Central States
Bankruptcy Workshop

Business Track

Assume the Worst: Executory Contract Law in 2022

Hon. Paul E. Singleton, Moderator
U.S. Bankruptcy Court (N.D. Ind.) | South Bend

Michael Brandess
Husch Blackwell LLP | Deerfield, Ill.

Krystal R. Mikkilineni
Dentons | Des Moines, Iowa

Marc N. Swanson
Miller, Canfield, Paddock and Stone, P.L.C. | Detroit

CONCURRENT SESSION

2022

Assume the Worst!

Executory Contracts in 2022

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Agenda

I. Introductions
II. Executory Contracts
III. Rejection
IV. Cure
V. Healthcare
VI. Questions

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Moderator and Panelists

Hon. Paul E. Singleton: Bankr. N.D. Ind. (South Bend, IN)

◆

Marc Swanson: Miller Canfield (Detroit, MI)

Krystal Mikkilineni: Dentons Davis Brown (Des Moines, IA)

Michael Brandess: Husch Blackwell LLP (Chicago, IL)

◆

The presenters thank Judge Lisa S. Gretchko for her tremendous contributions.

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What is an Executory Contract?

Approach	Definition
Countryman	The obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. *See In re Weinstein Co. Holdings LLC*, 997 F.3d 497, 504 (3d Cir. 2021).
Modified Countryman	Congress intended § 365 to apply to contracts where significant unperformed obligations remain on both sides. *See In re Brick House Properties, LLC*, 633 B.R. 410, 420–21 (Bankr. D. Utah 2021).

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What is an Executory Contract? (Cont.)

Approach	Definition
Functional	In determining whether a contract is executory under a functional approach, court examines whether the bankruptcy estate would benefit from assumption or rejection of the contract. *See In re Fin. Oversight & Mgmt. Bd. for Puerto Rico,* 631 B.R. 559 (D.P.R. 2021).
Blended	"Most recently, the United States Supreme Court, in describing what an executory contract is within the meaning of § 365 of the Bankruptcy Code, reaffirmed the continued vitality of both the Countryman approach and the functional approach, though not referring by name to these approaches. In Mission Product Holdings, Inc. v. Tempnology, LLC, —— U.S. ——, 139 S. Ct. 1652, 1657, 203 L.Ed.2d 876 (2019)." *In re Energy Conversion Devices, Inc.*, 621 B.R. 674, 707–08 (Bankr. E.D. Mich. 2020); *see also In re Cornerstone Valve LLC*, No. 19-30869, 2021 WL 1731770, at *2 (Bankr. S.D. Tex. Apr. 27, 2021).

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What is an Executory Contract? Practice Pointers

- Different approaches can lead to different results. Be mindful of your venue!
- *Weinstein*: The Third Circuit acknowledged that parties are free to contract around the default material-breach and substantial-performance rules and designate obligations as material that would not otherwise qualify as such under applicable law, thus rendering the contract executory.
- *In re Cornerstone Valve LLC*: File a proof of claim if there is any question as to whether the contract is executory.
- Master Contract v. P.O.s hypothetical and discussion
- What about Arbitration Agreements?

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True Lease v. Disguised Financing

Approach	Definition
UCC / Bright-Line Test (state by state)	"The UCC provides a test for whether an agreement that is in the form of a lease is a true lease or is, in fact, a disguised secured sale transaction. 810 ILCS § 5/1–203." *Lyon Fin. Servs., Inc. v. Illinois Paper & Copier Co.*, 247 F. Supp. 3d 923, 930 (N.D. Ill. 2017).
Economic Reality Test (*Pillowtex*)	"[F]actors relevant to evaluating the economic reality of the transaction include whether the purchase option is nominal, whether the lessee's aggregate payments have a present value equaling or exceeding the original cost of the leased property, and whether the term of the lease covers the useful life on the equipment." *Prospect ECHN, Inc. v. Winthrop Res. Corp.*, No. 19-CV-586 (SRN/ECW), 2021 WL 5086274, at *8 (D. Minn. Nov. 2, 2021).
Blended	"Under the U.C.C., courts apply an objective "bright-line test" to determine whether an agreement in the form of a lease is an actual lease versus a security interest. See Minn. Stat. § 336.1-203(b). If, after applying the bright-line test, the agreement is deemed a lease, some courts have undertaken an additional analysis of the "economic realities" underlying the parties' agreement to determine whether it is properly characterized as a lease or a security interest." *Prospect ECHN, Inc. v. Winthrop Res. Corp.*, No. 19-CV-586 (SRN/ECW), 2021 WL 5086274, at *8 (D. Minn. Nov. 2, 2021).

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Rejection: Can the Contract be Rejected?

- In re FirstEnergy Sols. Corp., 945 F.3d 431 (6th Cir. 2019) (finding that rejection of energy contract was subject to more than business judgment test, and must include consideration of public and other municipal / government interests)
- In re Ultra Petroleum Corp., 28 F.4th 629, 636–37 (5th Cir. 2022) (rejection of a natural gas transportation agreement remains subject to purview of both Bankruptcy Court and Federal Energy Resource Commission)
- Practice Pointer: Assess whether satisfaction of the business judgment rule is sufficient or if other factors will be considered

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Rejection: Rejection ≠ Termination

- *In re Energy Conversion Devices, Inc.*, 621 B.R. 674, 717–18 (Bankr. E.D. Mich. 2020) ("A rejection does not terminate the contract. Based on the "rejection-as-breach approach," the Court held "that under Section 365, a debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside bankruptcy. Such an act cannot rescind rights that the contract previously granted." Construing § 365 in this manner, the Court held that the debtor-licensor's rejection of the license agreement could not revoke the trademark license or the non-debtor licensee's right to continue to use that trademark.)
- Practice Pointer: The actions of the non-breaching party after rejection matter. Any act indicating an intent to continue will operate as a conclusive election, not indeed of depriving him of a right of action for the breach which has already taken place, but depriving him of any excuse for ceasing performance on his own part. Anything which draws on the other party to execute the agreement after the default in respect of time or which shows that it is deemed a subsisting agreement after such default will amount to a waiver.

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Rejection Damages

- Rejection = breach which is deemed to have occurred immediately before petition date; results in unsecured claim for rejection damages
- 502(g) – claim arising from rejection of executory contract/unexpired lease shall be determined and shall be allowed or disallowed "the same as if such claim had arisen before the date of filing."
- Calculation and amount of damages generally determined by state law to extent doesn't conflict with Bankruptcy Code.
- 502(b)(6) – limits rejection claim of lessor for debtor's rejection of nonresidential real estate lease
- 365(h) – non-debtor lessee to rejected lease – choose termination or to remain in possession
- 502(b)(7) – employment contract – damages limited
- Specific performance instead of monetary damages? – depends
- Practice Pointer: Claimants, put your best (ethical) foot forward with your rejection damages claim!
- Practice Pointer 2: Creditors, when drafting a contract, don't limit remedies to specific performance.

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The Cure

"Misjudged your limits
Pushed you too far
Took you for granted
I thought that you needed me more, more, more

Now I would do most anything
To get you back by my side
But I just keep on laughing
Hiding the tears in my eyes
'Cause [debtors] don't cry
[Debtors] don't cry
[Debtors] don't cry"

– The Cure, "[Debtors] don't cry"

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Plan Provisions and the Cure

Case	Plan Provision
Takata	"Assumption and assignment of any executory contract or unexpired lease pursuant to the Plan, or otherwise, shall result in the full release and satisfaction of any Claims or defaults, subject to satisfaction of the Cure Amount, whether monetary or nonmonetary . . ."
Aeromexico	"Assumption or assumption and assignment of any Executory Contract or Unexpired Lease pursuant to the Plan, or otherwise, shall result in the full release and satisfaction of any Claims or defaults, subject to satisfaction of the Cure Amount, whether monetary or nonmonetary. . ."
24 Hour Fitness	"Assumption of any Executory Contract or Unexpired Lease pursuant to the Plan shall result in the full release and satisfaction of any Claims or defaults, whether monetary or nonmonetary . . ."

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Plan Provisions and the Cure
What is a Claim?

- 11 U.S.C. § 101(5), "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...."
- *In re City of Detroit*, Michigan, 548 B.R. 748, 761, 763 (Bankr. E.D. Mich. 2016) (addresses significant breadth of "claim" in this context and notes that while the "fair contemplation test," has the advantage of allowing the Court to examine all of the circumstances surrounding a particular claim . . . 'one approach may not fit all circumstances.'" *citing In re Huffy Corp.*, 424 B.R. 295, 303 (Bankr. S.D.Ohio 2010).
- Practice Pointer: The full release and satisfaction of all claims is too broad. Obtain revised language in the confirmation order which limits the affect of assumption to that prescribed by the Bankruptcy Code.
- Practice Pointer 2: Even if your contract is listed on a cure notice, it does not always mean that the contract has been assumed. Review the document. Under what else you need to look for.

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Implied v. Express Assumption

In re Dura Auto. Sys., LLC, 628 B.R. 750, 755–56 (Bankr. D. Del. 2021) (3rd Circuit rejected argument that in favor of implied assumption of executory contract finding that "the rule established by the plain and unambiguous language of the Bankruptcy Code requiring court approval for the assumption of an executory contract.").

But note, while *Dura Auto* is controlling in the 3rd Circuit, but always be mindful of your venue!

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Cure Practice Pointers

- When representing the non-debtor counterparty to an executory contract, think hard before signing an amendment to the existing contract during the case.
- Expect to negotiate your cure amount.
- Carefully examine the cure schedules and related deadlines, which are often different than the deadline to object to the plan.

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Executory Contracts: Healthcare Sector Health Insurance Benefit Agreements

- What is a Health Insurance Benefit Agreement?

An agreement between US Government (HHS / CMS) and providers of healthcare goods and services whereby providers can receive reimbursement payments in accordance with relevant statutes for services rendered to qualified beneficiaries. Under the Prospective Payment System, healthcare providers are paid regular estimates, which are audited annually to determine whether the provider was overpaid. Adjustments are usually made the following year.

- Are they executory or statutory entitlements?
  - Statutory entitlement: *In re Verity Health Sys. of California, Inc.*, 606 B.R. 843, 851 (Bankr. C.D. Cal. 2019), *vacated on other grounds by stipulation*, No. 18-BK-20151-ER, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019)
  - Executory: *Parkview Adventist Med. Ctr. v. United States on behalf of Dep't of Health & Hum. Servs.*, 842 F.3d 757, 763 (1st Cir. 2016)

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Executory Contracts: Healthcare Sector CCRC: Residential v. Non-Residential?

- 11 U.S.C. § 365(d)(2) and (4): Rejection and Timing Obligations

- In re Passage Midland Meadows Operations, LLC, 578 B.R. 367, 377 (Bankr. S.D.W. Va. 2017) ("In sum, if the Master Lease is deemed "nonresidential" in nature, contrary to Passage's desire, (1) it is not estate property, (2) it may not be assumed, and (3) Welltower's hoped-for lease transition to Paramount would not transgress the automatic stay. The analysis is complicated by two considerations, namely, that (1) the Bankruptcy Code does not define the term "nonresidential[,]" and (2) a split of authority exists, with the majority taking an unexpected approach.") (finding the lease nonresidential).

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Executory Contracts: Healthcare Sector
CCRC: Residential v. Non-Residential?

Approach	Test
Lease Test (minority)	*In re Passage Midland Meadows Operations, LLC*, 578 B.R. 367, 378 (Bankr. S.D.W. Va. 2017) ("The nature-of-the-lease test focuses instead on whether the intent of the lease is to provide income for the commercial lessee ("income test")).
Property Test (majority)	*PNW Healthcare Holdings LLC*, 617 BR 354, 362 (Bankr. W.D. Wash. 2020) ("[T]he Court holds that the correct focus of the definition of residential real property versus nonresidential real property should be on the intended use of such property under the lease. In the case at hand, there is no dispute that the Canyon Landlords were aware of and intended that the Debtors' facilities would be used as skilled residential nursing facilities or assisted living facilities.")

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Questions? Buehler…

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Contact Info

Marc N. Swanson: (313) 496-7591; swansonm_millercanfield.com

Krystal R. Mikkilineni: (515) 246-7943; Krystal.Mikkilineni@dentons.com

Michael A. Brandess: (312) 526-1542; michael.brandess@huschblackwell.com

Outline for ABI Panel
Assume the Worst – Executory Contract law in 2022

Part I: Executory Contract/Unexpired Lease Issues

I. What is an executory contract and unexpired lease?

A. Executory Contract Approaches

1. **Blended Approach**: Executory contracts are defined both in terms of whether there are obligations of both parties continuing into the future (the Countryman approach), and whether there is a purpose that can be accomplished by rejection of the contract (the functional approach).

2. **Modified Countryman:** Congress intended § 365 to apply to contracts where significant unperformed obligations remain on both sides.

3. **Functional Approach:** In determining whether a contract is executory under a functional approach, court examines whether the bankruptcy estate would benefit from assumption or rejection of the contract.

4. **Countryman Approach:** The obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

B. Recent Examples of Executory Contract Approaches

1. **Blended Approach:**

   a. In re Energy Conversion Devices, Inc., 621 B.R. 674, 707–08 (Bankr. E.D. Mich. 2020):

"Most recently, the United States Supreme Court, in describing what an executory contract is within the meaning of § 365 of the Bankruptcy Code, reaffirmed the continued vitality of both the Countryman approach and the functional approach, though not referring by name to these approaches. In *Mission Product Holdings, Inc. v. Tempnology, LLC*, ––– U.S. ––––, 139 S. Ct. 1652, 1657, 203 L.Ed.2d 876 (2019), the Supreme Court stated that an executory contract under § 365 is "a contract that neither party has finished performing." The Court explained that "[a] contract is executory if 'performance remains due to some extent on both sides.' " *Id.* (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522, n.6, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984)). The Court explained further that an executory contract is

"an agreement [that] represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform)." *Id.* The Court described an executory contract as the type of a contract that a trustee or debtor in possession can evaluate in terms of whether future performance under the contract would be beneficial or burdensome to the estate, and that can be rejected under § 365, if found to be of no benefit or if found to be burdensome to the estate:

> Section 365(a) enables the debtor (or its trustee), upon entering bankruptcy, to decide whether the contract is a good deal for the estate going forward. If so, the debtor will want to assume the contract, fulfilling its obligations while benefit[t]ing from the counterparty's performance. But if not, the debtor will want to reject the contract, repudiating any further performance of its duties. *Id.*

Therefore, under *Mission Product*, executory contracts are defined both in terms of whether there are obligations of both parties continuing into the future (the Countryman approach), and whether there is a purpose that can be accomplished by rejection of the contract (the functional approach)." (emphasis added)

b. In re Cornerstone Valve LLC, No. 19-30869, 2021 WL 1731770, at *2 (Bankr. S.D. Tex. Apr. 27, 2021

"The Bankruptcy Code allows debtors in possession to assume, reject, or assign executory contracts and unexpired leases. 11 U.S.C. § 365(a). Executory contracts are contracts where both parties have material obligations that remain to be performed. *See Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1657 (2019). Rejection of an executory contract constitutes a breach of that contract by the debtor. *Id.*

"Section 365(a) enables the debtor (or its trustee), upon entering bankruptcy, to decide whether the contract is a good deal for the estate going forward. If so, the debtor will want to assume the contract, fulfilling its obligations while benefitting from the counterparty's performance. But if not, the debtor will want to reject the contract, repudiating any further performance of its duties." *Id.* at 1658.

The Seventh Circuit has held that "in the face of clear evidence of an intent to repudiate, the non-repudiating party is no longer under an obligation to perform. Because one party is not obligated to perform, the contract is no longer executory as defined in bankruptcy." *In re C&S Grain Co.*, 47 F.3d 233, 237 (7th Cir.

1995). *But see In re Kemeta, LLC*, 470 B.R. 304, 322 (Bankr. D. Del. 2012). While some courts have disagreed with the holding in *C&S Grain*, those courts typically have done so out of a concern that pre-petition repudiations should not limit a *debtor's* ability to assume executory contracts. *See In re Kemata*, 470 B.R. at 325. This case presents the opposite scenario. The debtor made clear, long before bankruptcy, that it no longer intended to perform and that it did not seek reciprocal performance."

2. Modified Countryman: In re Brick House Properties, LLC, 633 B.R. 410, 420–21 (Bankr. D. Utah 2021)

"The Tenth Circuit has adopted the Countryman test for determining whether a contract is executory, which looks at whether "the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."

However, the Seventh Circuit pragmatically observed that if too broadly applied, the Countryman test could render all contracts executory regardless of their completion status:

> Taken literally, this definition would render almost all agreements executory since it is the rare agreement that does not involve unperformed obligations on either side. In our view, however, this interpretation would not effect the intent of Congress. Rather, we believe that Congress intended § 365 to apply to contracts **where significant unperformed obligations remain on both sides**.

The Tenth Circuit agreed with the Seventh Circuit in *Olah v. Baird (In re Baird)*:

If *Myers* stood for the proposition that any contract was executory that had "future obligations" left unfulfilled, however immaterial, then the "definition would render almost all agreements executory since it is the rare agreement that does not involve unperformed obligations on either side." *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989). Rather, the remaining obligations have to be **significant**, which, following Countryman and *Thomas American Stone & Building*, we construe to be obligations which, if either side failed to perform them, would constitute a breach.

Thus, the issue is whether the status of the REPC was such that "significant unperformed obligations remained on both sides.""

3. **Functional Approach:** In re Fin. Oversight & Mgmt. Bd. for Puerto Rico 631 B.R. 559 (D.P.R. 2021). "Although the Countryman test is favored by many courts, "[s]ome courts have moved away from Professor Countryman's approach and have adopted a 'functional approach' which works 'backward from an examination of the purposes to be accomplished by rejection, and if they have already been accomplished then the contract cannot be executory.' " In re Redondo Constr. Corp., Case No. 02-02887 (ESL), 2019 WL 1549726, at *12 (Bankr. D.P.R. Apr. 8, 2019), aff'd, 621 B.R. 81 (D.P.R. 2020). The relevant "purposes" which courts examine include "(1) taking advantage of contracts which will benefit the estate; (2) relieving the estate of burdensome contracts; (3) promoting the debtor's fresh start; (4) permitting the allowance and determination of claims; and (5) preventing parties from remaining "in doubt concerning their status vis-a-vis the estate." In re Bradlees Stores, Inc., No. 00-16033, 2001 WL 34809984, at *5 (Bankr. S.D.N.Y. Mar. 28, 2001), aff'd, 2001 WL 1112308 (S.D.N.Y. Sept. 20, 2001); Laughlin v. Nickless, 190 B.R. 719, 723 (D. Mass. 1996); see also In re Redondo Constr. Corp., 2019 WL 1549726, at *12 ("The 'functional approach' application requires for the court to decide whether a contract is executory by analyzing whether rejection of the contract would benefit the debtor's estate and is thus aligned with the broader purposes of section 365."). Courts that have endorsed the functional approach take the view that "[b]ankruptcy courts should not be bound by static definitions of what is an executory contract, but should strive to satisfy the purposes" of section 365 "in conjunction with the goals of the debtor (or trustee), in order that equity may be served." In re Gladding Corp., 22 B.R. 632, 635 (Bankr. D. Mass. 1982); see also In re Cardinal Indus., 146 B.R. 720, 728 (Bankr. S.D. Ohio 1992) ("This approach has the conceptual advantage of using the underlying purposes of section 365 as benchmarks to define what constitutes an executory contract in bankruptcy."). *567 Application of the functional test also "conserves the time and effort that the parties and the court otherwise spend resolving the question of executoriness." In re Riodizio, Inc., 204 B.R. at 422.

> Whether the Court strictly applies the Countryman test is significant to the instant matter because the Committee contends that the Oversight Board has failed to demonstrate that the Plaintiffs have material obligations outstanding under the Settlement Agreements, and, it argues, the Settlement Agreements therefore would not be executory contracts under the Countryman test. The Oversight Board identifies three sets of obligations that allegedly remain outstanding."

4. Countryman

a. In re Weinstein Co. Holdings LLC, 997 F.3d 497, 504 (3d Cir. 2021)

"Section 365(a) of the Bankruptcy Code governs the treatment of executory contracts, but it does not define that term. Rather it provides that "[e]xcept as provided in sections 765 and 766 of this title [involving customer instructions and property not relevant here] and in subsections (b), (c), and (d) of this section, the trustee [or a debtor-in-possession, *see* 11 U.S.C. § 1107(a)], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). Without a definition of the word "executory," the Supreme Court recognized that legislative history generally "indicates that Congress intended the term to mean a contract 'on which performance is due to some extent on both sides.' " *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984) (quoting H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 58 (1978)).

However, this reading "would cut too broadly," as almost all contracts involve some unperformed obligations on both sides. *In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 238 (3d Cir. 1995). Thus, our Circuit (and several others) adopted the following definition proposed by Professor Vern Countryman: "[An executory contract is] a contract under which 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 performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); *see also In re Gen. DataComm Indus., Inc.*, 407 F.3d 616, 623 (3d Cir. 2005) (quoting Countryman and citing to *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3d Cir. 1989)); 3 Collier on Bankruptcy ¶ 365.02[2](a) n.10 (16th ed. 2020) (collecting cases). "Thus, unless both parties have unperformed obligations that would constitute a material

breach if not performed, the contract is not executory under § 365." *Columbia Gas*, 50 F.3d at 239. "The time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed." *Id.* at 240. What constitutes a material unperformed obligation is governed by relevant state law. *See id.* at 239 n.10. Putting all this together, the test for an executory contract is whether, under the relevant state law governing the contract, each side has at least one material unperformed obligation as of the bankruptcy petition date."

C. Practice Pointers

1. In many situations, different approaches will lead to different results.

2. **Weinstein**: The Third Circuit acknowledged that parties are free to contract around the default material-breach and substantial-performance rules and designate obligations as material that would not otherwise qualify as such under applicable law, thus rendering the contract executory.

3. ***In re Cornerstone Valve LLC:*** File a proof of claim if there is any question as to whether the contract is executory.

D. True Lease v. Disguised Financing

1. UCC definition of lease v. disguised security interest or economic reality test (Pillowtex). ***Prospect ECHN, Inc. v. Winthrop Res. Corp*., No. 19-CV-586 (SRN/ECW), 2021 WL 5086274**, at *8 (D. Minn. Nov. 2, 2021) (applying both bright line and economic realities tests and finding that the contract was a lease).

"Under the U.C.C., courts apply an objective "bright-line test" to determine whether an agreement in the form of a lease is an actual lease versus a security interest. See Minn. Stat. § 336.1-203(b). If, after applying the bright-line test, the agreement is deemed a lease, some courts have undertaken an additional analysis of the "economic realities" underlying the parties' agreement to determine whether it is properly characterized as a lease or a security interest. See In re Pillowtex, Inc., 349 F.3d 711, 719 (3d Cir. 2003) (stating that if none of the U.C.C. factors are present, courts are to consider the economic reality of the transaction); In re Ecco Drilling

Co., Ltd., 390 B.R. 221, 227–28 (Bankr. E.D. Tex. 2008) (noting that if the agreement is found to be a lease after applying the bright-line test, the inquiry comes to an end). The party seeking recharacterization of a lease bears the burden of proof to establish that the agreement is not a true lease. In re Pillowtex, 349 F.3d at 716."

2. Bright-Line Test

"First, a transaction in the form a lease creates a security interest "if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee." Minn. Stat. § 336.1-203(b). Second, one of four other factors must be present:

> (1) the original term of the lease is equal to or greater than the remaining economic life of the goods;
> (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
> (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or
> (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement."

Economic Realities Test (*Pillowtex*)
"[F]actors relevant to evaluating the economic reality of the transaction include whether the purchase option is nominal, whether the lessee's aggregate payments have a present value equaling or exceeding the original cost of the leased property, and whether the term of the lease covers the useful life on the equipment."

3. *Lyon Fin. Servs., Inc. v. Illinois Paper & Copier Co*., 247 F. Supp. 3d 923, 930 (N.D. Ill. 2017) (no reference to Pillowtex or economic realities)

"The UCC provides a test for whether an agreement that is in the form of a lease is a true lease or is, in fact, a disguised secured sale transaction. 810 ILCS § 5/1–203."

Part II: Rejection

III. Rejection

A. What is the standard for rejection?

1. In re FirstEnergy Sols. Corp., 945 F.3d 431 (6th Cir. 2019) "Bankruptcy court erred in applying only the business-judgment standard in determining that Chapter 11 debtor could reject electricity-purchase contracts that the Federal Energy Regulatory Commission (FERC) had previously approved under the Federal Power Act (FPA); the court should have applied an adjusted standard that better accommodated concurrent jurisdiction between, and separate interests of, the court and FERC, considering and deciding impact of contract rejection on the public interest, including consequential impact on consumers and any tangential contract provisions concerning such things as decommissioning, environmental management, and future pension obligations, to ensure that the equities balanced in favor of rejecting the contracts, and giving FERC a reasonable opportunity to provide an opinion on the public interest. 11 U.S.C.A. § 365; Federal Power Act § 321, 16 U.S.C.A. § 791a et seq."

2. In re Ultra Petroleum Corp., 28 F.4th 629, 636–37 (5th Cir. 2022): "Rejection is subject to the bankruptcy court's approval and is generally considered by the court under the deferential "business judgment" standard. *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, ––– U.S. ––––, 139 S. Ct. 1652, 1658, 203 L.Ed.2d 876 (2019). The rejection of an executory contract is a breach of contract, with "the same effect as a breach outside bankruptcy." *Id.* at 1666. Rejection leaves the counterparty to the contract with "a claim against the estate for damages resulting from the debtor's nonperformance." *Id.* at 1658. Due to the nature of bankruptcy and the insolvency of the debtor, however, this claim is rarely paid in full and the counterparty "may receive only cents on the dollar." *Id.* Additionally relevant to the Chapter 11 reorganization process described herein is 11 U.S.C. § 1129(a)(6), which states that a reorganization plan can be confirmed only if "[a]ny governmental regulatory commission

with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval."

Next, because "the business of transporting and selling natural gas ... is affected with a public interest," 15 U.S.C. § 717(a), the Natural Gas Act grants FERC "exclusive jurisdiction over the transportation and sale of natural gas in interstate commerce for resale," *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 300–01, 108 S.Ct. 1145, 99 L.Ed.2d 316 (1988). Part of FERC's responsibility is to ensure that all rates charged by natural-gas companies are "just and reasonable." 15 U.S.C. § 717c(a). All rates, even those arising from private contract negotiations, are "filed" with FERC, 15 U.S.C. § 717c(c), and cannot be modified or abrogated absent FERC's approval, *see Mirant*, 378 F.3d at 518.[1] The requirement that FERC approve any changes to a filed rate applies not only to the parties to the contract, but also to the courts—the "filed rate doctrine" prevents both parties *and* courts from modifying the filed rate contained in a tariff. *Id.* When FERC is considering whether to change a filed rate, it follows the *Mobile-Sierra* doctrine, and will change a rate only if the existing contract "adversely affect[s] the public interest." *637 *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348, 355, 76 S.Ct. 368, 100 L.Ed. 388 (1956); *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 344–45, 76 S.Ct. 373, 100 L.Ed. 373 (1956). FERC may not modify a filed rate simply because a party finds continued performance unprofitable. *See Mirant*, 378 F.3d at 518.

3. Practice Pointers: Consider whether a standard other than the business judgment rule should apply to the rejection.

B. Rejection ≠ Termination

1. Recent Examples

a. In re Energy Conversion Devices, Inc., 621 B.R. 674, 717–18 (Bankr. E.D. Mich. 2020)

After discussing non-bankruptcy breach of contract law, the Court applied its principles to rejection of executory contracts in bankruptcy: **"A rejection does not terminate the contract. When it occurs, the debtor and counterparty do not go back to their pre-contract positions. Instead, the counterparty retains the rights it has received under the agreement. As after a breach, so too after a rejection, those rights survive."** *Id.* **Based on the "rejection-as-breach approach," the Court held "that under Section 365, a debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside bankruptcy. Such an act cannot rescind rights that the contract previously granted."** *Id.* at 1666. Construing § 365 in this manner, the Court held that the debtor-licensor's rejection of the license agreement could not revoke the trademark license or the non-debtor licensee's right to continue to use that trademark. *Id.*

2. Practice Pointer: The actions of the non-breaching party after rejection matter. According to the *Energy Devices* court, "Where there has been a material breach which does not indicate an intention to repudiate the remainder of the contract, the injured party has a genuine election either of continuing performance or of ceasing to perform. **Any act indicating an intent to continue** will operate as a conclusive election, *not indeed of depriving him of a right of action for the breach which has already taken place*, but depriving him of any excuse for ceasing performance on his own part. Anything which draws on the other party to execute the agreement after the default in respect of time or which shows that it is deemed a subsisting agreement after such default will amount to a waiver.

C. Rejection Remedies

Bankruptcy Code section 502(g) provides that a claim arising from the rejection of an executory contract or unexpired lease shall be determined and shall be allowed or disallowed "the same as if such claim had arisen before the date of the filing of the petition." Rejection creates a breach of the contract or lease which is deemed to have occurred immediately before the petition date. See 11 U.S.C. § 365(g) (2022). This breach prior to the petition date creates an unsecured claim for rejection damages. The calculation and amount of damages are generally determined by state law to the extent it doesn't conflict with the Bankruptcy Code. See § 46:24. Rejection of executory contracts and unexpired leases—Effect of

rejection of executory contracts and unexpired leases, 2 Norton Bankr. L. & Prac. 3d § 46:24; In re Manchester Gas Storage, Inc., 309 B.R. 354 (Bankr. N.D. Okla. 2004).

Examples:

1) 502(b)(6) - limits rejection claim of a lessor for debtor's rejection of nonresidential real estate lease

2) 365(h) - rejection damages claim for non-debtor lessee to rejected lease depends on lessee's election of whether to treat lease as terminated or remain in possession

3) 502(b)(7) - rejection damages claim for rejection of employment contract limited by the Code

4) Specific performance sometimes allowed under state law even if debtor rejects the contract; what if only remedy under the contract is specific performance?

i. In re Spoverlook, LLC, 560 B.R. 358 (Bankr. D.N.M. 2016) - court found the majority rule is consistent with the statutory construction - 365 identifies two situations where the non-debtor may demand specific performance following contract rejection - 365(i) (non-debtor already in possession of real property is entitled to complete a pending sale) and 365(n) (rejection can't terminate the intellectual property rights of a technology lecensee). Several courts have ruled the other way though. See In re Walnut Associates, 145 B.R. 489, 494 (Bankr. E.D. Penn. 1992) ("if state law…authorize[s] specific performance under the rejected executory contract…the non-debtor should be able to enforce the contract against the [d]ebtor"); In re West Chestnut Realty of Haverford, Inc., 177 B.R. 501, 506 (E.D. Penn. 1995) (same). The court in Spoverlook refused to follow these cases though as those cases didn't acknowledge 101(5)(B) or the impact of a bankruptcy discharge on a creditor's ordinary state law equitable remedies.

ii. In re TOUSA, Inc., 503 B.R. 499 (Bankr. S.D. Fla. 2014)- court found that 502(c)(2) contemplates estimation of equitable remedies only if the claim "involves a right to payment" in the first instance. So the issue becomes whether the counterparty to the rejected contract had a right to payment under the contract or under state law. The bankruptcy court further held that rejection of a contract deprives the counterparty of its specific performance remedy.

iii. Some courts have held though that the remedy of specific performance is sometimes available if the claim cannot be reduced to monetary damages.

iv. Practice pointer: when drafting a contract, may not want to limit remedies in contract solely to specific performance. That remedy may be illusory in a bankruptcy setting.

5) Damages subject to mitigation - depends on whether state law requires non-injured party to mitigate damages - In re Manchester Gas Storage, Inc., 309 B.R. 354 (Bankr. N.D. Okla. 2004)

Part III: Automotive / Manufacturing Executory Contract Issues – Move up

IV. Automotive / Manufacturing

A. Plan provisions regarding payment of cure:

1. Takata: "Assumption and assignment of any executory contract or unexpired lease pursuant to the Plan, or otherwise, shall result in the **full release and satisfaction of any Claims** or defaults, subject to satisfaction of the Cure Amount, whether monetary or nonmonetary, including defaults of provisions restricting the change in control or ownership interest composition or other bankruptcy-related defaults, arising under any assumed executory contract or unexpired lease at any time before the effective date of assumption and/or assignment; *provided, however,* that nothing in this section 8.3(b) of the Plan or otherwise shall release the Plan Sponsor from any Assumed Liabilities as defined in the U.S. Acquisition Agreement. Any proofs of Claim filed with respect to an executory contract or unexpired lease that has been assumed shall be deemed disallowed and expunged, without further notice to or action, order or approval of the Bankruptcy Court or any other Person. Plan, section 8.3(b)."

2. Aeromexico: "(b) Assumption or assumption and assignment of any Executory Contract or Unexpired Lease pursuant to the Plan, or otherwise, shall result in the full release and **satisfaction of any Claims** or defaults, subject to satisfaction of the Cure Amount, whether monetary or nonmonetary, including defaults of provisions restricting the change in control or ownership interest composition or other bankruptcy-related defaults, arising under any assumed Executory Contract or Unexpired Lease at any time before the effective date of assumption or assumption and assignment. Any Proofs of Claim filed with respect to an Executory Contract or Unexpired Lease that has been assumed shall be deemed Disallowed and expunged, without further notice, or action, order or approval of the Bankruptcy Court or any other Person. Section 7.3(b) of the Plan."

3. 24 Hour Fitness: "Assumption of any Executory Contract or Unexpired Lease pursuant to the Plan shall result in the **full release and satisfaction of any Claims or defaults,** whether monetary or nonmonetary, including defaults of provisions restricting the change in control or ownership interest composition or other bankruptcy-related defaults, arising under any such Executory Contract or Unexpired Lease at any time before the date that the Debtors assume or assume and assign such Executory Contract or Unexpired Lease."

4. What is a "Claim"? The Plan refer to the definition of "claim" in section 101 of the Bankruptcy Code, which is 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...." 11 U.S.C. § 101(5).

Court's interpret this language as follows:

"Congress intended by this language to adopt the broadest available definition of 'claim,' " *Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991) (citations omitted), which includes " 'all legal obligations of the debtor, no matter how remote or contingent.' " *In re Huffy Corp.,* 424 B.R. 295, 301 (Bankr.S.D.Ohio 2010) (quoting *Grady v. A.H. Robins Co., Inc.,* 839 F.2d 198, 200 (4th Cir.1988)). This broad definition serves the two primary goals of bankruptcy: to ensure that all creditors are treated equitably and to secure a fresh start for the debtor. As the *Huffy* court put it, "a broad definition of claim allows a bankruptcy court to deal fairly and comprehensively with all creditors in the case and, without which, a debtor's ability to reorganize would be seriously threatened by the survival of lingering remote claims and potential litigation rooted in the debtor's prepetition conduct." 424 B.R. at 301.

….

The most widely adopted test, followed by *Parks* and *Dixon,* has been alternately termed the "fair contemplation," "foreseeability," "pre-petition relationship," or "narrow conduct" test. It looks at whether there was a pre-petition

> relationship between the debtor and the creditor, "such as contract, exposure, impact or privity," such that a possible claim is within the fair contemplation of the creditor at the time the petition is filed.
>
> *Id.* at 257 (quoting *Dixon,* 295 B.R. at 230) (other citations omitted). Under this test, a claim is considered to have arisen pre-petition if the creditor "could have ascertained through the exercise of reasonable due diligence that it had a claim" at the time the petition is filed. *Signature Combs,* 253 F.Supp.2d at 1037 (quotation & citations omitted). This test, which the Court will refer to as the "fair contemplation test," has the advantage of allowing the Court to examine all of the circumstances surrounding a particular claim—the debtor's conduct, the parties' pre-petition relationship, the parties' knowledge, the elements of the underlying claim—and use its best judgment to determine what is fair to the parties, in context. As the *Huffy* court points out, "one approach may not fit all circumstances." 424 B.R. 295, 303 (Bankr.S.D.Ohio 2010).

In re City of Detroit, Michigan, 548 B.R. 748, 761, 763 (Bankr. E.D. Mich. 2016)

B. ***Practice Pointer***: The full release and satisfaction of all claims is too broad. Obtain revised language in the confirmation order which limits the affect of assumption to that prescribed by the Bankruptcy Code.

C. ***Implied v. Express Assumption***

1. In re Dura Auto. Sys., LLC, 628 B.R. 750, 755–56 (Bankr. D. Del. 2021)

"In *University Medical Center*, the Third Circuit was tasked with deciding whether formal court approval is a prerequisite to assumption of an executory contract pursuant to section 365 of the Bankruptcy Code.[25] The Secretary of the United States Department of Health and Human Services argued that, due to the unique statutory scheme of the Medicare Act, a provider agreement should be deemed assumed if performance under the agreement is continued after the commencement of a bankruptcy case regardless of whether formal court approval of assumption is sought.[26] The court, however, rejected the notion that the circumstances presented modified the rule established by the plain and unambiguous language of the Bankruptcy Code requiring court

approval for the assumption of an executory contract.[27] In doing so, the court explained that motion practice and court approval prior to assumption is important so that the advantages and disadvantages to an estate and its parties in interest can be assessed.[28] It also highlighted that it serves to provide certainty and finality to all parties in interest regarding the status of a particular executory contract vis-à-vis the estate.[29]

Here, Plasti-Paint voluntarily continued to provide services under the Plasti-Paint Contracts following the sale until the New Contract could go into effect. There was no motivation to require a court-approved assumption of the Plasti-Paint Contracts and payment of the Cure Amount given Hain Capital's claim purchase. Rather, the focus of the parties was the continuation of Plasti-Paint's critical services and finalization of the New Contract and modified technical process. While Hain Capital was aware of the continued provision of services, *756 it never sought to compel an assumption of the Plasti-Paint Contracts under section 365(d)(2) of the Bankruptcy Code or otherwise prevent the parties from continuing their relationship or entering into the New Contract. Without the application of the doctrine of implied assumption, the Court is unable to grant the relief Hain Capital now seeks against the Purchaser in the Motion.[30] To the extent Hain Capital believes it has breach of contract or other claims against Plasti-Paint arising from the claims purchase, it is free to pursue those claims outside of these bankruptcy proceedings. In the meantime, Hain Capital possesses its purchased claims and may receive a distribution thereon if appropriate after completion of the claims reconciliation and allowance process."

2. ***Practice Pointers*** **–**

a. When representing the non-debtor counterparty to an executory contract, think hard before signing an amendment to the existing contract during the case.

b. Expect to negotiate your cure amount.

c. Carefully examine the cure schedules and related deadlines, which are often different than the deadline to object to the plan.

Part IV: Healthcare Executory Contract Issues

V. Health Insurance Benefit Agreements (Medicare / Medicaid Provider Agreements)

A. What is a Medicare / Medicaid Provider Agreement?

1. Health Insurance Benefit Agreement – an agreement between US Government (HHS / CMS) and providers of healthcare goods and services whereby providers can receive reimbursement payments in accordance with relevant statutes for services rendered to qualified beneficiaries. Under the Prospective Payment System ("PPS"), healthcare providers are paid regular estimates, which are audited annually to determine whether the provider was overpaid. Adjustments are usually made the following year.

B. Are the agreements executory contracts or statutory entitlement? (e.g., can be sold free and clear or needs to be cured) – lack of uniformity

1. Government's argument:

a. Outside of bankruptcy: statutory entitlement; not contracts

(i) See, e.g., Mem'l Hosp. v. Heckler, 706 F.2d 1130, 1136 (11th Cir. 1983) ("Upon joining the Medicare Program, however, the hospitals received a statutory entitlement, not a contractual right."); United States ex rel. Roberts v. Aging Care Home Health, Inc., 474 F. Supp. 2d. 810, 820 (W.D. La. 2007) ("Medicare Provider Agreements create statutory, not contractual, rights."); Maximum Care Home Health Agency v. HCFA, No. 3-97-CV-1451-R, 1998 WL 901642, at *5 (N.D. Tex. Apr. 14, 1998) ("[A] Medicare service provider

agreement is not a contract in the traditional sense. It is a statutory entitlement created by the Medicare Act.").

b. Inside bankruptcy: contracts

(ii) See, e.g., HIS of Ga., Inc. v. Michigan (In re first Am. Health Care of Ga., Inc.), 219 B.R. 324, 327 - 28 (Bankr. S.D. Ga. 1998) (treating state Medicaid Provider Agreement as executory contract without substantive analysis); In re Heffernan Mem'l Hosp. Dist., 192 B.R. 228, 231 n.4 (Bankr. S.D. Cal. 1996) ("[A] Provider Agreement is a contract providing for advance payments based on estimates and expressly permitting the withholding of overpayments from future advances…A Medicare [P]rovider [A]greement is an executory contract."); Tidewater Mem'l Hosp., Inc. v. Bowen (In re Tidewater Mem'l Hosp., Inc.), 106 B.R. 876, 880 (Bankr. E.D. Va. 1989) (stating without analysis the Medicare Provider Agreement was an executory contract); Advanced Prof'l Home Health Care Inc. v. Bowen (In re Advanced Prof'l Home Health Care Inc.), 94 B.R. 95, 96 (Bankr. E.D. Mich. 1988) (treatment of Medicare Provider Agreement as executory was apparently not contested by the debtor).

2. *In re Center City Health, LLC, et al.* (Bankr. D. Del. 19-11466 (KG)) - not executory [Dkt. 681 at p. 9, ¶ T]

a. References *In re B.D.K. Health Mgmt., Inc.*, No. 98-00609-6B1, 1998 WL 34188241, at *6 (Bankr. M.D. Fla. Nov. 16, 1998) which also held that provider agreements were not executory contracts ("the provider number are not executory contracts and thus, 11 U.S.C. § 365 does not apply. Consequently, Movants do not have to comply with the requirements of § 365 in order to effectuate a sale of their assets as set forth in the Motion.").

3. *In re Verity Health Sys. of California, Inc*., 606 B.R. 843, 850 (Bankr. C.D. Cal. 2019), *vacated on other grounds by stipulation*, No. 18-BK-20151-ER, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019) (finding that the provider agreements were not executory because they imposed no contractual obligation on the government).

4. *In re Vitalsigns Homecare, Inc*., 396 B.R. 232, 240 (Bankr. D. Mass. 2008) ("Requiring the provider agreement to be assumed prior to its sale, however, harmonizes both the Medicare and Bankruptcy statutes.") (discussing executory v. statutory entitlement without coming to a conclusion but finding that provider agreement must be assumed prior to sale).

5. Implications - why does this matter?

a. Getting new provider agreements can take too long - must be transferred to buyer through 365 or 363

b. If statutory entitlement, then can it be assigned under 11 U.S.C. § 363(f)?

(i) *In re Verity Health Sys. of California, Inc*., 606 B.R. 843, 851 (Bankr. C.D. Cal. 2019), *vacated on other grounds by stipulation*, No. 18-BK-20151-ER, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019) ("The Court finds that the Provider Agreements are akin to a license issued by a government agency, and therefore that the Provider Agreements may be sold under § 363.").

(ii) *In re Skyline Manor, Inc.*, No. BK14-80934, 2014 WL 7239703 (Bankr. D. Neb. Dec. 17, 2014) (bankruptcy court allowed sale of Medicaid Provider Agreement under 363(f)(5), over the objection of the State of Nebraska).

(iii) Overpayments become governmental claims

(iv) Successor liability cut off - 363(f) provides for sale of assets "free and clear of any interests" and the term "any interest" isn't defined in Bankruptcy Code. Courts have held, though, that the scope of 363(f) is not limited to "in rem" interests. *See, e.g.*, *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252, 258 (3d Cir. 2000) (holding that debtors "could sell their assets under 363(f) free and clear of successor liability that otherwise would have arisen under federal statute").

(v) Buyer must still apply for and obtain change of ownership certification from the Government and satisfy conditions for transfer. Government may argue it has the right to deny the transfer of the provider agreement because it has regulatory authority to do so under the Medicare Act. Government may also argue that failure to pay obligations by a debtor (or failure of buyer to assume the obligations) is a violation of applicable statute and regulations and results in provider agreement not being transferred without successor liability. Debtor can use section 525 of the Bankruptcy Code to combat this. If the proximate cause of the government's refusal to allow the transfer relates to unsatisfied financial obligations of the debtor, the government's refusal to recognize the buyer as taking assignment of the provider agreement without successor liability would be violation of section 525.

(vi) Practice Pointer: if arguing provider agreements are not executory contracts and can therefore be transferred as an asset of the bankruptcy estate under section 363, and Government objects, may argue equitable estoppel against the Government. Government has taken position outside of bankruptcy that the provider agreements are not contracts; as such, Government should be judicially

and equitably estopped from taking a contrary position in bankruptcy.

c. If executory:

(i) Must pay cure amounts, which could materially affect GUC distributions (HHS's right to recoupment / setoff of overpayments)

(ii) Buyer must provide adequate assurance of future performance

(iii) Successor liability flows to buyer

(iv) In re Bayou Shores SNF, LLC, 525 B.R. 160, 169 (Bankr. M.D. Fla. 2014) ("To assume an executory contract that is in default, a debtor must prove that it can promptly cure the default and provide adequate assurance of future performance.") (cure might be something other than or in addition to monetary cure.).

6. Does it matter? 11 U.S.C. § 362(b)(4) – regulatory powers and the automatic stay

a. *In re Bayou Shores SNF, LLC*, 828 F.3d 1297, 1331 (11th Cir. 2016) ("The bankruptcy court was without § 1334 jurisdiction under the § 405(h) bar to issue orders enjoining the termination of the provider agreements and to further order the assumption of the provider agreements.") (Government terminated provider agreement over debtor's objection and 11th Cir. held that bankruptcy court didn't have jurisdiction to mandate assumption).

b. *Parkview Adventist Med. Ctr. v. United States on behalf of Dep't of Health & Hum. Servs*., 842 F.3d 757, 763 (1st Cir. 2016) (finding the provider agreement executory but

noting that "the police and regulatory power exception to the stay applies to CMS's termination of the Provider Agreement" and is not property of the estate within the meaning of § 362(a)(3))

c. What are implications of assumption / assignment?

(i) Recoupment / Setoff of Overpayments

(a) *In re Vitalsigns Homecare, Inc*., 396 B.R. 232, 241 (Bankr. D. Mass. 2008) ("First, HHS may recoup overpayments from any payments due to the Debtor's estate from HHS; next it may recoup against funds held by the Trustee if such funds were generated by the past interim Medicare payments; next against any sale proceeds generated by the sale of the provider number; and finally to the extent there remains any overpayments to be recovered, HHS may proceed against the entity to which the Debtor's provider number is assigned. Nothing herein shall be interpreted, however, as terminating HHS' right to file a claim against the Debtor's estate or the Trustee's right to object thereto.")

d. Rejection or Termination

(i) Healthcare institution can no longer accept Medicare or Medicaid and seek reimbursement – could render entity nonviable

VI. CCRC - Residential v. Non-Residential Property (11 U.S.C. §§ 365(d)(2) and (4))

A. Discussion of differences and import

1. Rejection timing and obligations under 11 U.S.C. §§ 365(d)(2), (3) and (4)

2. *In re Passage Midland Meadows Operations, LLC*, 578 B.R. 367, 377 (Bankr. S.D.W. Va. 2017) ("In sum, if the Master Lease is deemed "nonresidential" in nature, contrary to Passage's desire, (1) it is not estate property, (2) it may not be assumed, and (3) Welltower's hoped-for lease transition to Paramount would not transgress the automatic stay. The analysis is complicated by two considerations, namely, that (1) the Bankruptcy Code does not define the term "nonresidential[,]" and (2) a split of authority exists, with the majority taking an unexpected approach.") (finding the lease nonresidential).

3. *In re Texas Health Enterprises, Inc*., 255 B.R. 181, 184 (Bankr. E.D. Tex. 2000) ("The Motion asks that the Court declare the Lease rejected and order immediate turnover of the property to Lytle. This Court can declare the Lease rejected based on its earlier hearing and determination that THE could not cure existing defaults or provide adequate assurance of future performance in order to maintain the Lease. However, rejection of a lease and termination of a lease are two different things. In re Drexel Burnham Lambert, 138 B.R. 687 (Bkrtcy.S.D.N.Y.1992); In re Udell v. Standard Carpetland USA, Inc., 149 B.R. 908 (N.D.Ind.1993) Even though this Court can readily declare the Lease rejected, it cannot precipitously terminate the Lease given the interest of the residents of this nursing home.") (finding the needs of the residents were paramount in deciding whether a lease could be turned over post-rejection).

B. Lease Test – whether lease is intended to produce income for lessee

1. *In re Passage Midland Meadows Operations, LLC*, 578 B.R. 367, 378 (Bankr. S.D.W. Va. 2017) ("The nature-of-the-lease

test focuses instead on whether the intent of the lease is to provide income for the commercial lessee ("income test"). See In re Care Givers, Inc., 113 B.R. 263 (Bankr. N.D. Tex. 1989) (concluding that although a nursing home had both a residential and nonresidential aspect, it was still considered residential); In re Independence Village, Inc., 52 B.R. 715 (Bankr. E.D. Mich. 1985) (concluding that a life-care facility for senior citizens was residential because people lived on the property); Matter of Terrace Apts. Ltd., 107 B.R. 382 (Bank. N.D. Ga. 1989) (concluding that nature of the property is the key factor in determining whether a property is residential); In re Texas Health Enters., Inc., 255 B.R. 181 (Bankr. E.D. Tex. 2000) (concluding that nursing home leases were residential leases); Alegre v. Michael H. Clement Corp. (In re Michael H. Clement Corp.), 446 B.R. 394 (N.D. Cal. 2011) (applying nature of the property test, which the court believed was the majority view, to determine that property was residential). ").

C. Property Test – focuses on leased property and whether people reside on such property

1. *PNW Healthcare Holdings LLC*, 627 BR 354, 362 (Bankr. W.D. Wash. 2020) ("[T]he Court holds that the correct focus of the definition of residential real property versus nonresidential real property should be on the intended use of such property under the lease. In the case at hand, there is no dispute that the Canyon Landlords were aware of and intended that the Debtors' facilities would be used as skilled residential nursing facilities or assisted living facilities. Further, as represented in the Joint Motion, the Master Subleases expressly recognize the residential nature of the Debtors' use of the Facilities by referring to "resident," "residents," or residential" no fewer than 40 times. . . . Based on the foregoing, the Court concludes that the Master Subleases between the Canyon Landlords and the Debtors PNW Master Tenant I, LLC and PNW Master Tenant II, LLC, are leases of "residential real property" not nonresidential, thereby making § 365(d)(2) applicable to such Master Subleases rather than § 365(d)(3) and (4).")

2. *In re Texas Health Enterprises, Inc*., 255 B.R. 181, 184 (Bankr. E.D. Tex. 2000) ("The Care Givers Court narrowly construed the language of § 365(d)(4) concluding that if people reside on the real property, it is not nonresidential even if it is also used for nonresidential purposes. The Care Givers Court found that § 365(d)(4) applies only to property which is wholly nonresidential and that real property which had both residential and nonresidential aspects is not "nonresidential" within the meaning of § 365(d)(4).") *citing In re Care Givers, Inc., 113 B.R. 263* (Bkrtcy.N.D.Tex.1989).

June 7, 2022

Arbitration Clauses as Separate Executory Contracts

Woods Drinkwater

Nelson Mullins Riley & Scarborough LLP

This term, Supreme Court Justice Elena Kagan has authored a pair of opinions related to arbitration. The first of these decisions, *Badgerow v. Walters*, 20-1143, 142 S. Ct. 1310 (2022) came down on March 31, 2022, where Justice Kagan, writing for the 8/1 majority, held that a court must have an independent basis of federal jurisdiction to undertake a petition to confirm or vacate an arbitration award.

Under Section 4 of the Federal Arbitration Act ("FAA"), a district court may use a "look-through" approach to determine whether it has jurisdiction over the underlying substantive controversy when considering a petition to compel arbitration, as adopted in *Vaden v. Discover Bank*, 556 U.S. 49 (2009). But the same approach is not available for parties seeking to confirm an arbitral award under Sections 9 and 10 of the FAA. Under these Sections, the court's review must be limited to the application itself.

In *Badgerow*, the parties presented a petition to confirm an arbitral award, which was confirmed by the district court and affirmed by the Fifth Circuit Court of Appeals. Here, the arbitration was conducted prior to any federal lawsuit in which a party sought to compel arbitration under Section 4. The Supreme Court reversed the lower courts, finding that the text of Sections 9 and 10 did not provide the same jurisdictional look-through provisions as when a district court is presented with an application to confirm an award for which it had previously compelled arbitration. Where there is no prior federal lawsuit in which arbitration was compelled, the application itself must meet jurisdictional requirements in order for a district court to take it up: diversity

jurisdiction, a federal question regarding confirmation of the award itself, or another cause for establishing jurisdiction.

Then, on May 23, 2022, Justice Kagan, writing this time for a unanimous court in *Morgan v. Sundance*, Inc., 21-328, --- S. Ct. ---- (U.S. May 23, 2022), held that the long-held majority rule specific to arbitration that a party can waive its arbitration rights by litigating only when its conduct has prejudiced the other side was improper. The Court found that, outside of arbitration, a "federal court assessing waiver does not generally ask about prejudice. Waiver, we have said, is the intentional relinquishment or abandonment of a known right." Id. at 5 (quoting *United States v. Olano*, 507 U.S. 725, 733 (1993)).

And while the Court recognized that for many years there has been a general policy consensus among the Circuits favoring arbitration, that "does not authorize federal courts to invent special, arbitration-preferring procedural rules." Id. at 6. Instead, the Court clarified, "[t]he policy is to make arbitration agreements as enforceable as other contracts, but not more so." Id. (quoting *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 n.12 (1967)). "Accordingly, a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation." *Id.*

Kagan continues, "Section 6 of the FAA provides that any application under the statute . . . shall be made and heard in the manner provided by law [meaning] to apply the usual federal procedural rules [and] a bar on using custom-made rules." *Id.* at 7. A court should not and must not apply a novel or arbitration-favoring analysis when considering a motion to compel arbitration.

Justice Kagan's arbitration focused opinions have pushed back on long standing policy and procedure favoring arbitration over litigation in federal district courts and demands a return to strict compliance with the text of the FAA.

For bankruptcy practitioners, arbitration clauses present a unique inquiry. Bankruptcy is unique in that it permits a debtor to assume or reject an executory contract under Section 365 of the Bankruptcy Code. That includes any contract containing an arbitration clause, as found in *Highland Capital Mgmt v. Dondero* (*In re Highland Capital Mgmt.*), No. 19034054, 2021 WL 5769320 (Bankr. N.D. Tex. Dec. 3, 2021). In

that case, the court found that the debtor's rejection of a limited partnership agreement containing an arbitration clause was, in effect, the rejection of two executory contracts: the partnership agreement and, separately, the arbitration agreement. *Id.* at *7.

The court's analysis led to the conclusion that an arbitration clause within another agreement creates an executory contract separate and apart from the parent agreement. See id. at *6-7. While arbitration may survive breach of a contract in general contract law, in bankruptcy, rejection of a contract precludes specific performance—including arbitration—against the trustee. *Id.*

The Supreme Court makes clear that the enforcement of an arbitration agreement is limited to contractual interpretation and not an overarching policy favoring arbitration over litigation. In bankruptcy, debtors are left with the unique ability to reject executory contracts, including separate arbitration agreements contained within other agreements. It follows then, that bankruptcy courts must consider favorably a debtor's rejection of an arbitration agreement as an executory contract when determining whether to compel a matter to arbitration.

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Michael Brandess is a partner with Husch Blackwell LLP in Chicago, where he represents both healthy and distressed companies and their principals. He has taken clients through complex sales, acquisitions, restructurings and liquidations across the country. Mr. Brandess was named an ABI "40 Under 40" emerging leader in 2021, and he is the 2022 president of the Chicago/Midwest Chapter of the Turnaround Management Association. He has authored numerous articles on matters ranging from family business-related issues to topics related to economic distress. Mr. Brandess regularly speaks on entrepreneurial, bankruptcy and insolvency matters. He has been named an "Illinois Rising Star" by *Super Lawyers* since 2016 and is rated AV-Preeminent by Martindale-Hubbell. Mr. Brandess also has been awarded Emerging Leader of the Year by the Chicago/Midwest Chapter of the Turnaround Management Association and The M&A Advisor. He received his J.D. *magna cum laude* from the University of Illinois College of Law.

Krystal R. Mikkilineni is a shareholder with Dentons in Des Moines, Iowa, and has more than eight years of experience representing clients and collaborating with colleagues on complex commercial reorganizations and restructurings, including in-court and out-of-court workouts. She represents businesses, creditors, trustees and individuals with reorganizations, insolvency matters and chapter 7, 11, 12 and 13 bankruptcies. Ms. Mikkilineni's primary focus is on chapter 11 bankruptcies, and she assists businesses with corporate and transactional work and mergers and acquisitions matters within the bankruptcy. She also has experience with company sales and acquisitions outside of bankruptcy. Ms. Mikkilineni is actively involved in the bankruptcy and restructuring industry and was recently recognized by two national organizations as a rising star in the legal community. The International Women's Insolvency & Restructuring Confederation named her one of five 2021 Rising Star Semi-Finalists, and she is a member of ABI's 2021 40 Under 40 class. She also recently participated as one of 40 attorneys in the Next Generation Program of the National Conference of Bankruptcy Judges in Washington, D.C. Ms. Mikkilineni received her B.A. *magna cum laude* in 2009 from the University of Northern Iowa and her J.D. in 2013 with honors from Drake University Law School, from which she holds a Business Law Certificate.

Hon. Paul E. Singleton is a U.S. Bankruptcy Judge for the Northern District of Indiana in South Bend. After graduating from law school in 2009, he worked at Indiana Legal Services, where he practiced family and landlord/tenant law. He then joined the Family Justice Center of St. Joseph County, where he handled cases involving civil protective orders. Judge Singleton's professional experience includes private practice in employment law at Faegre Baker Daniels (now Faegre Drinker Biddle & Reath LLP) and serving as assistant city attorney for the City of South Bend. He also served as Magistrate Judge for the St. Joseph Superior Court, where he presided over criminal and civil cases. Judge Singleton received his Bachelor's degree with honors from Wake Forest University and his J.D. with *Pro Bono* Distinction from the Sandra Day O'Connor College of Law at Arizona State University. Before attending law school, he taught social studies for Teach for America at National Academy Foundation High School in Baltimore.

Marc N. Swanson is principal and Bankruptcy Group Leader at Miller, Canfield, Paddock and Stone, P.L.C. in Detroit and specializes in representing debtors, lenders, creditors, equityholders and unsecured creditors' committees in bankruptcy cases and related litigation in Michigan and throughout the country. He has experience in the municipal, energy, automotive, banking and building supply industries. In 2021, *Crain's Detroit Business* selected Mr. Swanson as one of its "40 Under 40," and he is a member of ABI's 2019 class of "40 Under 40." He has been consistently recognized in *The Best Lawyers in America* for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization and by *Michigan Super Lawyers* as a rising star in business bankruptcy. Mr. Swanson co-chairs the Debtor/Creditor Rights section of the State Bar of Michigan and is president of the Turnaround Management Association's Detroit Chapter. In his role as counsel to the City of Detroit in its bankruptcy case, he argued and won two bankruptcy appeals at the U.S. Sixth Circuit Court of Appeals for the City. One of these appeals sought to unravel the City's entire bankruptcy plan and Grand Bargain, and the other appeal challenged the Detroit Water and Sewerage Department's ability to collect past due bills and set its rates. He also successfully represented the City at the U.S. Supreme Court in the appeal of its bankruptcy plan. Mr. Swanson frequently speaks at restructuring conferences and seminars and publishes articles on insolvency-related topics. He received his B.A. in 2004 from the University of Michigan and his J.D. in 2007 from the University of Minnesota Law School.