Hot Topics: Recent Cases on Executory Contracts and Unexpired Leases

By Aisha L. Williams and Jessica Gabel

The following is a review of recent decisions that address and discuss executory contracts, unexpired leases, and issues that arise under Section 365 of the Bankruptcy Code.


In this nonbankruptcy proceeding, Hayes Lemmerz sought a declaration that the Struktur Wheel did not infringe two patents held by Epilogics and Kuhl Wheels. The court granted Hayes’ non-infringement summary judgment motion. In relation to the summary judgment motion the district court made a number of other findings, including the enforceability of some executory contracts.

Hayes argued that Kuhl’s non-patent claims were barred by Hayes’s Chapter 11 bankruptcy proceeding. Hayes specifically argued that the claims were barred because the license was an unenforceable executory contract, and the alleged infringing conduct occurred post-petition. The court found that there was an executory contract (under the Countryman functional approach), and that prior to the filing of the petition Hayes had neither accepted nor rejected the contract between December 5, 2001, the filing of its bankruptcy petition, and January 10, 2003, the date the license was terminated by Kuhl. Moreover since Kuhl did not establish reasonable value of any post-petition benefits it provided to Hayes by a preponderance of the evidence, Kuhl could not recoup any loss under 11 U.S.C. § 503.

**Take Away:** Patent holders with infringement claims should seek an accord with the debtor to reject or accept executory contracts. Terminating a license agreement will only bar recovery.


Action arose out of an agreement between Defendant Bob Cummins Construction and Technomarine (Raddison was Technomarine’s assignee). Cummins subcontracted with Technomarine for the design, manufacture, and delivery of a floating dock system for a marina project. Technomarine’s performance suffered and Cummins had to compensate for Technomarine’s failure to timely pay its own subcontractors and for the failure to undertake

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warranty services on its work. Technomarine then filed bankruptcy in Canada and its assignee sought payment from Cummins under the subcontract.

Cummins argued that the assignment of the executory contract from Technomarine to Raddison was invalid under 11 U.S.C. § 365(c)(1). Cummins asserted that the Canadian trustee’s assignment of the subcontract violated Pennsylvania common law stating that a right “may not be effectively assigned where such assignment is prohibited by the writing creating the right.” The court rejected Cummins’ argument. It held that the common law was a public policy exception; one that was not implicated by the facts of the case. In order to be enforced the court held that the non-assignment clause must implicate issues that are so injurious or critical to public health and morals.

**Take Away:** Courts will analyze common law in the context of ipso facto clauses and can require something akin to irreparable harm before they will enforce a non-assignment clause.


Debtor and three affiliates filed a Chapter 11 case and confirmed a plan. The plan provided that, with certain exceptions, debtor's obligations to pay retirees benefits would continue and, further, that all retirement plans and compensation and benefit plans applicable to former employees or retirees would be treated as executory contracts which, on the effective date, would be deemed assumed pursuant to the provisions of §§ 365 and 1123(b). A former executive filed a claim for his Selective Executive Retirement Agreement (“SERP”) payments. At the date of filing, the former executive had retired and had received three of the ten annual payments due under the SERP; the debtor discontinued SERP payments, leaving a claim for the final seven payments.

The executive argued that the plan deemed all retirement plans, including the SERP, to be assumed executory contracts. As a result, the executive argued that the debtor should cure all defaults and continue making payments under the SERP. The Delaware bankruptcy court ruled that the SERP was not an executory contract, the plan could not deem it to be such, and the SERP could not be assumed in the plan. The bankruptcy court noted that the agreement specifically provided that the executive’s benefits were fully vested upon the effective date of his retirement. There was no dispute that the executive’s rights under the SERP thus vested prior to the bankruptcy filing, but the executive had no obligation to continue in the employ of the company in any capacity or to do anything material. Finally, the plan language could not “deem” a nonexecutory contract to be an executory contract so that a debtor could assume it.

**Take Away:** “A debtor cannot change the nature of a contract merely by electing to assume it under § 365.” In other words, the court refused to rewrite the plan of reorganization to “deem a non-executory contract to be an executory contract.”


In this Chapter 7 case, Colvin formed an LLC with others to operate a World Gym franchise in Idaho. The business needed cash infusion from the owners. Colvin could not honor the calls for new capital and the other LLC members made up his difference. A contract was eventually
drafted for the purpose of buying Colvin out (the “Buy-Out Agreement”). The LLC subsequently failed to pay Colvin the money due under the Buy-Out Agreement. Colvin later attempted to lure several key World Gym employees to the new gym where he worked. Colvin eventually filed bankruptcy and the trustee filed an adversary proceeding to recover the $45,000 owed under the Buy-Out Agreement.

The bankruptcy court found that the Buy-Out Agreement was executory because, on the one hand, the LLC owed Colvin money, and, on the other hand, Colvin had a continuing obligation to not hinder, delay, or tarnish the LLC. Ultimately, however, the court deemed the contract rejected by operation of law because the debtor made no motion to assume the contract in the first 60 days of bankruptcy as required by 11 U.S.C. § 365(d). The rejection therefore constituted a breach.

Take Away: Trustees, creditors, and debtors need to pay close attention to the 60-day deadline in §365(d). The court also observed in a footnote that Colvin’s duties under the agreement may have been akin to those of a personal services contract, a type of executory contract that may not be assumed by the trustee. 11 U.S.C. § 365(c)(1).

Prior to the filing of the bankruptcy case, the debtor, to avoid the enforcement of a default judgment by a former employee, entered into a settlement agreement with the employee under which it agreed to make payments for a specified period of time. After filing Chapter 11, the debtor argued that the settlement agreement was an executory contract, subject to rejection under 11 U.S.C. § 365(a).

The Court analyzed the settlement agreement both under the “Countryman” and “functional analysis” definitions of an executory contract and concluded that the agreement did not meet either definition. Under the Countryman definition, the mere right of the former employee to collect payments under the agreement was insufficient for the agreement to be deemed an executory contract. Under the “functional analysis” definition, the agreement was not executory because funds had already been deposited into the registry of the court and earmarked for payment to the former employee. Thus, the employee was a secured creditor and not a party to an executory contract.

Take Away: In order for the debtor to trigger its rights under 11 U.S.C. § 365(a) in the context of a settlement agreement, on the petition date the agreement must contain ongoing obligations for both parties.

In re Samaritan Alliance, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007)
Samaritan Alliance (“Samaritan”) entered into an acquisition agreement and a master lease agreement with Ventas Realty LP, under which Ventas acquired a hospital and then leased it back to Samaritan. Samaritan subsequently entered into various agreements with Cardinal Hill Rehabilitation Unit (“Cardinal Hill”), including a sublease agreement which permitted Cardinal Hill to open a nursing facility on the 7th floor of the hospital. In contemplation of its bankruptcy filing, Samaritan and Ventas entered into an agreement terminating the original lease. Simultaneously, Ventas entered into a new lease with the University of Kentucky (the
“University”). Four days later, Samaritan filed its Chapter 11 petition and all of Samaritan’s assets were subsequently sold to the University.

The central issue in the case was whether the Cardinal Hill retained its rights under 11 U.S.C. § 365(h). University argued that even if Cardinal Hill retained such rights, 11 U.S.C. § 365(f) allowed University to purchase the hospital free and clear of all liens and encumbrances, including Central Hill’s rights as a sublessee. The Court disagreed, stating that Cardinal Hill’s interest in the hospital remained pursuant to the sublease under 11 U.S.C. § 365(h) even in the context of a 363(f) sale.

**Take Away:** Real property of a debtor transferred to another party in a 363(f) sale may still be subject to the rights of a sublessee through the operation of § 363(h).


In this tax court case, the Greenfields were selected by the IRS for audit and the Greenfields consented to the IRS’s request to extend the limitations period under which it could assess further taxes in connection with the audit (the “Consent Agreement”). Six years later, Mr. Greenfield filed a Chapter 11 bankruptcy petition. The IRS filed three proofs of claim in the bankruptcy proceeding. The proceeding was later converted into a Chapter 7 liquidation and the IRS claims were paid. Eighteen years after the date that the Greenfields signed the Consent Agreement with the IRS, the IRS sent a notice of default to the Greenfields assessing taxes in connection with their 1982 tax return.

The Greenfields argued that the Consent Agreement was an executory contract which had been automatically rejected in the bankruptcy case by operation of 11 U.S.C. § 365(d)(1). The IRS argued that this consent was merely a unilateral waiver of the Greenfields’ right to the original period of limitations. The court agreed, reasoning that while this was the first case in which the particular consent form at issue had been considered in the bankruptcy context, courts have consistently found such consent to be a unilateral waiver and there was no reason to carve out a special rule in the bankruptcy context.

**Take Away:** Contractual waiver of an affirmative defense does not create an executory contract which would be subject to assumption or rejection by a debtor.

*In re Nickels Midway Pier, LLC*, 2007 WL 4171114 (3d Cir. Nov. 27, 2007)

Wild Waves and Nickels Midway Pier reached an agreement which required Wild Waves to lease a portion of an entertainment pier for three years and thereafter to purchase it in accordance with the terms of an unexecuted agreement.

The court first dealt with the issue of whether the lease and sale agreements were divisible portions of one agreement and held that it was. To prevent the sale agreement from being rejected, Wild Waves argued that, in accordance with New Jersey law, it had the option of treating the agreement as terminated upon the occurrence of an anticipatory repudiation. The
court concluded that there was no factual support for the anticipatory repudiation claim. Wild Waves subsequently argued that even if the sale agreement was executory, it was entitled to remain “in possession” of the pier under 11 U.S.C. § 365(i) because of its lease with Nickels. Again, the court disagreed, reasoning that Wild Waves’ failure to make the appropriate payments toward the purchase of the pier precluded Wild Waves from obtaining the protection of that provision.

**Take Away:** The protection of 11 U.S.C. § 365(i) may be unavailable to putative purchasers of real property who have not made payments toward that purchase.