Chapter 13

Rejection of Leases and Executory Contracts in Bankruptcy: What Does It Mean?

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Synopsis

§ 13.01. Overview .................................................................511
§ 13.02. Plain Language of the Statute .................................511
§ 13.03. What Does a Rejection Mean? .................................513
[1] — What the Code Provides ..................................513
§ 13.04. Case Study: A Real Life Rejection Scenario ..........517
[1] — Background ..............................................................517
[a] — Easement Agreement ........................................518
[b] — Disposal Agreement .............................................518
[2] — Defenses to the Debtor’s Motion to Reject the Easement
and Disposal Agreements ...........................................519
[3] — The Court’s Ruling ...................................................520
§ 13.05. Conclusion .............................................................522

§ 13.01. Overview.

Section 365 of the Bankruptcy Code governs the assumption and rejection of executory contracts and unexpired leases. The Code specifies that the rejection of an executory contract or lease constitutes a breach of the agreement. It further specifies that the rejected contract or lease shall be treated as if the debtor had breached the agreement immediately before the date of filing of the petition. The Code does not, however, fully delineate the consequences of rejection, particularly with regard to the rights and remedies available for non-debtor parties to the agreements. Where the Code is silent, courts have attempted to clarify what rejection means for the contract or lease at issue and what rights the other party to the agreement has upon rejection.

§ 13.02. Plain Language of the Statute.

It is commonly known that a trustee or debtor-in-possession can assume or reject an executory contract or unexpired lease. Section 365(a) provides:
(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.\(^1\)

An executory contract is an agreement where “‘the obligation 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 the other.’”\(^2\) An unexpired lease is just that, a lease that has not expired.

A number of agreements may appear to be executory contracts, but are not upon closer review. The first requirement is that there is a bona fide contract or lease, and often what appears to be a contract may not be when reviewed under applicable state law. For instance, property rights are not executory contracts, and often are held not to be contracts at all.\(^3\)

Second, contracts must also be executory. Simply because there remains some obligation to be performed, is not dispositive.\(^4\) Rather, the unperformed

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1 11 U.S.C. § 365(a) (emphasis added).
3 In re KY USA Energy, Inc., 439 B.R. 413, 415 (Bankr. W.D. Ky. 2010) (finding Farmout Agreement was “conveyance of an interest in realty” and “not subject to the provisions of 11 U.S.C. § 365, as it is not an executory contract or unexpired lease.”); In re KY USA Energy, Inc., 444 B.R. 734, 737 (Bankr. W.D. Ky. 2011) (reaching same conclusion in later proceeding in same case); see also In re Beeter, 173 B.R. 108, 114–16 (Bankr. W.D. Tex. 1994) (homeowners association obligations and dues in deed are covenants running with land and not subject to rejection); In re Raymond, 129 B.R. 354, 358-59 (Bankr. S.D.N.Y 1991) (same); Gouveia v. Tazbir, 37 F.3d 295, 297, 299 (7th Cir. 1994) (restrictive covenant was “an interest in real property. As such § 365 of the bankruptcy code is inapplicable.”); In re Hayes, 2008 WL 8444812, at *10–11 (B.A.P. 9th Cir. Mar. 31, 2008) (relying upon Gouveia to support holding that restrictive covenants were not subject to rejection under § 365).
4 Gouveia, 37 F.3d at 298–99 (“[A]lmost all agreements to some degree involve unperformed obligation [sic] on either side, such an expansive definition of the term ‘executory’ is not what Congress enacted through its choice of language in § 365.” (citations omitted)); In re Columbia Gas Sys., Inc., 50 F.3d 233, 244 n.20 (3d Cir. 1995) (“[N]ot every contract that appears executory because it has not been completely performed is executory for purposes of § 365.”).
obligation must be sufficient to constitute a material breach of the agreement if ultimately not performed. Administrative or ministerial obligations are not sufficient.\(^5\)

\section*{§ 13.03. What Does a Rejection Mean?}

Once a debtor moves to reject a contract or lease, questions arise as to what rejection means to the contract or lease at issue and what rights the non-debtor party has upon rejection.\(^6\)

\[1\] — What the Code Provides.

Section 365(g) simply states:

\[(g) \text{ Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease —}\]

\[ (1) \text{ if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition; . . . .}\]

Thus, upon rejection, the executory contract is treated as being breached by the debtor, and the non-debtor can file a claim for money damages resulting from the breach. However, the claim is treated as pre-petition claim, even

\(^5\) See, e.g., \textit{In re} Sudbury, Inc., 153 B.R. 776, 779 (Bankr. N.D. Ohio 1993) (“Whether the Debtor’s duties under the Cooperation Clauses are characterized as conditions or ministerial obligations, they are of a different character than bargained for consideration. Obviously an insurance company does not bargain for the Debtor’s cooperation in handling claims. It bargains for premiums. The Cooperation Clauses merely reflect the fact that the insurer’s ability to defend claims may require the insured to furnish information relating to the claim and not to prejudice the insurer’s defense.” (emphasis added)); Kent’s Run P’ship, Ltd. v. Glosser, 323 B.R. 408, 421 (W.D. Pa. 2005) (concluding that preparing property description, creating and filing documents were ministerial tasks that did not amount to material breaches); \textit{see also} \textit{In re} Streets & Beard Farm P’ship, 882 F.2d 233, 235 (7th Cir. 1989) (holding unperformed delivery of legal title to be a formality rather than “the kind of significant legal obligation that would render the contract executory.”).

\(^6\) From the debtor side, the effect of rejection can also be a question and consideration — for example, whether a debtor retains lease-provided rights to complete reclamation after rejection. The applicable law should be the same from the debtor side, but for purposes of this chapter, we are only addressing these issues from the perspective of a non-debtor party.

\(^7\) 11 U.S.C. § 365(g) (emphasis added).
though the breach (rejection) occurred after the debtor filed bankruptcy. This means that the non-debtor claimant now stands with the other pre-petition creditors, paid in the order of priority, and sometimes receiving only pennies on the dollar, if anything at all. Only those executory contracts and leases that are assumed post-petition are treated as administrative claims requiring payment in full or adequate assurance that the payments will be made.\(^8\)

Nevertheless, this does not answer the question of what happens with respect to the rights under the rejected agreement. Some rights are provided by statute. The Code specifies the rights of a non-debtor lessee when the debtor is the landlord and rejects a lease — the non-debtor retains all rights granted to it under the lease or it has the option to consider the lease terminated if the breach resulting from the termination is substantial enough. While the non-debtor/lessee cannot collect from the debtor for obligations under the lease, it may set off those amounts from any rent or payments owed to the debtor under the lease. Section 365(h)(1) provides, in pertinent part:

\[
(h)(1)(A) \text{ If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and —}
\]

if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or

if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

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(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.9

Sublessees, however, should be aware that if a debtor is the lessee (and then, in turn, the sublessor) and rejects the sublease and the master lease, then the sublessee’s rights under the sublease are not guaranteed. This is because the sublessee’s rights are dependent on those held by the debtor as lessee, and if the debtor/lessee rejects the main lease, the sublessee risks losing its interest in the leased property. As a sublessee, it is preferable to obtain an agreement with the original lessor protecting your rights under the lease in such an event.


The Code simply states that the rejection constitutes a breach for which a non-debtor party may assert a damages claim, and it provides for certain relief of the debtor as the landlord. It does not say anything with respect to the status of the contract or the lease following rejection when it comes to other executory contracts, including leases where the debtor is the lessee.

Many courts have held that a rejection of a contract or lease resulting in a breach, consistent with non-bankruptcy law, does not automatically terminate the contract or lease.10 Nor does the rejection “invalidate, rejudicate, repeal, 

10 In re Giordano, 446 B.R. 744, 748–49 (Bankr. E.D. Va. 2010) (rejection “does not make the contract disappear”); In re Miller, 282 F.3d 874, 878 (6th Cir. 2002) (“The rejection of the lease . . . is not a termination, thus, the debtor’s lease continued until termination by either party.” (internal citations omitted)); In re Flagstaff Realty Assocs., 60 F.3d 1031, 1034 (3d Cir. 1995) (holding that rejection does not alter substantive rights of the parties to lease); In re Austin Dev. Co., 19 F.3d 1077, 1083 (5th Cir. 1994) (debtor lessee’s failure to
or avoid an executory contract.”11 Rather, rejection merely excuses the debtor from performance, and the counterparty cannot assert an administrative claim arising from the non-performance.12 However, rejection does not permit the debtor to breach the contract in a way that entirely cuts off the rights of

assume nonresidential real property lease does not effect a termination of the lease or the forfeiture of the third parties’ rights in such lease; Leasing Serv. Corp. v. First Tenn. Bank Nat’l Ass’n, 826 F.2d 434, 436 (6th Cir. 1987) (discussing rejection’s effect on creditor’s security interest in property and concluding that debtor lessor’s rejection of lease had no effect on creditor’s security interest in property securing the lease); Osprey-Troy Officentre LLC v. World Alliance Fin. Corp., 822 F. Supp. 2d 700, 707–08 (E.D. Mich. 2011) (debtor lessee’s rejection of lease was not a termination (citing Leasing Serv., 826 F.2d 434)); In re Park, 275 B.R. 253, 259 (Bankr. E.D. Va. 2002) (“[T]he rejection of the lease by the trustee did not, standing alone, terminate the debtors’ leasehold interest.”)).

11 In re Walnut Assocs., 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992); see also In re Alongi, 272 B.R. 148, 154 (Bankr. D. Md. 2001) (“[R]ejection does not cancel, repudiate, or terminate contracts; . . . and . . . rejection does not . . . terminate state-law rights in or to specific property.” (internal quotations and citations omitted)); Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC, 686 F.3d 372, 376–77 (7th Cir. 2012), cert. denied, 133 S. Ct. 790 (2012) (rejection does not vaporize rights of the other contracting party and notes that for a debtor lessee “rejection does not abrogate the lease”); Thompkins v. Lil’ Joe Records, Inc., 476 F.3d 1294, 1308 (11th Cir. 2007) (“[T]he rejection of the Agreement . . . did not effectively rescind [the agreement] and reverse the executed transfer of the . . . copyrights . . . .”); In re Taylor-Wharton Int’l LLC, 2010 WL 4862723, at *3 (Bankr. D. Del. Nov. 23, 2010) (“[T]he effect of rejection is to relieve a debtor from future performance under the contract; rejection does not undo past performance under the contract. Consequently, to the extent that both or either of the parties have performed under the executory contract, the debtor’s rejection has no effect on such performance.”); In re Bachinski, 393 B.R. 522, 544 (Bankr. S.D. Ohio 2008) (“Courts consistently have held that rejection of an executory contract does not unwind transactions that already have been consummated — or void property rights that already have been obtained — under the contract prior to rejection.”); Sir Speedy, Inc. v. Morse, 256 B.R. 657, 659 (D. Mass. 2000) (“Rejection does not cause a contract magically to vanish.”); In re Bergt, 241 B.R. 17, 35 (Bankr. D. Alaska 1999) (“Rejection does not ‘nullify,’ ‘rescind,’ or ‘vaporize’ the contract or terminate the rights of the parties; it does not serve as an avoiding power separate and apart from the express avoiding powers already provided in the Bankruptcy Code.”); In re Hughes, 166 B.R. 103, 105 (Bankr. S.D. Ohio 1994) (“Consistent with the bankruptcy law’s general deference to state-law rights in or to specific property, rejection of a contract does not terminate such rights that arise from rejected contracts. Rejection is not itself an avoiding power.” (internal citations omitted)).

the counterparty. Some courts have even held that certain enforcement rights still exist, and some have allowed the enforcement of post-termination enforcement rights.


The above sections address and provide the law on the consequences of rejection. This assumes that the debtor is able to reject the agreement or lease in issue. However, that situation is not always a given, and there are several bases to fight rejection of a contract or lease if maintaining those rights in their complete form (i.e., the debtor is not permitted to escape its obligations) is desired. The United States Bankruptcy Court for the Eastern District of Kentucky recently rendered a decision finding that the debtor was not permitted to reject two agreements. The non-debtor party made a number of arguments contesting rejection, including that the agreements were property rights not subject to § 365; that if they were, they were not executory; and that the agreements were part of and consideration for a larger transaction and could not be rejected separately from the other contracts and leases involved in that transaction. This scenario is interesting in its illustration of what the court found compelling and as to what the decision to preclude rejection was eventually based on.

[1] — Background.

Two coal producers owned or held rights with regard to certain adjacent tracts of land. The parties each mined their respective properties but soon

13 In re Qimonda AG, 482 B.R. 879, 898 (Bankr. E.D. Va. 2012) (rejection does not give debtor license to engage in breaches of contract or cut off counterparty’s right entirely).
14 In re Walnut Assocs., 145 B.R. at 494 (“If state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.”); Sir Speedy, 256 B.R. at 660 (finding rejection did not result in termination and allowing enforcement of covenant not to compete to the extent enforceable under state law, whose “very purpose [was] to govern the relationship between the parties after the demise of the underlying contract”); Abboud v. Ground Round, Inc., 335 B.R. 253, 261–63 (B.A.P. 1st Cir. 2005) (citing Sir Speedy and finding non-debtor lessor could enforce term of lease requiring post-termination transfer of liquor license back to lessor because right did not result in a monetary “claim” but was enforceable by specific performance under state law).
realized that the way the property was divided was not conducive to either’s use of its respective property. To remedy the situation, the parties entered into several comprehensive and interrelated property exchanges and agreements, all executed or deemed to be executed on the same day as part of the master Property Exchange Agreement (the “Exchange Agreement”). The Exchange Agreement transferred certain rights and interests in property to allow the parties to operate more efficiently, and it also included a number of ancillary agreements that were part of the same transaction.

The principal consideration for the Exchange Agreement was some sixteen documents executed by the parties (the “Ancillary Documents”) whereby certain of the parties’ real property interests in the area were exchanged. This included the exchange of coal reserves, as well as a Disposal Agreement and an Easement Agreement. The parties agreed that if the parties did not complete all of the Ancillary Documents, the entire Exchange Agreement was void — it was all or nothing. The Exchange Agreement stated, in pertinent part:

2.6 Simultaneous Actions. Each of the actions required under this Section 2.2 [execution of the Ancillary Documents] shall be deemed to have occurred simultaneously at the Closing and unless all such actions are taken none of the actions provided for in this Agreement shall be taken or deemed to have been taken, and any acts which may have been performed in respect thereof shall be canceled and treated as if void and of no force and effect.

The Exchange Agreement also included an incorporation clause where the parties agreed that the Exchange Agreement and all of its schedules and exhibits, including the Ancillary Exchange Agreements, were the entire agreement.

One of the parties to the Exchange Agreement became a bankruptcy Debtor. The Debtor eventually sought to reject two of the Ancillary Documents, the Easement Agreement and the Disposal Agreement.

[a] — Easement Agreement.

In the Easement Agreement, the Debtor “grant[ed] and convey[ed]” the right of an easement for a roadway across the adjoining Debtor’s property.
The Easement Agreement was filed in the public land records with the applicable counties. The Debtor’s only obligations under the agreement were to allow the other party to cross the land and to submit usage reports. Thus, the Debtor’s sole de facto obligation under the Easement Agreement was to continue to allow the non-debtor to use the roadway across its property.

The Easement Agreement also referenced the Exchange Agreement, providing that it was entered into pursuant to a specific section of the Exchange Agreement. The Easement Agreement also included an incorporation clause providing that the Easement Agreement and the Exchange Agreement embodied the entire agreement between the parties.

[b] — Disposal Agreement.

The Disposal Agreement was also recorded in the land records of the respective counties. In the Disposal Agreement, the parties granted each other reciprocal rights to dispose of spoil materials generated in connection with their respective mining activities on real property controlled by the other.

Like the Easement Agreement, the Disposal Agreement also provided it was made “in exchange for and in consideration of the various property rights exchanged between [the parties] pursuant to the Exchange Agreement” and that the sole consideration for the agreement was the property right exchanges in the Exchange Agreement. It too included the same incorporation clause as the Easement Agreement.

[2] — Defenses to the Debtor’s Motion to Reject the Easement and Disposal Agreements.

The Debtor filed a motion to reject the Easement Agreement and Disposal Agreement but desired to assume all remaining agreements under the Exchange Agreement. The non-debtor counterparty to the agreements objected, arguing:

• The Easement Agreement and the Disposal Agreement constituted property rights, vested and recorded, and could not be executory contracts or leases;

• The Easement Agreement and the Disposal Agreement were not executory because the Debtor’s obligations thereunder were minimal;
The Easement Agreement and Disposal Agreement could not be rejected because they were part of a larger transaction that had been concluded and the consideration exchanged upon execution of the Agreements; and

Even if the Easement and Disposal Agreements could be rejected, the rejection constituted a breach by the Debtor but did not deprive the counterparty of the rights under the agreements, or, similarly, the agreements were more analogous to an unexpired lease, with the Debtor as the lessor, such that the counterparty was afforded the rights under 11 U.S.C. § 365(h).


The court declined to determine whether or not the agreements embodied property rights or to decide whether property rights could be rejected. In addition, the court declined to determine whether the agreements were executory. Both of these arguments would appear to involve threshold issues, that is, whether the agreements were even subject to 11 U.S.C. § 365 in the first instance. Instead, the court effectively assumed that the agreements were subject to rejection and decided to base its decision on the fact that the two agreements the Debtor sought to reject were part and parcel of a larger transaction — the remainder of which agreements the Debtor desired to retain.

Generally, in order for an executory contract or unexpired lease to be rejected, the contract or lease must be rejected in its entirety. Where multiple contracts are intended to comprise one agreement, the debtor may not sever them for purposes of rejection.16 Relying primarily on *KFC Corp. v*

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16 *See, e.g., In re LG Philips Displays USA, Inc., 2006 WL 1748671, at *4 (Bankr. D. Del. June 21, 2006) (“[A]ll of the contracts that comprise an integrated agreement must be either assumed or rejected, since they all make up one contract.”) (internal citations omitted); In re Philip Servs., Inc., 284 B.R. 541, 546 (Bankr D. Del. 2002), aff’d 303 B.R. 574 (D. Del. 2003) (holding that a non-assignable promissory note that former shareholders
Wagstaff Minnesota, Inc. (In re Wagstaff Minnesota, Inc.),\textsuperscript{17} the court noted that under general principles of contract interpretation, state law governs the determination of whether “several documents form one indivisible contract” and that the parties’ intentions determine whether several contracts form one indivisible agreement.\textsuperscript{18} Here, the court held that under applicable Kentucky law, which was also in issue in \textit{KFC Corp.},\textsuperscript{19} the clear and unambiguous terms of the Exchange Agreement evidenced the parties’ intent that the Transaction Agreements formed one indivisible contract, finding:

- The Transaction Agreements were executed contemporaneously by and between the same parties and all related to the same subject matter (\textit{i.e.}, the operations of the parties’ respective mining operations);
- The Exchange Agreement specifically provided that the Transaction “shall be canceled and treated as if void and of no force and effect” unless the Easement and Disposal Agreements, along with other Ancillary Documents, were entered into at the Closing;
- The Exchange Agreement defined the “entire agreement” to include the schedules and exhibits, and models of the Easement of acquired company received as part of consideration paid in connection with merger had to be regarded as non-separable part of merger agreement itself because “[u]nder general contract law, the parties’ intentions determine whether two separately executed documents are in reality one agreement.”); \textit{In re Annabel}, 263 B.R. 19, 24-25 (Bankr. N.D.N.Y. 2001) (holding that where the components of an agreement (\textit{i.e.}, the purchase of assets, seller’s covenant not to compete and the consulting agreement) were “intimately bound to one another with no apparent intention that the parties thereto intended anything other than a single, unseverable contract,” they could not be severed for purposes of rejection).

\begin{itemize}
\item\textsuperscript{17} Ch. 11 Case No. 11-43073, Adv. No. 11-2450, 2012 WL 10623 (D. Minn. Jan 3. 2012).
\item\textsuperscript{18} See also, \textit{e.g.}, \textit{In re Ritchey}, 84 B.R. 474, 476 (Bankr. N.D. Ohio 1988) (in deciding whether several writings are in fact “one contract” or “several contracts,” the Bankruptcy Court should look to state law as to whether the contract is divisible or indivisible).
\item\textsuperscript{19} See O’Bryan v. Mengel Co., 6 S.W.2d 249, 250 (Ky. 1928) (under Kentucky law, test for “whether a contract is to be treated as an entirety, or as severable, is the intention of the parties, to be gathered from the object and terms of the contract itself.” (internal citations omitted).
Agreement and the Disposal Agreement were included as exhibits;

- The Easement Agreement and the Disposal Agreement both defined the “entire agreement” as including the Exchange Agreement; and

- The sole consideration for the Transaction was the various property rights that the parties exchanged pursuant to the Exchange Agreement (and with respect to the Disposal Agreement, the reciprocal rights granted to the parties in that agreement).

Based on these findings, the court concluded that the Agreements were an “integral, interdependent, and non-severable part” of the Transaction. Because the Easement Agreement and the Disposal Agreement constituted an indivisible part of the Transaction, the court held that the Debtor could not reject the Agreements and denied the Debtor’s motion. Thus, careful drafting at the transaction stage pre-empted the Debtor’s ability to pick and choose which agreements from an integrated transaction it wanted to take advantage of and which it wanted to reject.

§ 13.05. Conclusion.

Questions often arise regarding the consequences of rejection of contracts and leases in bankruptcy, especially with respect to the rights of the non-debtor party to the agreement. Some rights are provided by statute, and where the Code is silent, courts have attempted to fill in the gaps. Most

20 In re Trinity Coal Corp., 514 B.R. at 531 (citing In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. Del. 2008) (“multi-part agreement is not severable if the parties entered into the agreement as a whole, without which there would have been no agreement”); Interstate Bakeries Corp., 751 F.3d at 963 (“determining an asset purchase agreement and a license agreement were integrated under Illinois law where the agreements were executed the same date, both agreements defined the ‘entire agreement’ as including both agreements, and a model of the license agreement was attached as an exhibit to the asset purchase agreement”); In re Physiotherapy Holdings, Inc., 506 B.R. 619, 626 (Bankr. D. Del. 2014) (considering whether agreements were executed at the same time as a factor in determining whether agreements were integrated)).
courts agree that a rejection of an executory contract or lease resulting in a breach does not automatically terminate the agreement. Rather, rejection simply excuses the debtor from performance. Beyond that, courts differ in their approaches to the effect of rejection, with some courts even holding that certain enforcement rights still exist. It is important to consider these principles when drafting leases, contracts, and integrated transactions and to consider ways to protect your client in the event that an agreement is rejected, as well as to understand the client’s rights under state law in the event of a breach of either an executory contract or a lease.