

La La Land or Hacksaw Ridge: **Executory Contracts and Entertainment Bankruptcies**

Materials Presented to
Feig Law and Robins Kaplan LLP
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Introduction

- Governed by section 365 of the Bankruptcy Code
- Important when a party files a bankruptcy case
- Important when negotiating and structuring contracts prior to a bankruptcy filing
- Meaning of assumption or rejection

Introduction

(Cont'd)

- Definition of executory contract
 - Countryman definition:

“[C]ontract under which the obligation of both the bankrupt and the other party to the contract is so far clearly unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.”
 - Legislative History to section 365

“It generally includes contracts on which performance remains due to some extent on both sides.”

Examples

- Acting Contract In re Qintex Entertainment, 950 F.2d 1492, 1496-97 (9th Cir. 1991) (George C. Scott's acting was completed so tv contract was not executory. Movie subdistribution and colorization agreement, however was executory)
- Acting Contract: But see In re Carrere, 64 B.R. 156, 159 (Bankr. C.D.Cal. 1986) (holding that trustee has no standing to reject contract for debtor's personal services; "[i]t would be inequitable to allow a greedy debtor to seek the equitable protection of [the] Court when her major motivation is to cut off the equitable remedies of her employer.)

Examples

- Recording Contract: *Delightful Music Ltd. v. James Taylor* (In re James Taylor), 913 F.2d 102 (3d Cir. 1990) (holding that recording agreement was executory); *In re Monument Record Corp.*, 61 B.R. 866, 867 (Bankr. W.D. Tenn. 1986) (holding that Ray Orbison's recording contract was not executory because it had been terminated prior to bankruptcy and only remaining obligation was to pay royalties); *In re Noonan*, 17 B.R. 793, 797 (Bankr. S.D.N.Y. 1982) (exclusive recording agreement held to be executory contract).
- Publishing Contract: *Stein and Day* 81 B.R. at 265 (a prebankruptcy publishing agreement was non-executory and, therefore, not susceptible to rejection where the non-debtor author's obligations were limited); *In re Learning Publications, Inc.*, 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988) (publishing agreement held not executory when only remaining obligation was requirement to pay royalties)

Procedural Considerations

- Debtor must seek court approval of contract assumption or rejection (Section 365(a))
 - A proceeding to assume, reject or assign an executory contract is a contested matter which requires a formal motion (Rule 6006(a))
 - Exception: A plan may provide for assumption or rejection of any contract not previously rejected (Section 1123(b)(2))

Procedural Considerations

(Cont'd)

- An executory contract must be assumed or rejected in its entirety—a Debtor cannot pick and choose provisions it wishes to retain. *See N.L.R.B. v. Bildisco & Bildisco*, 104 S. Ct. 1188 (1984).
 - The question of whether a single agreement or multiple documents constitute one integrated contract or lease as opposed to severable agreements that can be independently assumed or rejected is determined by state law, which generally looks to the intent of the parties. *See, e.g., In re United Air Lines, Inc.*, 453 F.3d 463 (7th Cir. 2006); *In re Gardinier*, 831 F.2d 974 (11th Cir. 1987).

Standard for Assumption or Rejection

- “Business Judgment” is the prevailing standard
 - *In re Pomona Valley Medical Group*, 476 F.3d 665 (9th Cir. 2007)
 - Compare: *In re Orion Pictures Corp.*, 4 F.3d 1095 (2nd Cir. 1993) (framing the business judgment inquiry as whether, in the debtor’s business judgment “it would be beneficial or burdensome to the estate to assume” the contract or lease).

Timing of Rejection or Assumption

- Section 365(d)(1): In Chapter 7 cases, an executory contract must be assumed or rejected within 60 days after the order for relief, otherwise it is deemed rejected
 - 60 day period may be extended for cause
- Section 365(d)(2): In cases under Chapters 9, 11, 12 or 13, an executory contract may be assumed or rejected at any time before confirmation of a plan
 - A party to a contract may request an earlier determination

Effects of Rejection

- Section 365(g): Rejection of a contract constitutes a breach
- When a contract or lease has not been previously assumed, the time of breach is immediately prior to the petition date
 - This results in nondebtor contract or lease parties having a prepetition claim against the Debtor for any damages (Section 502(g))
- When a contract or lease has been previously assumed, the time of breach is at the time of rejection
 - The nondebtor contract or lease parties then have an administrative priority claim against the Debtor (See *In re Frontier Properties, Inc.*, 979 F.2d 1358 (9th Cir. 1992)).

Effects of Rejection

(Cont'd)

- The distinction between a prepetition claim arising from rejection and an administrative claim arising from rejection after assumption impacts plan voting and claim treatment options
 - A party holding a claim arising from rejection is a creditor entitled to vote on a plan and such claims must be classified and treated as other members of their respective class. *See, e.g., In re Barakat*, 99 F.3d 1520 (9th Cir. 1996).
 - Administrative claims arising from rejection are not required to be classified and must be paid in full under a plan (thus precluding them from voting). *See* Section 503(b), 507(a), 1123(a)(1), 1129(a)(9), 1322(a)(2).

Effects of Rejection

(Cont'd)

- Rejection does not result in termination
 - “What §365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. The debtor's unfulfilled obligations are converted to damages. . . . But nothing about this process implies that any rights of the other contracting party have been vaporized. . . . [R]ejection is not "the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed." It "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence". *Sunbeam Prods. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012).
 - Exceptions: Section 365(n) (discussed below).

Assumption

- Section 365(b)(1) has three requirements for a trustee to assume an executory contract or unexpired lease:
 1. Cure defaults;
 2. Compensate actual pecuniary losses resulting from the default; and
 3. Adequate assurance of future performance.

Assumption

(Cont'd)

Cure means eliminating the circumstances or conditions that caused the default

- **Exceptions to the cure requirement:**

- For unexpired leases of real property, nonmonetary defaults need not be cured if it is impossible for the trustee to cure the default

- Exception to the exception: Failing to operate in accordance a nonresidential real property lease

Assumption

(Cont'd)

Exceptions to the Cure Requirement:

- No cure of a requirement to pay a penalty rate or perform a penalty provision
- No cure of a default under an *ipso facto* clause
 - The insolvency or financial condition of the debtor
 - The commencement of the bankruptcy case
 - The appointment of a bankruptcy trustee postpetition or any a custodian prepetition

Assumption

(Cont'd)

- **Compensation of pecuniary loss**
 - Issue of fact; case-by-case
- **Adequate assurance of future performance**
 - Issue of fact; case-by-case

Executory Contracts and Unexpired Leases That Cannot Be Assumed

- **Nonassignable under nonbankruptcy law**
 - Personal service contracts
 - Copyright, patent and trademark licenses
 - Circuit split: “Hypothetical” vs. “actual” assignment
- **Financial Accomodations**
- **Terminated nonresidential leases**

Assignment

- Once assumed, the Debtor may assign a lease or executory contract (Section 365(f)), which relieves the estate from any liability for breach occurring thereafter (Section 365(k)).
- For this reason, the assignee must provide “adequate assurance of future performance” (Section 365(f)(2)(B))
 - A landlord may require a security deposit from an assignee of an unexpired lease substantially the same as that required upon initial leasing (Section 365(l)).

Assignment

(Cont'd)

- Section 365(f)(1) invalidates contractual and legal anti-assignment provisions
 - Section 365(f)(1) is not limited to explicit anti-assignment provisions. Provisions which are so restrictive that they constitute de facto anti-assignment provisions are also rendered unenforceable. *In re Fleming Cos.*, 499 F.3d 300, 307 (3d Cir. Del. 2007).

Assignment

(Cont'd)

- Section 365(f)(1) invalidates contractual and legal anti-assignment provisions (*Cont'd*)
- Section 365(f)(3) invalidates contractual and legal provisions that would permit termination or modification because of the assumption or assignment of a lease

Assignment

(Cont'd)

- Assignment of a lease or executory contract requires a formal motion for authorization (Rule 6006(a))
 - The assignment is automatically stayed for 14 days after entry of the order (Rule 6006(d))
- The Debtor should consider combining a motion for authorization under Section 365 with a sale motion under Section 363 in order to take advantage of the provision in Section 363 for statutory mootness which is not found in Section 365
 - Sale of Film or Recording Libraries

Ride Through

- The “ride through” doctrine recognizes that, with the exceptions of the provisions for deemed rejection under Sections 365(d)(1) and (d)(4), there is no requirement that a debtor assume or reject a contract. Instead, the language of Section 365 is permissive. Thus, a contract neither assumed or rejected can “ride through” bankruptcy unaffected and bind the parties postpetition. *See, e.g., In re O’Connor*, 258 F.3d 392 (5th Cir. 2001).
- Not all courts have recognized the ride through doctrine. *See In re Jones*, 591 F.3d 308 (4th Cir. 2010) (finding no “ride through” in the context of an individual Chapter 7 debtor); *Gray v. W. Envtl. Servs. & Testing, Inc. (In re Dehon, Inc.)*, 352 B.R. 546, 565-566 (Bankr. D. Mass. 2006) (discussing ride through and declining to adopt or disavow).

Risks of Ride Through

- Risk to Debtor:
 - After confirmation, the nondebtor party can enforce its contractual rights under non-bankruptcy law
 - Debtor will have no discharge
 - With no assumption, the nondebtor party may be able to terminate the contract under an *ipso facto* clause
- Risk to Nondebtor:
 - No recourse to bankruptcy court for postconfirmation default or to cure existing defaults

Ipsa Facto Clauses

- **Provisions in a contract or lease that are automatically triggered by the bankruptcy or financial condition of the debtor:**
 1. The insolvency or financial condition of the debtor prior to the filing of the bankruptcy case;
 2. The commencement of a bankruptcy case; and
 3. The appointment or taking of possession by a trustee in the bankruptcy case or a custodian before the bankruptcy filing.

Ipsa Facto Clauses

(Cont'd)

- General rule under section 365(e): *Ipsa facto* clauses are not enforceable
- Exceptions to the general rule:
 - Personal service contracts
 - Copyright, patent and trademark licenses
 - Financial accommodations
- Never, ever take unilateral action without Court approval

Ipsa Facto Clauses

(Cont'd)

- **“Quasi *ipso facto* clauses” that may or may not be enforceable**
 - Prohibiting going out of business sales
 - Prohibiting changes in control
 - Rights of first refusal

Postpetition/Pre-Assumption or Rejection Performance

- Majority: Nondebtor parties are required to continue to perform under an executory contract lease pending assumption or rejection
- Claims based on a debtor's failure to perform during this gap period are generally entitled to administrative priority

Section 365(n)

- **Section 365(n)—rejection of an executory contract under which the debtor is the licensor of intellectual property**
 - Section 101(35) of the Bankruptcy Code:
The term “intellectual property” means—
 - A. trade secret;
 - B. patent, invention, process, design, or plant protected under title 35;
 - C. patent application;
 - D. plant variety;
 - E. work of authorship protected under title 17; or
 - F. mask work protected under chapter 9 of title 17;
 - to the extent protected by applicable nonbankruptcy law.

Section 365(n)

(Cont'd)

- **If the trustee rejects an executory contract under which the debtor is the licensor of intellectual property:**
 - A. Licensee option to treat the contract as terminated
 - B. Licensee option to retain its rights under the license

Section 365(n)

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- Split of authority on effect of licensor-debtor's rejection of certain licenses:
 - *Lubrizol*: Rejection of **patent** license terminates the license. *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir.1985) (365(n) option for licensee was enacted in response to *Lubrizol*).
 - *Sunbeam*: Rejection of **trademark** license does not terminate the license. *Sunbeam Prods. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012) (365(n) does not apply to a trademark license because it is not intellectual property under 101 (35)).

Section 1113: Collective bargaining agreements

- **Special rules apply to rejection of a collective bargaining agreement in chapter 11**
 - Reasonable efforts to negotiate changes necessary for reorganization
 - Fair and equitable treatment of creditors, the debtor and other affected parties like the employees

Section 1114: Retirement benefits

- Section 1114 of the Bankruptcy Code imposes limitations and conditions on the rejection or modification of retirement benefit plans that are similar to the limitations and conditions under section 1113 for the rejection or modification of collective bargaining agreements.