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EXECUTORY CONTRACTS

Effect of Rejection On Right Other Than Rights to Payment

By Ronald Barliant

Take it from me, judges need help. And lawyers win cases by helping judges. But when lawyers lead judges in the wrong direction, the judge may make a mistake and the lawyers may lose their case.

That's what may have happened in *In re Centura Software Corp.*, 281 B.R. 660 (Bankr. N.D. Cal. 2002), where a Chapter 11 debtor got away with terminating a trademark license by rejecting it under Bankruptcy Code § 365. The lawyers for the licensee led the judge in the wrong direction even before the argument began. By the time they realized their mistake, it was too late.

It's easy to understand how the lawyers and the judge became confused; the law of executory contracts in bankruptcy is confusing. Some-times § 365 seems like the bubble boy in that Seinfeld episode: impervious to anything outside itself. In particular,

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many lawyers and judges have been strangely resistant to applying the U.S. Supreme Court's directions about how to apply bankruptcy law:

"Unless some federal interest requires a different result, there is no reason why [state] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner v. U.S.*, 440 U.S. 48, 55 (1979). "Bankruptcy courts are not authorized in the name of equity to make wholesale substitutions of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides." *Raleigh v. Ill. Dept. of Revenue*, 530 U.S. 15, 25 (2000). "[W]here...the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *U.S. v. Ron Pair Enterprises Inc.*, 235 U.S. 235, 241 (1989).

The plain meaning of the Supreme Court's jurisprudence should be applied to the effect of rejection on rights arising under nonbankruptcy law, but often is not. The language of the statute is not difficult. Sec. 365(a) says that "the trustee, subject to the court's approval, may assume or reject any executory contract...of the debtor." Sec. 365(g) says that "the rejection of

an executory contract...of the debtor constitutes a breach of such contract." The trustee (or debtor in possession) can reject a contract, and the sole consequence is that the contract is thereby breached.

Remembering the High Court's direction to apply the Bankruptcy Code according to its terms, and its prohibition against altering nonbankruptcy rights in the absence of a federal interest, it should be easy to figure out a nondebtor's rights after rejection. Simply determine what rights a nonbreaching party to the contract would have as a result of a breach under nonbankruptcy law. If something in the Bankruptcy Code requires any of those rights to be analyzed differently because of the bankruptcy, apply that analysis; if not, the rights are not affected by the bankruptcy.

For example, if the nonbreaching party has a right to money damages, that would be a "claim" under § 101(5) ("a right to payment"), and the debtor would owe a corresponding "debt" under § 101(12) ("liability on a claim"). Claims and debts are subject to discharge (§§ 727, 1228, 1141, 1328) and may be dealt with in plans (§§ 1123, 1222, 1322). Since rejection equals breach, the right to money

damages of the nondebtor party to a rejected contract is analyzed by applying those code sections. No one is confused by that.

Frequently, however, contracts give rise to rights that are not simply rights to payment, and therefore not claims under the Bankruptcy Code. A contract may, for example, contain a covenant by the debtor not to compete with the other party. Under nonbankruptcy law, if the debtor breached, the other party would not be limited to money damages but could enforce that covenant by getting an injunction.

Bankruptcy courts have recently understood that nothing in the Bankruptcy Code changes that analysis. The judges in *In re Annabel*, 263 B.R. 19, 25-6 (Bankr. N.D. N.Y. 2001) and *Sir Speedy Inc. v. Morse*, 256 B.R. 657 (Mass. Dist. Ct. 2000), held that the debtors' rejection of contracts did not deprive the nondebtors of their rights to injunctions enforcing covenants not to compete. Indeed, since the late 1980s, when Michael Andrew and Jay Westbrook wrote influential law review articles, many courts and scholars, as well as the 1997 National Bankruptcy Review Commission, have come to the view that rejection is nothing more than the bankruptcy estate's decision not to become obligated on a contract; it does not wipe out contract obligations, nor is it an avoiding power that terminates otherwise unavoidable rights.¹

Yes, many courts, especially in older cases, have viewed rejection as a magical vehicle for releasing, repealing, discharging, revoking, voiding, canceling or avoiding contractual obligations. A particularly ignoble example is *Lubrizol Enterprises Inc. v. Richmond Finishers Inc.*, 756 F.2d

1043, 1048 (4th Cir. 1985). There, the court held that the debtor/licensor's rejection of an intellectual property license terminated the contract and the nondebtor/licensee's rights to the technology, thereby "[making] a state-law property right disappear." Jay Lawrence Westbrook, The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts, 5 Am.Bankr.Inst.L.Rev. 463, 470 (1997).

Unease with the *Lubrizol* result prompted Congress to add § 365(n) to the Bankruptcy Code, which now provides that the licensor's rejection of a technology license by the licensor does not terminate the licensee's right to use the technology, except at the licensee's option. "That fix joined a series of prior fixes also provoked by judicial mistakes arising from using executory-contract doctrine (specifically 'rejection') as a sort [of] pseudo avoiding power." *Id.* at 470.²

That brings us to *Centura Software*, a throwback case from California. The debtor had licensed the use of a trademark. In bankruptcy, the debtor, as debtor in possession, moved to reject the license. That is when the licensee's lawyers made their key mistake. They entered into a "Stipulated Order Approving Rejection of License Agreements" that only retained any rights the licensee might have under § 365(n). See *Centura*, 281 B.R. at 663.

It was not a mistake to agree to rejection of the license agreement. The decision to reject is within a DIP's discretion, usually measured by the liberal business judgment rule. And rejection is always appropriate when it is better for the estate to suffer the consequences of breaching than to perform. More-over, properly understood, rejection is usually not terribly harmful

to the nondebtor. The nondebtor has a claim for any money damages and is left with any other rights it may have under nonbankruptcy law. Of course, in *Centura Software*, rejection was not properly understood.

The mistake was reserving rights only under § 365(n). The lawyers cornered themselves by focusing on the stipulation in § 365(n). That made the issue not the effect of rejection under § 365(g), but of whether a trademark license falls within § 365(n). The court consequently entered into a long discussion of § 365(n) that, by its plain language and according to its legislative history, excludes trademarks.

It was only at the hearing, after the briefs had been filed, that the licensee's lawyers first argued that under § 365(g), rejection does not terminate the nondebtor party's rights. See *id.* at 673. By then it was too late. Treating the argument as if it were a last-minute make-weight, which is how it must have appeared to him, the judge dealt with it in only a few brief paragraphs, reflecting only a cursory analysis.

For example, the opinion actually cites Mr. Andrew's ground-breaking article as support for the proposition that rejection terminates a license. In fact, Mr. Andrew's conclusion is the exact opposite: "Does rejection of the agreement terminate the nondebtor party's right to the licensed or franchised use of the underlying asset? Because the estate succeeds only to the debtor's in that asset, the answer should be no. Rejection is not a rescission of the license or franchise, but merely that estate's determination not to assume it. Thus, as long as the license or franchise is not otherwise avoidable, the estate should be in the

same position as any other nonassuming transferee of the debtor's rights in the asset." Andrew, 59 U. Colo. L. Rev. at 916.

The court's misreading of Mr. Andrew's article simply illustrates the light regard the judge had for the licensee's last-minute argument.

The court misunderstood the effect of § 365(g) to restrict the nondebtor party to only a claim for breach-of-contract damages. Actually it does no such thing. It says only that "rejection of an executory contract...constitutes a breach of such contract." It says nothing about the consequences that flow from that breach. And we know from *Butner* that when the Bankruptcy Code says nothing about nonbankruptcy rights, those rights are not analyzed differently merely because one party is in bankruptcy. Since nothing in the Code says that a trademark licensee loses its rights to the mark, those rights must survive rejection, just as they would survive a breach by the licensor outside bankruptcy. So the judge was wrong.

Congress deserves some of the blame because of its insistence on dealing with misinterpretations of the Bankruptcy Code by applying a band-aid every time a special interest group cries loudly enough. The *Centura Software* court reasoned that because §§ 365(h), 365(i) and 365(n) specifically protect lessees of real property leases, purchasers of real property and intellectual property licensees, other types of rights in executory contracts must not be protected from termination. Where §§ 365(h), (i) and (n) do not apply, the court is suggesting, rejection can be used as an avoiding power.

This analysis is misguided. As Mr. Andrew notes: "Avoiding-power rejec-

tion is...simply more freight than negative inference will bear. It requires that 'rejection' be assigned a meaning fundamentally at odds with both the history and the purpose of the executory contracts doctrine, with no legislative history in support. It requires a corresponding abatement of the general principle, explicit in the statute and its legislative history, that a bankruptcy estate succeeds only to the debtor's rights and interests in property."

Andrew, Executory Contracts in Bankruptcy, at 929 (footnotes omitted).

Moreover, there is no principled reason that people who acquire rights in some types of property should be treated differently from people who acquire rights in other kinds of property, and no reason to believe Congress intended an unprincipled distinction.

And even if the wasteful Congressional habit of responding to parochial lobbyists with special provisions did reflect some point of view about the effect of rejection generally, it would not matter. It is the intent of the Congress that enacted § 365(g) in 1978 that is controlling, not the understanding of a later Congress. Moreover, we know from *Ron Pair* that we should not even be looking at other aids for interpretation if the statutory language is plain. Sec. 365(g) could not be plainer: "rejection...constitutes a breach." The word "breach" does not take on a new meaning because remedies are doled out in the context of a bankruptcy.

Bankruptcy law is dynamic. Lawyers who restrict themselves to conventional wisdom miss trends in the law that might have carried them to victory. Judges understand trends, and like to be a part of them if they see that the trend is going the right way. It is the

lawyer's job to spot those trends and argue them to the judge. Perhaps the lawyers in *Centura Software* will have a chance to redeem themselves on appeal. You may not be so lucky.

(1) See, e.g., *In re Lavigne*, 114 F.3d 379, 386-88 (2d Cir. 1997); *In re Austin Dev. Co.*, 19 F.3d 1077, 1081-83 (5th Cir. 1994); *In re Continental Airlines*, 981 F.2d 1450, 1459 (5th Cir. 1993); *In re Modern Textile Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990); *In re Taylor*, 913 F.2d 102, 106-07 (3d Cir. 1990); *Leasing Serv. Corp. v. First Tennessee Bank, Nat'l Ass'n*, 826 F.2d 434, 436-37 (6th Cir. 1987); *In re Rye Kyeom Park*, 275 B.R. 253, 257 (Bankr. E.D. Va. 2002); *In re Mitchell*, 249 B.R. 55, 58 (Bankr. S.D. N.Y. 2000); *In re Reppond*, 238 B.R. 442, 443 (Bankr. E.D. Ark. 1999); *Couture v. Burlington Housing Auth.*, 225 B.R. 58, 64 (D. Ver. 1998); *CASC Corp. v. Miller*, 180 B.R. 245, 263 (Bankr. C.D. Cal. 1995); *Thomas v. Herzog*, 133 B.R. 92, 95 (Bank. N.D. Ohio 1991); *In re Don & Lin Trucking Co.*, 110 B.R. 562, 566-68 (Bankr. N.D. Ala. 1990); Michael T. Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection," 59 U. Colo. L. Rev. 845 (1988); Jay Lawrence Westbrook, A Functional Analysis of Executory Contracts, 74 Minn. L. Rev. 227 (1989); Michael T. Andrew, Executory Contracts Revisited: A Reply to Professor Westbrook, 62 U. Colo. L. Rev. 1 (1991); Douglas G. Baird, The Elements of Bankruptcy 117 (Foundation Press Inc. 1992); 1 Epstein, Nickles & White, Bankruptcy 455-56 (West 1992); 3 Collier on Bankruptcy 365.09 (15th ed. 1999); National Bankruptcy Review Commission, Bankruptcy the Next Twenty Years, § 2.4.1 (1997) ("Rejection does not 'nullify,' 'rescind,' or 'vaporize' the contract or terminate the rights of the parties.")

(2) See 11 U.S.C. § 365(h) (rejection of a real property lease by a lessor's estate does not oust the lessee from possession); § 365(i) (rejection of a real property purchase contract does not curtail the right of the purchaser in possession to complete the purchase).



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