By Lisa S. Gretchko and Mark A. Bogdanowicz

How to Represent the Client that Wants Its Contract Rejected

Lisa S. Gretchko
Howard & Howard Attorneys PLLC
Royal Oak, Mich.

Mark A. Bogdanowicz
Howard & Howard Attorneys PLLC
Peoria, Ill.

Lisa Gretchko is a shareholder with Howard & Howard Attorneys PLLC in Royal Oak, Mich. She also serves as an ABI Director and an executive editor for the ABI Journal, *as well as co-chair of ABI's Unsecured Trade Creditors Committee. Mark Bogdanowicz is a shareholder in the firm's Peoria, Ill., office and serves as co-chair of ABI's Labor and Employment Committee.*

Almost universally, contract counterparties want a chapter 11 debtor to assume its executory contracts and unexpired leases. Since § 365(b)(1) of the Bankruptcy Code requires the debtor in possession to cure all defaults (or provide adequate assurance of prompt cure) in order to assume a contract or lease, assumption is like a dream come true for the contract counterparty insofar as it results in full payment of the pre-petition claim and insulates the contract counterparty from a potential preference action.[1] Bankruptcy practitioners are accustomed to representing clients that want the debtor to assume their executory contracts.

But what happens when the contract counterparty wants the chapter 11 debtor to *reject* an executory contract or unexpired lease? How does a bankruptcy lawyer handle that situation? Although the request is rare and seems counter-intuitive, it *does* occur and raises entirely different issues from the typical contract assumption/assignment issues.

The first question that the practitioner should ask a client is, "*Why* do you want the debtor to reject the contract?" The client may in fact have a good business reason for craving rejection. It may have closed a plant or suffered a serious loss at a plant (*i.e.*, fire, roof collapse, etc.), or the debtor may have curtailed or shut down operations as it slid into bankruptcy, forcing the client to find *other* customers in order to stay in business. Consequently, the contract counterparty might have so much work from its new customers that it lacks the production capability to handle the debtor's work. With unexpired nonresidential leases, the landlord may have found a stronger tenant to fill the space and might *want* the debtor to reject the lease. Similarly, the rent that was negotiated many years ago may now be below market value, and a new lease at current market rates may be economically advantageous. Once the lawyer understands *why* the contract counterparty "craves rejection," the lawyer is better able to answer based on the legal issues and obstacles.

Of course, the first obstacle is the fact that § 365(a) of the Bankruptcy Code gives the debtor (*not* the contract counterparty) the right to choose what contracts to assume and reject. Since contract assumption (and rejection) are subject to court approval, the contract counterparty that craves rejection will have an opportunity to object to any proposed assumption or assignment, but it must timely do so. In situations where the debtor's assets are being sold early in the case, the debtor often implements tight timetables or special procedures regarding the assumption and rejection of executory contracts. Counsel for the contract counterparty needs to be particularly alert to those deadlines and procedures.

Taking Control Before a Case Is Filed

For the contract counterparty who wants its contract rejected, one way (perhaps the most effective way) to fend off a debtor's attempt to assume a contract is to demonstrate that there is no executory contract or lease in existence. Counsel should carefully review the facts to determine whether the pre-petition executory contract or lease has been cancelled or terminated, or whether it expired pre-petition. This analysis often requires a return to basics — like the Uniform Commercial Code (UCC) or basic lease law.

The Uniform Commercial Code provides valuable ammunition to a contract counterparty that seeks rejection. Debtors often *slide* into bankruptcy, leaving a swath of defaults and broken promises in their wake. The contract counterparty often had reasonable pre-petition grounds for insecurity and demanded adequate assurance of future performance pursuant to UCC 2-609(1). If the debtor failed to provide adequate assurance of future performance within a reasonable time (not exceeding 30 days) pre-petition, then the debtor is considered to have *repudiated* the contract.[2] If the debtor repudiated all or part of the contract pre-petition, then UCC 2-703 permits the contract counterparty to cancel the contract.

Although termination of a contract pursuant to UCC 2-309(3) requires notice to the other party, "cancellation" pursuant to UCC 2-703 does not require notice to the other party. Thus, when counsel for the contract counterparty views the pre-petition facts through the prisms of UCC 2-609 and 2-703, he/she is more likely to find that the contract was actually cancelled pre-petition as a result of the debtor's failure to provide adequate assurance of future performance, and consequently, that there is no contract for the debtor to assume (or reject, for that matter). In that event, counsel can simply object to any proposed assumption. Since no executory contract exists, there is nothing to assume.

1 *See* Lisa S. Gretchko, "There's a Preference Defense Hiding in Plain View," *Am. Bankr. Instit. J.*, November 2007, at 16 and 43.

2 *See* U.C.C. 2-609(4).

For landlords, it is essential to have identified all potential events of default under the lease, as most recently amended, and to stay on top of cure periods with laser-like precision. Termination of most negotiated nonresidential real property leases is not self-executing. A prudent landlord will evaluate any alternatives for tenant replacement at the first signs of financial distress of the existing tenant and will immediately issue a notice of default, starting the clock on any applicable notice and cure period. Once that period lapses and the tenant's default remains uncured, the landlord will be well advised to transmit a lease-termination notice. Of course, the landlord faces a much easier situation if the lease term has expired pre-petition — assuming that there are no renewal options that have not already lapsed.

For national tenants, receipt of a default notice for one location is not likely to precipitate a bankruptcy filing. By contrast, the outcome may be quite different for "mom-and-pop" tenants with a single location. For purposes of bankruptcy, a lease is eligible for assumption unless it was terminated pre-petition. A lease merely being in default on the petition date will not suffice to prevent the possibility of a post-petition assumption. Without pre-petition termination, the tenant's leasehold interest becomes property of the tenant's bankruptcy estate. As such, the lease becomes hostage to the exercise of the tenant's business judgment with regard to assumption, assignment or rejection.

Once counsel for the contract counterparty can demonstrate that there is no executory contract or unexpired lease, he/she must raise that point whenever necessary. The most obvious time to raise the issue is in response to any motion to assume the contract or lease. However, executory contracts and unexpired leases do not always get assumed via motion; they are sometimes assumed in a proposed chapter 11 plan. Thus, unless counsel for the contract counterparty obtains language in a court order that expressly "trumps" any plan or confirmation order, the counterparty who seeks rejection needs to remain alert throughout the plan process in a chapter 11 case.

Forcing the Debtor's Hand Pre-Confirmation

In general, a chapter 11 debtor may assume, assign or reject an unexpired lease at any time prior to confirmation.[3] Under the appropriate set of facts, a contract counterparty may move the bankruptcy court to shorten that time period.[4] Bankruptcy courts have developed a multi-factor balancing test that weighs the harm to the movant against the harms to the bankruptcy estate.[5]

Not surprisingly, movants face significant hurdles in prevailing on such motions. As noted by Hon. **Susan Pierson Sonderby** (ret.) of the U.S. Bankruptcy Court for the Northern District of Illinois:

> Courts rarely force a debtor into assuming or rejecting a contract. The reason for the reluctance is that the "interests of the creditors collectively and the bankruptcy estate as a whole will not yield easily to the convenience or advantage of one creditor out of many."[6]

In denying the software licensor's motion to compel assumption of its executory contract, the bankruptcy court framed the issue in light of the importance of reorganization in chapter 11 cases. The court noted that debtors often decide what contracts and leases to assume in reliance upon a particular chapter 11 plan that is being confirmed.[7] Courts are often concerned with any situation in which debtors prematurely assume an executory contract or unexpired lease, only to find themselves unable to perform. In such scenarios, the debtors' decisions end up burdening the estate with additional administrative claims at the expense of general unsecured creditors.

The movant may stand a better chance of success on such a motion the longer a case has been pending — once the debtor has identified or should have identified what conditions need to be met for plan confirmation.[8] With the rapid speed at which large chapter 11 cases move these days, obtaining relief might be more aspirational than realistic, unless courts loosen the standard for compelling the debtor to assume or reject in order to accommodate the new face of chapter 11 cases.

Landlords of nonresidential real property have an opportunity to do slightly better. Section 365(d)(4)(B)(ii) of the Bankruptcy Code curtails a court's ability to extend the time that is needed for debtors to assume or reject a lease beyond the 210th day of a case without the landlord's prior written consent. If a debtor/tenant either fails to obtain such consent or fails to move the bankruptcy court for an extension of the initial 120-day period, the lease is deemed rejected and the landlord is free to secure a new tenant.[9]

Debtors continually try to devise new and creative ways to circumvent the statutory requirements of § 365(d)(4), such as the use of so-called "designation rights." Designation rights are a well-established creation of bankruptcy common law that allows debtors to "sell" their ability to assume and assign to a third party. The designation rights assignee, in turn, may subsequently assign the unexpired lease or executory contract to yet another third party for a fee. A problem arises when the sale documents provide that the designation rights period may be extended beyond the statutory 210-day maximum at the whim of the designation rights assignee. The appearance of designation rights in a sale motion or document should be a red flag for the contract counterparty counsel to carefully review the underlying documents and understand whether they have the potential to tie up or delay the decision to assume, assign or reject.

Losing Control: Watch Out for Auctions and Sale Procedures

As chapter 11 becomes more of a venue for liquidation rather than true reorganization, executory contracts and unexpired leases will become an increasingly important asset in order to maximize value for the benefit of the estate. Counsel for contract counterparties must be "on the lookout" for asset sales or auctions that contemplate the assignment of such contracts to third parties.

3 11 U.S.C. § 365(d)(2).
4 *Id.*
5 *See, e.g., In re Dana Corp.*, 350 B.R. 144, 147 (Bankr. S.D.N.Y. 2006).
6 *In re Kmart Corp.*, 290 B.R. 614, 620 (Bankr. N.D. Ill. 2003) (internal citations omitted).
7 *Id.* at 619-20.
8 *Cf. id.* at 620 (denying motion to compel assumption where complex case has only reached its first anniversary).
9 *See* 11 U.S.C. § 365(d)(4)(A).

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The first opportunity to exit the existing relationship presents itself when debtors propose cure amounts that significantly understate what is reflected in the counterparties' books and records. Counsel for the contract counterparty who craves rejection should quickly file an objection to "-0-" or understated cure amounts (with supporting documentation) to demonstrate the *true* cure amount owing. The executory contract or unexpired lease often loses its economic luster and "drops off" the list of assets to be assigned as part of a sale once the prospective purchaser sees the true cure amount that is owed to the contract counterparty, which is the easiest and least expensive way to secure a desired rejection. Unfortunately, debtors are increasingly proposing wildly compressed schedules in bidding and sale procedures; counsel for the contract counterparty should watch out for and object to procedures that provide no real notice and opportunity to object. If the court approves the tight schedule that debtors frequently propose, then counsel for the contract counterparty needs to be *especially* vigilant to file the objection to the cure amount on time.

Debtors often do not disclose the "proposed cure amount" until a few days before an auction or sale-approval hearing. Thus, to the extent that is possible, creditors should strongly negotiate for email notice of potential assignments, with copies to counsel. This avoids having the notice and adequate assurance package bounce around the office of the contract counterparty, leaving no practical time for its counsel to react and timely file an objection to the cure amount.

In the context of shopping center leases, landlords may have a further opportunity to obtain rejection, namely successfully challenging the replacement tenant on the grounds that "adequate assurance" has not been demonstrated. Section 365(b)(3) provides that

> adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance —
>
> (A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
>
> (B) that any percentage [of] rent due under such lease will not decline substantially;
>
> (C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
>
> (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

Although successfully opposing assumption and assignment on these grounds is more fact-intensive (and costly), it provides an alternative basis for landlords to regain control of their space in a rising economy.

The mere filing of an objection creates an opportunity for the contract counterparty and debtor to consensually reach a resolution of the issue. Debtors will often demand claim waivers or cash offers from the counterparty in exchange for a termination or "agreed rejection." Auction procedures frequently allow counterparties to participate in auctions and bid on their own unexpired leases or executory contracts. More "enlightened" procedures treat the counterparties as secured creditors, allowing them to credit-bid the amount of their cure claim at the auction. If a cure claim is large enough, counterparties may be able to avoid paying for the privilege of having their contracts rejected. In any event, counsel should carefully examine bid procedures to make sure that their clients have an ability to participate in the auction and are not denied access because they have not complied with any of many technical requirements for submitting a "qualified bid" under the court-approved bid procedures.

Conclusion

The rare contract counterparty that craves rejection requires bankruptcy counsel to look through a different prism in analyzing pertinent provisions of applicable law (whether that be the UCC, state lease law or the Bankruptcy Code). There will be several opportunities to accomplish the client's goal both before and during the chapter 11 case. However, getting there will require the contract counterparty and its counsel to carefully examine the facts and formulate an appropriate response. Obviously, the best outcome would be the counterparty discovering that there is no contract or lease to be assumed or having that contract or lease "drop off" the assumed list. If that does not come to pass, the counterparty, with the aid of its counsel, must assess how much to pay or give up in order to exit the relationship. abi