Chapter 7

Executory Contracts and Unexpired Leases of Nonresidential Real Property in Coal Bankruptcy Cases: An Overview for Operators, Landowners, Purchasers and Contract Parties Whose Interests May Be Impacted by Bankruptcy

Ronald E. Gold
Frost Brown Todd LLC
Cincinnati, Ohio

Adam R. Kegley
Frost Brown Todd LLC
Lexington, Kentucky

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§ 7.01. Introduction.

Several coal companies have filed voluntary and involuntary petitions for relief under title 11 of the United States Code (the “Bankruptcy Code”) in the past five years. As a result of these filings, various parties in the coal industry have been forced to become familiar with the impact of the

1 AEI Resources Holding, Inc., Case No. 02-10150 (Bankr. E.D. Ky. filed February 28, 2002); Anker Coal Group, Inc., Case No. 02-13597 (Bankr. N.D. W. Va. filed October 29, 2002); Cook and Sons Mining, Inc., Case No. 03-70789 (Bankr. E.D. Ky. filed August 25, 2003); Horizon Natural Resources Co., Case No. 02-14261 (Bankr. E.D. Ky. filed November 13 and 14, 2002); James River Coal Co., Case No. 03-4095 (Bankr. M.D. Tenn. filed March
Bankruptcy Code on their businesses. This chapter provides a general overview of merely one aspect of the Bankruptcy Code, specifically, section 365 of the Bankruptcy Code, that has become particularly relevant to more and more operators, suppliers, landowners, purchasers and other nondebtor contract and lease parties in the coal industry.

§ 7.02. Section 365 of the Bankruptcy Code.

[1] — Basic Overview of Section 365.

Section 365 of the Bankruptcy Code governs various rights and obligations between debtors, debtors in possession and trustees, and nondebtor parties to executory contracts and unexpired leases. Subject to certain restrictions, section 365 of the Bankruptcy Code gives a trustee or a debtor in possession the right, to assume, assume and assign or reject any executory contract or unexpired lease of the debtor. Rejection, assumption, and assumption and assignment of executory contracts and unexpired leases is subject to the approval of a bankruptcy court, which will utilize the business judgment standard in determining whether to authorize assumption or rejection. In addition to giving a trustee or a debtor in possession the right to assume, assume and assign or reject, section 365 of the Bankruptcy Code contains various provisions regarding the timing of assumption or rejection, assignment, performance, and the effects thereof, on both debtor and nondebtor parties to executory contracts and leases.


Section 365 of the Bankruptcy Code applies only to executory contracts and unexpired leases that a debtor entered into prior to the filing of a bankruptcy petition. As discussed below, contracts that are no longer executory, leases that have expired by their terms, and contracts and leases

30, 2001); Lodestar Energy, Inc., Case No. 01-50969 (Bankr. E.D. Ky. filed March 30, 2001); Pen Holdings, Inc., Case No. 02-979 (Bankr. M.D. Tenn. filed January 24, 2002); Quaker Coal Co., Case No. 00-51374 (Bankr. E.D. Ky. filed June 16, 2000).


3 Id. § 365.

4 Pursuant to 11 U.S.C. § 1107, a debtor in possession has most of the rights, powers and duties of a trustee.
entered into postpetition are all outside the scope of section 365 of the Bankruptcy Code. Similarly, although section 365 of the Bankruptcy Code governs many of the rights and obligations of parties to executory contracts and unexpired leases, the Bankruptcy Code is not comprehensive on this point and the interests, rights and obligations of parties to executory contracts and unexpired leases that are not governed by section 365 of the Bankruptcy Code are determined by state law.

§ 7.03. Fundamental Concepts in Bankruptcy Cases.

Section 365 of the Bankruptcy Code is but one of the many sections of the Bankruptcy Code governing the relationship among debtors, creditors and parties in interest and defining their respective rights and obligations in bankruptcy. Section 365 of the Bankruptcy Code exists within a comprehensive framework based upon several fundamental policies and purposes which are designed to give honest debtors a fresh start and to create an organized process for the liquidation, allowance and distribution of a limited pool of assets.


One of the primary goals of the Bankruptcy Code is to provide debtors with the ability to receive a fresh start and ultimately have many of their debts discharged or restructured. The filing of a bankruptcy petition gives

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5 See Stewart Foods, Inc. v. Broecker (In re Stewart Foods, Inc.), 64 F.3d 141, 145 (4th Cir. 1995)(debtor in possession cannot assume or reject nonexecutory contracts); see also In re Leslie Fay Cos., Inc., 168 B.R. 294, 300 (Bankr. S.D.N.Y. 1994)(section 365 of the Bankruptcy Code does not apply to postpetition contracts or leases); In re Kong, 162 B.R. 86, 91 (Bankr. E.D.N.Y. 1993)(contract or lease expired by its terms cannot be assumed or rejected).

6 See Butner v. United States, 440 U.S. 48, 54 (1979)(“Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.”); see also, United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609, 615 (7th Cir. 2005)(“the norm in bankruptcy law is that contracts (of which leases are a species) and property rights in general have the same force they would have in state court, unless the Code overrides the state entitlement.”).

7 E.g., Schneiderman v. Bogdanovich (In re Bogdanovich), 292 F.3d 104, 106 (2d Cir. 2002)(“Congress made it a central purpose of the bankruptcy code to give debtors a fresh start in life and a clear field for future effort unburdened by the existence of old debts.”).
debtors a “breathing spell” and stays collection efforts regarding prepetition debts in order to provide a trustee with time to collect assets for liquidation or in order to provide a debtor in possession with time to formulate and propose a reorganization plan. Under the Bankruptcy Code, all similarly situated creditors are treated equally for purposes of distribution. Debtors’ cases are administered in and under the supervision of bankruptcy courts.

It is important to recognize that the right to file a bankruptcy petition is granted and preserved by federal law. This right cannot be waived or taken away.


Although there are several different types of bankruptcy cases that may be filed under the Bankruptcy Code, for purposes of this chapter, three types of bankruptcy cases are particularly important. These types of bankruptcy cases are liquidation cases under chapter 7 of the Bankruptcy Code and reorganization and liquidation cases under chapter 11 of the Bankruptcy Code.

In a chapter 7 case, a trustee is appointed to collect a debtor’s property, reduce that property to money and ultimately distribute funds to a debtor’s creditors according to a priority scheme established by the Bankruptcy Code. A debtor’s creditors are entitled to receive a pro rata distribution on their claims against a debtor. Subject to certain exceptions, after all claims have been administered in a bankruptcy court, claims against a debtor that arose before the filing of the bankruptcy petition are discharged.

In a chapter 11 reorganization case, a debtor typically remains in possession of its property as a debtor in possession and continues to operate
its business with the ultimate goal of confirming a plan of reorganization. A debtor in possession is generally in charge of its reorganization process, under the supervision of a bankruptcy court; however, various parties in interest also play a part in nearly every aspect of a chapter 11 debtor’s bankruptcy case. As the Supreme Court has explained, “[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.”

One of the basic policies of chapter 11 and the Bankruptcy Code is the recognition by Congress and courts that a debtor’s property is more valuable if it can be used as part of a going concern rather than being sold in a chapter 7 liquidation. Subject to certain exceptions, after all claims have been administered in a bankruptcy court, claims against a debtor that arose before confirmation of a debtor’s plan of reorganization are discharged.

Chapter 7 is not the exclusive method of liquidating a debtor’s assets. In a chapter 11 liquidation case, a debtor’s assets may be sold through a sale or a combination of sales. Similar to a chapter 7 bankruptcy case, a debtor’s assets are sold in a chapter 11 liquidation case; however, it is a debtor, acting as a debtor in possession, rather than a trustee, that directs the sale process under the supervision of a bankruptcy court. In a chapter 11 liquidation case, a debtor’s property is often sold as part of a going concern and therefore is more likely to generate greater proceeds than if such property were liquidated in a chapter 7 case.

A chapter 7 or 11 bankruptcy petition may be filed voluntarily by a debtor or involuntarily against a debtor by a debtor’s creditors. Generally, in order to file an involuntary case against a debtor, there must be three (3) petitioning creditors whose claims are not contingent as to liability and are not subject to bona fide dispute. Additionally, such creditors’ unsecured claims must total at least $12,300.


Immediately upon the filing of a bankruptcy petition a bankruptcy estate is created. A debtor’s estate is comprised of all of a debtor’s legal and equitable interests in property, wherever located and by whomever held, as

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14 See id. § 303.
of the bankruptcy petition date.\textsuperscript{15} Property of the estate is broadly defined and includes both tangible and intangible property.\textsuperscript{16} Subject to certain exceptions, an estate’s right to property is no greater than a debtor’s right to property.\textsuperscript{17}

\section*{[4] — The Debtor, Claims, Creditors and Debts.}

The term “debtor” is defined by the Bankruptcy Code as the “individual, partnership, corporation or municipality concerning which” a bankruptcy case has been commenced.\textsuperscript{18} With the filing of a bankruptcy petition, the ownership of a debtor’s property “changes hands” from the debtor to the debtor’s estate.

The concept of a “claim” is fundamental to the administration of a debtor’s bankruptcy estate. Pursuant to section 101(5) of the Bankruptcy Code, a “claim” means:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured . . . .\textsuperscript{19}

The definition of a claim is important because, in relevant part, the Bankruptcy Code defines a “creditor” as an “entity that has a claim against the debtor that arose at the time of or before” the filing of a debtor’s bankruptcy petition.\textsuperscript{20} The definition of a claim is also important because a debtor is

\begin{footnotes}
\item[15] See \textit{id.} § 541(a).
\item[16] See \textit{id.}
\item[17] See 11 U.S.C. § 541(d); see also TTS, Inc. v. Citibank, N.A. (In re TTS, Inc.), 158 B.R. 583, 585 (D. Del. 1993)(“Section 541 does not give the debtor any greater rights to property than the debtor had before filing for Chapter 11.”).
\item[19] \textit{Id.} § 101(5).
\item[20] \textit{Id.} §101(10).
\end{footnotes}
able to receive a discharge only from a “debt,” which is defined as “liability on a claim.”21


In chapter 7 bankruptcy cases, an independent trustee is appointed to administer and liquidate a debtor’s estate for the benefit of the debtor’s creditors under the supervision of a bankruptcy court.22 A chapter 7 trustee is a fiduciary for the debtor’s estate.23


In chapter 11 bankruptcy cases, a debtor itself usually remains in possession of and administers an estate’s property for the benefit of the debtor’s creditors. Subject to certain exceptions, a debtor in possession has the rights, powers and duties of a trustee.24 Under certain circumstances, a bankruptcy court may appoint a trustee or an examiner, and under other circumstances, a bankruptcy court is required to appoint a trustee or an examiner, in chapter 11 bankruptcy cases.25 A debtor in possession has the same fiduciary duties as a trustee, including the duty to maximize the value of the bankruptcy estate.26


The term “party in interest” is not defined in the Bankruptcy Code; however, the Bankruptcy Code provides that debtors, trustees, creditors’ committees, equity security holders’ committees, creditors, equity security holders and indenture trustees are all parties in interest.27 Courts generally define the term “party in interest” broadly, and depending on the circumstances of each case, to include any party who has an actual pecuniary interest in a

21 Id. § 101(12).
25 See id. § 1104.
26 See Chinery, 330 F.3d at 573.
bankruptcy case, a party who has a practical stake in the outcome of a case, or a party who will be impacted in any significant way by a decision made in a bankruptcy case.28

With the filing of a bankruptcy petition, section 362 of the Bankruptcy Code imposes a stay that halts creditors’ attempts to collect prepetition debts. The automatic stay prohibits the commencement or continuation of an action or a proceeding against a debtor that was or could have been commenced prior to the filing of a bankruptcy petition.29 The automatic stay prohibits the enforcement of prepetition judgments, acts to create, perfect or enforce liens, and the setoff of debts owing to a debtor that arose before the filing of a bankruptcy petition.30 The automatic stay also prohibits a creditor from taking any action to obtain possession of property of a bankruptcy estate or of property from an estate or exercising control over property of an estate.31 A debtor’s interest in an executory contract and an unexpired lease is property of a debtor’s estate and is therefore protected, subject to certain exceptions, by the automatic stay.32

§ 7.04. Executory Contracts.

Although the term “executory contract” is not defined in the Bankruptcy Code, most courts apply the definition of an executory contract formulated by Professor Countryman, who stated that an executory contract is “a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of

30 See id.
31 See id. § 362(a)(3).
32 See 48th Street Steakhouse v. Rockefeller Group, Inc. (In re 48th Street Steakhouse, Inc.), 835 F.2d 427, 430 (2d Cir. 1987)(leasehold interests subject to the automatic stay); see also, In re Enron Corp., 300 B.R. 201, 212 (Bankr. S.D.N.Y. 2003)(contract rights subject to the automatic stay).
the other.” Generally, if a contract is capable of being materially breached by either party, then such a contract is executory and is therefore capable of being assumed, assumed and assigned or rejected by a trustee or debtor in possession under section 365 of the Bankruptcy Code.

A minority of courts utilize, or at least consider to some degree under certain circumstances, the so-called “functional approach” in determining whether a contract is an executory contract. As stated by the Sixth Circuit, with the functional approach a court “will work backward from an examination of the purposes to be accomplished by rejection and, if they have already been accomplished, then the contract cannot be said to be executory.” These purposes include “(i) relieving the debtor of burdensome future obligations . . . and (ii) creating a breach of contract which makes the other party to the contract a creditor with a claim that may be incorporated into a plan and ultimately rejected.”

As demonstrated by the foregoing authorities, there is more than one test employed by courts to determine whether a contract is executory for purposes of section 365 of the Bankruptcy Code. However, because the majority of courts rely on the Countryman definition in most cases, particularly in recent coal bankruptcy cases, this chapter discusses executory status solely by reference to Countryman’s “material breach” definition rather than the “functional approach.”


Contracts where performance is due on both sides fall squarely within the definition of an executory contract utilized by most bankruptcy courts and

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34 See Rieser v. Dayton Country Club Co. (In re Magness), 972 F.2d 689, 693 (6th Cir. 1992)(explaining that Countryman definition helpful but not controlling).
35 Id.
37 An extensive discussion of the history and theory of executory contracts doctrine is contained in Andrew, supra note 33.
are therefore capable of being assumed, assumed and assigned or rejected. In contrast, contracts where one party has no postpetition obligation are not executory because performance is not due by both parties. Such contracts are therefore not capable of being assumed, assumed and assigned or rejected. Similarly, contracts where the only remaining obligation is for one party to pay money to the other party cannot be assumed or rejected. If a contract obligates a debtor to pay money to a nondebtor party and the nondebtor party owes no obligation to the debtor, then such a contract merely constitutes a claim that will be administered in a bankruptcy court.

If performance under a contract is so complete that such contract can no longer be materially breached, then such a contract is not executory and therefore cannot be assumed, assumed and assigned or rejected. Similarly, contracts that have expired or terminated by their own terms are not executory and are therefore not capable of being assumed, assumed and assigned or rejected by a trustee or debtor in possession. Postpetition contracts are outside the scope of section 365 of the Bankruptcy Code and therefore are not capable of being assumed, assumed and assigned or rejected by a trustee or debtor in possession.

39 See, e.g., In re Spectrum Info. Techs., Inc., 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996) (contracts where one party has completed performance cannot be assumed or rejected).
40 See id.
41 Generally, if such a claim is ultimately allowed, then the creditor will receive its pro rata distribution, which may be cents on the dollar. In contrast, if a contract obligates a nondebtor to pay money to a debtor and the debtor owes no obligation to the nondebtor, the debtor may be entitled to full payment from the nondebtor party.
42 See In re Spectrum Info. Techs., Inc., 190 B.R. at 747 (obligations to make termination payments and contingent obligation to indemnify and defend insufficient to make contract executory).

In the typical chapter 11 bankruptcy case in the coal industry, a debtor in possession will likely be a party to a variety of different types of agreements that may or may not be executory contracts. Such agreements may include coal supply agreements, commission agreements, royalty agreements, override agreements, collective bargaining agreements, and options and rights of first refusal. Whether an agreement is an executory contract for purposes of section 365 of the Bankruptcy Code will always be determined on a case by case basis.

Coal supply agreements that have not expired or terminated by their terms are perhaps the clearest example of executory contracts in a coal bankruptcy case. Such contracts are almost always capable of being assumed, assumed and assigned or rejected by a trustee or debtor in possession because the parties to such contracts, unless such contracts have expired by their terms, will have remaining material performance obligations, e.g., the seller’s obligation to deliver coal and the buyer’s obligation to accept and pay for coal. Coal supply agreements have been routinely assumed, assumed and assigned or rejected in all of the recent coal bankruptcy cases.

Depending on the language of the particular agreement, a commission agreement may be executory. A commission agreement that merely requires a debtor to pay a commission to a broker for coal sold to a buyer likely will not be executory unless the party entitled to the commission owes an obligation to the debtor such that the commission agreement is capable of being materially breached by the nondebtor party. If a nondebtor party is merely entitled to payment from a debtor, then it is likely that such a party will have nothing more than an unsecured prepetition claim against a debtor that will be administered in the debtor’s bankruptcy case.

The executory status of a royalty or override agreement will depend on whether material obligations are owed by both parties to the agreement. A royalty or override agreement whereby a debtor is merely required to pay a royalty to a nondebtor party on coal mined or sold likely will not be an executory contract. However, even though a royalty or override agreement

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is not executory and is therefore not capable of being assumed, assumed and assigned or rejected, such agreement may contain clauses purporting to make the royalty obligation an obligation that runs with the land. The validity and enforceability of such clauses will be determined on a case by case basis by reference to the state law governing the agreement. At common law, the elements required for covenants to run with the land are (1) the original covenanting parties must have intended for the covenant to run; (2) there must be some form of privity of estate; and (3) the covenant must “touch and concern” the land. Resolution of this issue in the context of any bankruptcy case will be highly fact specific and will ultimately depend upon applicable state law.

Even if royalty and override agreements are not executory themselves, such agreements are often executed in conjunction with a lease or other contract that may be capable of being assumed, assumed and assigned or rejected. If a court determines, by reference to applicable state law, that a royalty or override agreement cannot be severed from a contract or lease that is capable of being assumed, assumed and assigned or rejected, then the treatment of the royalty or override agreement will “follow” or correspond to the treatment of the lease or contract from which the royalty or override agreement cannot be severed, i.e., if the lease or contract is assumed, then the assumed lease or contract would be subject to the royalty or override obligation.

There are several decisions addressing the issue of whether (i) a single agreement contains covenants that can be severed into multiple contracts or (ii) multiple agreements form a single contract for purposes of assumption or rejection pursuant to section 365 of the Bankruptcy Code. Regardless of these decisions’ particular rulings on the severability issue, they all share

the common characteristics of being (i) highly fact specific and (ii) concerned primarily with the intent of the parties. As stated by the Eleventh Circuit, “the intention of the parties is the governing principle in contract construction.”

Ultimately, a court will refer to applicable state law in order to determine whether an agreement is severable.

Clauses attempting to make royalty obligations run with the land are at issue not only in the context of assumption or rejection under section 365 of the Bankruptcy Code, but also in the context of asset sales, which are routinely conducted in bankruptcy cases. Under certain circumstances, section 363(f) of the Bankruptcy Code permits a trustee or debtor in possession to sell estate property free and clear of liens, claims, encumbrances and interests. If property is encumbered by a royalty obligation that runs with the land, then that royalty obligation may bind those who purchase assets in a bankruptcy sale conducted pursuant to section 363(f) of the Bankruptcy Code. Again, the ultimate resolution of this issue by a bankruptcy court will be determined by reference to applicable state law on a case by case basis.

Obligations created by collective bargaining agreements are critical for every debtor that is a party to such an agreement. Such obligations are also critical for all parties in interest because a debtor’s obligations under a collective bargaining agreement may be so great that such obligations (i) precipitated the debtor’s filing of a bankruptcy petition; (ii) may prevent the debtor from being able to reorganize; and/or (iii) may prevent the debtor from selling assets encumbered by obligations under a collective bargaining agreement. Collective bargaining agreements are usually executory contracts; however, collective bargaining agreements are given special treatment by section 1113 of the Bankruptcy Code. Generally, a debtor is required to perform all obligations under a collective bargaining agreement until

48 Gardiner, 831 F.2d at 976. In addition to considering the explicit terms of the agreements at issue, the Eleventh Circuit also considered (i) the nature and purpose of the agreements; (ii) whether the consideration for each agreement was separate and distinct; and (iii) whether the obligations of each party were interrelated. See Gardiner, 831 F.2d at 976. Other courts have considered the same or substantially similar factors. See Holly’s, 140 B.R. at 681; Royster, 137 B.R. at 532.
49 See, e.g., T&H Diner, 108 B.R. at 453.
and unless the collective bargaining agreement is modified or rejected in accordance with the provisions of section 1113 of the Bankruptcy Code.\textsuperscript{51}

Section 1113 of the Bankruptcy Code establishes numerous procedural and substantive prerequisites for rejection of a collective bargaining agreement. In order for a bankruptcy court to approve a proposed rejection of a collective bargaining agreement, the following requirements must be met: the debtor must make a proposal for modifications necessary to its reorganization based on the most reliable information available at the time; the union must reject the proposal without good cause; and the balance of the equities must clearly favor rejection of the agreement.\textsuperscript{52}

In interpreting the requirements of section 1113(c) of the Bankruptcy Code, bankruptcy courts have developed the following nine-factor test:

the debtor-in-possession must make a proposal to the union to modify the collective bargaining agreement; the proposal must be based on the most complete and reliable information available at the time of the proposal; the proposed modifications must be necessary to permit the reorganization of the debtor; the proposed modifications must assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably; the debtor must provide the union with such relevant information as is necessary to evaluate the proposal; between the time for the making of the proposal and the time of the hearing on the approval of the rejection of the existing collective bargaining agreement, the debtor must meet at reasonable times with the union; at the meetings, the debtor must confer in good faith to attempt to reach mutually satisfactory modifications of the collective bargaining agreement; the union must have refused to accept the proposal without good cause; and the balance of the equities must clearly favor rejection of the collective bargaining agreement.\textsuperscript{53}

The Bankruptcy Code also provides that “[i]f during a period when the collective bargaining agreement continues in effect, and if essential to

\textsuperscript{51} See id. § 1113(f).
\textsuperscript{52} See id. § 1113(c).
the continuation of the debtor’s business, or in order to avoid irreparable damages to the estate” a bankruptcy court may authorize a trustee or debtor in possession “to implement interim changes in the terms, conditions, wages, benefits, or work rules provided by a collective bargaining agreement.”

Options and rights of first refusal may be executory, which will be determined by a bankruptcy court on a case by case basis. A majority of bankruptcy courts appear to have held that rights of first refusal are executory and are therefore capable of being assumed, assumed and assigned or rejected. Bankruptcy courts appear to have split on the issue of whether rights of first refusal constitute anti-assignment provisions that are rendered unenforceable by section 365(f) of the Bankruptcy Code. A bankruptcy court conducting such an inquiry would likely consider: (i) the extent to which a right of first refusal hampers a debtor’s ability to sell or assign its property; (ii) whether the right of first refusal would prevent a debtor’s estate from realizing the full value of its assets; and (iii) the economic detriment on the nondebtor party if the right of first refusal were rendered unenforceable.

§ 7.05. Unexpired Leases.

The terms “lease,” “unexpired” and “unexpired lease” are not defined anywhere in the Bankruptcy Code. With respect to the term “lease,” the primary concern of most courts is whether an agreement is a true lease or a financing arrangement. The legislative history to section 502(b)(6)

55 See, e.g., In re Kellstrom Indus., Inc., 286 B.R. 833, 834-35 (Bankr. D. Del. 2002)(finding right of first refusal to be executory contract and collecting cases).
58 See United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609, 612 (7th Cir. 2005)(“only a ‘true lease’ counts as a ‘lease’ under § 365.”); see also Liona Corp. v. PCH Assocs. (In re PCH Assocs.), 804 F.2d 193, 198 (2d Cir. 1986)(stating that leases that are not bona fide are not leases for purposes of section 365).
of the Bankruptcy Code, which limits a lessor’s damage claim for a lease termination, states:

Whether a “lease” is a true or bona fide lease, or in the alternative, a financing “lease” or a lease intended as security depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a “lease.” The fact that the lessee, upon a compliance with the terms of the lease, becomes or has the option to become the owner of the leased property for no additional consideration or for nominal consideration indicates that the transaction is a financing lease or a lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal and interest either on a loan secured by the leased real property or on the purchase of the leased real property.59

With respect to the term “unexpired,” courts generally hold that a lease that has expired by its own terms cannot be assumed or rejected.60 However, courts are not in agreement regarding the issue of whether the terms “terminated” and “unexpired” are synonymous.61 A discussion of these issues is beyond the general scope of this chapter; however, it should be noted that this is one of many issues under section 365 of the Bankruptcy Code regarding which courts are not in agreement.

59 United Airlines, Inc., 416 F.3d at 614 (quoting S. Re. No. 989, 95th Cong., 2d Sess. 64 (1978)).
60 See, e.g., In re Kong, 162 B.R. 86, 91 (Bankr. E.D.N.Y. 1993).
61 Compare In re DiCamillo, 206 B.R. 64, 68 (Bankr. D. N.J. 1997)(finding terms “terminated” and “expired” to be distinguishable), with Robinson v. Chicago Housing Auth., 54 F.3d 316, 320 (7th Cir. 1995)(finding no meaningful distinction between the terms “unexpired” and “terminated”).
Section 365 of the Bankruptcy Code refers to unexpired leases of residential real property, unexpired leases of nonresidential real property and unexpired leases of personal property. For purposes of this chapter, the distinctions between these different types of leases are important with respect to the time by which a decision to assume or reject must be made pursuant to section 365(d) of the Bankruptcy Code, which will be discussed below.

The issue of whether a coal lease is an unexpired lease of nonresidential real property capable of being assumed, assumed and assigned or rejected is of particular interest in coal bankruptcy cases. A few judicial decisions have held that a mineral lease is a conveyance of minerals as land and is therefore not an executory contract or unexpired lease capable of being assumed or rejected under section 365 of the Bankruptcy Code. Specifically, in 1992 Judge William S. Howard of the United States Bankruptcy Court for the Eastern District of Kentucky held that a coal lease was neither an unexpired lease of nonresidential real property, nor was it an executory contract, capable of being rejected.62 In *Philbeck*, Judge Howard accepted the nondebtor lessee’s argument that, under Kentucky law, “a coal lease has been consistently held to be a conveyance of the minerals in place as land, no matter what the document which accomplishes the conveyance is called.”63 According to Judge Howard, “a coal lease conveys absolute title to the minerals under the surface.”64 Judge Howard went on to conclude that the lease in question also was not an executory contract that could be rejected because there were no unperformed obligations of the nondebtor party.65

Based upon this reasoning, it could be argued that the true nature of coal leases is such that coal leases are not leases capable of ever being assumed, assumed and assigned or rejected in a bankruptcy case. However, such an argument is arguably an overly broad reading of *Philbeck*. Specifically, it can be argued that Judge Howard’s ruling in *Philbeck* was limited to the particular lease in question and *Philbeck* does not stand for the proposition

63 Id.
64 Id.
65 Id. at 872.
that coal leases are outside of section 365 of the Bankruptcy Code. On the other hand, nine months prior to rendering the Philbeck opinion, Judge Howard denied a motion to reject a debtor’s coal lease with no analysis in another coal bankruptcy case.66 In Panbowl, Judge Howard stated that it was “conceded that Becknell is indeed dispositive of the issue of whether a coal lease can be rejected . . . .”67 In both Philbeck and Panbowl, Judge Howard cited Becknell & Crace Coal Co., Inc. v. Hicks (In re Becknell & Crace Coal Co., Inc.),68 in which the Sixth Circuit affirmed a finding by Judge Joe Lee, a bankruptcy judge in the Eastern District of Kentucky, that the lease-purchase agreement at issue in that case could not be rejected because it was a conveyance of minerals as land rather than a lease.69 However, the Sixth Circuit reversed Judge Lee’s finding that the agreement was not an executory contract and stated that “the Trustee should have been given the opportunity to assume or reject the contract.”70 With respect to its conclusion on the issue of whether the “lease-purchase” agreement was a lease or a conveyance, the Sixth Circuit relied on a Kentucky case in which Kentucky’s highest court stated that “what is commonly termed a coal mining lease is regarded as the conveyance of an estate or interest in the minerals as land unless the terms of the instrument require a different construction.”71 This statement from Johnson is an accurate expression of Kentucky law and supports the conclusion that resolution of the issue of whether a coal lease is a lease or a conveyance depends upon the precise language of the instrument in question and the intent of the parties. Despite the existence of such judicial decisions, in recent coal bankruptcy cases mineral leases have consistently been treated as unexpired leases of nonresidential real property capable of being assumed or rejected.

67 Id. at *2.
68 Becknell & Crace Coal Co., Inc. v. Hicks, 761 F.2d 319 (6th Cir. 1985).
69 Id. at 321.
70 Id. at 322.
71 Johnson v. Coleman, 288 S.W.2d 348, 349 (Ky. 1956).
§ 7.06. **Ipso Facto Clauses and Anti-Assignment Provisions.**


Executory contracts and leases frequently contain “ipso facto clauses,” or provisions that automatically operate to terminate or forfeit a debtor’s interest under an executory contract or lease when a debtor files a bankruptcy petition. Section 365 of the Bankruptcy Code renders ipso facto clauses unenforceable in most circumstances. Specifically, section 365(e)(1) of the Bankruptcy Code provides that:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

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

(B) the commencement of a bankruptcy case; or

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


Subject to certain restrictions, section 365(f)(1) of the Bankruptcy Code provides that a trustee or debtor in possession may assign an executory contract or unexpired lease notwithstanding a provision that prohibits, restricts, or conditions the assignment of such contract or lease. Despite the invalidity of most anti-assignment provisions, section 365(c) of the Bankruptcy Code provides that an executory contract or unexpired lease cannot be assumed or assigned if (i) applicable nonbankruptcy law excuses

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73 Id.
74 See id. § 365(f)(1).
the nondebtor party from accepting performance from a third party and (ii) the nondebtor party does not consent to assumption or assignment. Pursuant to section 365(c)(1)(A) of the Bankruptcy Code, if an executory contract or unexpired lease cannot be assigned under applicable state or federal law, then such contract or lease cannot be assumed or assigned by a trustee or debtor in possession. Such contracts typically include personal services contracts for the services of a particular person, certain types of government contracts, certain patent licenses and certain partnership agreements.

Section 365(c)(2) precludes the assumption or assignment of contracts to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor. Section 365(c)(3) precludes the assumption or assignment of nonresidential real property leases that have been terminated under applicable nonbankruptcy law prior to the filing of a bankruptcy petition.


A trustee or debtor in possession will seek to assume executory contracts and unexpired leases that are beneficial to a debtor’s estate and will seek to reject executory contracts and unexpired leases that are burdensome to the debtor’s estate. The Bankruptcy Code provides little guidance as to the standards to be applied by courts in evaluating assumption or rejection. Drawing on pre-Bankruptcy Code law, the majority of courts use the business judgment rule or business judgment test.

See id. § 365(c).

See, e.g., In re ANC Rental Corp., 277 B.R. 226, 235-36 (Bankr. D. Del. 2002) (collecting cases and stating that “the majority of courts have found 365(c)(1) applicable only where the identity of the contracting party is crucial under the applicable law because it is a personal services contract or for public safety reasons.”).

See id. § 365(c)(2).

See id. § 365(c)(3).

The business judgment test is the same test applied to judicial review of corporate decisions outside bankruptcy.80 The primary concern of a bankruptcy court faced with a motion for approval of assumption or rejection of an executory contract or unexpired lease under section 365 of the Bankruptcy Code is “the impact continued performance under the contract will have on the reorganization attempt of the debtor-in-possession.”81 Assumption or rejection of an executory contract or unexpired lease will be approved upon a mere showing that the action will benefit the estate.82 “Transposed to the bankruptcy context, the [business judgment] rule as applied to a bankrupt’s decision to [assume or] reject an executory contract because of perceived business advantage requires that the decision be accepted by courts unless it is shown that the bankrupt’s decision was one taken in bad faith or in gross abuse of the bankrupt’s retained business discretion.”83

Section 365 of the Bankruptcy Code was intended to validate the sound exercise of discretion by a debtor in possession.84 It has been noted that “under the policy of judicial independence mandated by the Code, and in light of the purpose and effect of § 365 as a whole, a trustee’s or debtor-in-possession’s decision to [assume or] reject should usually be approved, and . . . denied only where the trustee’s decision was clearly erroneous.”85

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83 Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1047 (4th Cir. 1985).
84 See, e.g., In re Waldron, 36 B.R. 633, 640 (Bankr. S.D. Fla. 1984)(noting that “[u]nder the Code, Congress limited the court’s jurisdiction to interfere with the exercise of the trustee’s or debtor-in-possession’s discretion to assume or reject executory contracts.”).

Bankruptcy courts generally will not consider the effect of assumption or rejection of an executory contract or unexpired lease on a nondebtor party.86 Even when the proposed assumption or rejection of an executory contract will work an actual injury to the nondebtor party, that injury should not control because a bankruptcy court’s primary concern remains “the impact continued performance under the contract will have on the reorganization attempt of the debtor-in-possession.”87

§ 7.08. Assumption and Assignment.

[1] — The Decision to Assume.

Assumption of an executory contract or unexpired lease is a trustee’s or debtor in possession’s decision for the debtor’s estate to assume the debtor’s obligations under an executory contract or unexpired lease. If an executory contract or unexpired lease is beneficial to a debtor’s estate, a trustee or debtor in possession will seek to assume such executory contract or unexpired lease and thereby gain the benefits of the executory contract or lease in exchange for assuming the expense of being obligated on the contract or lease going forward.


A trustee or debtor in possession has the burden of establishing that the executory contract or unexpired lease is subject to assumption and that all of the requirements of section 365 of the Bankruptcy Code have been satisfied.88 A bankruptcy court will consider whether to grant a motion to assume by utilizing the business judgment test.

86 See Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.), 89 F.3d 673, 676 (9th Cir. 1996)(noting that ordinarily an executory contract may be assumed or rejected “without the consent of the other party to the contract”); see also In re Chateaugay Corp., 10 F.3d 944, 955 (2d Cir. 1993)(noting that “Section 365 does not confer any power of election upon the other contracting party.”).


A contract must be executory and a lease must be unexpired before it can be assumed; contracts that are not executory and leases that have expired or terminated by their terms are not capable of being assumed. An executory contract or unexpired lease must be assumed in its entirety; a trustee or debtor in possession cannot assume only the beneficial rights.89 A trustee or debtor in possession takes executory contracts and unexpired leases as they are, subject to all of their provisions except those rendered unenforceable by applicable nonbankruptcy law or section 365 of the Bankruptcy Code.90

The current version of section 365 of the Bankruptcy Code provides that if there has been a default in an executory contract or unexpired lease, a trustee or debtor in possession may not assume such contract or lease unless, at the time of assumption, the trustee or debtor in possession (i) cures, or provides adequate assurance that the trustee or debtor-in-possession will promptly cure, such default; (ii) compensates, or provides adequate assurance that the trustee or debtor-in-possession will promptly compensate, the nondebtor party for any actual pecuniary loss to such party resulting from such default; and (iii) provides adequate assurance of future performance.91

As a result of the 2005 Act, section 365(b) of the Bankruptcy Code has been amended to provide that a debtor need not cure nonmonetary defaults under an unexpired lease of real property that are impossible to cure prior to assumption except a failure to operate in accordance with the terms of an unexpired lease of nonresidential real property, in which case the default must be cured at the time of assumption and the lessor must be compensated for any pecuniary loss resulting from the breach.

This amendment to section 365(b) may protect coal lessors by requiring a debtor lessee to cure a nonmonetary default at the time of assumption. For example, under a coal lease that contains a continuous mining provision, if a debtor ceases mining prior to assumption, then the debtor is in nonmonetary default. Although it is impossible to cure such a default in the sense that the

90 See 11 U.S.C. §§ 365(e), (f).
91 See id. § 365(b).
debtor has ceased mining prior to assumption, pursuant to the amendment of section 365(b) of the Bankruptcy Code by the 2005 Act, a debtor may be required to begin mining again at the time of assumption as a condition of assumption. Of course it is impossible to foresee how this amendment to section 365(b) of the Bankruptcy Code will be construed and applied by bankruptcy courts, but this amendment may provide additional protection for nondebtor lessors when dealing with debtor lessees.

By its express terms, section 365(b) of the Bankruptcy Code only applies if there has been a default in an executory contract or lease. If an executory contract or unexpired lease is not in default, then a trustee or debtor in possession may assume such contract or lease by satisfying the business judgment test, unless some other provision of section 365 of the Bankruptcy Code precludes assumption.

For contracts and leases that are in default, with respect to the adequate assurance requirement of section 365(b)(1)(C) of the Bankruptcy Code, what constitutes adequate assurance of future performance is not defined in the Bankruptcy Code. Most bankruptcy courts will consider adequate assurance on a case by case basis in order to determine whether a debtor will have sufficient future cash flow to meet its obligations under the contract or lease that is being assumed.


Following assumption, a debtor’s estate becomes obligated on the contract or lease and is bound to perform going forward. If a debtor defaults on an executory contract or unexpired lease after assumption, the damages are likely to be treated as administrative expenses. Pursuant to

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92 See 11 U.S.C. § 365(b); see also In re UAL Corp., 293 B.R. 183, 190 (Bankr. N.D. Ill. 2003)(explaining that section 365(b)’s requirements are only imposed if there has been a default).

93 See In re UAL Corp., 293 B.R. at 190.

94 See In re Martin Paint Stores, 199 B.R. 258, 263 (Bankr. S.D.N.Y. 1996)(adequate assurance should be given pragmatic construction and focus on ability to fulfill future financial obligations).

95 See, e.g., GATX Leasing Corp. v. Airlift Int’l, Inc. (In re Airlift Int’l, Inc.), 761 F.2d 1503, 1508 (11th Cir. 1985)(stating that “estate becomes liable for performance of entire contract, as if bankruptcy never intervened.”).

96 See id. at 1509.
section 365(g)(2) of the Bankruptcy Code, if a trustee or debtor in possession rejects an executory contract or unexpired lease after such lease has already been assumed, then such rejection constitutes a breach of the contract or lease as of the time of rejection.97 As a result of the 2005 Act, amendments to section 503(b)(7) of the Bankruptcy Code will entitle nondebtor lessors under unexpired leases of nonresidential real property that have been assumed and then subsequently rejected to an administrative expense claim on all monetary obligations due for a two (2) year period following the later of date of rejection or surrender of possession without reduction except for amounts paid by an entity other than a debtor.


A trustee or debtor in possession may assign an executory contract or unexpired lease to a third party.98 As explained by the Third Circuit, “[h]aving assumed an executory contract or unexpired lease, the trustee may elect to assign it. The Code generally favors free assignability as a means to maximize the value of the debtor’s estate . . . .”99 Assignment of an executory contract or unexpired lease relieves a trustee or debtor in possession and the debtor’s estate from any liability for breach of such contract or lease occurring after assignment.100 While an executory contract or unexpired lease may be assigned notwithstanding the existence of an anti-assignment provision in a contract or lease, if a trustee or debtor in possession assumes and delays assignment, then the trustee or debtor in possession may lose the anti-assignment protection contained in section 365(e) of the Bankruptcy Code.


Prior to assignment, an executory contract or unexpired lease must be assumed in accordance with section 365 of the Bankruptcy Code.101

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98 See id. § 365(f).
100 See 11 U.S.C. § 365(k).
101 See id. § 365(f)(2)(A).
The assignee of such contract or lease must provide adequate assurance of future performance, regardless of whether there has been a default in such contract or lease.102


Section 365(f)(1) of the Bankruptcy Code provides that provisions in an executory contract or unexpired lease that prohibit, restrict or condition the assignment of such contract or lease are not enforceable.103 Section 365(f)(3) of the Bankruptcy Code provides that provisions of an executory contract or unexpired lease that operate to terminate or modify such contract or lease upon assumption or assignment are not enforceable.104

§ 7.09. Rejection.


Rejection of an executory contract or unexpired lease is a trustee’s or debtor in possession’s decision for the debtor’s estate not to assume the debtor’s obligations under an executory contract or unexpired lease. If an executory contract or unexpired lease is burdensome to a debtor’s estate, a trustee or debtor in possession will seek to reject such executory contract or unexpired lease.


A trustee or debtor in possession has the burden of establishing that the executory contract or unexpired lease is subject to rejection and that rejection satisfies the business judgment test.105 Just as an entire executory contract or unexpired lease must be assumed, a trustee or debtor in possession is not permitted to reject only the burdensome provisions of an executory contract or unexpired lease.106

102 See id. § 365(f)(2)(B).
103 See id. § 365(f)(1).
104 See id. § 365(f)(3).

Courts are divided on the issue of whether rejection of an executory contract or unexpired lease constitutes breach or termination. Several courts have concluded that rejection does not automatically result in termination.107 Other courts have reached the opposite conclusion and stated that rejection constitutes termination.108

While courts have reached different conclusions regarding the effect of rejection, the majority rule appears to be that rejection constitutes a breach and does not result in automatic termination, which is arguably the better conclusion for at least three reasons. First, the Bankruptcy Code distinguishes between the terms breach, rejection and termination in various sections. The Bankruptcy Code also expressly provides that rejection constitutes a breach, but is silent on the issue of termination. This arguably evidences Congress’s awareness of the distinctions between these three concepts and its ability to explain the effect of rejection. Therefore, had Congress intended for rejection to constitute termination, then it would have explicitly so provided. Second, under state laws regarding contracts and leases, breach and termination generally have separate meanings. Third, some courts have concluded that rejection is treated as a breach, and not as a termination, in order to give the nondebtor party a claim for damages. According to these

107 See Eastover Bank for Savings v. Sowashee Venture (In re Austin Dev. Co.), 19 F.3d 1077, 1082 (5th Cir. 1994)(deemed rejection did not terminate lease); see also Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.), 900 F.2d 1184, 1191-92 (8th Cir. 1990)(lease rejection operates as breach of debtor’s continuing obligation under the lease, not as discharge or extinction of the obligation itself); In re Tri-Glied, Ltd., 179 B.R. 1014, 1018 (Bankr. E.D.N.Y. 1995)(deemed rejection of a lease is mere breach, not termination); In re Emple Knitting Mills, Inc., 123 B.R. 688, 691 (Bankr. D. Me. 1991)(following lease rejection, landlord had option of terminating and seeking damages or not terminating and seeking rent from tenant); Blue Barn Assocs. v. Picnic ‘N Chicken, Inc. (In re Picnic ‘N Chicken, Inc.), 58 B.R. 523, 526 (Bankr. S.D. Cal. 1986)(rejection of lease does not have the conclusive effect of termination); In re Storage Tech. Corp., 53 B.R. 471, 475 (Bankr. D. Col. 1985)(same).

courts, “if rejection were deemed a complete, immediate termination, it is not clear what the measure of the creditor’s claim would be.” At least one leading commentator has endorsed this conclusion.

Once an executory contract or unexpired lease is rejected, the debtor has no obligation to perform and is not entitled to receive performance from the nondebtor party under the contract or lease. Under certain circumstances, if a trustee or debtor in possession rejects an unexpired lease of real property under which a debtor is the lessor, then section 365(h) of the Bankruptcy Code gives the nondebtor lessee the option of either (i) treating the lease as being terminated by the rejection or (ii) remain in possession of the premises for the remainder of the term of the lease. If the nondebtor lessee chooses to remain in possession following rejection, then the lessee may offset against rent any damages caused by the debtor lessor’s nonperformance; however, the lessee will have no further claim against the debtor on account of any damage caused by the debtor’s nonperformance.

The effect of rejection on subleases is not addressed specifically in the Bankruptcy Code, therefore resolution of issues involving sublease will ultimately be determined by reference both to section 365 of the Bankruptcy Code and the applicable state law governing the lease and subleases at issue. For example, in a situation where a debtor leases property from a nondebtor lessor and then subleases the property to another party, the debtor is a party to at least two leases and is both a lessee (of the base lease) and a lessor (of the sublease). If the debtor sought to reject the sublease, then the nondebtor sublessee would be able to avail itself of the protection provided by section 365(h) of the Bankruptcy Code and choose to treat the sublease as terminated by the rejection or remain on the premises for the duration of the term of the sublease. However, if the debtor sought to reject the base lease, then the rights of the parties, particularly the base lessor and the sublessee are not so clear and would ultimately be determined by reference to controlling state law. In such a situation, a bankruptcy court may abstain from deciding the respective rights between the base lessor and the sublessee, in which case

109 See, e.g., In re Austin Dev. Co., 19 F.3d at 1082.
such parties would seek relief from a state court having jurisdiction over
the matter.\textsuperscript{113}

\textbf{[4] — Rejection Damages.}
Section 365(g)(1) of the Bankruptcy Code provides that the rejection
of an executory contract or unexpired lease of the debtor constitutes a breach
of such contract or lease immediately before the filing of the bankruptcy
petition.\textsuperscript{114} A claim arising from rejection of an executory contract or
unexpired lease will be determined and allowed or disallowed as if such
claim had arisen prior to the date of the filing of a bankruptcy petition.

\textbf{§ 7.10. Performance, Rights and Obligations Prior
to the Decision to Assume, Assume and Assign or
Reject.}

\textbf{[1] — Timing.}
In a case under chapter 7 of the Bankruptcy Code, a trustee must
assume or reject an executory contract, an unexpired lease of residential
real property or an unexpired lease of personal property within sixty (60)
days of the petition date, or within additional time granted by a bankruptcy
court within such 60-day period.\textsuperscript{115} If a trustee fails to reject an executory
contract, an unexpired lease of residential real property or an expired lease
of personal property within this deadline, then such contracts and leases
are deemed rejected.\textsuperscript{116} In a case under chapter 9, 11, 12 or 13 of the
Bankruptcy Code, a debtor in possession or trustee may assume or reject
an executory contract, an unexpired lease of residential real property or an
unexpired lease of personal property at any time prior to the confirmation
of a reorganization plan.\textsuperscript{117}

\textsuperscript{113} \textit{See} Tebo v. Elephant Bar Restaurant, Inc. (\textit{In re} Elephant Bar Rest., Inc.), 195 B.R. 353
(Bankr. W.D. Pa. 1996); \textit{see also} Chatlos Sys., Inc. v. Kaplan (\textit{In re} Chatlos Sys., Inc), 147
\textsuperscript{114} \textit{See} 11 U.S.C. § 365(g)(1).
\textsuperscript{115} \textit{See id.} § 365(d)(1).
\textsuperscript{116} \textit{See id.}
\textsuperscript{117} \textit{See id.} § 365(d)(2).
In a chapter 11 case, an unexpired lease of nonresidential real property under which the debtor is the lessee must be assumed or rejected within sixty (60) days of the petition date, unless this deadline is extended by a bankruptcy court.\footnote{118 See \textit{id.} § 365(d)(4).} The 2005 Act, which applies to cases filed on or after October 17, 2005, amends section 365(d)(4) of the Bankruptcy Code to provide that a lease of nonresidential real property will be deemed rejected if not assumed by the earlier of (i) 120 days after the petition date or (ii) the date a plan is confirmed; however, a bankruptcy court may extend the 120-day period for an additional 90 days. Any further extension will require written consent of the lessor. Section 365 of the Bankruptcy Code is silent regarding the deadline by which an unexpired lease of nonresidential real property under which a debtor is the lessee must be assumed or rejected.


A debtor’s prepetition contract rights are property of the estate pursuant to section 541 of the Bankruptcy Code.\footnote{119 See \textit{id.} § 541(a)(1); see also \textit{In re Enron Corp.}, 300 B.R. 201, 212 (Bankr. S.D.N.Y. 2003).} Prior to assumption or rejection, an executory contract can be enforced against a nondebtor party and a nondebtor party is bound to perform its obligations until an executory contract is assumed or rejected.\footnote{120 See \textit{Leslie Fay Cos., Inc. v. Corporate Prop. Assocs.} 3, 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994)(“the executory contract remains in effect and nondebtor contracting parties are bound to honor it.”).} A trustee or debtor in possession is required to timely perform most of the obligations of the debtor arising under an unexpired lease of nonresidential real property or an unexpired lease of personal property until such lease is assumed or rejected.\footnote{121 See 11 U.S.C. §§ 365(d)(3), (10).}


Prior to assumption or rejection, a nondebtor party to an executory contract cannot enforce a contract according to its terms.\footnote{122 See \textit{In re El Paso Refinery, L.P.}, 220 B.R. 37, 43 (Bankr. W.D. Tex. 1998)(“From the moment of filing to the moment of assumption or rejection, the non-debtor party is held to be barred from enforcing the contract and its terms.”).} Even though a nondebtor party cannot enforce an executory contract or lease prior to

\footnote{118 See \textit{id.} § 365(d)(4).}
\footnote{119 See \textit{id.} § 541(a)(1); see also \textit{In re Enron Corp.}, 300 B.R. 201, 212 (Bankr. S.D.N.Y. 2003).}
\footnote{120 See \textit{Leslie Fay Cos., Inc. v. Corporate Prop. Assocs.} 3, 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994)(“the executory contract remains in effect and nondebtor contracting parties are bound to honor it.”).}
\footnote{121 See 11 U.S.C. §§ 365(d)(3), (10).}
\footnote{122 See \textit{In re El Paso Refinery, L.P.}, 220 B.R. 37, 43 (Bankr. W.D. Tex. 1998)(“From the moment of filing to the moment of assumption or rejection, the non-debtor party is held to be barred from enforcing the contract and its terms.”).}
assumption or rejection, a nondebtor party may seek to compel assumption or rejection; however, such motions are rarely granted by bankruptcy courts. When considering a motion to compel assumption or rejection of an executory contract or unexpired lease, bankruptcy courts typically use their discretion and determine what constitutes a reasonable time for a debtor in possession to make an assumption or rejection decision in the context of the particular bankruptcy case. In determining what constitutes a reasonable time, bankruptcy courts have evaluated the “nature of the interests at stake, the potential harm to the parties, the potential benefits to the parties and the safeguards afforded to the parties.”

§ 7.11. Special Issues.


A debtor’s prepetition waiver of rights under section 365 of the Bankruptcy Code, such as an agreement to assume or not to reject a contract or lease, is not enforceable in a bankruptcy case. Prepetition waivers of rights under section 365 of the Bankruptcy Code violate public policy because such waivers attempt to bind a debtor in possession without regard to the impact on a debtor’s estate.


Postpetition contracts and leases are not capable of being assumed or rejected because such contracts and leases are outside the scope of section 365 of the Bankruptcy Code. The primary issue with respect to postpetition contracts and leases is whether such contracts and leases are in the debtor’s

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126 See id. at 117.
ordinary course of business under section 363 of the Bankruptcy Code. 128 If a debtor enters into a contract or lease postpetition and entering into such contract or lease is outside the debtor’s ordinary course of business, then bankruptcy court approval will be required. 129 Generally, if a debtor in possession executes a contract or lease postpetition and is authorized by a bankruptcy court or by section 363 of the Bankruptcy Code to enter into the contract or lease, then the debtor’s estate will be bound to perform under the contract or lease and any damages for breach will be entitled to administrative priority. On the other hand, if a debtor in possession enters into a postpetition contract or lease and such action is outside the debtor’s ordinary course of business and is not approved by a bankruptcy court, the contract or lease may be avoided pursuant to section 549 of the Bankruptcy Code.

To determine if a postpetition contract or lease is in the debtor’s ordinary course of business, bankruptcy courts apply a two-step analysis: (i) the “horizontal dimension” test; and (ii) the “vertical dimension” test (or reasonable expectation test). 130 The horizontal dimension test involves an inquiry into whether, from an industry wide perspective, the transaction is of the sort commonly engaged in by companies in that industry. 131 The vertical dimension test involves an inquiry into whether the transaction is one that creditors would reasonably expect a debtor to enter into without court permission. As explained by one court, the inquiry is “whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit.” 132

[3] — Postpetition Amendment or Modification.

Although a trustee or debtor in possession must assume or reject an executory contract or unexpired lease in its entirety, parties are free to amend or modify the terms of an executory contract or unexpired lease by agreement

130 See id.
131 See id. at 953.
132 Id.
prior to assumption or rejection. Where parties consensually modify an executory contract or unexpired lease prior to assumption or rejection, such modification generally does not operate as an assumption or rejection of the executory contract or unexpired lease. However, if the parties significantly modify or amend terms of the original contract to such an extent that the contract as modified is materially different from the original contract, then the nondebtor party may have an argument that the amended contract is not merely a continuation of the prepetition contract, but constitutes a new, postpetition contract. There is little case law on this issue in the bankruptcy context, but the validity of such an argument would ultimately turn on the precise language of the agreement at issue and the application of applicable state law.


The Eleventh Amendment to the United States Constitution protects states and certain state agencies from suits brought by private citizens. States and certain state agencies often attempt to assert that they are immune from suits in bankruptcy courts. Although a majority of the federal judicial circuits continue to recognize Eleventh Amendment immunity in bankruptcy cases, in Hood v. Tennessee Student Assistance Corp. (In re Hood), the United States Court of Appeals for the Sixth Circuit, which includes Ohio, Michigan, Kentucky and Tennessee, held that there is no Eleventh Amendment immunity in bankruptcy cases.

133 See City of Covington v. Covington Landing Ltd. P’ship, 71 F.3d 1221, 1227 (6th Cir. 1995); see also Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985); In re Beare Co., 177 B.R. 879, 881-82 (Bankr. W.D. Tenn. 1994).
135 See Nelson v. La Crosse County Dist. Attorney (In re Nelson), 301 F.3d 820, 832 (7th Cir. 2002); see also Mitchell v. Franchise Tax Bd. (In re Mitchell), 209 F.3d 1111, 1121 (9th Cir. 2000); Sacred Heart Hosp. of Norristown v. Pennsylvania (In re Sacred Heart Hosp. of Norristown), 133 F.3d 237, 243 (3d Cir. 1998); Fernandez v. PNL Asset Mgmt. Co. LLC (In re Fernandez), 123 F.3d 241, 246 (5th Cir.), amended by 130 F.3d 1138, 1139 (5th Cir. 1997); Schlossberg v. Maryland (In re Creative Goldsmiths of Washington, D.C.), 119 F.3d 1140, 1145-46 (4th Cir. 1997).
137 See id. at 767.
In *Hood*, the Sixth Circuit considered the issue of whether Article I, section 8 of the Constitution gives Congress the power to abrogate states’ sovereign immunity in section 106 of the Bankruptcy Code. After conducting a detailed analysis of the Supreme Court’s decision in *Seminole Tribe v. Florida*, the Constitution, and the framers’ understanding of the power to make uniform laws on bankruptcy matters, the Sixth Circuit held that section 106 of the Bankruptcy Code is a valid abrogation of sovereign immunity. As the Sixth Circuit explained, “[a]t the Constitutional Convention, the states granted Congress the power to abrogate their sovereign immunity under Article I, section 8. In 11 U.S.C. § 106(a), Congress used that power to grant states a benefit they had sought.”

The Supreme Court affirmed the Sixth Circuit’s holding in *Hood*. Because the Supreme Court held that the discharge of a student loan debt does not implicate a state’s Eleventh Amendment immunity, the Supreme Court declined to decide the broader question of whether section 106 of the Bankruptcy Code is a valid abrogation of sovereign immunity. Consequently, the Sixth Circuit’s holding that section 106 of the Bankruptcy Code is a valid abrogation of sovereign immunity remains controlling precedent within the Sixth Circuit.

Even in the judicial circuits that recognize Eleventh Amendment immunity, state and state agencies arguably are not entitled to Eleventh Amendment immunity with respect to certain bankruptcy matters, such as entry of confirmation orders and motions to assume or reject executory contracts and unexpired leases, because such matters are not “suits” for purposes of the Eleventh Amendment. The Fourth Circuit has held that

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138 *See id.* at 758.
140 *See Hood*, 319 F.3d at 767.
141 *Id.* at 768.
143 *See id.* at 445.
144 On April 4, 2005, the Supreme Court granted certiorari in *Central Virginia Comm. College v. Katz*, No. 04-885 to again consider the issue of whether section 106 of the Bankruptcy Code is a valid abrogation of sovereign immunity in bankruptcy cases. A decision in *Katz* will likely be rendered prior to July 2006.
confirmation of a chapter 11 plan of reorganization is not a suit for purposes of the Eleventh Amendment.\textsuperscript{145} According to the Fourth Circuit,

The confirmation order in this case was not entered in a suit “against one of the United States” filed by a private party. The state was not named a defendant, nor was it served with process mandating that it appear in a federal court. While it was served with notice of the proposed plan and its confirmation, it was free to enter federal court voluntarily or to refrain from doing so. This is to be distinguished from the case in which a debtor, a trustee or other private person files an adversary proceeding against the state in a bankruptcy court to issue process summoning the state to appear.\textsuperscript{146}

At least one bankruptcy court has recognized that a state’s pecuniary interest may be modified or eliminated by a bankruptcy court’s administration of a bankruptcy estate.\textsuperscript{147} The bankruptcy court in \textit{In re Sae Young Westmont-Chicago, LLC},\textsuperscript{148} held that a motion to assume and assign a lease is not a suit for purposes of the Eleventh Amendment.\textsuperscript{149}

\textbf{[5] — Rights of Re-Entry.}

Mineral leases frequently contain clauses preserving a lessee’s right to re-enter leased property for various purposes, such as to conduct reclamation in accordance with state and federal law. Other leases are silent with respect to rights of re-entry. In either case, this issue is important to both lessors and lessees alike because a lessee has a strong incentive to comply with applicable state and federal mining laws in order to continue to conduct mining operations and a lessor has a similar interest in complying with such laws in order to minimize potential liability for owning unreclaimed land. The penalties for failure to comply with the federal Surface Mining Control and Reclamation Act and its state counterparts can be severe, including civil

\textsuperscript{145} See Maryland v. Antonelli Creditors’ Liquidating Trust, 123 F.3d 777, 787 (4th Cir. 1997).
\textsuperscript{146} Id. at 786-87.
\textsuperscript{147} See Pitts v. Ohio Dep’t of Taxation (\textit{In re Pitts}), 241 B.R. 862, 868 (Bankr. N.D. Ohio 1999).
\textsuperscript{148} \textit{In re Sae Young Westmont-Chicago, LLC}, 276 B.R. 888 (Bankr. N.D. Ill. 2002).
\textsuperscript{149} Id. at 897-98.
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and criminal fines and permit blocking. Pursuant to the terms of a mineral lease, a right of re-entry will often survive termination of the lease; in such cases, a right of re-entry will survive a debtor’s rejection of a lease regardless of whether rejection terminates the lease or merely constitutes a breach of the lease. The lessee’s right of re-entry would continue to be governed by the terms of the lease following rejection.

In cases involving mineral leases that do not contain re-entry clauses, persuasive arguments can be made that a bankruptcy court has the authority pursuant to section 105 of the Bankruptcy Code to enter orders granting a debtor lessee the right to re-enter the leased premises following rejection of such a lease in order to conduct reclamation. Additionally, such an argument is further supported by a 1985 opinion for the Office of Surface Mining Reclamation and Enforcement in which an administrative law judge noted that an applicant might have a legal right of entry for the purpose of reclamation work on property regardless of its cancellation of the lease because the federal Surface Mining Control and Reclamation Act requires the reclamation work to be done, and this was well known to the lessor when it entered the lease.150


Pursuant to section 364(d) of the Bankruptcy Code, a bankruptcy court may authorize a debtor in possession to obtain postpetition financing secured by a lien senior or equal to other liens on property of the estate if (i) a debtor in possession is unable to obtain such credit otherwise and (ii) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.151 A bankruptcy court may authorize a debtor in possession to grant liens on the debtor in possession’s leasehold interests notwithstanding anti-encumbrance provisions contained in a debtor’s unexpired leases with its lessors and notwithstanding anti-assignment provisions in such leases.

150 See New River Coals, Ltd. v. OSM, Docket No. NX 5-8-R.