

SOUTHEASTERN BANKRUPTCY LAW INSTITUTE
April 1-3, 2004

**ASSUMPTION AND REJECTION OF UNEXPIRED LEASES
AND EXECUTORY CONTRACTS**

by
Lawrence R. Ahern, III
Raja J. Patil
Andrew D. Stosberg
Greenebaum Doll & McDonald PLLC

TABLE OF CONTENTS

	Page
I. The Interplay Between Section 363(f) and Section 365(h), (i) and (n) of the Bankruptcy Code (The <i>Qualitech Steel</i> Case)	2
II. The Severability, for Purposes of Assumption and Rejection, of Master Leases and Related Agreements	6
III. The Enforceability of Rights of First Refusal In Executory Contracts (<i>E-Z Serve Convenience Stores</i>)	9
IV. The Ability of a Trustee or Debtor-in-Possession to Assume Executory Contracts that are Nonassignable Under Applicable Nonbankruptcy Law: The Interplay Between Bankruptcy Code Section 365(f)(1) & (2) and Revised Article 9	12
A. Validity v. Enforceability	13
B. The Role of the Bankruptcy Trustee	15
C. Trustee Compensation	15

**ASSUMPTION AND REJECTION OF UNEXPIRED LEASES
AND EXECUTORY CONTRACTS**

by
Lawrence R. Ahern, III
Raja J. Patil
Andrew D. Stosberg
Greenebaum Doll & McDonald PLLC

I. The Interplay Between Section 363(f) and Section 365(h), (i) and (n) of the Bankruptcy Code (The *Qualitech Steel Case*)

A superficial glance at sections 363 and 365 of the Bankruptcy Code may lead one to conclude that the two bankruptcy statutes are largely independent of one another. Section 363 deals with the "[u]se, sale or lease of property" while section 365 deals with "[e]xecutory contracts and unexpired leases."¹ However, the statutes interrelate closely to the extent that both deal with the use and disposition of interests in property of the estate. Section 363, for example, provides in relevant part that a trustee may "may sell property free and clear of any interest in such property of an entity other than the estate."² Section 365(h)(1)(A) addresses a lessee's possessory interest in a debtor's real property, providing in relevant part that

if the trustee rejects an unexpired lease of real property under which the debtor is the lessor and (ii) if the term of such lease has commenced, the lessee may retain its rights under the lease ... that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension³

Although the Bankruptcy Code does not expressly define "interest,"⁴ for purpose of section 363(f), courts generally favor a broad interpretation of the word, relying on the facts that it is preceded by the word "any"⁵ and that its plain meaning as defined by *Black's Law*

¹ See 11 U.S.C. §§ 363 & 365.

² 11 U.S.C. § 363(f) (emphasis added).

³ 11 U.S.C. § 365(h)(1)(A).

⁴ See, e.g., 11 U.S.C. §§ 101 and 363.

⁵ See *United States v. Gonzales*, 520 U.S. 1 (1997).

*Dictionary*⁶ is also expansive. Hence, the interplay between sections 363(f) and 365(h) creates an apparent conflict of interests⁷ when a sale of the debtor's real property, in which a lessee has a possessory interest, occurs pursuant to section 363(f). The conflict, specifically stated, is whether a section 363(f) sale, free and clear of any "interest," erases a lessee's possessory interest in the debtor's property, which appears to be protected under section 365(h).

Until 2003, no court at the circuit level had addressed this issue. However, that changed when the Seventh Circuit issued its opinion in *Precision Industries, Inc. v. Qualitech Steel, SBQ, LLC*.⁸ *Qualitech* involved a company/lessee, Precision, that leased real estate from a debtor who filed a chapter 11. The bankruptcy resulted in a section 363 sale of most of the debtor's assets, including the real property that was leased to the lessee. The bankruptcy court held that its sale order extinguished Precision's possessory rights pursuant to section 363(f). However, on appeal, the district court reversed, holding that there was an actual conflict between sections 363(f) and 365(h) and, in light of the conflict, section 365(h) trumped 363(f) because section 363(f)'s provisions were more general than the specific preservation of lessee's possessory rights by section 365(h). The debtor appealed the district court decision to the Seventh Circuit.

In reviewing the district court's decision, the Seventh Circuit focused on whether the purported conflict between sections 363(f) and 365(h) was actual or fictitious. In its review of these Code sections, the Seventh Circuit worked through the following steps in their statutory interpretation:

⁶ *Black's Law Dictionary* 816 (7th ed. 1999) (defining "interest" as "[a] legal share in something; all part of a legal or equitable claim or right in property").

⁷ Forgive the pun.

⁸ 327 F.3d 537 (7th Cir. 2003).

- 1) The express language of the statutes did not suggest that one section trumped the other. However, the statutes contained explicit cross-references to other Bankruptcy Code sections that contain mandates applying to the referring statute.⁹
- (2) The text of section 363(f), standing by itself, allows for a sale of the debtor's assets free and clear of any interest.¹⁰
- 3) In contrast, the text of section 365(h), standing by itself, applies when the real property is not sold and the debtor remains in possession of the real property, subsequently rejecting a lease on the real property, with the lessee maintaining its possessory right to the real property.¹¹

On this basis, the Court of Appeals held that, because Precision did not contest to the sale of the debtor's real property and did not seek adequate protection pursuant to section 363(e),¹² its possessory interest was extinguished by the sale.¹³ As for section 365(h), the Court concluded that it simply did not apply because a rejection of the lease never occurred in this instance.

The solution that the Seventh Circuit offered to lessees who are distressed by a proposed section 363 sale may seem hollow. While *Qualitech* advises a distressed lessee to object to the sale and seek adequate protection under 363(e), it does not provide guidance as to what specifically would constitute adequate protection of the lessee's possessory interest. The lessee in this case, Precision, failed to formally request adequate protection; therefore, it was not necessary for the Court to provide such guidance.

⁹ 327 F.3d at 547.

¹⁰ *Id.* at 548.

¹¹ *Id.*

¹² 11 U.S.C. § 363(e) (providing in relevant part that "[n]otwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property ... sold ...or proposed to be sold ... the court ...shall prohibit or condition such ...sale ... as is necessary to provide adequate protection of such interest"). Discussed *infra*.

¹³ *Id.*

Section 363(e) provides that a lessee's possessory interest must at least receive adequate protection in the form of "compensat[ion] for the value of its leasehold."¹⁴ A form of adequate protection more consistent with most lessees' expectations would be continued possession of the real property by the lessee, which section 363 may facilitate a court might wish otherwise to "prohibit" a sale of the real property.¹⁵ Another form of adequate protection likely permissible under section 363(e) would be monetary compensation. However, suggesting adequate protection in the form of monetary compensation leads to more questions, not the least of which is how to value the possessory interest and whether it should be given priority treatment as an administrative expense.

In sum, *Qualitech's* holding that section 363(f) is not trumped by section 365(h) and that the two sections, instead, apply in mutually exclusive circumstances is the sole, circuit-level authority on the issue of the interplay between the statutes. It does not, however, completely resolve all issues tangential to this interplay, most notably, the issue of what constitutes adequate protection of a lessee's possessory interest that is detrimentally affected by a section 363 sale.

¹⁴ 11 U.S.C. § 363(e).

¹⁵ *See* 11 U.S.C. § 363(f).

II. The Severability, for Purposes of Assumption and Rejection, of Master Leases and Related Agreements

It is a well-settled rule, under section 365 of the Bankruptcy Code, that the debtor must assume or reject a contract in its entirety.¹⁶ The debtor "cannot ... use bankruptcy to effect a modification in its obligations under its leases or executory contracts. Rejection assumption, or assignment. Not modification."¹⁷ However, this general rule becomes more complicated when it is applied in conjunction with the contract law principles of severability and indivisibility. There are two basic lines of authority in which this interaction is noteworthy.

In the first line of cases, bankruptcy courts have construed a single document to contain multiple contracts that may be assumed or rejected in a piecemeal fashion. In other words, while a single document may, on its fact, be titled as a "contract," this contract, in actuality may contain multiple contracts; the same rationale applies to leases.¹⁸ Courts have stated that "where a contract, though contained in a single document, is divisible into several different agreements, some of the divisible agreements may be assumed or rejected under section 365 without assuming or rejecting the entire contract."¹⁹

The majority of courts that have analyzed the issue of severability for purposes of section 365 have applied the state contract law principles of the state's law which governs the contract or

¹⁶ *In re Cafeteria Operators, L.P.*, 2003 WL 22231273 at *2 (Bankr. N.D. Tex. 2003); *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996); *In re Convenience USA, Inc.*, 2002 WL 230772 at *2 (Bankr. M.D.N.C. 2002).

¹⁷ 1 David G. Epstein, Steve H. Nickles & James J. White, *BANKRUPTCY § 5-1* at 439 (West Practitioner Series 1992).

¹⁸ *NORTON BANKRUPTCY LAW AND PRACTICE 2D*, (Hon. William L. Norton, Jr., ed.), 39:11.

¹⁹ *Cafeteria Operators*, 2003 WL 22231273 at *2 quoting *In re Convenience USA, Inc.*, 2002 WL 230-772 at *2 (citing *In re Gardinier, Inc.*, 831 F.2d 974 (11th Cir. 1987); *In re Holly's Inc.*, 140 B.R. 643, 681 (Bankr. W.D. Mich.1992); *In re Cutter's, Inc.*, 104 B.R. 886, 889 (Bankr. M.D. Tenn.1989)).

lease.²⁰ Other courts however, have taken an indirect approach to applying state contract law, and have done so only incidentally to their holdings.²¹

In its 1996 *Stewart Title* decision, the Fifth Circuit, applying Texas contract law, states:

[A] contract is divisible, or severable, when one party's performance consists of more than one "distinct and separate item[] and the price paid by the other party is apportioned to each item. No one test or rule of law can be used to ascertain whether a contract is divisible or indivisible. Determination of the issue depends primarily on the intention of the parties, the subject matter of the agreement, and the conduct of the parties."²²

The *Stewart Title* three-prong test, and tests very similar to it, have been applied by other courts in construing their respective state law governing severability.²³

The court in *Stewart Title* went on to hold that "[t]he intent of the parties is the principal determinant of divisibility."²⁴ In determining the parties' intent, many courts apply a version of another three-factor test, which examines (1) the differing nature and purpose of parts to the

²⁰ *Cafeteria Operators, L.P.*, 2003 WL 22231273 at *3 (applying Michigan contract law on severability issue); see also *Convenience USA* at *2 (applying Texas contract law in analyzing divisibility of leases); *Stewart Title* at 739 (S.D. Ohio 1993) (applying Texas contract law); *In re Plum Serv. Corp.*, 159 B.R. 496, 498-99 (applying Ohio contract law); *In re Beare Co.*, 177 B.R. 879, 881 (Bankr. W.D. Tenn. 1994) (applying Tennessee state law); *In re Ritchey*, 84 B.R. 474, 476 (Bankr. N.D. Ohio 1988) (applying Ohio contract law); *In re Chemtoy Corp.*, 19 B.R. 475, 481 (Bankr. N.D. Ill. 1982).

²¹ "No federal case has specifically held that state law governs whether multiple obligations in a transaction are severable. Rather, the cases that have applied state law to the severability issue have done so incidentally to their holdings." *In re Plitt Amusement*, 233 B.R. 837, 846 (citing *Quintex Entertainment, Inc.*, 950 F.2d at 1496 (applying state law, without discussion, to a severability issue); *Gardinier*, 831 F.2d at 975-76 (same); *Pollock*, 139 B.R. at 940 (stating, in dicta, that "[w]hether multiple obligations in an agreement or transaction are severable is a question of state law"); *In re T&H Diner, Inc.*, 108 B.R. 448, 453 (D.N.J. 1989); *In re Café Partners/Washington 1983*, 90 B.R. 1, 6 (Bankr. D.C. 1988) (whether a lease is entire is "usually" a question of state law).

²² *Stewart Title*, 83 F.3d at 739 (citations omitted).

²³ *Cafeteria Operators, L.P.* at 3 (applying three-prong Stewart test under Michigan law); see also *In re Convenience USA, Inc.*, 2002 WL 230772 at *3 (the determination of divisibility of leases "depends primarily upon the intent of the parties, the subject matter of the agreement, and the conduct of the parties"); see also *Plum Run*, 159 B.R. at 499 ("Whether a contract...is entire of divisible depends generally upon the intention of the parties, and this must be ascertained by the ordinary rules of construction, considering not only the language of the contract, but also, in cases of uncertainty, the subject-matter, the situation of the parties, and the circumstances surrounding the transaction, and the construction placed upon the contract by the parties themselves."); see also *Beare*, 177 B.R. at 881 (noting that under (Tennessee) state law severability of a contract is determined by the intent of the parties, as evidenced by the contract itself).

agreement, (2) the separate and distinct consideration which may be attributed to different parts of the agreement and (3) the non-interrelatedness of obligations of the parties to the agreement.²⁵

Under a second line of authority, bankruptcy courts have held that separate contracts or leases may be integrated into one non-severable agreement for purposes of assumption or rejection.²⁶ This rule of indivisibility may apply regardless of whether the two instruments refer to one another²⁷ and whether they contain cross-default provisions.²⁸ In determining whether separate instruments should be integrated, courts use the same fact-intensive tests that are used to

²⁴ *Id.* (citations omitted)

²⁵ Norton Bankruptcy Law and Practice 2d §39:11; *Gardinier*, 831 F. 2d 974; *In re Plitt Amusement Co. of Washington, Inc.*, 34 Bankr. Ct. Dec. 395 (Bankr. C.D. Cal. 1999); *Matter of Holly's Inc.*, 140 B.R. 643 (Bankr. W.D. Mich. 1992); *In re Cutters, Inc.*, 104 B.R. 886 (Bankr. M.D. Tenn. 1989); *Matter of East Hampton Sand & Gravel Co., Inc.*, 25 B.R. 193 (Bankr. W.D. Mo. 1993); *In re Downtown Properties, Inc.*, 162 B.R. 244 (Bankr. W.D. Mo. 1993); *In re Beare Co.*, 177 B.R. 879 (Bankr. W.D. Tenn. 1994).

²⁶ *In re Steaks to Go, Inc.*, 226 B.R. 35, 37 (Bankr. E.D. Mo. 1998) (written franchise agreement and document titled "Guaranty of Franchisees Undertakings" formed a single executory contract); *In re Karfakis*, 162 B.R. 719, 725 (Bankr. E.D. Penn. 1993) (lease and franchise agreement together formed a single contract); *In re Harrison*, 117 B.R. 570, 571-572 (Bankr. C.D. Ca. 1990) (dealer agreements, motor fuel station leases, auto care agreements, and auto care limited warranties between franchisor and franchisee formed one controlling agreement); *In re Braniff, Inc.*, 118 B.R. 819, 844-845 (Bankr. M.D. Fla. 1990) (lease agreement, partial assignment agreement, and purchase agreement documents involving twenty-six aircraft all formed one unified contract); *T & H Diner*, 108 B.R. at 453 (lease and sale agreements that were simultaneously executed, referenced each other, and were integral parts of a single transaction formed one indivisible contract); *In re Café Partners*, 90 B.R. 1, 7 (Bankr. D.D.C. 1988) (a lease and two tenant improvement loans from a landlord were treated as a single executory contract because use of premises was conditioned on repayment of loans); *In re Textstone Venture, Ltd.*, 54 B.R. 54, 55 (Bankr. S.D. Tex. 1985) (multiple documents for note, deed of trust, and option to purchase agreement were all part of single loan transaction); *In the Matter of East Hampton Sand & Gravel Co., Inc.*, 25 B.R. 193, 199 (Bankr. E.D.N.Y. 1982) (lease and note, executed simultaneously and referencing each other, were a single contract that could not be severed for §365 purposes); *In re A.R. Dameron & Associates, Inc.*, 3 B.R. 450 (Bankr. N.D. Ga. 1980) (lessee's agreement to construct improvements integrated with lease); *In re Atlantic Computer Systems, Inc.*, 173 B.R. 844 (S.D.N.Y. 1994) (master agreements, equipment schedules, and "flex leases" with lessee of computer equipment not shown to be separate agreements so as to permit debtor in possession to reject portions of the agreements and assume portions of agreements); *Gardinier*, 831 F.2d at 978 (involving two contracts within a single instrument); *In re Kobel*, 232 B.R. 57, 65 (Bankr. E.D.N.Y. 1999) ("Where several documents are construed as one contract, the debtor must assume or reject them together."); *In re Ritchey*, 84 B.R. at 476; *Plitt*, 233 B.R. at 841.

²⁷ *Plitt*, 233 B.R. at 841

²⁸ *Plitt*, 233 B.R. at 847, citing *Braniff*, 118 B.R. at 845 (aircraft purchase and financing agreements); *Wheeling-Pittsburgh Steel Corp.*, 54 B.R. at 779 (insurance policies); *In re Sambo's Restaurants, Inc.*, 24 B.R. 755, 757-58 (restaurant leases).

determine severability. In fact, several courts have used the analysis interchangeably between the two issues.²⁹ Similar to the courts following the *Stewart* line of cases, decisions in this second line of authority apply state law and place great weight on the intent of the parties.³⁰ In the end, however, the determination of the issue is said to come down to whether the contracts or leases are "inherently integrated aspects of a single underlying transaction."³¹

III. The Enforceability of Rights of First Refusal In Executory Contracts (E-Z Serve Convenience Stores)

Section 365(f)(1) strikes down any provision that "restricts or conditions" assignment of executory contracts or leases, as well as provisions that directly prohibit such assignment.³² Therefore, under section 365(f), a lease or executory contract may be assigned by the debtor or trustee notwithstanding a lease provision which purports to restrict or prevent such assignment.

Courts have applied 365(f) to "provisions that are so restrictive that they constitute de facto anti-assignment provisions."³³ "[T]he court retains some discretion in determining whether

²⁹ *In re Atlantic Computer Systems, Inc.*, 173 B.R. at 854 (in determining whether several instruments formed one indivisible agreement the court examined "(1) whether the nature and purpose of the agreements are different, (2) whether the consideration for each agreement is separate and distinct; and (3) whether the obligations of each party to the instruments are interrelated") citing *Gardinier*, 831 F.2d at 978.

³⁰ *Ritchey*, 84 B.R. at 476; see also *Plitt*, 233 B.R. at 841 (applying both Washington and California contract law to determine whether separate instruments constitute an integrated, non-severable contract); see also *Karafakis*, 162 B.R. at 725 ("Whether the parties assented to all the promises as a single whole, so that there would have been no agreement what[so]ever if any promise or set of promises were struck out.")

³¹ *Karafakis*, 162 B.R. at 725; *Harrison*, 117 B.R. at 573.

³² See 11 U.S.C §365(f)(1).

³³ *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45, 50 (Bankr. M.D.N.C. 2003) quoting *In re LeSalle National Trust*, 288 B.R. 114, 123 (E.D. Va. 2003) (citing *In re Rickel Home Ctrs., Inc.*, 240 B.R. 826, 831(D. Del.1998)).

a lease provision that does not explicitly prohibit assignment qualifies as a de facto anti-assignment clause thereby rendering it unenforceable."³⁴

A right of first refusal has been held to constitute an executory contract and may fall within the ambit of section 365(f).³⁵ *In re Mr. Grocer, Inc.*³⁶ was one of the first cases to directly address the enforceability of a right of first refusal provision under section 365(f). The New Hampshire Bankruptcy Court in that decision held that any right of first refusal granted to a landlord in a lease agreement is unenforceable purely based on the plain language of section 365(f)(1).³⁷ In addition, the court concluded that enforcing the right of first refusal would have a chilling effect on a sale of the debtor's assets, thereby preventing the estate from receiving the best offer possible from prospective purchasers.³⁸

Several courts have disagreed with³⁹ or declined to follow⁴⁰ the *Mr. Grocer* rule against enforcement of rights of first refusal. These courts instead use a "facts and circumstances" test, as opposed to *per se* invalidation, to determine whether or not to enforce rights of first refusal. Specifically, in *In re E-Z Serve Convenience Stores, Inc.*,⁴¹ the Bankruptcy Court for the Middle District of North Carolina recently stated the following general test:

³⁴ *E-Z Serve*, 289 B.R. at 50, citing *In re Joshua Slocum, Ltd.*, 922 F.2d 1081, 1092 (3d Cir. 1990); *In the Matter of Village Rathskeller, Inc.*, 147 B.R. 665, 672 (Bankr. S.D.N.Y. 1992); *In re Mr. Grocer*, 77 B.R. 349, 355 (Bankr. D.N.H. 1987)).

³⁵ The majority of courts hold that a right of first refusal is an executory contract. *E-Z Serve*, 289 B.R. at 53 n. 4; *In re Kellstrom Industries, Inc.*, 286 B.R. 833, 834-835 (Bankr. D. Del. 2002); *In re Coordinated Financial Planning Corp.*, 65 B.R. 711, 713 (9th Cir. 1986); *In re Hardie*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989). But see *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999). The essence of an executory contract is that the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) (quoting *Countryman, EXECUTORY CONTRACTS IN BANKRUPTCY: Part I*, 57 Minn. L.Rev. 439, 460 (1973)).

³⁶ *In re Mr. Grocer*, 77 B.R. 349.

³⁷ *Id.* at 353.

³⁸ *Id.* at 353-54.

³⁹ *E-Z Serve*, 289 B.R. at 51.

⁴⁰ *Matter of Headquarters Dodge, Inc.*, 1992 WL 437432 at *4 (D.N.J.1992).

⁴¹ *E-Z Serve*, 289 B.R. 45.

A court must examine the particular facts and circumstances of the transaction to determine whether a lease clause restricts or conditions assignment including the extent to which the provision hampers a debtor's ability to assign, whether the provision would prevent the bankruptcy estate from realizing the full value of its assets, and the economic detriment to the non-debtor party.⁴²

The court concluded that the landlord's right of first refusal was not so restrictive that it constituted a *de facto* anti-assignment provision. Among other things, the court in *E-Z Serve* stated that in order to be invalid under section 365(f), a right of first refusal must have a "chilling effect" on the proposed sale.⁴³

Finally, *E-Z Serve* held that the right of first refusal, in that particular case, did not fall within the framework of section 365(f).⁴⁴ As rationale for this holding the court stated:

The right of first refusal in this case does not restrict or burden assignment of the lease. The holder of a right of first refusal can merely require the owner, when and if he decides to sell, to offer the property at the price he is willing to sell to a third party. The right of first refusal does not limit bidding ... nor does it compel the owner of property to sell at a price below that which may be offered in the open market.⁴⁵

In addition, after citing numerous other cases in which courts recognized a right of first refusal,⁴⁶ the court in *E-Z Serve* pointed out that the "concern of these courts when presented with a contractual right of first refusal is not whether to enforce such a right, but how to incorporate a

⁴² *Id.* at 50; see also *In re Peterson's Ltd., Inc.*, 31 B.R. 524, 527 (Bankr. S.D.N.Y. 1983).

⁴³ *Id.* at 51.

⁴⁴ *E-Z Serve*, 289 B.R. at 52.

⁴⁵ *Id.*

⁴⁶ *Id.* citing (*In re Food Barn Stores, Inc.*, 107 F.3d 558, 567 (8th Cir.1997) (the terms of the contractual right of first refusal conveyed "the privilege to secure assignment of the lease by equaling another bidder's offer, and the bankruptcy court scrupulously honored this aspect of the bargain"); *In re Farmland Industries, Inc.*, 284 B.R. 111 (Bankr. W.D. Mo. 2002 (bidding reopened to afford the holder of a right of first refusal and opportunity to exercise its contractual right of first refusal); *In re Table Talk, Inc.*, 53 B.R. 937 (Bankr. D. Mass.1985) (despite the failure of the trustee to obtain court approval prior to entering into a contract granting a right of first refusal, that right is effective and enforceable); *In re Matter of Wauka, Inc.*, 39 B.R. 734 (Bankr. N.D. Ga.1984) (since the right of first refusal included in a sales contract and warranty deed did not violate the rule against perpetuities, the holder would be permitted to exercise that right.).

right of first refusal into the bidding and sale procedures of the bankruptcy auction in a fair and equitable manner that still allows for maximization of the value of the estate."⁴⁷

In reaching its decision to enforce the right of first refusal, *E-Z Serve* considered the following facts:

1) the landlord's uncontested evidence of economic detriment if the right was not enforced; 2) the right of first refusal was a material term of the lease and served as consideration for below-market rent; 3) material terms of a lease should generally not be rewritten by the Court; 4) the landlord's offer was greater than the competing offer with respect to the specific leasehold; 6) the bids were subject to Court approval; and 7) the sale of the property to a lower bidder was not in the best interest of the estate.⁴⁸

IV. The Ability of a Trustee or Debtor-in-Possession to Assume Executory Contracts that are Nonassignable Under Applicable Nonbankruptcy Law: The Interplay Between Bankruptcy Code Section 365(f)(1) & (2) and Revised Article 9⁴⁹

The recent revision of Article 9 met with dramatic success and has been adopted in every state, the District of Columbia and the U.S. Virgin Islands. All but five jurisdictions⁵⁰ also adopted a uniform date, July 1, 2001, as the effective date of the revision.⁵¹ By January 1, 2002, revised Article 9 was the law in virtually all jurisdictions.

Revised Article 9 overrides restrictions on assignment and may empower the trustee to help the secured creditor in the sale of collateral. A secured lender's collateral package is enhanced by a series of provisions in revised Article 9 that broadly expand the rights and property interests that may be assigned, regardless of anti-assignment language in contracts or

⁴⁷ *Id.* at 53.

⁴⁸ Harris, Aleana, ALI-ABA COURSE OF STUDY: RECENT BANKRUPTCY CASES OF NOTE, July 30-August 2, 2003, SJ004 ALI-ABA 763.

⁴⁹ This section of these materials is based in part on an article by Lawrence R. Ahern III in the Fall, 2001, issue of *NABTalk*. Permission for this use reserved.

⁵⁰ The effective date was delayed until October 1, 2001 in Connecticut and until January 1, 2002 in Alabama, Florida and Mississippi. The U.S. Virgin Islands adopted the revision in early 2002, effective April 1, 2002.

other state statutes.⁵² These provisions are likely to have the practical effect of increasing secured creditors' collateral in a bankruptcy, by tying up additional assets and enabling the secured creditor to reach even more proceeds of property of the estate. However, they may also benefit unsecured creditors in some situations by requiring the trustee's help before the secured creditor can realize on its collateral.

A debtor-in-possession or bankruptcy trustee thus should appreciate that there is a limitation on this anti-assignment override, which may give the trustee an opportunity to add value to the estate. By overriding both contractual and legal limitations on a person's ability to create a broad Article 9 interest in what would otherwise be nonassignable property, new Article 9 gives the secured party a grasp on the proceeds that is improved before bankruptcy and even more enhanced after bankruptcy. In some situations, however, it may also enhance a trustee's powers to assume and assign property in bankruptcy and in the process give the trustee a role in realizing the value of assets that the secured creditor could not realize without the trustee's help.

Thus, the amendment of Article 9 may create a compensable role for the trustee and even benefit unsecured creditors in some situations by requiring the trustee's help before the secured creditor can realize on its collateral. In such situations, there is a limitation on this anti-assignment override, which may give the trustee an opportunity to add value to the estate. These rules enhance a trustee's powers to assume and assign some property in bankruptcy and, in the process, give the trustee a role in realizing the value of assets that the secured creditor could not realize without the trustee's help.

⁵¹ A uniform effective date was included in the proposed statute. § 9-701.

⁵² §§ 9-406 through 9-409. These pro-assignment rules are not limited merely to restrictions that say the assignment is prohibited. See § 9-406 cmt. 5. They also override restrictions that say the assignment is permitted but only with the consent of the third-party obligor or restrictions that simply declare that assignment will constitute a default, so that the party who wishes to take a right to payment, either to

A. Validity v. Enforceability

A bankruptcy practitioner must understand the complex Article 9 provisions concerning validity and enforceability of security interests, to adequately perform his or her duties if the debtor owns licenses or other general intangibles that have been encumbered by a lender. The general rule that overrides contractual and legal restrictions on assignment of such rights⁵³ does not apply to security interests in health-care-insurance receivables or general intangibles. Instead, there are special rules for these excluded transactions⁵⁴ that are similar. To the extent that there might otherwise be an effective restraint on the debtor's alienation of these rights, such restrictions are not effective to prevent the creation, or attachment or perfection of a security interest. This override, however, does not extend to *enforcement* of the security agreement, on the principle that the obligated person (the franchisor, licensor, etc.) should not be forced to deal with the assignee.⁵⁵

This more limited override, which does not prevent restrictions on enforcement, applies to more transactions than just payment streams. It protects obligors on general intangibles that are not payment streams. For example, a franchisee's rights under a franchise agreement, generally speaking, are general intangibles and may not be assignable. In such a case, even though there is an anti-assignment provision in the franchise agreement or even though state law says that the franchisee cannot assign its rights under the franchise, Article 9 overrides those contractual and legal restrictions to permit attachment and perfection.⁵⁶ The franchisor is not,

secure a debt or as a purchase of a right to payment, may do despite such a restriction in the underlying transaction.

⁵³ § 9-406.

⁵⁴ § 9-408.

⁵⁵ § 9-408(4); § 9-408 cmt. 6.

⁵⁶ *Caution:* This broad override of anti-assignment provisions in agreements and statutes was one of the most controversial parts of the new law. In enacting the legislation, some states have modified this uniform language, particularly as it might allow assignment of lottery winnings or structured settlement

however, forced by Article 9 to accept a substitute franchisee. One can have a security interest in the franchisee's rights, but in order to turn that into cash, the secured party will have to wait until the franchisee disposes of it, either with the consent of the franchisor or, more significantly for this discussion, *in bankruptcy*.

B. The Role of the Bankruptcy Trustee

To understand the importance of this fine distinction, a bankruptcy practitioner must remember the interplay of Article 9 and the Bankruptcy Code. Suppose a trustee for a fast-food chain finds that its franchise agreements contain anti-assignment language but are subject to a security interest. Outside bankruptcy, for the reasons expressed above, the lender cannot sell the franchise and force the franchisor to accept its buyer. Therefore, only if the third-party obligor consents to the sale can the secured party generate proceeds of its collateral. In bankruptcy, the trustee's abandonment of the asset would throw the creditor back into that limitation on enforcement. The trustee may wring value from such assets that the creditor could not obtain outside bankruptcy. If the trustee is not sensitive to these rules, however, the sale by the trustee will simply produce proceeds that may be claimed by the secured creditor. The alert trustee will anticipate that the secured creditor must obtain the trustee's assistance to take advantage of the provisions of the Bankruptcy Code that invalidate certain contractual anti-assignment clauses⁵⁷ and thereby to realize the value from the collateral. In that situation, where the secured creditor needs the trustee's help in liquidating its collateral, the trustee may reasonably ask that the value added by the circumstance of bankruptcy be shared with the estate.

payments. Therefore, while it is always critical in dealing with a uniform law to examine the relevant state's version of Article 9, it is especially important to do so in this area.

⁵⁷ Various provisions in executory contracts and unexpired leases that prohibit the assignment of such contracts are not effective in bankruptcy. *See* 11 U.S.C. §365(e) & (f) (1994).

C. Trustee Compensation

May the trustee be paid for this work? The trustee who sells fully-encumbered assets usually may expect not to be compensated from the estate.⁵⁸ However, in the example above, the trustee may seek to carve out compensation from the proceeds as an expense of disposing of the property.⁵⁹ Beyond that, if the trustee successfully demands that the estate share in the proceeds for the benefit of general creditors, his or her compensation may be based on that result.

NAS:541567.4

⁵⁸ *See, e.g.*, In re Lan Associates XI, L.P., 192 F.3d 109, 119 (3d Cir. 1999) (holding "that a trustee who expends time and effort administering fully encumbered assets should not receive compensation except to the extent that his actions provide an actual benefit to the estate").

⁵⁹ 11 U.S.C. § 506(c) (1994).