Bankruptcy Bullets

Andrea Campbell Davison

Executory Contracts

Welcome to the latest installment of Bankruptcy Bullets, a quick-reference guide intended to assist attorneys in navigating the sometimes intimidating and often confusing arena of bankruptcy law. This article provides a brief explanation of executory contracts, their treatment under the Bankruptcy Code, and what to expect if you or your client is a party to one.

What is an Executory Contract?

Defined, an "executory contract" is a contract under which performance remains outstanding for both parties and for which failure to perform those obligations would result in a material breach of the contract. Executory contracts are property of the bankruptcy estate; therefore, the automatic stay imposed by 11 U.S.C. § 362 prevents parties from terminating or otherwise adversely affecting the debtor's rights under the contract (please refer to the Summer 2011 Bankruptcy Bullets by Khang Tran for more details on the automatic stay!). This is the case despite any contract provision to the contrary, including any provision which designates the bankruptcy filing of a party to be an automatic default or allows termination upon the bankruptcy filing of the contract counter-party. Such "ipso facto" clauses, as they are called, are not enforceable as a matter of bankruptcy law.

What happens when a party to an executory contract files for bankruptcy?

A debtor has a fiduciary duty to maximize the value of the bankruptcy estate for all creditors. As a corollary, a debtor has the authority, subject to court approval, to determine which executory contracts bring value to the estate and which do not. If the executory contract is valuable to the debtor, the debtor may "assume" the contract and continue performing under it. If the executory contract is not valuable, the debtor may "reject" the contract and terminate it. A debtor must have sound business judgment for assuming or rejecting a contract. Note that a debtor must assume or reject a contract in full; a debtor cannot pick and choose the valuable provisions.

What if the debtor assumes my contract?

If a debtor elects to assume your executory contract, the debtor must continue to perform under the contract or provide "adequate assurance" that the debtor will and is able to perform. The debtor must also cure any existing defaults, monetary or otherwise, under the contract. Often, a debtor will assume a contract and then assign its interest to a third party for value (in which case, the purchaser must provide adequate assurance that it can perform under the contract). Bankruptcy law favors assignment, and generally it will be allowed despite any contract provisions to the contrary.

What if the debtor rejects my contract?

If the debtor elects to reject your executory contract, the debtor will be relieved of its obligations under the contract. Rejection constitutes breach by the debtor as of the day the bankruptcy case was filed, and entitles the non-debtor party to a general unsecured claim for damages arising out of such breach.

Is there a deadline for a debtor to assume or reject an executory contract?

Generally, a debtor has until the confirmation of the plan of reorganization to decide whether to assume or reject an executory contract. However, a non-debtor party may request that the court set an earlier deadline for the debtor to decide based on compelling circumstances. In deciding whether to set such a deadline, a court will generally consider, among other factors: the damage the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; the importance of the contract to the debtor's business and reorganization; whether the debtor has had sufficient time to evaluate the potential value of its assets; whether the debtor's exclusive time to file a plan has expired; and the complexity of the case.

For more information on executory contracts, please see 11 U.S.C. § 365.

Andrea Campbell Davison is a bankruptcy attorney with Arent Fox LLP in Washington, D.C. She can be reached at davison.andrea@arentfox.com.