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Ohman & Notgood LLP

TO: Kane Richardson, General Counsel of Hexative

FROM: Samantha Law, Esq.

DATE: February 18, 2021

RE: Executory contract and unexpired lease assumption and rejection

Commented [JL1]: Add section on 502(b)(6)

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” (hereafter referred to collectively as executory contracts) at any time prior to confirmation of a plan of reorganization pursuant to section 365(a) of the Bankruptcy Code. An executory contract is any contract under which both parties have remaining material unperformed obligations. Courts set a low bar to finding that a contract is executory and therefore, generally favor allowing a debtor to assume or reject its contracts.

The ability to assume or reject executory contracts is a powerful tool for a debtor in bankruptcy. When a debtor “assumes” an executory contract, the debtor agrees, in effect, to continue to honor and perform under the contract both for the balance of the bankruptcy case as well as after the debtor emerges from bankruptcy through the expiration of 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 against the debtor for damages in the bankruptcy for damages arising from the rejection (as well as other claims it may have) and that claim is treated similarly to other pre-bankruptcy claims against the debtor.

One important limitation on a debtor’s ability to assume or reject an executory contract is that, absent consent of the non-debtor party, the debtor must assume or reject the contract in whole; the debtor may not cherry-pick provisions from a contract that it wants to assume, while seeking to reject other provisions of the same agreement. Absent consent, an executory contract must be assumed or rejected in its entirety, with all of its benefits and burdens.¹

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 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. However, a debtor (and a bankruptcy court) may not unilaterally rewrite the debtor’s contracts without consent of the non-debtor party to the contract.

The Bankruptcy Court must authorize the debtor's proposed assumption or rejection of each of its executory contracts. Bankruptcy courts are generally deferential to a debtor's determination to assume or reject and will generally approve the debtor's determination if it is supported by sound business judgment. Generally, a debtor will assume those executory contracts it believes are prospectively economically advantageous and will reject those contracts it believes are not prospectively economically advantageous. Pending court approval of the debtor's determination to assume or reject, the debtor and the non-debtor party must continue to perform their obligations under the contract. In this regard, the non-debtor party generally remains entitled 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.

When a debtor rejects an executory contract, the non-debtor party to the rejected contract may file a claim against the debtor for damages that arise from the rejection of the executory contract. The calculation of damages is controlled by underlying state law. By way of example, if a debtor has a contract to purchase 100 widgets per year for the next 3 years at \$50/widget and 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 this example, 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.

State law (which generally governs the calculation of claims against the debtor) 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 and 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 – \$3000 (100 widgets per year * \$10/widget reduction in contract price * 3 years).

The power to assume or reject an executory contract in bankruptcy is significant for a debtor. It permits the debtor to retain (*i.e.*, assume) those contracts that are beneficial to it and walk away from (*i.e.*, reject) those that are not. Furthermore, those contracts that it rejects are treated as pre-bankruptcy claims that may be compromised (or paid less than in full) in a plan of reorganization. The debtor is also given the luxury of time – it may assume or reject its executory contracts at any time prior to confirmation of a plan of reorganization and, pending that determination, it may force the non-debtor to continue to perform under the executory contract. Therefore, a debtor can (and should) “time” its decision to assume or reject. If an executory contract is economically

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beneficial on day 1, 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 (to extract the benefit) and thereafter reject the executory contract when it becomes non-beneficial on day 120.

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. Rather, it may breach the contract. However, that breach is treated as a post-bankruptcy filing breach (rather than a pre-bankruptcy filing breach) and therefore the damages arising from the breach must be paid in full to confirm a plan of reorganization (and therefore, unlike a rejection, the claim that arises from the post-bankruptcy breach is not subject to compromise in the course of the bankruptcy case).