).

25. Computer Commun., Inc. v. Codex Corp. (*In re* Computer Commun., Inc.), 824 F.2d 725, 728 (9th Cir. 1987). ALAN N. RESNICK & HENRY J. SOMMER, 2 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 38.02 (Matthew Bender) ("[if t]he debtor is a party to an executory contract[,] cancellation of the contract by the nondebtor party may be a violation of the automatic stay").

26. 11 U.S.C. § 362(a). "[I]f the debtor is performing as lessee under an unexpired lease [or an executory contract] at the time it files a Chapter 11 petition, the lessor [or non-debtor] cannot subsequently enforce its right under the lease [or executory contract] against the debtor until the automatic stay is lifted . . . ." Interface Group-Nevada, Inc. v. Trans World Airlines, Inc. (*In re* Trans World Airlines, Inc.), 145 F.3d 124, 136 (3d Cir. 1998).

room"[27] and a period of time within which to make decisions, including determinations about its executory contracts.[28]

Second, Code section 365 provides the Debtor with three forms of available relief, *assumption*, *rejection*, or *assignment* of the executory contracts in the bankruptcy estate,[29] subject to the bankruptcy court's approval.[30] Code section 365(a) permits a debtor to "assume or reject any executory contract . . . of the debtor," and section 365(f) authorizes assignment of the contract by the debtor to a third party, all subject to court approval and certain restrictions.[31] Section 365 may be used to assume, reject, or assign almost any type of contract.[32] Exceptions to the general rule are for personal service contracts and other contracts for which applicable non-bankruptcy law excuses the non-debtor from accepting any one else's performance.[33]

If a contract is *assumed*, the debtor in essence ratifies or reaffirms its obligations under the agreement and must thereafter continue to perform those obligations exactly as written.[34] If assumed, the contract must be taken by the debtor with all of its burdens; the debtor cannot assume the beneficial parts while simultaneously rejecting the unfavorable parts, and the court cannot rewrite the terms.[35] In order to assume a

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27. Brown v. Chestnut (*In re* Chesnut), 422 F.3d 298, 301 (5th Cir. 2005). *See also* Reliant Energy Serv., Inc. v. Enron Canada Corp., 349 F.3d 816, 825 (5th Cir. 2003).

28. Bonneville Power Admin. v. Mirant Corp. (*In re* Mirant Corp.), 440 F.3d 238, 241 (5th Cir. 2006) ("the bankruptcy stay precedes any termination permitted by either the Anti-Assignment Act or the agreement of the parties").

29. 11 U.S.C. § 365 (2012). Section 365 applies only if the contract is in existence at the commencement of the bankruptcy case. If the contract has expired by its own terms, or has been terminated under applicable law, prior to the filing of the bankruptcy petition, there is nothing left to assume, assign, or reject. *See, e.g.*, Erickson v. Polk, 921 F.2d 200, 202 (8th Cir. 1990). Executory contracts are a part of the estate created by the filing of a petition. Vanderpark Props., Inc. v. Buchbinder (*In re* Windmill Farms, Inc.), 841 F.2d 1467, 1469 (9th Cir. 1988).

30. 11 U.S.C. § 365(a). *See, e.g.*, Thinking Machines Corp. v. Mellon Fin. Servs. Corp. (*In re* Thinking Machines Corp.), 67 F.3d 1021, 1025 (1st Cir. 1995); Elliot v. Four Seasons Props. (*In re* Frontier Props., Inc.), 979 F.2d 1358, 1367-68 (9th Cir. 1992) (observing that prior court approval to assumption is a sufficient safeguard.); Univ. Med. Ctr. v. Sullivan (*In re* Univ. Med. Ctr.), 973 F.2d 1065, 1075-76 (3d Cir. 1992).

31. 11 U.S.C. § 365(a), (f)-(g).

32. *See, e.g.*, Bachman v. Commercial Fin. Servs., Inc. (*In re* Commercial Fin. Servs., Inc.), 246 F.3d 1291, 1293 (10th Cir. 2001).

33. 11 U.S.C. § 365(c)(1)(A).

34. WILLIAM HOUSTON BROWN, 2 THE LAW OF DEBTORS AND CREDITORS § 13:44 (West 2013).

35. *See* Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996); City of Covington v. Covington Landing Ltd. P'ship, 71 F.3d 1221, 1226-27 (6th Cir. 1995) ("When the debtor assumes the lease or the contract under § 365, it must assume both the benefits and the burdens of the contract. Neither the debtor nor the

contract, the debtor must cure, or provide assurance that it will promptly cure, all defaults prior to assumption[36] and must provide adequate assurance of future performance of the contract.[37] Any breach of or liability under an assumed contract is treated as an administrative expense in the Chapter 11 case.[38]

If a contract is *rejected*, then the debtor is both absolved of further responsibility to perform the contract and also deprived of any further benefit of it.[39] Rejection operates as a complete breach by the debtor; the bankruptcy estate becomes liable for damages caused by that breach and such claim is treated as a prepetition unsecured claim under Section 365(g).[40] The contract does not, however, cease to exist. The Fifth Circuit has explained: "[Section] 365(g)(1) speaks only in terms of 'breach.' The statute does not invalidate the contract, or treat the contract as if it did not exist."[41]

Last,[42] an executory contract generally may be *assigned* regardless of contractual provisions that otherwise limit assumption or assignment.[43] However, before it can be assigned,

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bankruptcy court may excise material obligations owing to the non-debtor contracting party."); *In re* Nitec Paper Corp., 43 B.R. 492, 498 (S.D.N.Y. 1984).

36. *See* 11 U.S.C. § 365(b)(1)(A) (2012).

37. *See id.* § 365(b)(1)(C).

38. *See* Adventure Resources, Inc. v. Holland, 137 F.3d 786, 798-99 (4th Cir. 1998); Nostas Assocs. v. Costich (*In re* Klein Sleep Prods., Inc.), 78 F.3d 18, 22-23 (2d Cir. 1996); Collingwood Grain, Inc. v. Coast Trading Co. (*In re* Coast Trading Co.), 744 F.2d 686, 692-93 (9th Cir. 1984).

39. Sunbeam Products, Inc. v. Chicago American Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012) (Rejection "frees the estate from the obligation to perform."). "[W]e acknowledge the general principle that a debtor may not reject a contract but maintain its benefits." Sharon Steel Grp. v. Nat'l Fuel Gas Distribution Corp., 872 F.2d 36, 40 (3d Cir. 1989).

40. 11 U.S.C. § 365(g)(1) (2012) (providing that "the rejection of an executory contract. . . .of the debtor constitutes a breach of such contract. . . .immediately before the date of filing the petition").

41. O'Neill v. Cont'l Airlines, Inc. (*In re* Cont'l Airlines), 981 F.2d 1450, 1459 (5th Cir. 1993), cert. denied, 513 U.S. 874 (1994); Mirant Corp. v. Potomac Electric Power Co. (*In re* Mirant Corp.), 378 F.3d 511, 519 (2004).

42. In the interest of completeness it should be noted that, although unmentioned in the Code and the Rules, the reported cases identify a fourth mode of dealing with an executory contract in Chapter 11, and that is for the debtor to permit the contract to "ride through" the proceeding, untreated at all. *See* Consol. Gas Elec. Light & Power Co. v. United Rys. & Elec. Co., 85 F.2d 799, 805 (4th Cir. 1936)(holding that "unless rejected, [an executory contract] passes with other property of the debtor to the reorganized corporation"); *Consolidated Gas* was a Bankruptcy Act case, but the doctrine is alive in cases decided under the Bankruptcy Code. *See, e.g.*, Stumpf v. McGee (*In re* O'Connor), 258 F.3d 392, 404-05 (5th Cir. 2001) (observing that "[t]here appears to be general agreement that the 'passthrough' theory continues to apply in Chapter 11 cases governed by the code"). Nevertheless, the occasions for utilization of "ride through" are rare.

43. *See* 11 U.S.C. § 365(f)(1) ("Except as provided . . . a provision in an executory contract or unexpired lease of the debtor, . . . that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease . . . .").

the debtor must both assume the contract and provide adequate assurance of future performance by the assignee.[44]

Section 365(a) permits the bankruptcy estate to select, within certain limits, which executory contracts it will reject and which it will assume.[45] As the Fifth Circuit has put it, "[i]n effect, Section 365 allows debtors to pick and choose among their agreements and assume those that benefit their estates and reject those that do not."[46] Section 365(d)(1) provides that "[i]n a case under chapter 7 of [the Code], if the trustee does not assume or reject an executory contract . . . of the debtor within 60 days after the order for relief . . . then such contract . . . is deemed rejected," but section 365(d)(2) provides for a significantly longer deadline in Chapter 11, i.e. the time of confirmation of a plan.[47]

III. STRATEGIC AND PRACTICAL SUGGESTIONS FOR SIX KEY PROBLEMS PRESENTED BY AN EXECUTORY-CONTRACT COUNTERPARTY'S CHAPTER 11 CASE

The debtor's exercise of its rights and options under section 365 can cause serious problems and losses for the non-debtor party. The protections for non-debtors in the Code and the Rules[48] are limited; unless the debtor elects to assume the contract, which entails cure of defaults, or unless the non-debtor is happy to be rid of the contract, the non-debtor will suffer various detriments.[49] Yet there are or may be actions or steps, pre- and post-petition, that the non-debtor party's counsel can take to avoid or at least mitigate the risks and the downsides of the counterparty's utilization of section 365 during its Chapter 11 case.

The exception to general assignability is the same as for assumption: a debtor may not assign a contract as to which applicable nonbankruptcy law excuses the non-debtor from accepting performance from a person other than the debtor. *See also id.* § 365(c)(1)(A).

44. *See id.* § 365(c)(1), (f)(2).

45. *Id.* § 365(a). *See, e.g., id.* § 365(b) (providing that "the trustee may not assume" an executory contract "[i]f there has been a default" on that contract unless the trustee "cures" and "compensates" (or provides adequate assurance thereafter) with respect to such default).

46. River Prod. Co. v. Webb (*In re* Topco, Inc.), 894 F.2d 727, 741 (5th Cir. 1990).

47. 11 U.S.C. § 365(d)(1)-(2).

48. *See* FED. R. BANKR. P. 6006(e).

49. 11 U.S.C. § 365(d)(1); *see, e.g., id.* § 365(e)(1) (prohibiting termination or modification of an executory contract after the bankruptcy case commences solely because of a provision conditioned on insolvency, filing bankruptcy, or the appointment of a custodian or a bankruptcy trustee).

A. *Problem 1: Non-debtor Required Performance in the Interim before Assumption or Rejection*

1. Risk/downside

Once the bankruptcy case is filed, the non-debtor is required to perform its obligations. This is true even though the debtor's performance obligation is suspended and the non-debtor is stayed from exercising its remedies and rights, as the debtor decides whether to assume or reject the contract.[50] Nothing in the words of section 365 so states, but the case law almost uniformly so holds, finding such a rule to be required or implied in order to effectuate the relief that section 365 affords the debtor.[51] For instance, in *Krafsur v. UOP (In re El Paso Refinery, L.P.)*, one Texas bankruptcy court held:

> Pending the debtor's assumption or rejection of an assumable executory contract, the *non-debtor is bound by the contract's terms*. . . . Until the court has affirmatively authorized rejection, the *non-debtor party is not free to ignore the terms of the contract*, and *must continue to perform*. It follows that, if the nondebtor party refuses that performance, the estate has a remedy.[52]

Another Texas bankruptcy court has agreed, finding "overwhelming authority to the effect that other parties to a contract with the debtor *must* perform under a contract with the debtor prior to the debtor's decision to assume or reject."[53] The remedy alluded to by these courts is an injunction that may be

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50. Krafsur v. UOP (*In re* El Paso Refinery, L.P)., 220 B.R. 37, 42-43 (Bankr. W.D. Tex. 1998).

51. See, e.g., *id.* at 43 (explaining that after commencement of Chapter 11 case but before the debtor accepts or reject the executory contract, contracts are enforceable against the non-debtor).

52. *In re* El Paso Refinery, L.P., 196 B.R. 58, 71-72 (Bankr. W.D. Tex. 1996) (emphasis added) (internal citations omitted); *accord* Univ. Med. Ctr. v. Sullivan (*In re* Univ. Med. Ctr.), 973 F.2d 1065, 1075 (3rd Cir. 1992); St. Francis Physician Network v. Rush Prudential HMO, Inc. (*In re* St. Francis Physician Network), 213 B.R. 710, 716-17 (Bankr. N.D. Ill. 1997) ("[I]t is settled that a pre-petition contract is not enforceable against a debtor in possession until it is assumed under § 365, even though it is enforceable by the debtor in possession.").

53. *In re* Mirant Corp., No. 03-46590 at 13-14 (Bankr. N.D. Tex., Dec. 23, 2003) (per curiam) (emphasis added), *available at* http://www.txnb.uscourts.gov/ sites/txnb/files/ opinions/2003-46590-Mirant_Corporation_12_23_2003.pdf (citing, inter alia, Pub. Serv. Comm'n of N.H. v. N.H. Electric Coop., Inc. (*In re* Pub. Serv. Comm'n of N.H.), 884 F.2d 11, 14 (1st Cir. 1989) (creditors are bound to honor executory contracts until the debtor commits itself to assumption or rejection)).

entered against the non-debtor under section 105(a).[54] Reported cases around the country are to the same tenor,[55] and authority to the contrary is negligible.[56]

While the non-debtor is obliged to continue to perform the executory contract during the interim, it is not unusual for the debtor to be unable to, or fail to, pay the non-debtor for its post-petition performance.[57] One protection for the non-debtor is that any amount due from the debtor in exchange for the non-debtor's post-petition performance, if not paid, can become an administrative expense claim.[58] Thirty years ago in *NLRB v. Bildisco & Bildisco*, the Supreme Court stated in dictum:

> If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the *reasonable value of those services*, which, depending on the circumstances of a particular contract, *may be what is specified in the contract.*[59]

That is a certain amount of comfort,[60] but hardly complete assurance of payment or even of amount to be paid.

Moreover, the Supreme Court did not identify the time at which the debtor is to pay for such "reasonable value." The lower courts have posited that to compel the debtor to make such payment, the unpaid, performing non-debtor party must file a

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54. 11 U.S.C. § 105(a) ("The court may issue any order . . . necessary or appropriate to carry out the provisions of this title.").

55. *In re* El Paso Refinery, L.P., 220 B.R. 37, 44 (Bankr. W.D. Tex. 1998) (the non-debtor has "an independent duty" to perform until assumption or rejection); *In re* BCE West, L.P., 257 B.R. 304, 307 (Bankr. D. Ariz. 2000) (executory contracts may, generally, "be enforced by, but not against, a debtor prior to assumption");Cont'l Energy Assocs. v. Hazleton Fuel Mgmt. (*In re* Cont'l Energy Assocs.), 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995); *see also*, Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197, 200 (1985) ("[D]uring the period from the date of filing until the date on which the DIP rejects or assumes an executory contract, the non-debtor party is bound to perform . . . .").

56. *See In re* Lucre Inc., 339 B.R. 648, 652 (Bankr. W.D. Mich. 2006) (explaining that "[e]ach party has obligatons under the contract which remain unperformed at the time of debtor's bankruptcy . . . and . . . failure to perform . . . would constitute a material breach . . . thereby excusing the other party from performing its remaining duties.").

57. *See, e.g., In re El Paso Refinery, L.P.*, 196 B.R. at 71-72.

58. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531-32 (1984).

59. *Id.* at 531 (emphasis added) (internal citations omitted).

60. One Texas bankruptcy court rephrased the *Bildisco* dictum to emphasize that the allowed amount of such an administrative claim "will *not necessarily* be the price specified in the contract." *In re* Pilgrim's Pride Corp., 421 B.R. 231, 243 n.11 (Bankr. N.D. Tex. 2009) (emphasis added).

motion for approval of an "administrative expense."[61] Even when such "reasonable value of the services" is proven and the motion is granted, the time for payment remains uncertain, as many courts do not require immediate payment.[62] There is an ultimate deadline, but it is not until the effective date of a plan.[63]

One recent Texas Chapter 11 case illustrates the risk that while the non-debtor may request allowance of an administrative expense claim as compensation for post-petition performance, and even if approved by the bankruptcy court in the contractual amount rather than some lesser "reasonable value", payment of the claim may await a later stage in the case. In *In re UTEX Communications Corp.*,[64] a competitive local exchange carrier in Chapter 11 refused to pay any amount for the post-petition telecommunication services the non-debtor counterparty, AT&T, was compelled to provide.[65] AT&T moved for allowance and payment of an administrative expense for that ongoing usage of its facilities and services.[66] After extensive proceedings, the bankruptcy court found that AT&T was entirely correct as to the $162,000 amount due for its post-petition services to the debtor; however, "[a]s for the timing of the payment, the Court agrees with [the debtor] that *payment need not be immediate*, but the Court has discretion on the timing [although] the claim must be paid on the effective date of the plan."[67]

2. Practice suggestions

a. Before bankruptcy

Knowing in advance that it will likely have to continue its performance uncompensated for some period of time if the other party files a Chapter 11 case, the non-debtor party may consider obtaining some security or assurance of payment during the negotiation and documentation of the executory contract. Such protection might take the form of a letter of credit, a perfected lien on valuable collateral, or a third party's guaranty. Of course, those measures are more typical in secured lending and may not be available or feasible in normal commerce.

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61. *In re Pilgrim's Pride Corp.*, 421 B.R. at 243.

62. *See, e.g., id.* at 238 (concluding services are not given priority under § 503(b)(9)).

63. Full payment of all allowed administrative expenses is statutorily required as a condition to confirmation under § 1129(a)(9)(A), unless the administrative claimholder agrees to payment terms. *See* 11 U.S.C. § 1129(a)(9)(A) (2012).

64. *In re* UTEX Commc'n Corp., 457 B.R. 549 (Bankr. W.D. Tex. 2011).

65. *Id.* at 553.

66. *Id.* at 557.

67. *Id.* at 569 (emphasis added).

b. During bankruptcy

For the postbankruptcy era, the non-debtor party to a contract has multiple options. First, the non-debtor's counsel should file a notice of appearance[68] and be active early in the case. That includes educating the court that the debtor is requiring post-petition goods or services under the relevant executory contract for which the non-debtor deserves prompt payment. Moreover, the lawyer should consider objecting to the debtor's proposed post-petition financing if the budget does not include appropriate amounts for payment of the invoices of the non-debtor for services it is performing post-petition. If it does not, and if there is no other source for payment, then the estate may be administratively insolvent, which can be cause for the case to be dismissed or converted to liquidation.[69]

Second, the non-debtor's counsel should prepare to take affirmative steps in the bankruptcy court. One such measure is, as shown in the *UTEX* case, to move for allowance and payment of an administrative expense claim, although as noted above, the time for payment may be delayed.[70] A further step may be to move for relief from the automatic stay for "cause" under section 362(d)(1) in order to obtain permission of the court to exercise contract remedies.[71] A small amount of case law supports such relief.[72] And another remedy for the unpaid non-debtor is available, albeit weak: the Code and the Rules authorize the non-debtor to file a motion for an order fixing an earlier, pre-confirmation deadline for the debtor to assume the contract, which would require cure of all pre- and post-petition defaults, or else to reject the contract.[73]

Third, if the debtor fails to pay post-petition invoices, the lawyer may inform the U.S. Trustee who is charged with supervising Chapter 11 case administration.[74] The U.S. Trustees' national Chapter 11 debtor guidelines clearly require that "[the debtor] must pay all obligations arising after the filing of the

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68. 11 U.S.C. § 1109(b); FED. R. BANKR. P. 9010(a).

69. 11 U.S.C. § 1112(b)(1), (4)(A).

70. *In re* UTEX Commc'n Corp., 457 B.R. 549, 553 (Bankr. W.D. Tex. 2011).

71. 11 U.S.C. § 362(d)(1).

72. *In re* W. Elecs. Inc., 852 F.2d 79, 82

(3d Cir. 1988) (fact that contract cannot be assumed is ground for relief from stay); 4 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 68.11[4] (2013).

73. 11 U.S.C. § 365(d)(2); FED. R. BANKR. P. 6006(b).

74. 28 U.S.C. § 586(a) (2012).

petition in full when due."[75] Nonpayment of post-petition liabilities can be a reason for the U.S. Trustee to move for dismissal or conversion of the case.[76] If the debtor is not only failing or refusing to pay its post-petition invoices but is also affirmatively misbehaving or breaching its fiduciary duties to the estate, the non-debtor counterparty's attorney may consider moving, or joining other creditors in a motion, for appointment of a trustee.[77]

B. *Problem 2: Rejection of the Contract*

1. Risk/downside

The debtor's power to reject presents at least two risks. First, it is very easy for the debtor to reject a contract. As a general matter, in a typical chapter 11 case, the evaluative standard for a section 365 rejection motion is the business judgment of the debtor.[78] As noted above, Section 365 permits debtors to "pick and choose" which of their executory agreements to assume and which to reject."[79] Moreover, "[i]t is well established that 'the question whether a lease should be rejected . . . is one of business judgment.'"[80] The debtor almost always can articulate a reasonable financial reason for rejection, so normally the non-debtor cannot stop the debtor from rejecting an executory contract.

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75. *Guidelines for Chapter 11 Cases, Northern & Eastern Districts of Texas, Region VI*, UNITED STATE TRUSTEE 3 (effective May 5, 2012), http://www.justice.gov/ust/r06/docs/general/idi/Chapter11_Guidelines.pdf.

76. *Id.* at 3.

77. *See* 11 U.S.C. § 1104(a)(1).

78. *See* River Prod., Co. v. Webb (*In re* Topco, Inc.), 894 F.2d 727, 739-40 n.17 (5th Cir. 1990). "[M]easured under [the] traditional 'business judgment test,' [rejection] requir[es] only that [the] trustee demonstrate that rejection will benefit [the] estate." Sharon Steel Corp. v. Nat'l Fuel Gas Distr. Corp., 872 F.2d 36, 40 (3d Cir. 1989).

79. *In re Topco, Inc.* at 741.

80. Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1309 (5th Cir. 1985) (alteration in original) (quoting Grp. of Inst'l Inventors v. Chicago, Milwaukee, St. Paul & Pac. R.R. Co. 318 U.S. 523, 550 (1943)). That lenient standard is elevated only when the subject matter of the rejection motion implicates, and impinges on, the public interest. The cornerstone is *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), in which the High Court concluded that for certain contracts, such as labor contracts, the bar for rejection should be higher, *id.* at 524-27; More recently, the Fifth Circuit used *Bildisco* as a point of departure to hold that a bankruptcy or district court hearing a motion to reject an executory contract should evaluate not only bare business judgment supporting the motion, but also "carefully scrutinize the impact of rejection upon the public interest" when the contract to be rejected is a contract involving the sale of electricity in interstate commerce. Mirant Corp. v. Potomac Electric Power Co. (*In re* Mirant Corp.), 378 F.3d 511, 525 (5th Cir. 2004); *But see In re* Pilgrim's Pride Corp., 403 B.R. 413, 424 (Bankr. N.D. Tex. 2009) (noting the applicability of the Packers and Stockyards Act did not rise to the level of requiring consideration of the public interest).

The second downside is that rejection absolves the debtor and its estate from any further obligation to perform the contract,[81] and it leaves the non-debtor with a general unsecured claim for its breach-of-contract damages as of the petition date. In fact, in the Fifth Circuit, the non-debtor party does not even have a claim in the bankruptcy case until the debtor rejects the contract.[82] Frequently, unsecured claims in Chapter 11 cases receive small or no distributions on their claims. Normally the establishment of the non-debtor's claim, after the court has approved rejection, is a straightforward matter of preparing and filing the proof of claim before the special deadline for doing so.[83]

But if the claim is objected to by the debtor, the proceeding to resolve the allowed amount of the claim will be a contested matter that will be conducted more or less as civil litigation including pretrial discovery and motion practice.[84] One Fifth Circuit decision points out that the establishment of a rejected counterparty's claim can even require an adversary proceeding.[85] Adversary proceedings are, essentially, separate lawsuits within the context of the overall Chapter 11 proceeding and can take longer to resolve than a contested motion.

2. Practice suggestions

a. Before bankruptcy

To state the obvious, there is no good substitute for assessing the creditworthiness of a counterparty to a proposed contract—before entering into the contract. As mentioned above, if there is doubt about the other party's ability to perform, then counsel for the non-debtor should consider either seeking up front a lien or security interest to secure, or obtaining a letter of credit to assure, the other party's performance. Drawing a letter of credit is not subject to the automatic stay created by the debtor's

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81. Sunbeam Products, Inc. v. Chicago American Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012) (Rejection "frees the estate from the obligation to perform.").

82. *In re* Continental Airlines, 981 F.2d 1450, 1459-60 (5th Cir. 1993); Eastover Bank for Savings v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1082 (5th Cir. 1994) (explaining that under § 502(g) a creditor or non-debtor of a rejected contract may "assert a claim for damages as of the date of bankruptcy").

83. *See* 11 U.S.C. §§ 365(g), 502(g)(1) (2012).

84. *See* FED. R. BANKR. P. 6006; *see also* FED. R. BANKR. P. 9014.

85. Schaefer v. Superior Offshore Int'l, Inc. (*In re* Superior Offshore Int'l, Inc.), 591 F.3d 350, 354 (5th Cir. 2009)("A party to a rejected executory contract with the debtor . . . would have to liquidate his damages, possibly in an adversary proceeding, before receiving compensation from the plan." 11 U.S.C. § 502(g).") (citing 11 U.S.C. § 502(g)).

bankruptcy case;[86] and while it requires a court order lifting the automatic stay to exercise, a lien does assure the holder of ultimately receiving payments or property on its rejection claim in an amount not less than the value of the collateral on the petition date.[87] Another mode of assurance is to obtain a third party's guaranty.[88]

b. During bankruptcy

During the Chapter 11 proceedings, the non-debtor can resist, negotiate, or file a damage claim. First, if it does not wish to acquiesce in the rejection and thereby lose its business with the debtor, the non-debtor may try to object to the debtor's motion on the ground that good business judgment should indicate that the contract be assumed instead.[89] As noted, this will likely be a difficult undertaking.

Second, the non-debtor can offer, or respond to a debtor's overture, to renegotiate the agreement in order to induce the debtor not to reject. After all, negotiations for compromises have always been the hallmark of Chapter 11 cases.[90]

Third, after the court approves a rejection, the non-debtor can and should prepare a well thought out and supportable proof of claim for all of its breach-of-contract damages and file it within the court's deadline.[91] A recent case illustrates this. In *In re Pilgrim's Pride Corp.*,[92] the debtors utilized section 365 and rejected poultry growing contracts that contained clauses specifying various ways the contracts could be terminated and setting forth the consequences of each form of termination.[93] The debtors argued that they could rely on the terms of those clauses

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86. *See* Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 589-90 (5th Cir. 1987); *see also* EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (*In re* Stonebridge Techs., Inc.), 430 F.3d 260, 269 (5th Cir. 2005).

87. 11 U.S.C. § 1129(b)(2)(A).

88. Stephen A. Weiss, *Suretyship as Adequate Protection in Bankruptcy: The Status of Unsecured Third Party Guaranties Under Section 361 of the Bankruptcy Code*, 12 CARDOZO L. REV. 285, 296-98 (1990)(quoting the legislative history of § 361 of the Bankruptcy Code, "another form of adequate protection might be the guarantee by a third party outside the judicial process of compensation for any loss incurred in the case").

89. *In re* Pilgrim's Pride Corp., 403 B.R. 413, 426-27 (Bankr. N.D. Tex. 2009) (explaining that the business judgment rule does not give a debtor "unfettered freedom to use the power given by Code § 365(a) however [it wishes]").

90. Protective Comm'n Indep. for Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968) ("Compromises are a 'normal part of the process of reorganization.'") (quoting Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 130 (1939)).

91. *In re* Pilgrim's Pride Corp., 467 B.R. 871, 874-75 (Bankr. N.D. Tex. 2012).

92. *Id.* at 875-76.

93. *Id.*

to limit the damages owed by the counterparties to those rejected contracts, but the court held that the rejection and Code-deemed breach of the contract does not require the court to interpret and effectuate the termination provisions of that contract:

> [The d]ebtors elected in the instant matter to utilize section 365(a) of the Code to eliminate their future obligations under the . . . contracts. They thus chose to breach those contracts—rather than looking to the contracts and non-bankruptcy law for relief; now [the d]ebtors must accept the consequences of their breach.[94]

Accordingly, the rejected counterparties could assert the full amount of their breach-of-contract damages as unsecured claims.

While minimal distributions to unsecured creditors are characteristic of most Chapter 11 cases, sometimes the dividends can be surprisingly high; so it is advisable to file a proof of claim.[95] And if the non-debtor did obtain collateral or a letter of credit, then obviously the recovery can be much better. If the debtor and the non-debtor have mutual claims that each arose prepetition, the doctrine of offset may assist the non-debtor.[96] And whether or not each of the claims arose either prepetition or post-petition, the equitable doctrine of recoupment may be available to the non-debtor where the claims arose out of the same contract or the same transaction.[97]

Fourth, rejection by the debtor does not mean that the contract is terminated or has ceased to exist,[98] and the non-debtor party's rights against any other parties obligated on the

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94. *Id.* at 882.

95. *See, e.g.*, O'Neill v. Cont'l Airlines (*In re* Cont'l Airlines), 981 F.2d 1450, 1459 (5th Cir. 1993) (filing of a proof of claim by non-debtors).

96. 11 U.S.C. § 553(a) (2012); *See* IRS v. Luongo (*In re* Luongo), 259 F.3d 323, 333 (5th Cir. 2001).

97. Herod v. Sw. Gas Corp. (*In re* Gasmark Ltd.), 193 F.3d 371, 374-75 (5th Cir. 1999); Kosadnar v. Metro. Life Ins. Co. (*In re* Kosadnar), 157 F.3d 1011, 1013-14 (5th Cir. 1998); U.S. Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (*In re* U.S. Abatement Corp.), 79 F.3d 393, 398 (5th Cir. 1996); *see generally*, David G. Epstein & Jonathan A. Nockels, *Recoupment: Apples, Oranges and Fruit Basket Turnover*, 58 SMU L. REV. 51, 53, 64 (2005).

98. Eastover Bank for Savings v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1083 (5th Cir. 1994). *See also* GSL of Ill, LLC v. McCaffety Elec. Co. (*In re* Demay Int'l LLC), 471 B.R. 510, 532 (S.D. Tex. 2012) (holding that "'[r]ejection,' i.e., the Debtor's decision not to assume a lease or executory contract, does not equate to 'termination'"); Banc One Capital Partners v. Addison Airport of Texas (*In re* H.B. Leasing Co.), 188 B.R. 810, 815 (Bankr. E.D. Tex. 1995) (explaining that rejection does not terminate the unexpired lease or the Debtor's security interest in it).

contract persist despite the debtor's rejection, as explained by a Texas bankruptcy court:

> [A] claim relating to rejection of an executory contract must be filed only to make the claim an "allowed" claim payable out of the estate. Failure to file a claim timely does not eliminate the claim; it merely precludes the claim from becoming an allowed claim in chapter 11.[99]
>
> If another party is liable on the debt, neither the disqualification of the claim as an "allowed claim" nor the discharge affects the liability of the third party on the debt.[100]

After rejection of the contract, the non-debtor party may even still have some valuable rights with respect to the debtor, additional to the right to file an unsecured proof of claim. For instance, covenants not to compete[101] and rights of first refusal[102] may in certain instances constitute executed, severable agreements that survive rejection of the executory contract and remain enforceable.

C. *Problem 3: Selective Rejection (Cherry Picking)*

1. Risk/downside

The third risk is that the debtor will, in a situation where the contractual relationship or "the deal" between the debtor and the non-debtor is represented by multiple contract documents—as is common in joint ventures, complex development deals, equipment leases with multiple schedules, and series of cross-defaulted real estate leases—, seek to "cherry-pick" and assume the parts that it finds profitable or beneficial and reject the rest.[103]

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99. Capco Energy, Inc. v. McMoran Oil & Gas, LLC (*In re* Capco Energy, Inc.), No. 08-32282, 2011 WL 13508, at *5 (Bankr. S.D. Tex. Jan. 4, 2011).

100. *Id.* In *In re Austin Dev. Co.*, 19 F.3d at 1084, the leasehold continued to exist, despite rejection, for the benefit of the leasehold mortgagee.

101. *See, e.g.*, Cinicola v. Scharffenberger, 248 F.3d 110, 119 (3d Cir. 2001) (covenants not to compete may survive contract rejection).

102. *See, e.g.*, *In re* Bergt, 241 B.R. 17, 19 (Bankr. D. Alaska 1999) (right of first refusal was not executory as of the petition date and, therefore, could not be rejected under section 365). *But see In re* Kellstrom Indus., Inc., 286 B.R. 833 (Bankr. D. Del. 2002) (contra).

103. In one striking example, *In re* Hawker Beechcraft, Inc., No. 12-11873, 2013 WL 2663193, at *10 (Bankr. S.D.N.Y. June 13, 2013), a bankruptcy court authorized a debtor to cherry pick its relationship with an equipment manufacturer and supplier; the debtor was permitted to assume two master purchase agreements along with 395 purchase

The case law nationally is uniform that a debtor may *not* assume only certain portions of a single executory contract; it must either assume the entire agreement, with all of its burdens, or else reject the entire agreement.[104] As one court explained,

> Under Section 365 of the Bankruptcy Code a Debtor may assume an executory contract, but in so doing must assume both the benefits and the burdens of the contract; the Debtor may not pick and choose from the desirable and undesirable portions of the contract.[105]

However, the debtor may assume one executory contract and reject another. Thus, "[w]here a lease or *contract contains several different agreements*, and the lease or contract can be severed under applicable non-bankruptcy law, section 365 allows assumption or rejection of the severable portions of the lease or contract."[106]

So contracts that are determined to be divisible, consisting of separate, distinct contractual agreements, may be assumed and rejected on an agreement-by-agreement basis; and that determination is made by bankruptcy courts based on state law.[107] For instance, in *Stewart Title Guaranty Co. v. Old Republic Nat'l Title Ins. Co.*,[108] a bankruptcy trustee rejected a lease of a title abstract plant and then sold, as a "potential asset," the right granted under that lease to reproduce all of the records from 1961 to date.[109] When the lessor refused to permit the purchaser to copy those files, the purchaser sued the lessor for breach and for specific performance.[110] The Fifth Circuit considered whether the contract was severable and whether the reproduction right was executed, not executory.[111] Looking to Texas law, the court found three factors to ascertain divisibility or not: "the intention of the parties, the subject matter of the

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orders issued by the debtor pursuant to them, but also to reject another 928 purchase orders.

104. *Id.* at *3.

105. *In re* Café Partners/Washington 1983, 90 B.R. 1, 5 (Bankr. D.D.C. 1988).

106. *In re* Wolflin Oil, L.L.C., 318 B.R. 392, 397 (Bankr. N.D. Tex. 2004) (emphasis added) (internal quotation omitted); *See also In re* Adelphia Bus. Solutions, Inc., 322 B.R. 51, 54 (Bankr. S.D.N.Y. 2005).

107. *In re Hawker Beechcraft, Inc.*, 2013 WL 2663193, at *3.

108. Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.3d 735, 737 (5th Cir. 1996).

109. *Id.*

110. *Id.* at 738.

111. *Id.* at 738-39.

agreement, and the conduct of the parties."[112]

The Fifth Circuit regarded the parties' intent to be "the principal determinant," and that issue hinged on the language of the contract and the question "whether or not the parties would have entered into the agreement absent the parts."[113] They would not have, based on the language of the contract and also the parties' relationship, thus satisfying the first factor.[114] The second factor, subject matter of the contract, also was indicative of two separate agreements.[115] And the parties' performance of the agreement over time coupled with separate methods of payment for each of the two separate agreements supported the court's conclusion on the third factor.[116]

Even with the factors posited by *Stewart Title*, severability vel non can be difficult to predict. For instance, in a subsequent case, *Lifemark Hospitals, Inc. v. Liljeberg Enterprises, Inc.* (*In re Liljeberg Enterprises, Inc.*),[117] the Fifth Circuit reversed a lower court ruling that a pharmacy agreement was severable and assumable apart from the lease of the hospital in which it was situated and to which it was cross-defaulted.[118] But in a Texas bankruptcy decision, *In re Wolflin Oil, L.L.C.*,[119] over the objection of the lessor, the debtor successfully rejected two of six store leases and assumed the rest under the authority of *Stewart Title*; all six leases had been assigned to the debtor pursuant to a single asset purchase agreement, and each lease was cross-defaulted to the others.[120]

2. Practice suggestions

a. Before bankruptcy

To avoid the risk of selective rejection, where a joint development or project "deal" is truly regarded by the non-debtor party as a single contract, the non-debtor's counsel should strive at the contract-drafting stage to "sew together" all of the

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112. *Id.* at 739 (citing Johnson v. Walker, 824 S.W.2d 184, 187 (Tex. App. 1991)) (internal quotations omitted).

113. *Id.* (citing Lake LBJ Mun. Util. Dist. v. Coulson, 771 S.W.2d 145, 153 (Tex. App. 1988) and quoting McFarland v. Haby, 589 S.W.2d. 521,524 (Tex. App. 1979)).

114. *Id.* at 740.

115. *Id.*

116. *Id.*

117. Lifemark Hospitals, Inc. v. Liljeberg Enters., Inc. (*In re* Liljeberg Enters., Inc.), 304 F.3d 410 (5th Cir. 2002).

118. *Id.* at 418.

119. *In re* Wolflin Oil, L.L.C., 318 B.R. 392 (Bankr. N.D. Tex. 2004).

120. *Id.* at 399-400.

agreements that often are papered separately. For instance, in an oil and gas development venture, it is common that the deal be evidenced by separate documents for an acquisition agreement, a joint development agreement, a joint operating agreement, a tax partnership agreement, and others.

Under *Stewart Title* the three hallmarks of a single, integrated contract are intent of the parties primarily as expressed in contract language, subject matter, and conduct of the parties.[121] So the attorney should consider the advisability of drafting into the recitals of each separate document a clear statement that the parties acknowledge and intend that the transactions contemplated in that document are an integral part of, and are integral to the common subject matter of, *all* of the integrated agreements. A definition of "integrated agreements" that embraces all of the separate documents that collectively evidence and represent the complete deal may be helpful. As shown in the *Liljeberg* case, a cross-default provision can also help indicate that the non-debtor would not have entered into one agreement without the other.[122]

Additionally, the lawyer should focus on the boilerplate provisions that typically fall into the last article of a contract document, such as paragraphs concerning "entire agreement," "interpretation," and "conflicting provisions," in order to make sure their language does not conflict with or support any argument against, a single and integrated contract. And later, in performing the integrated, single contract evidenced by those separate contract documents, the non-debtor must avoid any conduct that could demonstrate to the contrary. One more useful step may be to provide for consolidation into a single payment of all amounts that come due from time to time under each of the multiple contract documents.

b. During bankruptcy

During bankruptcy, it is too late to reconfigure the words on the pieces of paper to better demonstrate indivisibility, so the non-debtor's lawyer must gear up to litigate the three *Stewart Title* factors to show a single, integrated contract.[123] If the court so finds, it may be much tougher for the debtor to decide to reject the overall agreement than to reject severed parts would have been. The issue may be drawn in proceedings on motions to

121. Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996).

122. *In re Liljeberg Enters., Inc.*, 304 F.3d at 445-46.

123. *See Stewart Title*, 83 F.3d at 740-41.

assume or reject filed by the debtor or in a declaratory complaint filed as an adversary proceeding by either party.

D. *Problem 4: Renegotiation on Debtor's Threat of Rejection*

1. Risk/downside

As noted, it is not uncommon for debtors to use the threat of rejection as leverage against the non-debtor. And while Code section 365 does not mention this possibility, the reported cases show that the debtor and the other party may, subject to court approval, agree to amend an executory contract that the debtor then assumes during the pendency of the Chapter 11 case.[124]

The Fifth Circuit has validated the practice, so long as the amendment is consensual.[125] "Nothing in the Code suggests that the debtor may not modify its contracts when all parties to the contract consent."[126] In *In re Texas Commercial Energy*, the debtor, a retailer electric provider in Texas's deregulated electricity market, filed a Chapter 11 petition and, although it is unclear what leverage it brought to bear, did just that: it negotiated an assumption-with-revision of its supply agreement with the Electric Reliability Council of Texas.[127] The order approving such amendment and assumption of the contract was later incorporated into the plan of reorganization.[128]

2. Practice suggestions

a. Before bankruptcy

The author has no additional suggestions for the prebankruptcy, contract-negotiation and drafting era. A contract containing a provision that in the event of a future bankruptcy filing a debtor will *not* seek to reject the agreement is invalid because it interferes with the debtor's ability to assume or reject the contract, and the debtor does not have the capacity to waive in advance the rights bestowed by section 365.[129] Similarly, the debtor cannot agree before bankruptcy not to seek an

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124. Electric Reliability Council of Tex., Inc. v. May (*In re* Tex. Commercial Energy), 607 F.3d 153, 155 (5th Cir. 2010); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985).

125. *In re Tex. Commercial Energy*, 607 F.3d at 155; *Richmond Leasing*, 762 F.2d at 1311.

126. *Richmond Leasing*, 762 F.2d at 1311.

127. *In re* Tex. Commercial Energy, 607 F.3d at 155.

128. *Id.*

129. *See, e.g.*, *In re* Trans World Airlines, 261 B.R. 103, 114-15 (Bankr. D. Del. 2001).

amendment of the contract during its Chapter 11 proceeding.[130]

b. During bankruptcy

Once in Chapter 11, the debtor cannot use Code section 365 to rewrite the contract—the statutory option is either to assume the contract or to reject it—so any renegotiation of the contract during the bankruptcy case will be strictly volitional on the part of the non-debtor.[131] But it is common for the debtor to use the threat of rejection as a tool to seek to extract concessions, ranging from forgiveness or reduction of otherwise-required cure amounts to major revisions of contract terms, from the non-debtor party.

Although granting contract amendments to a debtor who is using the levers of bankruptcy to try to force those concessions can be painful and even galling for the non-debtor, the issue really reduces to a simple financial question—whether the non-debtor is willing to lose the customer or counterparty. Because this process is a bargaining process, the non-debtor's lawyer should use all negotiating skill. Some justification for the non-debtor agreeing to contract changes may often be found in the obtaining of certainty—by getting the contract assumed, even if with changes—in the murkiness of a large Chapter 11 case. If the debtor and the non-debtor agree on amendment of the terms in the context of assumption, the court will almost always approve.

E. *Problem 5: Cure and Assumption*

1. Risk/downside

An initial risk for the non-debtor counterparty is simply that it will have little or nothing to say about the assumption. It is true that not only must existing defaults be cured but also adequate assurance of future performance must be provided, and those issues could be contested by the non-debtor, but usually without much effort. The assuming debtor will continue to be the counterparty for the remaining life of the contract, whether the non-debtor likes it or not.[132]

The second problem can be the sheer erosion of time before the debtor must decide to assume or to reject. The debtor can

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130. *See generally id.*

131. 11 U.S.C. § 365(a) (2012) (permitting the trustee to "assume or reject" any executory contract).

132. Indemnity Co. v. Nat'l Gypsum Co. Settlement Trust (*In re* Nat'l Gypsum Co.), 208 F.3d 498, 506 (5th Cir. 2000) ("The non-debtor lacks any decision-making authority in the assumption process.").

wait all the way until confirmation of its plan to assume or reject.[133] Section 365 and Rule 6006(b) permit the non-debtor to move for a sooner deadline, but this is a very thin remedy.[134] For example, in *Alberta Energy Partners v. Blast Energy Services, Inc. (In re Blast Energy Services, Inc.)*,[135] the non-debtor to an executory contract to assign a one-half interest in certain technology proactively sought, by early motions, to compel the debtor either to reject the contract or to make an early decision, both of which the bankruptcy court denied.[136] While that order was on appeal, the court confirmed the debtor's plan that provided for assumption of the contract.[137] The appeals of confirmation and of the denial of the non-debtor's motions became procedurally complicated, and the debtor argued that the appeals were moot.[138] The Fifth Circuit ultimately remanded for further consideration, but the non-debtor was not assured of a different outcome back in the lower court, after that lengthy period of contention with the debtor.[139]

Third, when a debtor waits until confirmation to assume or reject, the non-debtor often does not learn of the decision until the last minute. This can take the form of the debtor filing a schedule or supplement to a plan, listing or describing the contracts to be assumed or rejected, only shortly before confirmation hearing.[140] Meanwhile, as a not-yet-rejected contract counterparty, the non-debtor may not be able to vote on the plan because it does not hold an allowed claim.

Fourth, to assume the contract, the debtor must promptly cure all defaults and provide adequate assurance of future performance. Normally, particularly when the assumption of multiple contracts is in issue, the debtor will request and obtain a deadline for the non-debtor party to object to the debtor's proposed cure of the defaults. Moreover, the debtor may request and receive some extra time to implement the cure, although it is supposed to be done "promptly." If there is disagreement, as

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133. *Id.* § 365(d)(2) ("[T]he trustee may assume or reject an executory contract . . . at any time before the confirmation of a plan.").

134. *Id.* ("[B]ut the court, on the request of any party . . . may order the trustee to determine within a specified period of time whether to assume or reject . . . ."); FED. R. BANKR. P. 6006(b).

135. Alberta Energy Partners v. Blast Energy Servs., Inc. (*In re* Blast Energy Servs., Inc.), 593 F.3d 418 (5th Cir. 2010).

136. *Id.* at 421-22.

137. *Id.* at 422.

138. *Id.* at 421–23 (arguing equitable mootness and statutory mootness).

139. *Id.* at 428 (remanding for further consideration of equitable mootness).

140. 11 U.S.C. § 1123(a)(2) (2012) (stating that a bankruptcy plan must contain the classes of claims against the debtor).

often there is, the non-debtor party will be under a deadline to object if the debtor's proposed cure amount or default-curative action is insufficient or if the proposed adequate assurance of future performance is unsatisfactory; and the non-debtor will have a disadvantage of having to prove to the contrary under tight time constraints, with the bankruptcy judge deciding who wins on these points.[141] In such circumstances, the non-debtor party may lose dollars or be compelled to compromise its position.

For an example of how bankruptcy courts, and even the Fifth Circuit, will sometimes lean in these matters in the direction of a debtor—in the name of "equity"—to prevent a lease or contract lapse and permit assumption, consider the Fifth Circuit decision in *Valley Educational Foundation, Inc. v. Eldercare Properties Ltd. (In re Eldercare Properties Ltd.)*.[142] There, while the two parties were mediating certain issues pertaining to a lease the court had ordered assumed, the deadline to exercise a five-year lease extension passed by; and when the lessor argued that the lease therefore terminated by its terms, the bankruptcy court held that "Texas common law principles of equitable intervention . . . excuse[d] ElderCare's technical omission," and the Fifth Circuit agreed.[143]

Furthermore, the requirement of "adequate assurance of future performance" is just not much of a lever for the non-debtor. As one court put it,

> it is not unusual (and in fact is common) for a Chapter 11 debtor to have had financial difficulties in timely paying its debts. If this alone were grounds for not authorizing a Chapter 11 debtor to assume a lease, then rarely could a Chapter 11 debtor ever assume a lease in Chapter 11—which is certainly not what is intended by § 365(b)(1).[144]

This is usually not an issue the non-debtor will win, if contesting assumption. [145]

If the debtor assumes the contract, it is bound to perform according to its terms—but so is the non-debtor party.[146] Whether

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141. Lisa S. Gretchko, *Beware the Executory Contract Bait and Switch*, 29 AM. BANKR. INST. J. 42, 42-43 (2010).

142. *In re* Eldercare Properties. Ltd., 568 F.3d 506 (5th Cir. 2009).

143. *Id.* at 508.

144. *In re* Patriot Place, Ltd. 486 B.R. 773, 802-03 n.11 (Bankr. W.D. Tex. 2013).

145. Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1310 (5th Cir. 1985) ("Section 365 is intended to provide a means whereby a debtor can force another party to an executory contract to continue to perform under the contract . . . .").

146. *Id.* at 1310.

the non-debtor likes or desires this outcome, if the bankruptcy court approves a debtor's request to assume it, the contract is reinstituted and binding on both parties going forward. The non-debtor will not be able to raise in the future any issues about the proper amount to cure defaults and about performance or breach by the debtor up to the effective date of the bankruptcy court's order; such issues will be barred by res judicata.[147]

2. Practice suggestions

a. Before bankruptcy

The possibility of bankruptcy lurks in every dealing of the non-debtor with every customer, supplier, or counterparty, and section 365 is a commercial fact of life. So some contract drafters include special provisions that address the possibility of a bankruptcy and that a debtor might opt to assume the contract.[148] To be fair, such a provision could speak of the possible circumstance of bankruptcy in terms of the possibility of either party filing a case in the future. The provision might stipulate a time period for the to-be debtor to make the assumption or rejection decision, the parameters within which defaults would be cured, and the measures of adequate assurance of future performance that must be provided. While there is no assurance that a bankruptcy court will honor such provisions, such terms may at least be evidentiary and provide a basis for the non-debtor's arguments in the courtroom.

b. During bankruptcy

Again, the non-debtor party will be well advised to begin to prepare for all eventualities with respect to its contract with the debtor from the moment of receipt of the first notice of the debtor's bankruptcy. As compared to other courts, bankruptcy courts operate on accelerated time lines,[149] so the non-debtor will be helped to deploy counsel early and to prepare to prove up its rights and its position in any contract proceedings. Specifically the non-debtor should be prepared to rebut the debtor on the amount, or the action necessary, to cure all defaults as well as on

147. Travelers Indem. Co. v. Bailey, 557 U.S. 137, 129 S. Ct. 2195, 2205-06 (2009) (explaining that bankruptcy court orders are entitled to res judicata).

148. *See, e.g.*, Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 19 (2013).

149. *In re* Clay, 35 F.3d 190, 195 (5th Cir. 1994) (referring to bankruptcy courts as "speedy courts").

the adequacy of adequate protection.

If the non-debtor party does not wish for its contract to be assumed, a recent Fifth Circuit case, *Escarent Quantum Diversified Holdings, Inc. v. Wienheimer* (*In re Escarent Entities, L.P.*),[150] may assist. The court held that if a default is nonmonetary in nature and incapable of being cured, the debtor may not assume the contract.[151] Therefore, if the non-debtor's lawyer can identify such an incurable nonmonetary default, the non-debtor may prevent assumption by timely objection to the debtor's request for approval to assume.[152]

Last, there may be some bankruptcy benefit to the non-debtor in having its contract assumed by the debtor, additional to the maintenance of the business with the debtor. Although the Fifth Circuit appears to have reserved judgment,[153] other courts have held that executory-contract assumption prevents the debtor from later suing the non-debtor party for recovery of preferential transfers[154] and fraudulent transfers.[155]

F. *Problem 6: Assumption and Assignment*

1. Risk/downside

Section 365(f) provides that a debtor may assign an executory contract "notwithstanding a provision in an executory contract . . . or in applicable law, that prohibits, restricts, or conditions the assignment of such contract."[156] Whether the debtor is using Chapter 11 as a platform to auction substantially all of its assets or else as a business tool to prune its business back to a profitable core and to emerge as a rehabilitated firm, it is common for debtors to seek court approval to assign valuable executory contracts to third parties, subject to court approval. The risk is that the non-debtor counterparty may not wish to have an unknown or disliked person substituted for the debtor.

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150. Escarent Quantum Diversified Holdings, Inc. v. Wienheimer (*In re* Escarent Entities, L.P.), 423 Fed. App'x 462, 465 (5th Cir. 2011).

151. *Id.* at 466.

152. Note that after 2005, 11 U.S.C. § 365(b)(1)(A) (2012) provides for ignoring incurable nonmonetary defaults with respect to nonresidential real property leases, but no comparable provision exists for other contracts.

153. Compton v. Anderson (*In re* MPF Holdings U.S. L.L.C.), 701 F.3d 449, 452 n.1 (5th Cir. 2012).

154. *See, e.g., In re* Superior Toy & Mfg. Co., 78 F.3d 1169, 1176 (7th Cir. 1996).

155. *See, e.g.*, Official Comm. of Unsecured Creditors v. Aust (*In re* Network Access Solutions Corp.), 330 B.R. 67, 76 (Bankr. D. Del. 2005).

156. 11 U.S.C. § 365(f)(1) (2012).

2. Practice suggestions

a. Before bankruptcy

The inclusion of anti-assignment clauses in contracts is reflexive on the part of most contract drafters, even though Code section 365 will later render the provision ineffective as to the debtor once in bankruptcy.[157] Again, with section 365 being so much a part of commercial life in the 21st century, it may be appropriate for the non-debtor's lawyer to draft into the contract some provisions to govern, or at least influence, the assignment of the contract in the event the other party files a Chapter 11 case and seeks to assign the contract away. For example, such a contract provision may stipulate that a proper assignee must have a certain creditworthiness or level of financial ability or performance experience and expertise. No assurance of enforcement in a bankruptcy court can be given, but such provision may provide a basis for the argument of the non-debtor in seeking to at least influence the approval or disapproval of a particular proposed assignee.

b. During bankruptcy

During a Chapter 11 case, in order for the debtor to assign a contract, it must first, or contemporaneously, assume it, and that demands the cure by the debtor of all defaults. So litigating the cure may be one action the non-debtor's attorney may need to take. Second, apart from making an argument based on a contract provision purporting to specify the necessary financial ability and other characteristics of any assignee, the non-debtor may wish to contest the proposed assignee's provision of adequate assurance of future performance.

IV. CONCLUSION

Even thirty-six years after the adoption of the Bankruptcy Code, its jurisprudence remains rather idiosyncratic and unpredictable, inconsistent from court to court, even in the courts within the Fifth Circuit and certainly around the nation, and subject to varying application in Chapter 11 cases, Section 365 in particular can work in ways that can be unpleasant and financially painful for firms that are necessarily drawn into the Chapter 11 cases of contract counterparties. The strategies and steps that this article suggests to address and deal with the six

157. *Id.* § 365(b)(1).

identified problems for the non-debtor party are not comprehensive and are limited in efficacy; and the recommendations may or may not apply, as each Chapter 11 case is unique. But it is hoped that the suggestions at least illustrate for the non-debtor's in-house or outside counsel some pathways or options for lawyering a desirable, or at least a better, result for his or her non-debtor client in this milieu of uncertainty and risk.