Boyd & Hembree LLP

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| To: | William Nash, GC of Vandelay Industries |
| From: | Suzanne Boyd |
| Date: | October 31, 2014 |
| re: | Treatment of Executory Contracts and Unexpired Leases in Bankruptcy  |
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When a company files for protection under chapter 11 of the Bankruptcy Code, it may usually “assume” or “reject” its “executory contracts” and unexpired leases at any time prior to confirmation of a plan of reorganization. Section 365(a) of the Bankruptcy Code provides this right. It permits the debtor to retain (*i.e*., assume) those contracts and leases that are beneficial to it and walk away from (*i.e*., reject) those that are not. An executory contract is any contract under which both parties to the contract have remaining material unperformed obligations. Courts set a low bar to finding that a contract is executory and they generally favor allowing a debtor to assume or reject its executory contracts.

The ability to assume or reject executory contracts is a powerful tool for a debtor. When a debtor “assumes” an executory contract, the debtor agrees, in effect, to continue to honor and perform under the executory contract through the term of the contract, both for the balance of the bankruptcy case as well as after the debtor emerges from bankruptcy. The non-debtor party to the contract is then required to perform under the contract. When a debtor “rejects” an executory contract, it repudiates its further obligations under the contract. As discussed below, the non-debtor to the contract may file a claim in the bankruptcy case for damages arising from the rejection. That claim is treated similarly to other pre-bankruptcy claims against the debtor and may be compromised (or paid less than in full) in a plan of reorganization.

One important limitation on a debtor’s ability to assume or reject an executory contract is that, absent consent of the non-debtor party to the contract, the debtor must assume or reject the whole executory contract. The debtor may not cherry-pick provisions that it likes and wants to assume, but reject other provisions of the same contract. Absent consent, an executory contract must be assumed or rejected in its entirety, with all of its benefits and burdens.[[1]](#footnote-1)

The bankruptcy court must authorize the debtor’s proposed assumption or rejection of each of its executory contracts. Because bankruptcy courts are generally deferential to a debtor’s determination to assume or reject a contract, a court will approve the debtor’s determination if it is supported by sound business judgment. A debtor will assume those executory contracts which it believes are prospectively economically advantageous to it and it will reject those contracts which it believes are not prospectively economically advantageous to it. Pending court approval of the debtor’s determination to assume or reject, the non-debtor party must continue to perform its obligations under the executory contract.

When a debtor rejects an executory contract, the non-debtor party to the rejected contract may file an unsecured claim against the debtor for damages that arise from rejection of the contract. This claim is deemed to have arisen immediately before the filing of the bankruptcy case and is treated as a pre-bankruptcy claim. The non-debtor party will be entitled, however, to be paid in full for its performance under the contract from the date of the bankruptcy filing until the date of rejection of the contract.

A claim based on rejection of an executory contract is generally limited to the actual damages sustained as a result of the rejection. The calculation of damages is controlled by underlying state law, not by bankruptcy law. By way of example, say that a debtor has agreed to a contract to purchase 100 widgets per year for the next 3 years at $50/widget. If the market price for widgets falls, the debtor will ordinarily seek to reject the contract and, after rejection, the non-debtor party may file a claim against the debtor for its damages arising from the contract rejection. In the example above, the non-debtor may file a claim arising from the rejection of the contract for as much as $15,000 (100 widgets per year \* $50/widget \* 3 years). That claim will be treated and paid along with similarly situated creditors that had claims that arose prior to the filing of the bankruptcy case.

Additionally, state law ordinarily requires that a party to a breached contract use reasonable efforts to mitigate its damages from the breach. The same is required in bankruptcy from the non-debtor counterparty to a rejected executory contract. Any mitigation achieved by the non-debtor party will reduce that party’s claim against the debtor. Consider again the widget example above. If, after rejection, the non-debtor is able to find a different buyer for the same widgets over the same time period, but who will only pay $40/widget rather than the $50/widget the debtor had agreed to pay, the rejection damages claim that the non-debtor can file is based upon the difference in price it can obtain for its widgets. In this example, the rejection damages claim will be limited to $3000 (100 widgets per year \* $10/widget reduction in contract price \* 3 years).

While state law governs the calculation of damages, the Bankruptcy Code also imposes certain caps on some claims for so-called “rejection damages.” Damages arising from the rejection of a lease of non-residential real property are capped under section 502(b)(6) of the Bankruptcy Code (note that no other damages are subject to this cap, such as unpaid pre-bankruptcy rent for a store lease). Under that section, a lessor’s claim for rejection damages is limited to the greater of (a) one year’s worth of rent, or (b) 15% of the remaining amount due under the lease (calculated from the earlier of the date of the bankruptcy or the date the landlord repossesses the premises), not to exceed three years of rent. Different courts address the calculation of a “year” of rent differently. Some calculate it based upon time remaining on the lease (*i.e*., the cap is calculated utilizing the rent due in the first year to three years after rejection); others calculate it by utilizing the average annual rent based on the remaining amount due under the lease during the remaining term of the lease (which, for example, will capture rent escalation provisions in a lease that occur later in the term of the lease). For purposes of this competition, if you determine that section 502(b)(6) applies in your analysis, you should calculate the cap based on the average remaining amount due under the lease (*i.e*., taking into account any rent escalation provisions during the remaining term of the lease).

The power to assume or reject an executory contract in bankruptcy is a significant benefit to a debtor. One benefit is time—a debtor may assume or reject most of its executory contracts at any time prior to confirmation of a plan of reorganization. Pending assumption or rejection, the debtor may force the non-debtor to continue to perform under the executory contract. Leases of non-residential real property, however, are treated slightly differently. Unlike other executory contracts, a debtor must assume or reject a lease of non-residential real property no later than 210 days after the commencement of the bankruptcy case. If the debtor does not assume the contract within this period, it is deemed to be rejected. A debtor can (and should) “time” its decision to assume or reject. If an executory contract is economically beneficial on day one, but becomes non-beneficial by the end of day 120 and thereafter, then the debtor should maintain the executory contract for the first 120 days of its bankruptcy and then reject the executory contract when it becomes non-beneficial.

One word of caution is appropriate in trying to “time” assumption or rejection of executory contracts. The debtor may only make the decision to assume or reject one time. If the debtor rejects, and its predictions of the future of the market do not turn out to be accurate, the debtor may not later seek to assume the contract. Similarly, if the debtor assumes the contract, it may not later seek to reject that same contract. The debtor’s post-filing failure to perform under the contract will be treated as post-bankruptcy breach. And in order to confirm a plan, the debtor must pay the damages for breaching the contract in full. Unlike a rejection, the claim that arises from the post-bankruptcy breach is not subject to being paid less than in full in the plan of reorganization.

1. It is not uncommon, and it is perfectly appropriate, for a debtor to seek to renegotiate some or all of its executory contracts in a bankruptcy proceeding based upon current market conditions and other circumstances. If the non-debtor agrees to modify certain terms of a contract in exchange for an assumption of that contract, that may be done with court approval. But a bankruptcy court will not allow a debtor to rewrite a contract unilaterally without consent of the non-debtor party to the contract. [↑](#footnote-ref-1)