

A GENERAL OVERVIEW OF THE TREATMENT OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES UNDER SECTION 365 OF THE BANKRUPTCY CODE

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“Executory contracts” have been described as involving the most “psychedelic” law in bankruptcy.¹ The Bankruptcy Code addresses executory contracts and unexpired leases in section 365. This section can be a bit overwhelming due to its coverage of this nuanced and difficult legal area. The materials that follow are meant to address and explore in general, practical terms, *some* of the issues involved in the treatment of executory contracts and unexpired leases in bankruptcy.

1. From the outset, thoroughly examine the debtor’s affairs to determine whether any executory contracts or unexpired leases are present.

The presence of executory contracts or unexpired leases, and how they are dealt with, can have significant implications to the bankruptcy estate. Depending on the chapter under which the bankruptcy case is brought, and the type of contract or lease at issue, different treatment is afforded under section 365. This differing treatment includes the timeframe within which the trustee or debtor-in-possession has to make a decision to assume or reject, as well as the duties owed the nondebtor to the agreement prior to such decision. Thus, it is important to be aware from the outset of any executory contracts or unexpired leases that may exist.

a. Executory Contract Definitions

The Bankruptcy Code does not provide a definition for the term “executory contract.” Rather, definitions for the term have developed through case law and law

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¹ Jay Lawrence Westbrook, *Article: A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 228 (1989) (“Bankruptcy is that volume of the law that might have been written by Lewis Carroll, every conventional legal principle refracted through the prism of insolvency. In that fact lies much of its students’ joy -- and their frustration. In no chapter of that volume has the law become more psychedelic than in the one titled ‘executory contracts.’”).

review articles. Two well-known approaches for determining whether a contract is executory are the “material breach” test and the functional approach.

The Countryman “Material Breach” Test

- An executory contract is an agreement where “the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.”²

The “material breach” test has been used by the Courts of Appeals for the Third,³ Fourth,⁴ Seventh,⁵ Eighth,⁶ and Ninth Circuits.⁷

The “Functional Approach”

- “This test focuses upon whether or not the estate will benefit from the assumption or rejection of the contract: ‘even though there may be material obligations outstanding on the part of only one of the parties to the contract, [the contract] may nevertheless be deemed executory under the functional approach if its assumption [or] rejection would ultimately benefit the estate and its creditors.’”⁸
 - An oft-cited early case utilizing a functional approach is *In re Jolly*, 574 F.2d 349, 351 (6th Cir. 1978) (“Such definitions [as the “material breach” test] are helpful, but do not resolve this problem. The key, it seems, to deciphering the meaning of the executory contract rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can’t be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act.”).

² V. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1974).

³ *Enterprise Energy Corp. v. United States (In re Columbia Gas Sys.)*, 50 F.3d 233, 239 (3rd Cir. 1995).

⁴ *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 264 (4th Cir. 2004).

⁵ *In re Streets & Beard Farm Partnership*, 882 F.2d 233, 235 (7th Cir. 1989).

⁶ *Cameron v. Pfaff Plumbing & Heating, Inc.*, 966 F.2d 414, 416 (8th Cir. 1992).

⁷ *In re Pacific Express, Inc.*, 780 F.2d 1482, 1487 (9th Cir. 1986).

⁸ *Shoppers World Cmty. Ctr., L.P. v. Bradlees Stores (In Re Bradlees Stores, Inc.)*, 2001 U.S. Dist. LEXIS 14755 (S.D.N.Y. 2001) (quoting *Sipes v. Atlantic Gulf Communities Corp. (In re General Dev. Corp.)*, 84 F.3d 1364, 1374 (11th Cir. 1996)).

In the Sixth Circuit, courts consider the applicability of both the “material breach” test and the functional approach in determining whether a contract is executory.⁹

The Bankruptcy Code does not set a specific point at which this determination is made. The general rule is that the determination is made based on the status of the contract as of the petition date.¹⁰ There is a line of case law, however, holding that under some circumstances the determination of whether a contract is executory should be made as of the time the motion to assume or reject is brought.¹¹

b. Common Examples of Executory Contracts

Common examples of executory contracts include:

- Long-term purchase agreements;
- Service contracts;

⁹ See *In re Cardinal Indus.*, 146 B.R. 720, 729 (Bankr. S.D. Ohio 1992), where the bankruptcy court noted:

Reading the *Jolly* and *Terrell* decisions together demonstrates that the Sixth Circuit has used “the traditional definition of an executory contract enunciated in the legislative history and refined by Countryman, [and] it has also applied a practical, or ‘functional,’ approach in its determination of whether or not a contract is executory in a rejection context.” See *Structurlite*, 86 Bankr. at 926. Both decisions remain good law in this circuit. The more recent decision in *Terrell* cites the *Jolly* decision with approval, and there is no evidence that the court sought to overrule the functional approach of *Jolly*. Therefore, in determining whether or not an agreement is executory, a bankruptcy court, at least in this circuit, must consider the applicability of both the functional approach and the Countryman definition.

¹⁰ See *Enterprise Energy Corp. v. United States (In re Columbia Gas Sys.)*, 50 F.3d 233, 238 (3rd Cir. 1995) (“The time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed.”); *Annas v. Allard*, 272 B.R. 633, 643 (E.D. Mich. 2002); *Certified Class of Ohio Residential Customers of Level Propane Gases, Inc. v. Level Propane Gases, Inc. (In re Level Propane Gases, Inc.)*, 2007 U.S. Dist. LEXIS 45514 (N.D. Ohio 2007) (“The key date for determining the state of the contractual obligations and whether the contract is executory . . . is the date the bankruptcy petition was filed.”) (citing *In re Pomona Valley Med. Group, Inc.*, 476 F.3d 665, 669 n.1 (9th Cir. 2007) (citations omitted); *In re Gen. DataComm Indus., Inc.*, 407 F.3d 616, 623 (3rd Cir. 2005) (citation omitted); *In re Sunterra Corp.*, 361 F.3d 257, 264 (4th Cir. 2004) (citation omitted); *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996) (citation omitted); *In re Newcomb*, 744 F.2d 621, 624 (8th Cir. 1984)).

¹¹ See *In re B & K Hydraulic Co.*, 106 B.R. 131, 136 (Bankr. E.D. Mich. 1989) (“When termination of the contract requires an affirmative act of the non-debtor party, the contract remains executory because such an act is stayed under 11 U.S.C. § 362(a). When termination occurs without any action by the non-debtor party, the contract is no longer executory and no longer subject to assumption or rejection.”); *In re Pesce Baking Co.*, 43 B.R. 949, 957 (Bankr. N.D. Ohio 1984) (“The critical date for determining the executory nature of a contract is the date on which the bankruptcy court considers the debtor’s application. [citation omitted] Although a collective bargaining agreement may be executory on the date the debtor’s bankruptcy petition is filed, once the agreement expires of its own terms, the debtor’s application to reject it becomes moot.”); *In re Rioldizio, Inc.*, 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997) (“Ordinarily, executoriness is determined as of the petition date. [citations omitted] Sometimes, however, postpetition events alter the executoriness of a contract, as when a contract expires postpetition. In those circumstances, a court will look to the date the motion to assume or reject is made or heard rather than the petition date.”).

- Settlement agreements;
- Insurance contracts;
- Employment contracts;
- Construction contracts;
- Real estate sales contracts; etc.

This list is only illustrative, not exhaustive. As can be seen from the above definitions, a contract’s subject matter has no bearing on whether such contract is executory.¹²

c. Unexpired Leases

These generally speak for themselves. They are worth mentioning, however, to reiterate that to come within the reach of section 365, the lease must be *unexpired*. If the lease terminates pre-petition – it is not an unexpired lease. The determination of whether a lease has been irreversibly terminated pre-petition is a matter of state law.¹³ Similarly, if prior to assumption a lease expires by its own terms (e.g., the lease term naturally ends) – it is not an unexpired lease.

II. Available Treatment for Executory Contracts and Unexpired Leases

With each executory contract or unexpired lease, the trustee or debtor-in-possession¹⁴ has three options:

- Reject,
- Assume, or
- Assume and assign.

¹² As will be discussed below, certain contracts, such as personal services contracts and contracts to lend money, are excepted from the trustee’s ability to assume or assign under section 365(c), but they are still executory contracts.

¹³ See *In re 1345 Main Partners*, 215 B.R. 536, 541 (Bankr. S.D. Ohio 1997) (Applying Ohio law and noting that “as a general rule, the filing of a bankruptcy petition does not resurrect a lease, and a bankruptcy court does not have the power to resurrect a lease which was properly terminated under state law prior to the bankruptcy petition.”); *In re Waterkist Corp.*, 775 F.2d 1089, 1091 (9th Cir. 1985) (First, a determination must be made whether the lease was terminated under applicable state law prior to the bankruptcy filing. If so, a determination must be made as to whether termination “could have been reversed under a state anti-forfeiture statute or other applicable law.”)

¹⁴ 11 U.S.C. § 1107 (“[A] debtor in possession shall have all the rights ... and powers, and shall perform all the functions and duties, ... of a trustee serving in a case under [Chapter 11].”).

These rights cannot be waived by a debtor pre-petition.¹⁵ A contract cannot be assumed in part and rejected in part – it must be either accepted or rejected in its entirety.¹⁶

III. How will the executory contract(s) and/or unexpired lease(s) be treated under section 365?

Section 365 provides the debtor with the breathing space to determine which pre-petition contracts and unexpired leases are beneficial to the bankruptcy estate and should be assumed and retained or assigned, and which are detrimental and should be rejected.¹⁷ Different types of executory contracts and unexpired leases receive different treatment and are subject to different requirements under section 365.

a. Executory Contracts, Unexpired Residential Real Property Leases and Unexpired Personal Property Leases in Chapter 7

- Under section 365(d)(1), if the trustee does not assume or reject an executory contract or lease within **60 days** after the order for relief (or within such additional time as the court may fix for cause), then the contract or lease is deemed rejected.
 - Any extension for cause must be fixed within the original 60-day period, i.e., any extension must be granted prior to the expiration of the original period.

¹⁵ The court in *In re TWA*, 261 B.R. 103, 114 (Bankr. D. Del. 2001) noted:

A debtor's authority to assume or reject an executory contract "is vital to the basic purpose [of] a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization." *N.L.R.B. v. Bildisco*, 465 U.S. 513, 528, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984) (emphasis added). It seems [...] that a debtor's prepetition agreement not to reject an executory contract, or conversely, to assume such a contract, violates public policy in that it purports to bind the debtor-in-possession to a course of action without regard to the impact on the bankruptcy estate, other parties with a legitimate interest in the process or the debtor-in-possession's fiduciary duty to the estate.

¹⁶ *City of Covington v. Covington Landing Ltd. Partnership*, 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 bankruptcy court may excise material obligations owing to the non-debtor contracting party. *In re Village Rathskeller, Inc.*, 147 Bankr. 665, 671 (Bankr. S.D.N.Y. 1992) ('The agreement becomes property of the estate in the same shape as it existed prior to bankruptcy, with all of its benefits and burdens.')").

¹⁷ *Penn Traffic Co. v. COR Route 5 Co., LLC (In re Penn Traffic Co.)*, 2005 U.S. Dist. LEXIS 20407, 5-6 (S.D.N.Y. 2005).

- If a personal property lease is rejected or is deemed rejected, the leased property is no longer part of the bankruptcy estate.¹⁸ Under section 365(p)(2), the individual chapter 7 debtor can then notify the lessor in writing and express a desire to assume the previously rejected lease. If the lessor is willing, the individual debtor can assume the lease (and the debtor, not the estate, is liable).¹⁹

b. Executory Contracts, Unexpired Residential Real Property Leases and Unexpired Personal Property Leases in Chapter 9, 11, 12, or 13

- Under section 365(d)(2), executory contracts and unexpired residential real property and personal property leases can be assumed or rejected at **any time prior to, and including, plan confirmation**.
 - However, 365(d)(2) provides that the nondebtor party may request the court to order the trustee of debtor-in-possession either accept or reject within a specified time period.

c. Unexpired Non-Residential Real Property Leases

Sections 365(d)(3) and (d)(4) provide rather extensive protection for nondebtor parties to non-residential real property leases.

- Section 365(d)(3) requires that the trustee or debtor in possession timely perform all obligations of the debtor under an unexpired lease for non-residential real property (other than obligations relating to the debtor's financial condition) until the lease is assumed or rejected.
 - This is notwithstanding the provisions of section 503(b)(1) which limit administrative expense priority to those costs and expenses necessary to preserve the estate.²⁰
 - For cause, the court can extend the time for performance of obligations arising within 60 days from the order for relief, but such extension cannot go beyond the 60-day period.²¹

¹⁸ 11 U.S.C. § 365(p)(1).

¹⁹ *Id.* § 365(p)(2).

²⁰ *See Id.* §§ 365(d)(3) and 503(b)(1).

- The trustee or debtor-in-possession cannot retain possession of the non-residential real property without paying rent or incurring an administrative expense claim for the payment of rent in the amount called for under the lease that accrues after the order for relief.²²
 - To avoid incurring an administrative expense burden, the trustee or debtor-in-possession must reject a lease promptly. Vacating and abandoning a lease without rejection (or acceptance of the abandonment by the nondebtor lessor) will not be sufficient to avoid an administrative claim against the estate.²³
- Section 365(d)(4) provides that if a lease of non-residential real property (where the debtor is the lessee) is not assumed by the earlier of (1) **120 days** from the order of relief, or (2) **the entry of the confirmation order** – it is deemed rejected and the property must be immediately surrendered to the lessor.
 - On motion, one 90 day extension may be granted for cause prior to the expiration of the 120-day period.²⁴
 - Any subsequent extension may only be granted with the prior written consent of the lessor.²⁵

d. Unexpired Personal Property Leases in Chapter 11

- Section 365(d)(5) provides that in Chapter 11 cases, the trustee or debtor-in-possession must perform all obligations of the debtor under an unexpired lease of personal property that first arise on or after **60 days** from the order for relief, until such lease is assumed or rejected.
 - There is a narrow exception if the court, “after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof.”²⁶

²¹ *Id.* § 365(d)(3).

²² 1-14 *Collier Trustees & Debtors in Possession* P 14.07 (citing *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 40 C.B.C.2d 295 (7th Cir. 1998) and *Centerpoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205 (3rd Cir. 2001)).

²³ *Id.* (citing *In re Slim Life Weight Loss Ctrs., Corp.*, 182 B.R. 701 (Bankr. D.N.J. 1995)).

²⁴ 11 U.S.C. § 365(d)(4).

²⁵ *Id.*

²⁶ *Id.* § 365(d)(5).

- Section 365(d)(5) covers items such as equipment leased for use in the debtor’s business and expressly excludes from its coverage “personal property leased to an individual primarily for personal, family, or household purposes.”²⁷
- If the end of the 60-day period falls in the middle of a rental period, the payment should be prorated.²⁸

IV. Deciding to Assume or Reject

A range of factors must be taken into account in determining whether a lease or contract should be assumed or rejected. Although the precise factors to be considered will vary with the situation, the key is that they assist in achieving the most beneficial result for the bankruptcy estate. Some general considerations include:

- Whether money will be saved by assumption or rejection;
- The effect that assumption or rejection will have on the desirability of the debtor for acquisition;
- The effect assumption or rejection will have on operations; and
- The impact assumption or rejection will have on the debtor’s ability to effectuate a confirmable plan.²⁹

The trustee or debtor-in-possession’s decision to assume or reject is subject to the court’s approval.³⁰ The standard used by courts to grant or deny approval to assume or reject varies. The more prevalent approach calls for a court to examine the contract or lease in light of the surrounding circumstances, and then apply its “business judgment” to determine whether the decision to assume or reject will be beneficial or burdensome to the bankruptcy estate.³¹ Another line of cases holds that “except in extraordinary

²⁷ *Id.*

²⁸ 1-24 *Collier Trustees and Debtors in Possession* P 24.08 (2007).

²⁹ *See id.*

³⁰ 11 U.S.C. § 365(a) provides that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”

³¹ *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 1993) (“[T]he process of deciding a motion to assume is one of the bankruptcy court placing itself in the position of the trustee or debtor-in-possession and determining whether assuming the contract would be a good business decision or a bad one.”).

situations, [court approval to assume or reject under section 365] should be granted as a matter of course.”³²

V. Contracts Incapable of Assumption and/or Assignment

Certain contracts are incapable of assumption and/or assignment under section 365. Specifically, those to which applicable law excuses the nondebtor party to the contract or lease from accepting performance from, or rendering performance to, an entity other than the debtor or the debtor in possession.³³ This preserves the common law non-assignable nature of personal services contracts. Unless the nondebtor party consents, assumption and assignment are not possible under section 365.³⁴

Also excepted from assumption or assignment under section 365, are contracts to make loans, extend debt financing or other financial accommodations to or for the benefit of the debtor or its issue.³⁵

VI. Manner in Which Assumption, Assumption and Assignment, and Rejection are Practically / Procedurally Achieved

Assumption or rejection can be procedurally accomplished by motion or through a plan under Chapter 9, 11, 12, or 13. Either way, the court must approve. If the request to assume, reject, or assign is brought by motion, it is a contested motion governed by *Federal Rule of Bankruptcy Procedure* 9014.³⁶ Notice of the motion must be served on the nondebtor party to the contract or lease, the other parties in interest as directed by the court, and the United States trustee.³⁷

Below is a short discussion of the requirements and effects of assumption, assignment, and rejection under section 365.

³² *In re Farrar McWill, Inc.*, 26 B.R. 313, 315 (Bankr. E.D. Ky. 1982) (citing *In re Summit Land Co.*, 13 B.R. 310, 315 (Bankr. D. Utah 1981)).

³³ 11 U.S.C. § 365(c)(1).

³⁴ *Id.*

³⁵ *Id.* § 365(c)(2).

³⁶ See *Federal Rule of Bankruptcy Procedure* 6006(a) (“A proceeding to assume, reject, or assign an executory contract or unexpired lease, other than as part of a plan, is governed by Rule 9014.”).

³⁷ See *Federal Rule of Bankruptcy Procedure* 6006(c).

a. Assumption

Preparing to Assume

If there has been no default in the executory contract or lease, then the trustee or debtor-in-possession needs only court approval to assume.

However, If there has been a default (other than of a type explicitly excepted),³⁸ several requirements must be met prior to assumption. The trustee or debtor-in-possession must (1) cure the default or provide adequate assurance that it will be cured promptly, (2) compensate the nondebtor party for any actual pecuniary loss suffered as a result of the default or provide adequate assurance of prompt compensation, and (3) provide adequate assurance of future performance under the contract or lease.³⁹

What constitutes “adequate assurance” in a particular case is left to be developed by the facts and circumstances of that particular case.⁴⁰ In some cases, cure or compensation for actual loss may be provided in a form other than cash payment, so adequate assurance of prompt cure or compensation may involve something other than the availability of cash.⁴¹ Courts interpreting the “adequate assurance of future performance” requirement have adopted a pragmatic approach, focusing on the ability to meet the financial obligations of the contract.⁴²

³⁸ Excepted from the pre-assumption requirements of 365(b)(1) are those defaults resulting from

a breach of a provision relating to--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; 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 under the executory contract or unexpired lease.

11 U.S.C. § 365(b)(2)

³⁹ *Id.* § 365(b)(1).

⁴⁰ 1-365 *Collier Bankruptcy Manual*, 3d Edition Revised P 365.05 (2005).

⁴¹ *Id.*

⁴² *In re GlycoGenesys, Inc.*, 352 B.R. 568, 578 (Bankr. D. Mass. 2006) (citing *In re Martin Paint Stores*, 199 B.R. 258 (Bankr. S.D.N.Y. 1996); *In re Carlisle Homes, Inc.*, 103 B.R. 524 (Bankr. D. N. J. 1988)); *see also, In re Rachels Industries, Inc.*, 109 B.R. 797, 803 (Bankr. E.D. Tenn. 1990) (“[C]ourts often determine whether adequate assurance of future performance has been offered by considering ‘whether the debtor’s financial data indicated its ability to generate an income stream sufficient to meet its obligations, the general economic outlook in the debtor’s industry and the presence of a guarantee.’”) (quoting *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985)).

Effect of Assumption

Assumption of a contract or lease entails the benefits as well as the burdens associated therewith.⁴³ Following assumption, “the estate becomes liable for performance of the entire contract, as if bankruptcy had never intervened.”⁴⁴ The expenses and liabilities incurred as a result of the assumption are entitled to administrative priority under section 503(b)(1).⁴⁵ This administrative priority includes pre-petition defaults to the contract or lease assumed.⁴⁶

b. Assumption and Assignment

Preparing to Assign

Before a lease can be assigned, section 365(f)(2) requires that it be assumed.⁴⁷ Thus, if there has been a default, the requisites of section 365(b)(1) must be complied with.

Whether there has been a default or not, adequate assurance of future performance must be provided the counterparty to the lease or contract before it can be assigned.⁴⁸ What qualifies as “adequate assurance of future performance” under section 365(f)(2) is the same as that required under section 365(b)(1).⁴⁹

Negation of Attempts to Prohibit Assignment

With the exception of the limitations imposed by section 365(c), contracts and leases are generally assignable under section 365(f) notwithstanding contrary provisions or terms in a lease or contract. Terms attempting to prohibit, condition, or restrict

⁴³ *In re Rachels Industries, Inc.*, 109 B.R. 797, 803 (Bankr. E.D. Tenn. 1990).

⁴⁴ *Id.* (quoting *In re Airlift International, Inc.*, 761 F.2d 1503, 1508 (11th Cir. 1985)).

⁴⁵ *Adventure Resources v. Holland*, 137 F.3d 786, 798 (4th Cir. 1998) (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984)).

⁴⁶ *Adventure Resources v. Holland*, 137 F.3d 786, 799 n. 18 (4th Cir. 1998) (citing *LJC Corp. v. Boyle*, 248 U.S. App. D.C. 56, 768 F.2d 1489, 1494 n.6 (D.C. Cir. 1985); *Mass. Air Conditioning & Heating*, 196 B.R. 659 at 663; *In re Moline Corp.*, 144 B.R. 75, 79 (Bankr. N.D. Ill. 1992); *In re French*, 131 B.R. 138, 141 (Bankr. E.D. Mo. 1991); *In re Leon's Casuals Co., Inc.*, 122 B.R. 768, 771 (Bankr. S.D. Ala. 1990); *In re Monroe Well Serv., Inc.*, 83 B.R. 317, 321 (Bankr. E.D. Pa. 1988); *Mushroom*, 78 B.R. 754 at 759; 2 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY P 365.08[1] (15th ed. 1996) (“[A] trustee must proceed cautiously in electing whether to assume or reject [an executory contract] since an assumption will have the effect of making the expenses and liabilities incurred expenses of administration.”); Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 525 (1996)).

⁴⁷ 11 U.S.C. § 365(f)(2)(A).

⁴⁸ *Id.* § 365(f)(2)(B).

⁴⁹ See footnote 42, *supra*.

assignment are rendered unenforceable by section 365(f)(1). Moreover, section 365(f)(3) invalidates terms or provisions of the contract, lease, or applicable law which would permit termination because of assumption or assignment.⁵⁰

Effect of Assignment

Once a contract or lease has been assigned, section 365(k) relieves the trustee and the estate from any liability for breaches occurring after the assignment.⁵¹ This varies from the common law rule that the assignor remains ultimately liable after assignment until the obligations owed are discharged.

c. Rejection

As discussed above, rejection can be achieved by either affirmative act or passive inaction.

Effect of Rejection

When an executory contract or unexpired lease not previously assumed is rejected, such rejection is treated as a breach occurring immediately before the petition date.⁵² The result is a pre-petition non-priority breach of contract claim.⁵³

If the contract or lease has been assumed and is subsequently rejected, such rejection constitutes a breach at the time of rejection.⁵⁴ Whether the damages resulting from such a breach are entitled to administrative priority under section 503 is an open question. A leading treatise suggests that the “better approach” is to recognize that the estate received the benefit of the contract at the time it was assumed and therefore any damages flowing from the subsequent breach should be viewed as administrative priority expenses.⁵⁵

⁵⁰ See generally, 3-365 *Collier on Bankruptcy*-15th Edition Rev. P 365.08 (2007).

⁵¹ 11 U.S.C. § 365(k).

⁵² *Id.* §§ 365(g)(1) and 502(g).

⁵³ Certain types of creditors, particularly lessors of non-residential real estate, suffer less exposure to these consequences than would otherwise be the case as a result of section 365(d)(3) which gives their claims administrative priority for amounts accruing post-petition.

⁵⁴ 11 U.S.C. § 365(g)(2)(A).

⁵⁵ 3-365 *Collier on Bankruptcy*-15th Edition Rev. P 365.09 (2007) (citing *Adventure Resources v. Holland*, 137 F.3d 786 (4th Cir. 1998); *Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2nd Cir. 1996) ; *Elliott v. Four Seasons Props. (In re Frontier Props., Inc.)*, 979 F.2d 1358 (9th Cir. 1992)).

If the contract or lease is assumed, the case is converted under section 1112, 1208, or 1307, and then the contract is rejected, such rejection constitutes a breach occurring immediately prior to the conversion.⁵⁶

VII. Enforcement of the Executory Contract by the Estate Prior to Assumption or Rejection

This is a particularly difficult subset within an already nuanced legal area, but some general observations can be made.

Prior to assumption or rejection, the nondebtor party to a contract remains bound to perform, while the trustee or debtor-in-possession is not (save certain exceptions such as 365(d)(3)⁵⁷).⁵⁸ Although the nondebtor party to the contract may “not find this state of affairs particularly palatable,”⁵⁹ it is not without options.

The nondebtor party can request, pursuant to 365(d)(2), that the court order the trustee or debtor-in-possession assume within a specified period of time. Additionally, cases have held that where the trustee or debtor-in-possession “induces a nondebtor to render performance pursuant to an unassumed prepetition executory contract, pending its decision to reject or assume, the nondebtor party will be entitled to administrative priority ... to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate.”⁶⁰ Thus, in some circumstances, the nondebtor party can receive an administrative priority at least for those goods or services rendered post-petition, even if the contract is ultimately rejected. If the contract is ultimately assumed, then all of the nondebtor party’s claims relating to such contract (including pre-petition claims) would be afforded administrative priority.⁶¹

⁵⁶ *Id.* § 365(g)(2)(B).

⁵⁷ As discussed earlier, nondebtor parties to non-residential real estate leases are afforded significant protection for claims accruing post-petition.

⁵⁸ *Mason v. Official Comm. of Unsecured Creditors (In re FBI Distrib. Corp.)*, 330 F.3d 36, 43 (1st Cir. 2003) (“Although during the Chapter 11 proceeding a prepetition executory contract remains in effect and enforceable against the nondebtor party to the contract, the contract is unenforceable against the debtor in possession unless and until the contract is assumed.”).

⁵⁹ Douglas W. Bordewieck, *ARTICLE: The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 Am. Bankr. L.J. 197, 200 (Summer 1985).

⁶⁰ *In re FBI Distrib. Corp.*, 330 F.3d at 42-43.

⁶¹ See *Adventure Resources v. Holland*, 137 F.3d 786, 798 (4th Cir. 1998) (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984)).

VII Concluding Thoughts

The above materials have only scratched the surface of the treatment of executory contracts and unexpired leases in bankruptcy. Familiarity with the area is important for practitioners of all types; consumer and commercial, debtor and creditor, and so on. Issues in the area arise too frequently, with stakes too high, for a practitioner not to expend the time necessary to develop and maintain a working knowledge of the area.