ASSUMPTION AND ASSIGNMENT OF EXECUTORY CONTRACTS: PRESERVING THE VALUE OF NON-BURDENSOME CONTRACTS AND LEASES

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I. INTRODUCTION

Section 365(a) of the Bankruptcy Code provides that a trustee or debtor in possession may assume or reject an unexpired lease or executory contract. In many circumstances the ability to assume a favorable and important lease/contract on the one hand, or to reject a burdensome lease/contract on the other, is critical to the success or failure of the debtor's reorganization efforts. The ability to assign an assumed lease or contract is equally important. Whether a contract is executory, or in the case of personal property whether a lease is considered a "true lease" has implications for both parties to the agreement. If the lease or contract is viewed by debtor as a valuable asset, debtor will likely assume the lease or contract and continue to benefit from the beneficial terms, or assign the lease/contract to a third party. In the event of assumption, Section 365(b)(1) of the Bankruptcy Code obligates the debtor to cure defaults and provide adequate assurance of future performance. If, however, the debtor views the lease or contract as burdensome, debtor may seek to reject the lease/contract. Upon rejection, the contract/lease is deemed to have been breached and the non-debtor party is entitled to a prepetition damage claim. *See* 11 U.S.C §§ 365(g) and 502(g).

II. THE BASICS

A. What is an Executory Contract?

The determination of whether a contract is executory is an age-old challenge in bankruptcy proceedings. The majority of courts addressing the issue have adopted the so-called Countryman approach, named after Professor Vern Countryman. Under the Countryman approach, a contract will be deemed "executory" if performance remains due on both sides of the contract such that a failure of either to complete performance would result in a material breach that would excuse the other party from performing. Countryman, *Executory Contracts in Bankruptcy: Part 1,* 57 Min. L. Rev. 439, 460 (1973); *see, e.g., Unsecured Creditors' Comm. Of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.),* 139 F. 3d 702 (9th Cir. 1998); *Sharon Steel Corp. v. National Fuel Gas Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989); H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977) (executory contract "generally includes contracts on which performance remains due to some extent on both sides"). A minority of courts have adopted the "functional approach," pursuant to which the characterization of a contract as executory is premised upon the benefits that assumption or rejection would produce for the bankruptcy estate. *See, e.g., Cohen v. Drexel Burnham Lambert Group Inc. (In re Drexel Burnham Lambert Group Inc.),* 138 B.R. 687, 707-709 (Bankr. S.D.N.Y. 1992).

To assist in the determination of "executoriness," parties may include provisions in the contract intended to direct a court considering the issue. Notwithstanding these efforts, most courts will look to the substance of the rights and obligations of the parties, and the substance should override labels that do not reflect the substance. *See, e.g., Liona Corp. v. PCH Assocs. (In re PCH Assocs.),* 804 F.2d 193, 199 (2d Cir. 1986) ("[T]he bankruptcy court is to

look to the circumstances of the case and consider the economic substance of the transaction rather than the 'locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease,"' to determine whether the transaction embodies a 'true lease' or a financing transaction."). That said, the intent of the parties does matter and the expression of that intent through the words of the contract or lease is perhaps the best evidence of that intent. *See, e.g., Thomson McKinnon Secs. Inc., v. Leasure (In re Thomson McKinnon Secs. Inc.)*, 132 B.R. 9, 12 (Bankr. S.D.N.Y. 1991) ("The scope and meaning of a release will be determined by the manifested intent of the parties—in Corbin's words, "by the process of interpretation, just as in the case of determining the meaning of an executory contract.")

B. Requirement to Cure

Section 365(b)(1)(A) provides that a debtor may not assume an unexpired lease or executory contract unless at the time of assumption the debtor cures, or provides adequate assurance that the default will be promptly cured. The duty to cure does not apply to a default arising from failure to perform a nonmonetary obligation under an unexpired lease of real property, if it is impossible for the debtor to cure the default by performing nonmonetary acts at and after the time of assumption. If, however, the nonmonetary default is failure to operate, then the default shall be cured by performance after the time of assumption; provided, however that the debtor is obligated to pay the landlord the amount of any pecuniary losses resulted from the default. *See, §365(b)(1)(B).* Note, however, that the limitation on the duty to cure nonmonetary defaults is limited to nonresidential real property leases. Thus, in circumstances where performance under the lease is related to another agreement and subject to cross default provisions, the ability to assume the lease notwithstanding a nonmonetary default that cannot be cured, will not protect the debtor from a default under the related agreement. For example, if the

debtor ceases to operate at a leased location, it may be able to assume the lease. However, if "going dark" is a breach under a related franchise agreement, §365(b)(1)(A) provides no protection for the potential loss of the franchise agreement.

The debtor is required to provide adequate assurance that it will promptly cure defaults. *See e.g. In re M. Fine Lumber Co., Inc.*, 383 B.R. 565, 570 (Bankr. E.D.N.Y. 2008) ("Section 365(b)(1)(A) provides that the debtor must cure, or provide adequate assurance that it will promptly cure any defaults. 'Whether a cure is 'prompt' for purposes of §365(b)(1)(A) depends on the facts and circumstances of each case.'"). The Bankruptcy Code does not define what constitutes a prompt cure or what is required to provide adequate assurance of a prompt cure. In determining whether the prompt cure requirement is satisfied, courts will consider: 1) the debtor's past financial performance, 2) any inequitable acts by the non-debtor party, 3) harm or prejudice suffered by the non-debtor party resulting from past defaults, and 4) the term of the contract or lease. *In re America the Beautiful Dreamer, Inc.,* No. 05-47435, 2006 WL 2038646, at *3 (Bankr. W.D. Wash. 2006).

C. Adequate Assurance of Future Performance

Likewise, the determination of whether a debtor has satisfied Section 365(b)(1)(C) or Section 365(f)(2)(B) which each require "adequate assurance of future performance," is fact specific and based on the circumstances of each case. Courts focus on the nature of the parties, their prior dealings and present circumstances, the contract at hand and the feasibility of debtor's proposed future performance. *Madisonview Towers v. Yardley (In re Yardley)*, 77 B.R. 643, 646 (Bankr. M.D. Tenn. 1987); *In re Sapolin Paints, Inc.*, 5 B.R. 412 (Bankr. E.D.N.Y. 1980). Because the Bankruptcy Code does not define what constitutes adequate assurance of future performance (except with respect to shopping centers), the

nondebtor party should consider inclusion in the contract what constitutes adequate assurance of future performance. While there is no guaranty that a court will enforce the parties' agreement on this issue, the inclusion of specific requirement may impact the court's decision.

Section 365(b)(3) specifically defines the form of adequate assurance if the lease involves real property located in a shopping center. Subsections (A), (B), (C) and (D) of Section 365(b)(3) respectively provide that: (A) the source of rent or (in the case of assignment), the financial condition and operating performance of the proposed assignee, be similar to that of the debtor when the lease was entered; (B) that the percentage rent not decline substantially; (C) that the assumption or assignment be subject to all the provisions of the lease; and (D) that assumption or assignment will not disrupt the tenant mix or balance at the shopping center.

D. Contractual Limitations on Assignment

Counterparties to leases and executory contracts may seek to limit the right to assign the contract or lease in the event of bankruptcy proceedings. However, Section 365(f)(1) provides that notwithstanding a provision in a contract or lease (or in applicable law) that prohibits, restricts or conditions the assignment of such contract or lease, the debtor may assign such contract under Section 365(f)(2) if the debtor assumes the lease or contract in accordance with Section 365, and adequate assurance of future performance by the assignee is provided. Also, Section 365(f)(3) provides that any provision that authorizes a non-debtor to terminate or modify a contract or lease in the event of its assignment is unenforceable.

E. Obligations and Rights That Cannot be Assigned

Section 365(c) provides that the debtor may not assume or assign any executory contract or unexpired lease of the debtor, whether or not the lease or contract prohibits or restricts the assignment of rights or the delegation of duties if: "applicable law excuses a party,

other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, and such party does not consent to the assumption and assignment (Sections 365(c)(1)(A) and (B)); the contract is a contract to make a loan, or extend other debt financing or financial accommodations to or for the benefit of debtor, or to issue a security of the debtor (Section 365(c)(2)); or the lease is of nonresidential real property and has been terminated under applicable law prior to the order for relief (Section 365(c)(3).

The prohibitions of Section 365(c) are typically associated with the assignment of personal service contracts. To the extent performance under the contract depends upon a special relationship, special knowledge, or a unique skill, upon which the other party is entitled to rely, the services/duties are likely nondelegable and the contract may not be assigned. *In re Rooster, Inc.*, 100 B.R. 228 (Bankr. E.D. Pa. 1989). However, §365(c)(1) has been applied to contracts other than personal service contracts. *See, e.g., Gardner v. Nike, Inc.*, 279 F3d 774 (9th Cir. 2000) (holding exclusive copyright licenses nonassignable under section 365(c) and federal nonbankruptcy law); *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 f.3d 673 (9th Cir. 1996) (holding nonexclusive patent nonassignable under §365(c) and federal nonbankruptcy law).

Read literally, Section 365(c) also prohibits the debtor from assuming contracts where applicable law excuses the non-debtor contract party from accepting performance from or rendering service to someone other than debtor, unless such party consents. In *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 749 (9th Cir. 1999), the Ninth Circuit held that a debtor could not assume an executory nonexclusive patent license

because applicable nonbankruptcy law prohibited the contracts assignment, even though the debtor had no intent to assign the contract. By so ruling, the Ninth Circuit followed prior decisions by the Third and Eleventh Circuits (the Fourth and Sixth Circuits have also adopted this reasoning). This reasoning is known as the "hypothetical test" because no actual assignment is necessary. *See also In re Sunterra Corp.*, 361 F.3d at 266-67; *In re James Cable Partners, L.P.*, 27 F.3d. 534, 537 (11th Cir. 1994); *In re Access Beyond Tech.*, 237 B.R. 32, 49 (Bankr. D. Del. 1999).

A prohibition on Debtor assuming executory contracts even when there is no intent to assign based on applicable nonbankruptcy law that prohibits assignment without consent could have a significant impact on a Debtor's reorganization efforts. First, there is the leverage gained by the nondebtor contract party. Second, there is the potential that the value of significant assets will be lost. These concerns are exacerbated if the debtor's core business is dependent upon executory license agreements. Accordingly, debtors have argued that a literal reading of Section 365(c) is not appropriate since it prohibits the debtor's assumption of its own contracts. Some courts have agreed, and follow the so-called "actual test" to determine if a debtor may assume a contract that could not be assigned under applicable nonbankruptcy law. *See, Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997). The First Circuit adopted a test that looks at the actual transaction involved in assessing whether Section 365(c) will prevent assumption of a nonassignable patent license. Under the "actual test" a court will determine on a case-by-case basis whether the nondebtor party is being "forced" to accept performance from someone other than the debtor with whom it originally contracted. The Fifth Circuit adopted the First Circuit's approach in *Bonneville Power Admin. V. Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006).

F. Ipso Facto Clauses

Section 365(b)(2) provides that the Section 365(b)(1) cure requirement does not apply to a default that breaches a provision relating to: "(A) the insolvency or financial condition of the debtor at any time prior to the closing of the case; (B) the commencement of a case under [the Bankruptcy Code]; (C) the appointment of or taking possession by a trustee in a case under [the Bankruptcy Code]; or (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations……"

Section 365(e) provides that, notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an unexpired lease or executory contract may not be terminated or modified, and any right or obligation thereunder may not be terminated or modified, at any time after the commencement of the case, solely because of: "(A) the insolvency or financial condition of the debtor at any time prior to the closing of the case; (B) the commencement of a case under [the Bankruptcy Code]; (C) the appointment of or taking possession by a trustee in a case under [the Bankruptcy Code]."

The practical impact of these sections is to render unenforceable contract/lease provisions that provide for default or termination, and limit performance or assignability in the event bankruptcy proceedings are filed. The two exceptions to enforceability of the ipso facto rules are an executory contract to make a loan or extend financial accommodation and an executory contract under which applicable law excuses a party from accepting performance from or rendering performance to a party other than the debtor. *See, §§365(c)(1) and 365(e)(2)(A).*[1]

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[1] It should be noted that certain contract provisions if effectuated prior to the bankruptcy filing may have the impact of terminating the contract or lease prior to filing and are generally enforceable. Examples include operational clauses that provide for termination upon cessation of business or an unauthorized change of control.

G. **Rejection**

Section 365(g)(1) provides that rejection of an unexpired lease or executory contract constitutes a breach.[2] If the contract or lease has not been assumed under Section 365 or in connection with a confirmed plan, the breach is deemed to have occurred immediately before the petition date. Pursuant to Section 502(g), the claim arising from such breach is treated as if it arose prepetition. Thus, an unsecured nondebtor party to a rejected lease or contract will be entitled to a general unsecured claim. The amount of the claim may be subject to additional litigation.[3] In the case of an unexpired lease, the rejection functions as a breach, but not as a termination of the lease. The underlying obligations continue post rejection. *In re CP Holdings, Inc.*, 349 B.R. 189 (8th Cir. B.A.P. 2006).

Parties to executory contracts can seek to mitigate the potential dispute over damages in the event of a bankruptcy by including liquidated damage provisions. If the liquidated damages clause is one that would be enforced under applicable state law, the clause may be enforced by the bankruptcy court. *In re Independent American Real Estate, Inc.*, 146 B.R. 546 (Bankr. N.D. Tex. 1992).

Another avenue of protection in the event of rejection is to take a security interest in the subject matter of the contract. Doing so may encourage the debtor to assume the contract. However, if the contract is rejected, you may be able to recover the secured collateral. Also, to

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[2] The consequence of a rejection by the debtor of an unexpired lease of real property under which the debtor is lessor (§365(h)) and of an executory contract under which the debtor is a licensor (§365(n)) are discussed elsewhere herein.

[3] With respect to calculating a damage claim for the rejection of an unexpired lease where the debtor is lessee, see §502(b)(6).

the extent of its secured position, the nondebtor party will be entitled to adequate protection during the case pending assumption or rejection per §363 of the Code.

A party to a contract or lease may also require that a security deposit be tendered by the potential debtor which amount will provide security for any damages resulting from a breach or rejection. The landlord or nondebtor contract party will be deemed a secured creditor to the extent of such deposit. *In re Mainstream Access, Inc.*, 134 B.R. 743 (Bankr. S.D.N.Y. 1991).

III. WHEN THE DEBTOR AS LESSOR REJECTS AN UNEXPIRED LEASE

Where the debtor is the lessor of real property subject to an unexpired lease, the Bankruptcy Code provides debtor the option of assumption or rejection of the lease. While rejection of a lease may be economically beneficial to the debtor, the impact on a lessee of the property could be devastating. To balance the interests of debtor and its lessees, Section 365(h) of the Bankruptcy Code provides protections for the lessee in the event debtor chooses to reject an unexpired lease of real property. Section 365(h) works as follows: 1) If the rejection amounts to a breach that would entitle the lessee to treat the lease as terminated by its terms, applicable nonbankruptcy law or any other agreement, the lessee may treat the lease as terminated; or 2) if the lease term has commenced, the lessee can retain its rights under the lease for the balance of the term of such lease and for any renewal or extension of such rights to the extent enforceable under nonbankruptcy law.

If the lessee decides to retain its rights under the lease, it can offset against the rent due for the term and any renewal period, the value of any damages caused by the nonperformance of debtor after the date of rejection. The lessee shall not have any other right to damages occurring after the date of rejection caused by nonperformance.

In the event the rejection is of a lease of real property in a shopping center, and the lessee chooses to retain possession after rejection, lease restrictions pertaining to radius, location, tenant mix, use and exclusivity remain in effect.

Notwithstanding the rights afforded a lessee to a rejected lease, Section 363(f) authorizes a debtor, upon satisfaction of statutory conditions, to sell interests in property free and clear of liens, claims and interests in property. Can a debtor pursuant to Section 363(f) sell property free and clear of the interests of a lessee that seeks the benefits of Section 365(h)?

The conflict between Sections 363(f) and 365(h) were addressed by the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ LLC*, 327 F.3rd 537 (7th Cir. 2003). In *Qualitech*, the tenant sought to invoke its rights under §365(h) to remain in leased premises that had been sold in a Section 363(f) sale free and clear of all interests. Based on the facts of that case, including the fact that the tenant, despite notice, failed to object to the proposed free and clear sale, the court ruled that the tenant's rights were cut off by the Section 363(f) sale, notwithstanding the provisions of Section 363(h).

Several courts have chosen not to follow Qualitech. In *In re Haskell*, 321 B.R. 1 (Bankr. D. Mass. 2005), the court stated "If the court were to grant the Debtor's Sale Motion, the provisions of [section] 365(h) would be eviscerated." *Id.* The court also commented that even if debtor provided adequate protection to the lessee pursuant to §363(e), the result would be the same. In *In re Zota Petroleums, LLC*, 483 B.R. 154 (Bankr. E.D. Va. 2012), the court stated: "The rights of a tenant may not be extinguished by a §363 sale; to hold to the contrary would give open license to debtor to dispossess tenants by utilizing the §363 sale mechanism.) *Id. at 163.* In *In re Crumbs Bake Shop*, 522 B.R. 776 (Bankr. D. N.J. 2014), the court construed the interplay between §§363 and 365 in the context of an attempt to sell assets free and clear of the

rights of assignees of debtor's trademarks. In *Crumb*, the court held that there was nothing in §363(f) that trumps or supersedes the rights of licensees under §365(n). Later, in *In Re Revel AC, Inc.*, 532 B.R. 216 (Bankr. D.N.J., 2015), the same court, considering the right of tenants under §365(h) to retain possession of leasehold interests despite debtor's efforts to sell free and clear under §363(f), held that a §363 sale does not and could not trump the rights granted to the tenants by §365(h).

Other courts (other than the *Qualitech* court) have ruled that there is no conflict between §§363 and 365. Those courts have offered that the statutes should be afforded plain meaning and should be construed so as to avoid any conflict between them. There is no evidence that Congress intended to subordinate §363(f) to §365(h). If Congress had intended for the protections of §365(h) to apply without limitation even when property subject to the lease is sold, Congress could have made that clear. *In re MMH Automotive Group,* LLC, 385 B.R. 345, 365 (Bankr. S.D. Fla. 2008).

IV. REJECTION OF LICENSE AGREEMENTS UNDER Section 365(n)

In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985), the court allowed the debtor to reject the license and thereby strip the nondebtor licensee of all of its rights to use the patented technology. In response, Congress enacted Section 365(n) of the Bankruptcy Code. The purpose, as stated in the legislative history, was to make clear that the rights of a licensee of intellectual property cannot be unilaterally cut off as a result of the rejection of the license pursuant to §365. Section 365(n) reads as follows:

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive—

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property

(including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract or any agreement supplementary to such contract—

(i) perform such contract; or

(ii)provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

The Bankruptcy Code's definition of "intellectual property" excludes trademarks. Thus, some courts have held that trademark licenses are not entitled to the protections of §365(n) in the event the license is rejected. *See, e.g. In re Old Carco LLC*, (406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009). However, the Seventh Circuit in *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012), stated that *Lubrizol* had been incorrectly decided, and ruled that notwithstanding its omission from the definition of intellectual property, a licensee could retain use of trademarks. Citing *Thompkins v. Lil' Joe Records, Inc.*, 476 f.3d 1294, 1306 (11th Cir. 2007), the court stated that rejection does not effectuate a rescission of the contract.

If a prepaid license is entered in connection with a broader transaction, the license may be viewed as an integrated part of a larger transaction. Two Circuit Court cases have ruled that in such circumstances, the license is not an executory contract subject to

rejection. *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010); *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014).

Where a license is exclusive and thus able to be assigned by the licensee, courts have held that the license agreement is not executory. *See, e.g. In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001).

Section 365(n) protects a licensee's rights to intellectual property as they existed immediately before the date the case was commenced. Accordingly, a licensee will not be entitled to modifications or improvements that are created after that time.

V. SUPPLY CONTRACTS

If the debtor is a manufacturer or perhaps a retailer, at filing, it is likely to be party to multiple contracts with suppliers and vendors. Depending on the structure, some of these contracts may qualify as executory contracts. At the outset of the case, the debtor may not be prepared to assume the contracts, perhaps because the contract terms are for periods longer than the debtor is currently prepared to commit, or because the pricing is no longer attractive. Also, the debtor may be in default of its payment obligations. Nonetheless, the debtor requires the uninterrupted supply of the goods provided through the contracts. On the other hand, the nondebtor contract party is concerned with managing its exposure to a financially stressed customer. Perhaps there is large account receivable balance. Can the debtor demand that the supplier continue to perform under the contract? Pending assumption, must the supplier continue to sell to the debtor? If so, is the supplier required to continue to extend credit terms? These issues and questions describe the tension that surrounds open supply contracts when a company files a Chapter 11 proceeding.

The first issue is whether the supply contract is an executory contract. Most supply contracts will qualify as executory contracts, but it is not always clear-cut. Some supply contracts while identifying the product, pricing, terms and even require the supplier to commit to meeting a specified quantity of the debtor's product needs, do not require the debtor to purchase product. Even in this scenario, if there are open orders issued under the contract as of the petition date, the contract may be viewed as executory. Certainly, if the supply contract contains unfulfilled mutual obligations that if not fulfilled would constitute a breach, the supply contract will be considered executory in nature.

Pending assumption, the Debtor can demand that the supplier continue to provide product in compliance with the contract. If the suppler refuses, the debtor can petition the bankruptcy court for relief, asserting, *inter alia*, claims for breach of contract and violation of the automatic stay. From the supplier's standpoint, it is risky to refuse to comply with the supply agreement. Refusal to supply could cause financial damage to the debtor, thus increasing the supplier's exposure.

Although the supplier may not want to risk refusal to comply with the supply agreement, it may want to demand assurances that it will be paid for post-petition delivery. Yes, any unpaid post-petition obligations may qualify as administrative expenses; however, there is no guaranty at the outset of the case that administrative claims will be paid in full, or for that matter that the court will grant administrative claim status. The supplier could also seek to rely upon state law rights; specifically, U.C.C. §§ 2-702 and 2-609 that, respectively, allow a seller of goods to refuse to deliver goods to an insolvent buyer, or to suspend performance under a contract for sale of goods where it has reasonable grounds that the buyer cannot pay. Are these viable options for the supplier?

In *In re Pacific Gas and Elec. Co.*, 2004 U.S. Dist. LEXIS 22023 (N.D. Cal. 2004), the court, while recognizing the supplier's right to request adequate assurance of performance under U.C.C. §2-609, ruled that to allow the supplier to withhold performance pending receipt of financial assurances that the debtor could pay, would undermine the clear legislative purpose to provide debtor with "breathing space" until the decision to assume or reject is made. The court determined that the supplier's only remedy was to file a motion to expedite the assumption or rejection process under §365(d). In *In re Continental Energy Assoc. Ltd. Pshp.*, 178 B.R. 405 (Bankr. M.D. Pa. 1995), the debtor had sought a court order to compel a vendor to continue performance until such time as a decision to assume or reject was made. The debtor was $15 million in arrears at the petition date. The debtor offered cash in advance terms for the post-petition sales. The court ruled that it could compel a vendor to supply goods post-bankruptcy pending assumption or rejection of the contract. The court further observed that the debtor's agreement to pay in advance vitiated any concerns about the vendor's constitutional rights to be compensated for property.

In re Lucre, Inc., 339 B.R. 648 (Bankr. W.D. Mich. 2006) provides a different take on the duty of a supplier to perform and/or extend credit pending assumption or rejection of an executory contract. In *Lucre*, the service provider ("SBC") sought relief from the stay in order to avoid the burden of providing post-petition services to debtor. SBC asserted that the debtor was in breach of its obligations under the contract on the petition date. The court considered whether any provision of the Bankruptcy Code empowered the debtor to demand that SBC continue to perform under the agreement notwithstanding debtor's prepetition breach. The court determined that a debtor cannot demand performance from the other party to the contract when the debtor's prepetition breach remains uncured. Further, the court stated that the

automatic stay imposed upon the filing of the petition does not empower the debtor to compel performance from the other party. Given its breach, the debtor could not have compelled performance immediately before the petition date; therefore, it is illogical to conclude that the nondebtor's refusal to perform was a violation of the automatic stay. Finally, the court stated that the prepetition breach justified nonperformance by the nondebtor irrespective of the form of adequate protection offered. In effect, the debtor's remedy to force performance is to assume the contract and cure the prepetition default.

The decision in *Lucre* should be considered an outlier. Accordingly, suppliers should tread lightly when deciding whether to refuse post-petition performance on any executory contract. The supplier should consider requesting that the court require the debtor to decide whether to assume or reject the contract at an early stage. Also, the supplier should seek adequate protection before being forced to provide post-petition credit. If the contract is scheduled to expire in the short-term and the product or services provided are unique to the supplier, consider approaching the debtor to negotiate an amendment to the contract to extend the term (perhaps adjusting pricing as well), with the contract being assumed as amended. Amending the current contract and assumption is a better result than executing a new contract post-petition, even if that contract provides for payment of prepetition indebtedness. The assumption will go a long way to protecting the supplier from preference exposure for prepetition payments received. Finally, from a prospective standpoint, consider including in supply contracts the right to modify credit terms to COD or CIA in the event of a bankruptcy filing.

VI. OIL AND GAS LEASES

A. Are Oil and Gas Interests subject to Bankruptcy Code Section 365 as Executory Contracts or Unexpired Leases?

While federal law governs the treatment of executory contracts and unexpired leases, the bankruptcy courts will look to the treatment of an oil and gas lease under *state law* to determine the nature of the rights granted thereunder and, therefore, whether such lease qualifies as an executory contract or unexpired lease. *In re Topco, Inc.*, 894 F.2d 727 (5th Cir. 1990) (citing *In re Harris Pine Mills*, 862 F.2d 217 (9th Cir. 1988), *In re Petroleum Products*, 72 Bankr. 739 (Bankr. D. Kan. 1987)); *see*, *also*: *In re Hanson Oil Company*, 97 B.R. 468, 471 ("Whether or not the instant lease comes within the purview of § 365(d)(4) requires a determination of the interest created by an oil and gas lease under state law"); *Matter of Myklebust*, 26 B.R. 582 (Bankr. W.D. Wis. 1983). Disparate and varying treatment of oil and gas leases under state law has led to a patchwork of treatment at the federal level under the Bankruptcy Code. In some jurisdictions, oil and gas leases are not subject to administration pursuant to Section 365, while in other jurisdictions, oil and gas leases are treated as executory contracts or unexpired leases capable of assumption, assumption and assignment, or rejection.

1. The Majority Rule – Oil and gas lease are NOT subject to Section 365.

A majority of bankruptcy courts have held that oil and gas leases are neither executory contracts nor unexpired leases and, thus, are not subject to Section 365. *In re Hanson Oil Company*, 97 B.R. 468, 470-471 (Bankr. S.D. Ill. 1989); *In re Heston Oil Company*, 69 B.R. 34, 36 (N.D. Okla. 1986); *In re Matter of Topco*, 894 F.2d 727, 740 (5th Cir. 1990); *In re*

Frederick Petroleum, 98 B.R. 762, 767 (S.D. Ohio 1989). The reasoning relied upon by bankruptcy courts to reach this determination, however, varies.

A number of courts who consider oil and gas leases to be beyond the purview of Section 365 do so because applicable state law conveys an ownership interest in real property to the oil and gas lessee. Generally, the interest conveyed is something less than fee simple absolute, but something more than a merely possessory interest. *Shields v. Moffitt*, 683 P.2d 530, 532-33 (Okla. Supr. Ct. 1984) (noting real estate interest variance from absolute ownership down to naked possession). States where courts have treated oil and gas leases as conveying a real property interest include: Illinois (*In re Hanson Oil Company*, 97 B.R. 468, 470-471 (Bankr. S.D. Ill. 1989)); Kansas (*Kneller v. Federal Land Bank of Wichita*, 247 Kan. 399 (Kan. Supr. Ct. 1990)); Kentucky (*Ralston v. Thacker*, 932 S.W.2d 384, 387 (Ky. Ct. of App. 1996)); New Mexico (*Maralex Resources, Inc. v. Gilbreath*, 134 N.M. 308, 312 (N.M. Supr. Ct. 2003); Oklahoma (*Shields v. Moffitt*, 683 P.2d 530, 532-33 (Okla. Supr. Ct. 1984) and *In re Heston Oil Company*, 69 B.R. 34, 36 (N.D. Okla. 1986)); and Texas (*Natural Gas Pipeline Co. v. Pool*, 124 S.W.3d 188, 192 (Tex. Supr. Ct. 2003) and *In re Matter of Topco*, 894 F.2d 727, 740 (5th Cir . 1990)).

Some courts, in finding and determining that oil and gas leases are not subject to the provisions of Section 365, rely on a finding that, pursuant to applicable state law, oil and gas leases grant the lessee a "license" to enter upon land for purposes of exploring and drilling for oil and gas. Analyzing further, these courts find that a license does not constitute an unexpired lease or an executory contract. States where courts have treated oil and gas leases as "licenses" include: Ohio (*In re Frederick Petroleum*, 98 B.R. 762, 767 (S.D. Ohio 1989)) and Oklahoma (*In re Clark Resources, Inc.*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986)).

2. Minority Rule – Oil and gas leases ARE subject to Section 365.

A minority of courts held that oil and gas leases are subject to administration pursuant to Section 365 of the Bankruptcy Code. Courts holding that oil and gas leases are subject to treatment in accordance with Section 365 typically do so on the basis that such oil and gas leases constitute "unexpired leases" within the contemplation of the statute: Ohio (*In re Gasoil, Inc.*, 59 B.R. 804, 806-808 (Bankr. N.D. Ohio 1986)) and Michigan (*In re Aurora Oil & Gas Corporation*, 439 B.R. 674, 677-680 (Bankr. W.D. Mich. 2010)).

Relatively few courts have held that an oil and gas lease is subject to Section 365 on the basis that oil and gas leases are intangible personal property and such lease constitutes an executory contract. The main case in this vein, *In re J.H. Land & Cattle Company*, 8 B.R. 237 (Bankr. W.D. Okla. 1981), is the subject of much criticism both from industry commentators and other courts.

B. Are midstream agreements covered by Section 365?

The midstream industry has historically believed that midstream agreements – if properly and carefully drafted to convey an interest in real property – would not be subject to rejection under Section 365 in the event a party to such agreement filed for bankruptcy protection. Traditionally, this has meant structuring midstream agreements so as to convey property interests in the nature of "covenants running with the land" and/or "equitable servitudes." The belief that the inclusion of real property conveyances in midstream agreements can, in effect, "bankruptcy proof" such agreements has been subject to significant recent challenge that introduces uncertainty regarding their treatment in bankruptcy.

1. *In re Sabine Oil & Gas Corporation*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016).

In March 2016, the Bankruptcy Court for the Southern District of New York issued a bench decision in the bankruptcy case of producer Sabine Oil & Gas Corporation ("Sabine"). Sabine, a producer, sought to reject certain of its midstream agreements. Sabine sought to reject gathering agreements with each of Nordheim Eagle Ford Gathering, LLC ("Nordheim") and HPIP Gonzales Holdings, LLC ("HPIP"), arguing that such agreements were "unnecessary drains on the Debtors' resources", and highlighting an estimated $115 million in cost savings over the life of the contracts should rejection be permitted. Nordheim and HPIP objected, arguing that midstream agreements conveyed real property rights that were not properly the subject of rejection under Section 365. The court in Sabine considered several questions:

a. Do dedications in midstream agreements convey an interest in real property (i.e., covenants running with the land or equitable servitude) sufficient to bar rejection of the midstream agreement in entirety, or are dedications merely part of a larger executory contract, which may be rejected?

b. Will rejection of a midstream agreement invalidate a covenant running with the land, or would such a covenant survive efforts to otherwise reject a midstream agreement?

c. Was Sabine's decision to seek rejection of its gathering agreements with Nordheim and HPIP a reasonable exercise of Sabine's business judgment?

In its bench decision, the Court determined the third question in the affirmative, but noted that rejection of the gathering agreements would only relieve Sabine of those obligations, which would be capable of rejection under applicable law (here, Texas law). The court withheld judgment as to the remaining questions, while telegraphing a clear and concerning message for midstream participants and counterparties: the court did not seem likely to hold that

the gathering agreements at issue constituted an interest in or burden upon real property sufficient to survive Sabine's efforts to reject the gathering agreements.

In a follow-up decision, the court in *Sabine* held that the midstream agreements at issue did not concern *Sabine's* land or its use (i.e., oil, gas, and/or minerals *in situ*); the midstream agreements addressed solely minerals *subsequent to removal* from the ground. Sabine was therefore permitted to *reject* its midstream agreements with each of Nordheim and HPIP.

2. Additional litigation: Quicksilver and MHR

The potential rejection of midstream agreements has garnered significant attention in two cases filed in the Bankruptcy Court for the District of Delaware: *Quicksilver Resources, Inc.* and *Magnum Hunter Resources Corp*. In each case, the advanced arguments similar to those advanced by Sabine.

In *Quicksilver*, the debtor sought to reject three gas gathering and processing agreements and a joint operating agreement. The issues raised were fully briefed before the court – including amici curiae briefs filed by the Gas Processors Association and the Texas Pipeline Association – and awaiting a decision from the bankruptcy court judge. In April, 2016, Quicksilver voluntarily withdrew its motion on the heels of a settlement between the purchaser of Quicksilver's assets and the counter-parties to the gathering and joint operating agreements which were the subject of such motion.

Similarly, in a heavily redacted motion and companion adversary complaint, Magnum Hunter also sought to reject an unfavorable midstream agreement, pointing to *Sabine* in support of efforts to jettison the agreement. On April 14, 2016, the court authorized the rejection and voluntary dismissal of the adversary proceeding without significant comment.

3. What does this mean for producers or midstream companies?

An assessment of the vulnerabilities of midstream agreements will, by necessity, turn heavily upon the specific language used in the subject agreement and the impact or weight afforded to such language under applicable state law. As we have seen with oil and gas leases, disparate treatment of dedication language in midstream agreements under state law may have significant impact at the bankruptcy court level in any adjudication of whether a midstream agreement is or is not an executory contract or unexpired lease capable of rejection pursuant to Section 365.