

# The Bankruptcy Code is Part of Every Contract

by David S. Kupetz

Contracts govern countless commercial transactions entered each day by business entities throughout the United States. In connection with the need to promote and regulate commerce, the U.S. Constitution empowers the Congress “[t]o establish...uniform laws on the subject of bankruptcies throughout the United States.” Moreover, the Constitution prohibits the states from passing any law that impairs the obligation of contracts. Under the bankruptcy clause of the Constitution, however, Congress is empowered to impair contract rights. See *Railway Labor Executives’ Ass’n v. Gibbons*, 455 U.S. 457, 466 (1982).

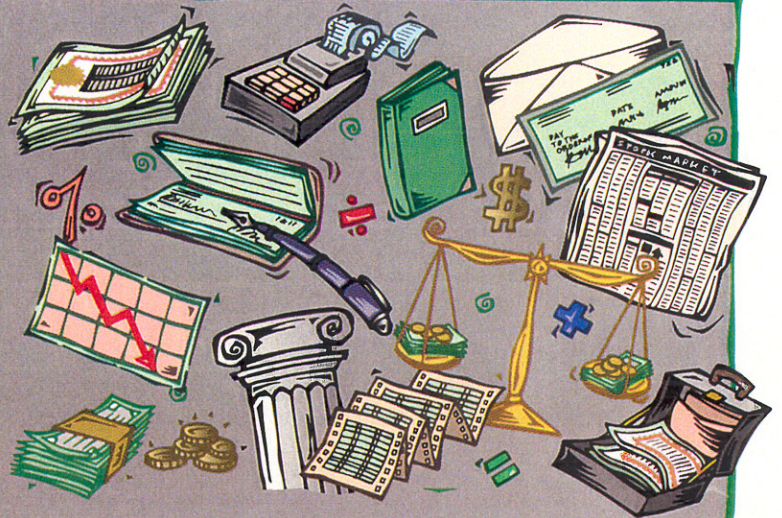
The Bankruptcy Code (Code) embodies the power to alter contractual rights and is itself part of every contract. Many lawyers fail to address the potential of bankruptcy when drafting contracts. Rather than addressing the potential impact of the Code’s antitorfeiture provisions on contract rights, many contracts simply provide for forfeiture upon an act of bankruptcy. Instead, contract drafters should consider including provisions that specify, to the extent permitted, how the parties’ respective rights will be affected by the commencement of a Chapter 11 bankruptcy reorganization case. Although such provisions in prebankruptcy contracts may not be binding after the commencement of a Chapter 11 case, they may influence

many judges addressing post-bankruptcy issues and disputes between parties to the contract. Furthermore, in some circumstances, a lawyer may be able to save a party to a contract months of heartache and thousands of dollars of damages, fees and costs simply by addressing bankruptcy issues at the time the contract is drafted and not strictly in a reactive manner after a bankruptcy petition has been filed.

Initially, this article explains that the Code, as an implicit part of every contract, constitutes an ever-present threat to undermine prebankruptcy contractual rights. Next, the impact of the post-bankruptcy power granted to the debtor under the Code to elect to perform or breach prebankruptcy contracts is examined. Thereafter, the article analyzes the Code’s antitorfeiture provisions and the enforceability of prebankruptcy waivers of rights granted the debtor under the Code. The tension between the Code and the nondebtor’s right to rely on the enforceability of a bargained-for waiver or forfeiture agreement is explored. Finally, the article provides suggestions for increasing the likelihood that a nondebtor party to a contract will continue to receive the benefit of its bargain after bankruptcy intervenes.

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Although bankruptcy courts are often referred to as courts of equity, bankruptcy judges exercise their equitable powers within the confines of the Code.



### The Bankruptcy Code: An implicit part of every contract

Contract rights are generally governed by state law. Federal bankruptcy law enacted pursuant to the constitutional grant of bankruptcy power preempts state law, however, and is the supreme law of the land on the subject of bankruptcies throughout the United States. Moreover, each contract is made as if the Code were expressly incorporated in the contract. Not only is the existing Code "read into contracts in order to fix obligations as between the parties," but future amendments to the Code under "the reservation of essential attributes of sovereign power [are] also read into contracts as a postulate of the legal order." *Home Bldg. & Loan Ass'n. v. Blaisdell*, 290 U.S. 398, 435 (1934).

Upon commencement of a bankruptcy case by a party to a contract, the implicit provisions of the contract embodying the Code are activated, and the Code may interfere with and override the ordinary exercise of contractual rights. The National Bankruptcy Review Commission (Commission), established under the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, 4147 (1994), summarized the interplay of bankruptcy law and nonbankruptcy substantive law applicable to contracts as follows:

With a few important exceptions, bankruptcy law accepts the nonbankruptcy substantive law applicable to a contract, but bankruptcy adjusts the form of the remedies available upon breach. Damages may be calculated under state law, but they are paid out according to bankruptcy priorities and principles. Specific performance may be available under state law, but it is rarely permitted against the [bankruptcy] trustee [or debtor in possession]. Thus, state contract law generally defines a party's rights, while federal bankruptcy law determines how those rights are enforced in a bankruptcy case.

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Numerous substantive provisions of the Code affect contract rights. A bankruptcy court cogently summarized substantive provisions of the Code that fundamentally influence contract rights as follows:

The...Code substantively alters the rights and remedies of both debtors and creditors in a most fundamental way. For example, section 502 disallows certain claims which would be enforceable under nonbankruptcy laws. Under section 502(b), claims for unmatured interest are not allowed (except as provided in section 506), a landlord's claim under section 502(b)(6) for breach of a lease is limited in a manner inconsistent with the law of many states, and some claims are simply disallowed. *See* § 502(b)-(j). Sections 503 and 507 create, as a matter of federal law, a priority scheme among unsecured creditors. Section 552 cuts off the operation of after-acquired property clauses in security agreements. Section 108 provides debtors with extensions of certain nonbankruptcy deadlines in specified circumstances. The debtor is given broad authority to set aside and avoid certain pre-bankruptcy transactions under sections 544, 546, and 548. Most significantly, the...Code gives the debtor broad authority to use, sell or lease property, and to assume executory contracts and leases as a matter of federal law, notwithstanding the rights of creditors under applicable nonbankruptcy laws. *See* §§ 363, 364, 365. And, importantly from the debtor's standpoint, reorganization in bankruptcy permits the debtor to modify and impair the rights of creditors. *See* §§ 1123, 1124, 1129, 1222, 1225, 1322, 1325.

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*In re Pease*, 195 B.R. 431, 434 (Bankr. D. Neb. 1996).

Although bankruptcy courts are often referred to as courts of equity, bankruptcy judges exercise their equitable powers within the confines of the Code. *See Pepper v. Litton*, 308 U.S. 295, 304 (1939) (“This Court has held that for many purposes ‘courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity,’”) (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934)). The Ninth Circuit Court of Appeals stated that “[e]quity may not be invoked to defeat clear statutory language, nor to reach results inconsistent with the statutory scheme established by the Code.” *Committee of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerine Oil Co.)*, 59 F.3d 969, 973 (9<sup>th</sup> Cir. 1995). Attempting to achieve equity, bankruptcy judges may seek to balance Congressional intent as expressed in the Code with the parties’ right to rely on the enforceability of a bargained-for agreement.

#### **Performance or breach of prebankruptcy contracts**

A primary goal of Chapter 11 is rehabilitation of the debtor. Thus, a long-standing principle of bankruptcy law is that a debtor should not be compelled to perform under a prebankruptcy contract that is burdensome to the estate. The Code provides that, subject to court approval, a debtor “may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. § 365(a) (1994). In a Chapter 11 case, “an unexpired lease or executory contract may be treated under four options: 1) it may be rejected, 2) it may be assumed and retained, 3) it may be assumed and assigned, or 4) it may ‘ride through’ the bankruptcy process.” *In re Taylor*, 198 B.R. 142, 159 (Bankr. D.S.C. 1996) (citing 1 *David G. Epstein et al., Bankruptcy* § 5-1, at 438 (1<sup>st</sup> ed. 1992)). Despite this limited number of potential alternative treatments for contracts under § 365, applying the section to a specific situation is not necessarily simple. In the context of a bankruptcy case, the issue of whether a contract is “executory” is a question of federal law. *See Qintex Entertainment*, 950 F.2d at 1495 (citing *Griffel v. Murphy (In re Wegner)*, 839 F.2d 533, 536 (9<sup>th</sup> Cir. 1988)). The Code, however, does not define the term “executory contract.” In enacting the Code, Congress recognized that

“there is no precise definition of what contracts are executory,” but said the definition “generally includes contracts on which performance remains due to some extent on both sides.” H.R. REP. NO. 95-595, at 347 (1978), *reprinted* in 1978 U.S.C.C.A.N. 5787, 6303. The U.S. Supreme Court defined contracts as executory when “performance remains due to some extent on both sides.” *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984) (citation omitted).

Under the definition applied by most courts, a contract is executory when it contains “obligation[s] of both [parties that]...are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”

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Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) (footnote omitted). Because a contract will be considered only if both parties still have material unperformed obligations, most courts examine the unperformed duties and obligations of each party in order to determine whether an agreement is an executory contract in the bankruptcy

context. Agreements which constitute outright conveyances of property rights (as opposed to agreements requiring an ongoing relationship involving mutual obligations between the parties) are not executory contracts.

The Code was designed to allow a debtor to elect to discontinue performance under a burdensome contract, while permitting the debtor to force the other party to the contract to continue performance under a contract valuable to the bankruptcy estate. A debtor in default under an executory contract may nonetheless assume the contract if it cures (or provides adequate assurance that it will promptly cure) such default, compensates (or provides assurance of prompt compensation) for any pecuniary loss of the other party resulting from such default, and provides adequate assurance of future performance under the contract. *See* 11 U.S.C. § 365(b)(2). Assumption of a contract may become more complicated when nonmonetary defaults are involved. *See, e.g., Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9<sup>th</sup> Cir. 1997). If the debtor in possession has reasonably exercised its business judgment in determining

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whether to reject or assume an executory contract, the decision will generally be approved by the court. In general, once a contract can be assumed, it can be assigned, subject to providing adequate assurance of future performance by the assignee. *See* 11 U.S.C. § 365(f)(2).

Rejection of an executory contract that was not previously assumed constitutes a breach of the contract relating back to the date immediately preceding the filing of the debtor's bankruptcy petition. *See* 11 U.S.C. § 365(g)(1). A claim resulting from the rejection of an executory contract thus becomes a prepetition unsecured claim which must be presented through the normal claims administration process. *See* 11 U.S.C. § 502(g). In contrast, if an executory contract is breached after it is assumed, the resulting claim is an administrative expense of the bankruptcy estate. When a debtor rejects the contract under section 365, most courts hold that the other party to the contract is limited to asserting a claim for damages resulting from the breach and generally cannot compel further performance of the debtor. *See Richmond Metal Finishers*, 756 F.2d at 1048 (citations omitted) ("Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages



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remedy for the non-bankrupt party....Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a), and that consequence cannot therefore be read into Congressional intent.”).

#### **Antiforfeiture provisions of the Code**

The Code explicitly invalidates provisions of private agreements that deprive the debtor of the use and benefit of property as a result of the debtor's financial condition, the commencement of a bankruptcy case, or the appointment of or taking possession by a bankruptcy trustee or a custodian before the commencement of a bankruptcy case. *See* §§ 541(c)(1), 363 (l), 365(e), and 1101(11). The Code reversed prior practice under the Bankruptcy Act which generally allowed contractual forfeiture provisions to be enforced against the debtor. Under the Code, *ipso facto* clauses are generally unenforceable forfeiture provisions. One court discussed the Congressional intent underlying the Code's prohibition against the enforceability of *ipso facto* clauses, as follows:

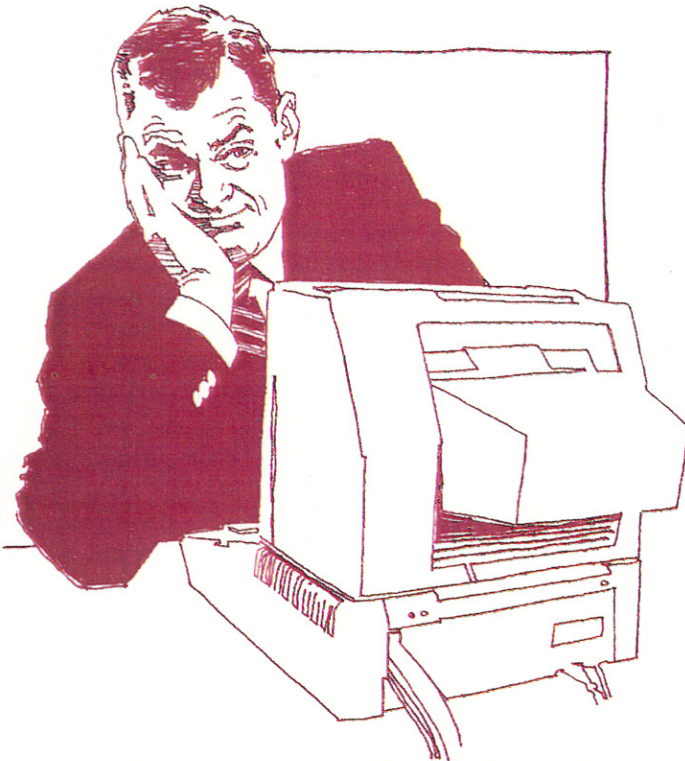
A creditor cannot force a default upon a debtor by the use of the *ipso facto* clause of a contract solely because of a bankruptcy filing. In several sections of

the...Code, such as Sections 363(l), 365(e), and 541(c), Congress has attempted to do away with such bankruptcy clauses. “It is clear from the legislative history and from the express intention of Congress to protect the ‘fresh start of debtors’ that the invocation of insolvency statutes is not favored.” The Creditor's *ipso facto* clause in the Contract thwarts the Debtors' fresh start provided under the Code and imposes a penalty upon the Debtors for exercising their constitutional right to file bankruptcy.

*Century Bank at Broadway v. Peacock (In re Peacock)*, 87 B.R. 657, 659 (Bankr. D. Colo. 1988) (citations omitted).

The Code eliminates restrictions that prevent transfer of the debtor's property to the bankruptcy estate. *See* 11 U.S.C. § 541(c)(1). Although eliminating barriers to the transfer of property to the estate, this provision only preserves a debtor's property rights; it does not increase them. *See California v. Farmers Markets, Inc. (In re Farmers Markets, Inc.)*, 792 F.2d 1400, 1402 (9<sup>th</sup> Cir. 1986) (“Section 541(c)(1)(A)...avoids only those restrictions which prevent transfer of the debtor's property to the estate.”). Accordingly, restrictions imposed prebankruptcy pursuant to contracts and/or applicable nonbankruptcy law on what later becomes property of the estate are enforceable, unless they violate one of the antiforfeiture provisions of the Code.

The debtor may use, sell or lease property in accordance with the applicable requirements of the Code, regardless of any provision in the contract or applicable nonbankruptcy law conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case concerning the debtor, or on the appointment of the taking of possession by a bankruptcy trustee or a custodian, that results in a forfeiture, modification, or termination of the debtor's interest in the property. *See* 11 U.S.C. § 363. With certain exceptions, an executory contract or unexpired lease of the debtor may not be terminated or modified at any time after the commencement of the debtor's bankruptcy case as a result of a provision in the contract or lease that is conditioned on the insolvency or financial condition of the debtor, the commencement of the bankruptcy case, or the appointment of or taking possession by a bankruptcy trustee or a prebankruptcy custodian. *See* 11 U.S.C. § 365(e)(1). The exceptions to the general rule correspond to the provisions of the Code preventing a debtor from assuming or assigning any executory contract or unexpired lease if: (i) the other party to the contract or lease does not consent and applicable nonbankruptcy law excuses that party from accepting from or rendering performance to an entity other than the debtor; or (ii) the contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.



**On the other hand, the distinction between a blanket prohibition against bankruptcy filing and a waiver of the automatic stay may be a distinction without a meaningful difference.**

See *id.* and § 365(c)(1), (2). Such contracts and leases are carved out from the antiforeclosure provisions of section 365(e)(1). See 11 U.S.C. § 365(3)(2).

A number of courts have addressed the scope of the term "financial condition" used in the Code's antiforeclosure provisions. See *Cooper v. B & L, Inc. (In re Bulldog Trucking, Inc.)*, 66 F.3d 1390, 1398 (4<sup>th</sup> Cir. 1995); *Gumport v. Sterling Press (In re Transcon Lines)*, 58 F.3d 1432, 1439-40 (9<sup>th</sup> Cir. 1995). "[U]nder the plain language of the statute, financial condition must mean something more than insolvency in the bankruptcy sense." *Bulldog Trucking*, 66 F.3d at 1398 (footnote omitted).

**Pre-bankruptcy waivers:** There is "an inviolate right of access to the courts of bankruptcy to seek rehabilitation." *In re Adana Mortgage Bankers, Inc.*, 12 B.R. 989, 1009 (Bankr. N.D. Ga. 1980) (citing *Merritt v. Mt. Forest Fur Farms of Am., Inc. (In re Mt. Forest Fur Farms of Am., Inc.)*, 103 F.2d 69, 71 (6<sup>th</sup> Cir. 1939)). Accordingly, an agreement waiving the right to commence a case under the Code is unquestionably unenforceable. See *In re Heward Bros.*, 210 B.R. 475, 479 (Bankr. D. Idaho 1997) ("Generally, a prepetition agreement to waive a benefit of bankruptcy is void as against public policy."). Most of the reported decisions addressing prebankruptcy waivers have involved waivers of the automatic stay. Some courts have found waivers of the automatic stay unenforceable. See *In*

*re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996). Apparently all courts recognize that waivers of the automatic stay are not self-executing and that a motion for relief under section 362(d) is required for enforcement. See 11 U.S.C. § 362(d); *In re Shady Grove Tech Center Assocs. Ltd. Partnership*, 216 B.R. 386, 389 (Bankr. D. Md. 1998); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 874 (M.D. Fla. 1993); *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) (footnote omitted). Furthermore, most courts seem to recognize that prepetition waivers of the automatic stay are not binding on third-party creditors. See *In re South E. Fin. Assocs., Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997); *In re Atrium High Point Ltd. Partnership*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995); *Powers*, 179 B.R. at 483; *Sky Group Int'l*, 108 B.R. at 89. One court has also held that prepetition agreements providing for waiver of the automatic stay are not *per se* binding on the debtor. See *In re Polk*, 160 B.R. at 873. Some courts, however, have distinguished prepetition waivers of the automatic stay from agreements precluding the debtor from filing a bankruptcy petition by stating that the former is enforceable and binding on the debtor because it is simply a waiver of a single benefit of the Code in exchange for the creditor's cooperation. See *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 912-13 (Bankr. D.S.C. 1995); *In re Cheeks*, 167 B.R. 817, 818-19 (Bankr. D.S.C. 1994); *In re Club Tower L.P.*, 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991); *In re Citadel Properties, Inc.*, 86 B.R. 275, 276-77 (Bankr. M.D. Fla. 1988). On the other hand, the distinction between a blanket prohibition against bankruptcy filing and a waiver of the automatic stay may be a distinction without a meaningful difference. In fact, most of the decisions involving enforcement of prebankruptcy waivers of the automatic stay are single asset real estate cases in which generally, any opportunity for reorganization is destroyed if the stay is lifted.

Some courts hold prepetition waivers of the automatic stay *per se* enforceable against the debtor. See *Cheeks*, 167 B.R. at 818; *Club Tower*, 138 B.R. at 311; *Citadel Properties*, 86 B.R. at 276. Others have found such waivers enforceable under more limited circumstances. See *In re Powers*, 170 B.R. 480, 484 (Bankr. D. Mass. 1994). The primary justification espoused for enforcing prepetition waivers of the automatic stay is that refusing to enforce the waivers would discourage consensual restructurings and out-of-court workouts. *Darrell Creek Assocs.*, 187 B.R. at 913; *Cheeks*, 167 B.R. at 819; *Club Tower*, 138 B.R. at 312. However, it might be concluded that standard use and enforcement of pre-bankruptcy waivers could actually reduce out-of-court workouts by encouraging debtors to enter Chapter 11 earlier.

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## Suggestions for maximizing protection of the nondebtor's contract rights

*Form will not be elevated over the substance of the transaction:* In many instances, a contracting party may believe that applying the desired label to a transaction is a quick fix for potential future trouble that could arise when the other party commences a bankruptcy case. Common examples of such labels are "an absolute assignment of rents" that is in reality a security interest in the rents, or a "lease" that is really a disguised security agreement. Discussing an "absolute assignment," one court stated in *Foundry of Barrington Partnership v. Barrett (In re Foundry of Barrington Partnership)*, 129 B.R. 550, 556-57 (Bankr. N.D. Ill. 1991):

Prudential further argues, the Debtor cannot reorganize because the rental income it needs to operate is not merely cash collateral, but is Prudential's property under the "absolute assignment of rents." That "absolute assignment" is subject to a license in favor of the Debtor to use the rent until there is a default under the note or mortgage. Further, the "absolute assignment" terminates when the debt is paid in full. So the "absolute assignment" is not so absolute after all....The assignment of rents gave Prudential an interest in the rents and underlying leases. That interest, however, exists only to assure payment of the debt and performance of the other obligations of the Debtor. That is clear because the assignment terminates once the debt is paid. Prudential can call this arrangement an "absolute assignment" or, more appropriately, "Mickey Mouse." It's still a lien, and the rent is still the Debtor's property, subject to that lien.

Generally, state law determines whether the label applied accurately reflects the true nature of the transaction. However, "[i]t is the economic substance of a transaction that should determine the rights and obligations of interested parties." *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 949 F.2d 585, 597 (2d Cir. 1991). Thus, bankruptcy courts "may look through form to substance when determining the true nature of a transaction as it relates to the rights of parties against [bankrupt estates]." *Id.* (citing *Pepper v. Litton*, 308 U.S. 295, 304 (1939)). Many courts have found that "absolute assignments" of rents were actually assignments for security purposes and that the assigned rents were, accordingly, property of the debtor's bankruptcy estate subject to the creditor's lien. *See, e.g., In re Mocco*, 176 B.R. 335, 347 (Bankr. D.N.J. 1995); *In re Newberry Square, Inc.*, 175 B.R. 910, 911 (Bankr. E.D. Mich. 1994). Other courts have found to the contrary, however, and have upheld assignments as absolute transfers of all rights to the property. *See Commerce Bank v. Mountain View Village, Inc.*, 5 F.3d 34 (3d Cir. 1993); *In re Glen Properties*, 168 B.R. 537 (D.N.J. 1993).

Many courts have grappled with whether a transaction labeled a "lease" is a true lease or a disguised security agreement. If the transaction created a financing arrangement and not a lease, the creditor will hold a claim against the debtor payable in accordance with a confirmed plan of reorganization. The debtor can make deferred cash payments over a number of years, provided that the secured creditor retains its lien and receives the full present value of its allowed secured claim. 11 U.S.C. § 1129(b)(2)(A) (1994). Such payments may amount to less than is owed under the remaining term of the agreement if "lease" payments were to be made. In contrast, if the transaction constitutes a lease, the debtor can assume or reject under § 365 of the Code. If the debtor elects to assume, the creditor can demand full payment of its claim pursuant to the terms of the lease.

For a discussion of factors relevant to a determination of the economic substance of a transaction labeled a "lease," see *Port Angeles Waterfront Assocs. v. Port of Port Angeles (In re Port Angeles Waterfront Assocs.)*, 134 B.R. 377 (B.A.P. 9<sup>th</sup> Cir. 1991); *Baker v. Harris Pine Mills (In re Harris Pine Mills)*, 862 F.2d 217 (9<sup>th</sup> Cir. 1988); *Pacific Express, Inc. v. Teknekron Infoswitch Corp. (In re Pacific Express, Inc.)*, 780 F.2d 1482 (9<sup>th</sup> Cir. 1986). Nonetheless, while bankruptcy courts "must be careful not to elevate form over substance, [the] form sometimes has substance." *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687, 709 (Bankr. S.D.N.Y. 1992).

*The contract should reflect that the parties have considered the impact of bankruptcy on their relationship:* The way to give substance to a prebankruptcy agreement designed to minimize the impact of bankruptcy on the nondebtor party to the contract is to specifically include stipulated facts in the agreement that support the granting of relief likely to be sought by the nondebtor postbankruptcy. Because the enforceability of prebankruptcy waivers is questionable and inclusion of those provisions may lead to unnecessary or unproductive litigation regarding their enforceability, specific waivers of bankruptcy rights or powers might be omitted from a prebankruptcy agreement. The contract should reflect, however, that the parties have considered the impact of bankruptcy on their relationship by including specific stipulated facts and warranties that will help the nondebtor minimize the impact of an intervening bankruptcy on its contract rights. Although stipulations as to questions of law are not binding on the court or the parties, inclusion of stipulated facts in certain prebankruptcy contracts carefully considered in light of the potential impact of a future bankruptcy case may allow the nondebtor party to the contract to minimize the impact of bankruptcy on its rights

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and limit the expense, delay and frustration that it might otherwise suffer.

In some instances, it may be possible to structure a transaction so as to minimize the impact of a future bankruptcy. For example, instead of providing goods or services to a customer (a potential debtor under the Code) on credit, a creditor can require cash on delivery (C.O.D.). If C.O.D. credit terms are not available, the creditor might be able to obtain a security deposit, a third-party guaranty (secured or unsecured), and/or a security interest in goods (assuming the transaction involves the sale of goods) or in other collateral. The contract may include cross-default provisions with regard to other contracts the entity has with the potential debtor or with guarantors of the potential debtor's obligations, or between the nondebtor party and entities affiliated with the potential bankruptcy debtor and/or with regard to contracts between the potential debtor and other parties. Care should be given with regard to whether creating stringent default provisions and/or shortened cure periods may unnecessarily trigger defaults in other agreements of the debtor that the creditor may desire be kept in good standing. Moreover, in sales transactions governed by Article 2 of the Uniform Commercial Code, a creditor may demand assurance of performance, stop the goods in transit, or exercise reclamation rights. Obviously, a secured creditor must obtain a valid security interest and must properly perfect that security interest under applicable

nonbankruptcy law in order to avoid becoming an unsecured creditor in the event of a bankruptcy filing. See *Pacific Express, Inc. v. Teknekron Infoswitch Corp.* (*In re Pacific Express, Inc.*), 780 F.2d 1482, 1486 (9th Cir. 1986).

Structuring a transaction to eliminate risk (i.e., C.O.D. payment) or minimize risk (i.e., obtaining a third-party guaranty, a security deposit, or a security interest in connection with what otherwise would be an unsecured transaction) may not be a viable alternative, or it may only be a partial solution. Accordingly, the prebankruptcy contract appropriately may state that the parties have considered the impact of bankruptcy on their relationship. The contract should then include stipulated facts agreed on in light of potential bankruptcy issues that are likely to arise if the other party to the contract commences a Chapter 11 case. Some examples are provided below of areas in which including such language in a contract on a preemptive basis, rather than simply reacting once a bankruptcy case is filed, may well serve the interests of the nondebtor party to the contract.

*Adequate protection:* On commencement of a Chapter 11 case, a secured creditor is entitled to receive "adequate protection" to compensate it for any decline in the value of its collateral resulting from the automatic stay of section 362, the use, sale, or lease of the collateral under section 363, or the granting of a lien under section 364. 11 U.S.C. §§ 363(e), 364(d), 362(d)(1). "Adequate protection" ensures that the creditor receives the value it bargained for prebankruptcy. Accordingly, the prebankruptcy contract should specifically identify the ingredients necessary to provide the creditor with adequate protection in the event of a subsequent bankruptcy filing. Determinations of what constitutes adequate protection are made on a case-by-case basis. Insofar as the concept of adequate protection is designed to protect the secured creditor from any postbankruptcy decrease in the value of its collateral, the parties, as a first step, should agree on the value of the collateral. This agreement may be supported by reference to specific appraisals, other data and an agreed-on and explicitly-stated valuation formula. Obviously, valuations can change based upon changes in the market for the particular collateral or other factors. Nonetheless, an agreement on current value and/or a formula for determining value in the future provides a starting point from which the rights of the secured creditor can be assessed in the event of a future bankruptcy filing by the debtor.

Further, depending on the situation involved, the agreement may identify specific factors necessary in order to avoid a decrease in the value of the collateral (this is what "adequate protection" is designed to protect the secured creditor against). These factors might include, for example, maintenance obligations, capital improvement

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requirements, continuous operations requirements, minimum occupancy requirements (assuming improved real estate collateral is involved), minimum revenue requirements and, among other possibilities, insurance requirements. With respect to each or any of such requirements that apply to the collateral at hand, the contract can state the specified requirements are necessary to provide the secured creditor with adequate protection postbankruptcy. The parties may set forth detailed criteria for complying with these requirements. Further, the parties should detail the negative impact on the collateral's value that will result from failure to comply with the requirements necessary for providing adequate protection.

The Code divides an undersecured creditor's total claim into a secured claim to the extent of the collateral's value and into an unsecured claim to the extent of the deficiency. 11 U.S.C. § 506(a). The first sentence of § 506(a) simply "tells us that a secured creditor's claim is to be divided into secured and unsecured portions, with the secured portion of the claim limited to the value of the collateral." *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879, 1884 (1997). The second sentence of § 506(a), providing that value shall be determined in light of the valuation's purpose and the property's proposed disposition or use, directly addresses the question of how to value the collateral. In *Rash*, the debtor chose to retain and use the collateral to generate an income stream. The U.S. Supreme Court held that actual use, rather than hypothetical dispositions or uses of the collateral, is the proper basis for determining the value of the collateral under § 506(a); from both the creditor's and the debtor's perspectives, surrendering and retaining the collateral are not equivalent acts. *Id.* at 1884-86. For a detailed discussion of *Rash*, see Kathryn R. Heidt & Jeffrey R. Waxman, *Supreme Court's Rash Decision Fails to Scratch the Valuation Itch*, 53 BUS. LAW. 1345 (1998).

When a potential debtor is authorized to use in prebankruptcy what would be cash collateral upon the commencement of a case, the agreement can specifically provide that: (i) upon the commencement of a bankruptcy case, the secured creditor is entitled to adequate protection of its interests in the subject property (cash collateral); (ii) one purpose of the agreement is to assure the secured creditor that, if bankruptcy is filed, the debtor will provide adequate protection by making payments to the secured creditor in accordance with the terms of the agreement (e.g., providing that payments are made as required under a revolving loan agreement); and (iii) failure to pay as provided in the contract would result in a denial of adequate protection precluding the use of cash collateral. Of course, stipulations as to questions of law, such as "adequate protection" are not binding.

*Present value under a cram-down plan:* The bankruptcy court may confirm a plan of reorganization, over the objection of a secured creditor, if the holder of the secured

claim retains its lien and receives a stream of payments amounting to the present value of its allowed secured claim and the plan otherwise satisfies the requirements of the Code. 11 U.S.C. § 1129(b)(2)(A). To determine whether secured creditors are provided the present value of their claims, bankruptcy courts make case-by-case determinations of what interest the reorganizing debtor would have to pay a creditor in order to obtain a loan on equivalent terms in the open market. See *Connecticut Gen. Life Ins. Co. v. Hotel Assocs. (In re Hotel Assocs.)*, 165 B.R. 470, 476 (B.A.P. 9<sup>th</sup> Cir. 1994). The court may be guided, in part, by comparing the proposed plan to the terms of the original loan, although a court may approve a plan that bears no real relationship to the terms of the original loan. As part of an extensive discussion of the appropriate method for calculating the interest rate that provides a secured creditor the present value of its secured claim pursuant to a plan, the court stated in *SM 104 Ltd.*, 160 B.R. 202, 232 n.54 (Bankr. S.D. Fla. 1993):

In this case, the Debtor's proposed twenty year amortization with a ten year balloon is not unreasonable.

The fact that the original EquiVest loan to the Debtor was for a term of five years is not dispositive, or even persuasive. As long as the feasibility of a plan can be shown and the creditor is properly compensated and protected for the use of its money via an appropriate interest rate, it is not improper for a plan to stretch out payments, even if the loan was originally intended to be a short term loan. See *In re Hollanger* [sic], 15 B.R. 35, 47 (Bankr. W.D. La. 1981) (seven year extension in farm reorganization [sic]); *In re Benson* [sic], 9 B.R. 854, 858 (Bankr. N.D. Ill. 1981) (20 year extension of 2 year note [sic]).

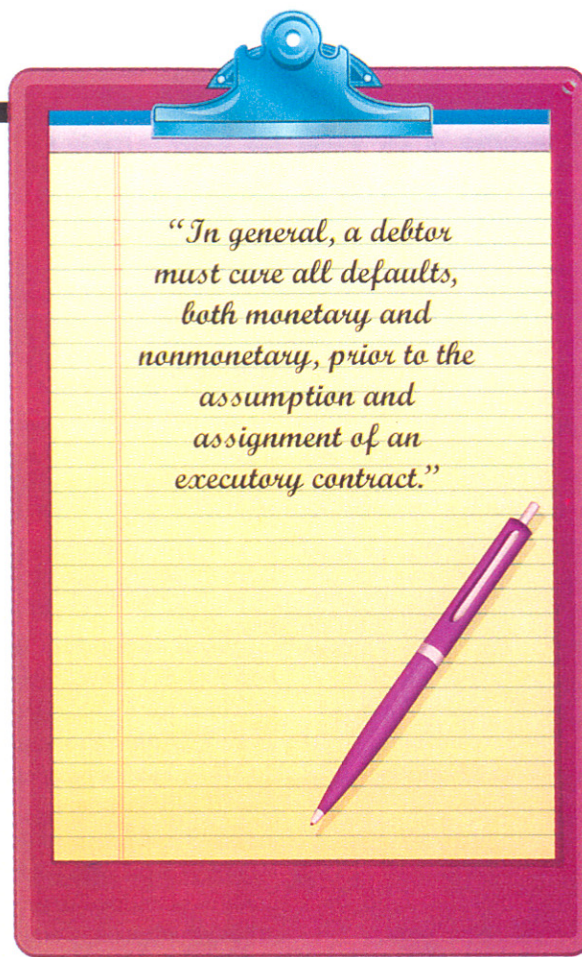
The contract itself can provide that the parties have considered the impact of a future bankruptcy filing by the borrower on their contractual rights. Specifically, the contract may state that the interest rate provided under the prebankruptcy loan is based on a specified, minimum loan-to-value ratio, the loan term, the amortization schedule, and other specific covenants contained in the prebankruptcy loan agreement, such as a due on-sale clause and/or environmental and other indemnities. The contract may stipulate that the interest rate reflects the length of the payment term, the quality of the collateral, and the risk of subsequent default by the debtor. The parties may agree the contractual interest rate would be greater in order to adequately compensate the secured creditor for its increased risk if any of these variables were altered in a manner adverse to the secured creditor.

Determination of whether the interest rate applied under a Chapter 11 plan providing for deferred payments to the secured creditor satisfies the present value test is driven, in large part, by the value of the secured creditor's collateral. Just as when considering "adequate protection" issues

prebankruptcy, when considering the question of the discount rate that might be applied under a cram-down plan, the secured creditor may desire to have the prebankruptcy contract include an agreement on the value of the collateral. Again, this agreement may be supported by reference to specific appraisals, other data, and an agreed-on and explicitly stated valuation formula. Additionally, the agreement may include a detailed formula for determining an appropriate interest rate in the event of a future bankruptcy, depending upon, at a minimum, the loan-to-value ratio, the loan term, the amortization schedule, projections of future revenues, and other covenants that might be significant in the context of the particular transaction. For an interest rate formula applied under § 1129(b) by one court in a thoughtful opinion, see *SM 104, Ltd.*, 160 B.R. at 233.

*Incurable default and other default provisions:* “In general, a debtor must cure all defaults, both monetary and nonmonetary, prior to the assumption and assignment of an executory contract.” *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029, 1033 (9<sup>th</sup> Cir. 1997). As an exception to the general rule, the debtor is not required to cure nonmonetary defaults under provisions of an executory contract relating to the insolvency or financial condition of the debtor, the commencement of the debtor’s bankruptcy case, or the appointment of or taking possession by a bankruptcy trustee or a prebankruptcy custodian. See 11 U.S.C. § 365(b)(2) (1994). Some courts have held that contractual provisions regarding the operational status of the debtor’s business, such as provisions allowing for termination of a franchise agreement for failure to operate the business for a certain number of consecutive business days, are enforceable and that defaults under such provisions constitute historical, nonmonetary defaults that, by definition, cannot be cured. See *Cooper v. B & L, Inc. (In re Bulldog Trucking, Inc.)*, 66 F.3d 1390, 1398 (4<sup>th</sup> Cir. 1995); see also *Claremont Acquisition Corp.*, 113 F.3d at 1033. Other incurable default provisions are likely to be specific to a particular situation and should be considered on a case-by-case basis.

In order to increase the likelihood that the nondebtor contracting party can, if it desires, prevent assumption of the contract postbankruptcy, the agreement should define specific non-monetary defaults. The materiality and



*“In general, a debtor must cure all defaults, both monetary and nonmonetary, prior to the assumption and assignment of an executory contract.”*

economic significance of such provisions should be explicitly agreed on and detailed in the contract. The parties may stipulate to the basis and need for such provisions. For example, in connection with any future possible contentions regarding the materiality of an automobile dealership’s failure to maintain operations, the prebankruptcy contract could set forth the party’s agreement that any such failure would result in the franchisor’s loss in sales and good will, in addition to creating difficulties in providing authorized service to existing local customers, among other things. In addition, the contract could specifically provide that an “economic profit” projected at a specified figure per month based upon historic results would be lost during the time

operations were shut down (or a formula may be agreed on for projecting such losses) and that other costs (specify, if possible, anticipated type and extent of costs) would likely be incurred by the franchisor in the event of a cessation in the franchisee’s business operations.

Default provisions other than missed payments under an agreement, in general, are designed to provide the nondefaulting party with: (i) an early warning regarding financial or other problems encountered by the other party to the contract; (ii) the ability to move forward with the enforcement of its rights and remedies under the contract; and (iii) the opportunity to seek to negotiate a consensual modification of the contract or some other resolution with the defaulting party. Contracts generally provide grace periods for curing events of default. Frequently, notice of default must be provided in order to trigger commencement of a cure period. Creditors may consider shortening the cure period under their contracts. Section 108 of the Code extends cure periods that have not expired prior to the commencement of a bankruptcy case to the later of the end of such periods or 60 days after the entry of the order for relief. 11 U.S.C. § 108(b). Cross-default provisions are frequently included in contracts. Lenders and others, however, may be concerned about creating cross-defaults in other debt instruments of the borrower. Accordingly, certain events of default may not be effective until notice is given.

*(Continued on page 62)*

### Determining add-ons to secured claims

**Default interest:** A secured creditor is generally entitled to postpetition interest at the rate set forth in its contract with the debtor. This is the most common exception to the general bankruptcy rule prohibiting the accrual of postpetition interest on creditors' claims. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946). "It was considered unfair to allow an undersecured creditor to recover interest from the estate's unencumbered assets before unsecured creditors had recovered any principal." *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 373 (1988). Section 506(b) provides, an oversecured creditor may recover "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." 11 U.S.C. § 506(b). Furthermore, the secured creditor's entitlement to postpetition interest exists whether or not any agreement provides for interest. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 245 (1989) (concluding that the language of § 506(b) entitles holders of both consensual and nonconsensual oversecured claims to postpetition interest on their claim). Oversecured creditors with consensual liens, however, are not always granted their contractual (default) rate of interest. *In re Terry Ltd. Partnership*, 27 F.3d 241, 243 (7th Cir. 1994). Moreover, under a plan of reorganization or pursuant to a sale outside of a plan, the debtor may "cure" and nullify all consequences of the default, including the higher postdefault interest rate. See 11 U.S.C. §§ 363, 1123(a)(5), 1124(2) and *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335, 338 (9th Cir. 1989); *Great W. Bank & Trust v. Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)*, 850 F.2d 1338, 1342 (9th Cir. 1988).

In the prebankruptcy contract, the parties may agree that a default rate of interest is commonly included in transactions of this type and is included in the subject contract to cover additional but unforeseeable costs and risks associated with a default by the borrower. The contract can further provide that such a default creates a situation requiring the creditor to actively monitor the collateral to ensure its value is preserved, and that the costs incurred in performing this task vary from case-to-case and simply cannot be calculated in advance. The parties may agree that the default rate of interest is designed to address this difficulty. To the extent specific problems flowing from default can be identified and detailed, this can be



tract along with a recital providing that the parties agree the default rate is designed to compensate the lender for costs caused by default, and is not a punitive damages provision. Of course, this conclusory statement will be of less value than specific factual recitals showing the increased costs incurred by the creditor upon default.

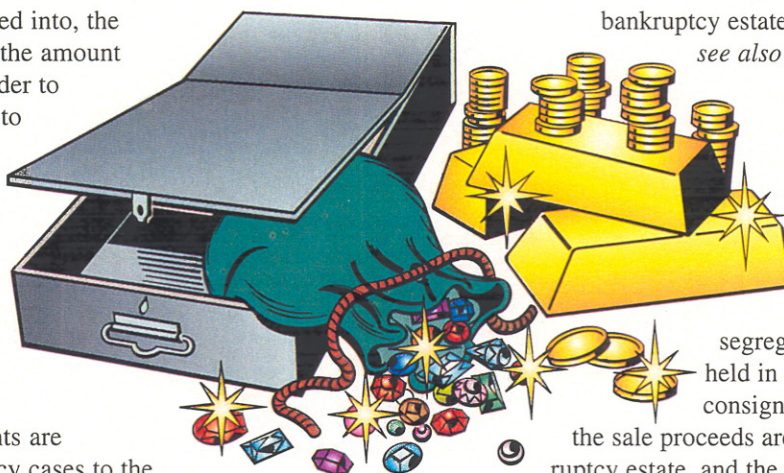
**Attorneys' fees:** A fully secured creditor is entitled to recover postpetition attorneys' fees only if attorneys' fees are provided for in its contract with the debtor. Although parties generally bear their own legal fees under the "American Rule," Congress can legislate exceptions to the rule. See *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 269-71 (1975). The fees sought, however, must be reasonable. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) ("Recovery of postpetition interest is unqualified. Recovery of fees, costs, and charges, however, is allowed only if they are reasonable and provided for in the agreement under which the claim arose."). Although the prebankruptcy contract may support the allowance of postpetition attorneys' fees even without specifically mentioning "bankruptcy," the more advisable approach for the secured creditor is to include a broad attorneys' fees provision. It may provide that the secured creditor is entitled to recover attorneys' fees for matters taken to collect any and all obligations under the agreement and to otherwise enforce any and all of its rights with respect to the agreement and, in addition, fees incurred in connection with a bankruptcy filing by the other party to the contract. Furthermore, the agreement may provide for the recovery of attorneys' fees in connection with any litigation brought against it by the potential debtor or a bankruptcy trustee, whether in bankruptcy court or otherwise, including, without limitation, any action brought under the Code's avoidance powers. Language regarding avoidance actions should be included with caution because state law may entitle the debtor (if it prevails) with the right to recover attorneys' fees in connection with such actions.

**Prepayment provisions:** Courts have found typical prepayment penalty provisions contained in a lending instrument to be a "charge" allowable postpetition under section 506(b), so long as it is reasonable. "Charges" in § 506(b) encompass more than out-of-pocket expenses. See *In re A.J. Lane & Co.*, 113 B.R. 821, 823 (Bankr. D. Mass. 1990). The concept of "charge" as used in § 506(b) includes prepayment penalty provisions. See *Continental Sec. Corp. v. Shenandoah Nursing Home Partnership*, 193 B.R. 769, 775 (W.D. Va.), *aff'd sub nom. In re Shenandoah Nursing Home Partnership*, 104 F.3d 359 (4th Cir. 1996). To meet the test of reasonableness, a prepayment penalty formula must effectively estimate actual damages so that "the charges...[do not] operate as either a penalty on the debtor or a windfall to a lender, at the expense of other

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creditors of the bankruptcy estate." *In re Duralite Truck Body & Container Corp.*, 153 B.R. 708, 714 (Bankr. D. Md. 1993). A specified formula that reasonably measures actual damages to be suffered as a result of early payment is more likely to be allowable. One author (Edythe L. Bronston, *The Enforceability of Prepayment Premiums in Bankruptcy Court*, 18 CAL. BANKR. J. 54, 58 (1990)) has proposed such a formula as follows:

Such a formula would subtract the lender's present offered rate on similar loans from the contractual rate on the prepaid loan, multiply that by the principal balance on the loan, and provide a premium equal to the present discounted value of that payment stream. Finally, a lender should be prepared (in a litigation context) to substantiate the fact that the amount of damages for breach of the underlying contract was difficult to ascertain at the time said contract was entered into, the reasonableness of the amount charged and, in order to stave off attempts to subordinate all of the fee, the amount of actual damages incurred by the early payoff.



### Subordination agreements

Subordination agreements are enforceable in bankruptcy cases to the same extent they are enforceable under applicable nonbankruptcy law. See 11 U.S.C. § 510(a). Creditors seeking to enjoy benefits under subordination agreements postbankruptcy have run into problems when the subordination agreement fails to explicitly provide that, in the event of bankruptcy, senior creditors shall receive postpetition interest before any payments are made to junior creditors and that the senior creditors' postpetition fees and costs are paid prior to any payments to junior creditors. The following language was proposed in *South-east Banking Corp.*, 212 B.R. at 689 n.2 (quoting *First Fidelity Bank, Nat'l Assoc., N.J. v. Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.)*, 134 B.R. 528, 535 n.14 (Bankr. S.D.N.Y. 1991)) by a bankruptcy judge and cited approvingly by a district court as providing "a clear example of the kind of language that would create a clear and explicit right to post-petition interest [and fees and costs]:"

"Upon any distribution to creditors of the Company in a liquidation or dissolution of the Company or in bankruptcy, reorganization, insolvency, receivership, or similar proceeding relating to the Company or its property or in an assignment for the benefit of creditors or any marshalling [sic] of assets and

liabilities of the Company: (1) holders of the Senior Debt shall be entitled to receive payment in full of all Obligations with respect to the Senior Debt (including interest after the commencement of any proceeding at the rate specified in the applicable Senior Debt, whether or not such interest is an allowable claim in any such proceeding [and also including all attorneys' fees and other costs incurred in any such proceeding, including attorneys' fees and costs incurred after the commencement of any case under the...Code]) before Securityholders shall be entitled to receive any payment of any Obligations with respect to the Securities...."

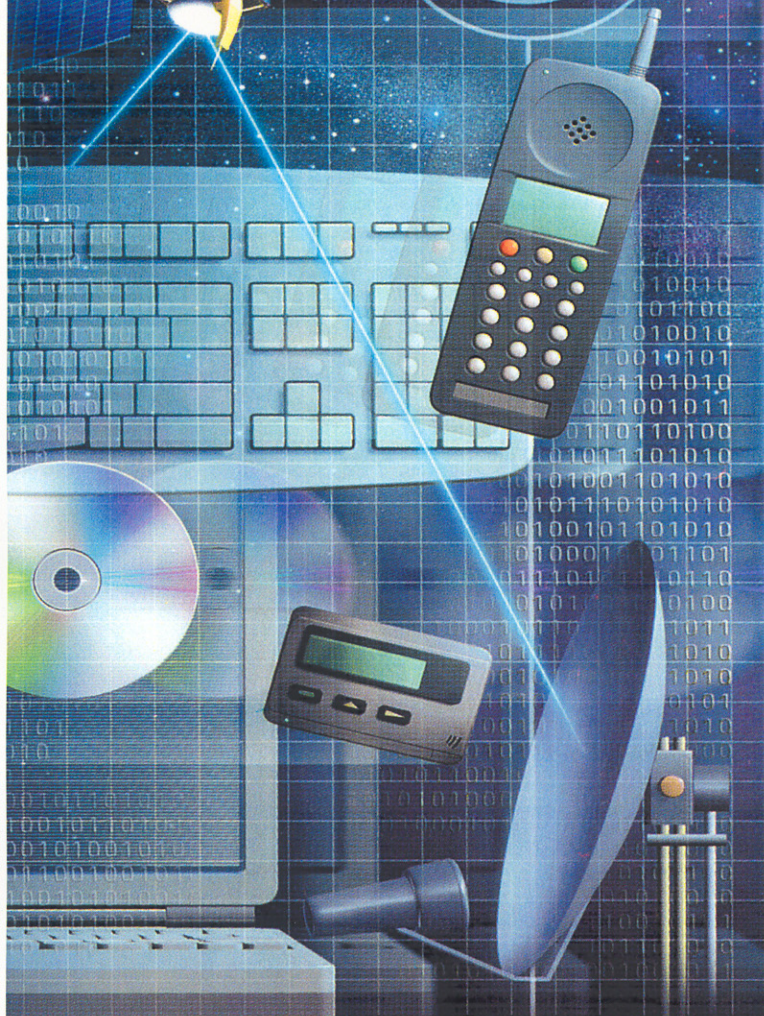
### Scope of the bankruptcy estate

*Consignment agreements:* The Code expansively sweeps all of the debtor's interests in property into the bankruptcy estate. See 11 U.S.C. § 541(a); see also *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983). If the debtor is a consignee under a consignment agreement, the consignor's rights are best protected by an agreement that sale proceeds are to be

segregated by the consignee and held in trust for the benefit of the consignor. When this is not done, the sale proceeds are property of the bankruptcy estate, and the consignor is merely another creditor with no specific right to the proceeds.

*Escrow and other trust arrangements:* Although the Code broadly sweeps the debtor's property interests into the estate, property of the estate does not include any power that a debtor may exercise solely for the benefit of an entity other than the debtor, nor any equitable interest in property in which the debtor holds only legal title. See 11 U.S.C. § 541(b)(1), (d). Paragraph (2) of subsection (c) of § 541 provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title [the Code]." *Id.* § 541(c)(2). Accordingly, property held in traditional spendthrift trusts generally does not become property of the estate. Furthermore, "[p]roperty that a debtor holds in trust for another does not become property of the estate available for distribution to creditors. Whether the Debtor held the property in trust is governed by state law." *Siegel v. Boston (In re Sale Guar. Corp.)*, 220 B.R. 660, 663-64 (B.A.P. 9<sup>th</sup> Cir. 1998) (citations omitted). Accordingly, in structuring transactions with a potential debtor involving escrow or other types of trust

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**...an intellectual property licensee could avoid the risk of a future bankruptcy by purchasing the technology outright, if possible, instead of merely taking it under a license agreement.**

arrangements, attention must be given to any interests retained by the debtor in property subject to the transaction. The estate's rights are identical and limited to those held by the prepetition debtor and are governed by applicable nonbankruptcy law. In addition, with regard to transfers made to escrows or other trust arrangements, the parties should be careful to analyze issues in advance regarding the potential avoidability of such transfers in the event of a bankruptcy or insolvency of the transferor.

#### **Protections for intellectual property licensees**

Following the Fourth Circuit's decision in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4<sup>th</sup> Cir. 1985), perceived by many to have chilled the licensing of intellectual property, the intellectual property community sought special protection of intellectual property licensees from rejection of a license agreement by a debtor. Congress enacted section 365(n) of the Code in 1988 to protect licensees and assignees of copyrights and other forms of

other intellectual property. The section allows the intellectual property licensee, upon rejection of the license agreement by the debtor/licensor, the option to either "retain its rights" in the intellectual property while continuing to pay royalties or to treat the executory contract as terminated. 11 U.S.C. § 365(n).

The nondebtor technology licensee has two options when the debtor/licensor rejects the license agreement: (i) it can treat the contract as terminated if the rejection would constitute a breach were the licensor not in bankruptcy, allowing the licensee to treat the license as terminated under applicable nonbankruptcy law; or (ii) it can retain its rights under the agreement to use the licensed intellectual property for the duration of the contract period and for any extension periods provided for as a matter of right by nonbankruptcy law (which includes lawful renewal periods provided for at the licensee's option in the contract itself). See § 365(n)(1)(A), (B); see also *Encino Bus. Management, Inc. v. Prize Frize, Inc.* (*In re Prize Frize, Inc.*), 150 B.R. 456, 459 (B.A.P. 9<sup>th</sup> Cir. 1993), *aff'd*, 32 F.3d 426 (9<sup>th</sup> Cir. 1994):

If the first choice is made, the licensee may assert a claim against the estate for damages caused by the rejection, as a breach of contract under §§ 365(g) and 502(g), and forfeit any and all rights to continue using the subject technology.

The second alternative allowed under § 365(n) of the Code is likely to be a more attractive choice for the nondebtor/licensee because, among other things, the licensee's right to use the licensed technology is preserved for the term of the contract, notwithstanding the debtor/licensor's rejection of the contract. Upon the licensor's rejection, § 365(n)(1)(B) allows the licensee to retain its right to the technology under the contract and under any agreement supplementary to the license. The rights do not include a right to compel specific performance by the licensor under the contract — except for a right, to the extent it exists in the agreement, to enforce any exclusivity provision of the contract.

In this manner, the licensor is relieved of any burdens to take additional affirmative actions under the contract such as a duty to provide training, maintenance, promotion, or updates to the licensee. The licensee is protected by being able to retain the ability to use the license in the intellectual property, but the licensor/debtor is not burdened to take affirmative actions — some of which could deplete the bankruptcy estate at the expense of the general creditors — while trying to reorganize or make a fresh start.

Under this scenario, the licensee will retain an unsecured claim for damages from rejection, as a breach of contract under § 365(g), although damages may be less if the licensee elects to proceed under § 365(n)(1)(B) rather than under § 365(n)(1)(A), because the licensee still retains its rights to the intellectual property under § 365(n)(1)(B).

If the nondebtor/licensee chooses to continue to use the licensed technology notwithstanding the debtor/ licensor's rejection of the license, the licensee must continue to pay all "royalties" due the licensor. *See* 11 U.S.C. § 365(n)(2)(B). Further, the licensee waives any right of setoff and any administrative claim. *See* 11 U.S.C. § 365(n)(2)(C)(i) and 11 U.S.C. § 365(n)(2)(C)(ii). If the licensee elects to continue to use the licensed property, the debtor/licensor is required to allow the licensee access to the intellectual property and may not interfere in any way with the licensee's rights pursuant to the license agreement and any supplementary agreement. 11 U.S.C. § 365(n)(3)(A), (B).

Like a lessee, who could, if feasible and desirable, purchase rather than lease property from a potential debtor, an intellectual property licensee could avoid the risk of a future bankruptcy by purchasing the technology outright, if possible, instead of merely taking it under a license agreement. Of course, instances in which an outright purchase of the intellectual property is feasible or warranted may be infrequent. Costs may be prohibitive for the potential licensee. Moreover, among other things, the owner/licensor may be unwilling to sell and lose control over its invention. Considering the issues presented by a possible future bankruptcy, the licensee should seek both to create disincentives for rejection of the license agreement and to create protections in the event of rejection.

Because the Code's definition of "intellectual property" is limited, the licensee desiring the protection of section 365(n) should attempt to characterize property covered by the agreement in terms that are within the scope of the definition. The license agreement should expressly state the parties' agreement that the licensed property is "intellectual property" as defined in the Code and that section 365(n) will govern if the licensor commences a case under the Code. Although these provisions may not have a binding effect in a later bankruptcy case by the licensor, they should be of value in demonstrating the party's intent at the time the agreement was negotiated and may serve as an admission in a future bankruptcy case.

If the licensee elects upon rejection by a debtor/ licensor of an intellectual property license to continue to use the property, the licensee is obligated to continue to make "royalty payments" to the licensor. *See* 11 U.S.C. § 365(n)(2)(B). Although rejection does not prevent the licensee's continued use of the property, it permits the licensor to avoid the continued performance of affirmative obligations under the agreement. These might include any obligation to train the licensee's personnel, to provide marketing or promotional functions, technical service, product service, maintenance functions, defense against infringement, or other such obligations. Further, if not specifically delineated in the license agreement, the courts are likely to define "royalties" broadly. *See Encino Bus. Management, Inc. v. Prize Frize, Inc. (In re Prize Frize,*

*Inc.)*, 150 B.R. 456, 459-60 (B.A.P. 9<sup>th</sup> Cir. 1993), *aff'd*, 32 F.3d 426 (9<sup>th</sup> Cir. 1994). Accordingly, from the licensee's perspective, the license agreement should specify the payments (royalty payments) related to the use of the technology and segregate payments attributable to the performance of collateral obligations or services such as maintenance, training, marketing, or other services. If the payments are lumped into one royalty payment, upon rejection by the debtor/licensor, the licensee could still be compelled to pay the full price for the collateral obligations even if they are no longer being performed.

As an alternative, the license agreement could provide for a royalty rate reduction explicitly stating that to the extent the royalty payment for intellectual property is attributable to the licensor's performance of collateral obligations or services, the royalties shall be reduced by a specifically defined amount if the collateral obligations are not being performed. A more drastic option would be to structure a forfeiture of the license upon a defined event of material breach (other than insolvency, financial condition, bankruptcy, or the appointment of a bankruptcy trustee or prebankruptcy custodian).

#### **Adequate assurance of future performance**

In general, notwithstanding any provision in the contract to the contrary, a debtor may assign to a third party an executory contract if the contract is assumed and if "adequate assurance of future performance by the assignee of such contract...is provided." 11 U.S.C. § 365(f)(2)(B). With the exception of shopping center leases, the Code does not define what constitutes "adequate assurance of future performance." *See* 11 U.S.C. § 365(b)(3). Congress has provided special protections for shopping-center lessors by specifically setting forth requirements that must be satisfied in order to establish adequate assurance of future performance for assumption and/or assignment by debtors who are lessees of premises located in shopping centers. 11 U.S.C. § 365(b)(3)(A)-(D). Although the term "shopping center" is not defined in the Code, the term should be strictly construed. *See In re Joshua Slocum, Ltd.*, 99 B.R. 250, 256-57 (Bankr. E.D. Pa. 1989), *aff'd*, No. CIV.A. 89-4277, 1989 WL 428204 (E.D. Pa. 1989), *vacated*, 922 F.2d 1081 (3d Cir. 1990). The prebankruptcy contract should delineate, in significant detail, the scope and nature of the continuing obligations of the parties over the life of the contract. Further, the parties should attempt to agree, in the event of bankruptcy and a proposed assignment, what, at a minimum, would be required to constitute adequate assurance of future performance. These requirements should be set forth in detail, and the parties may agree, again, in detail, on the adverse impact that would be suffered upon failure to perform any or all of the requirements (this should be set forth in detail to the extent feasible).

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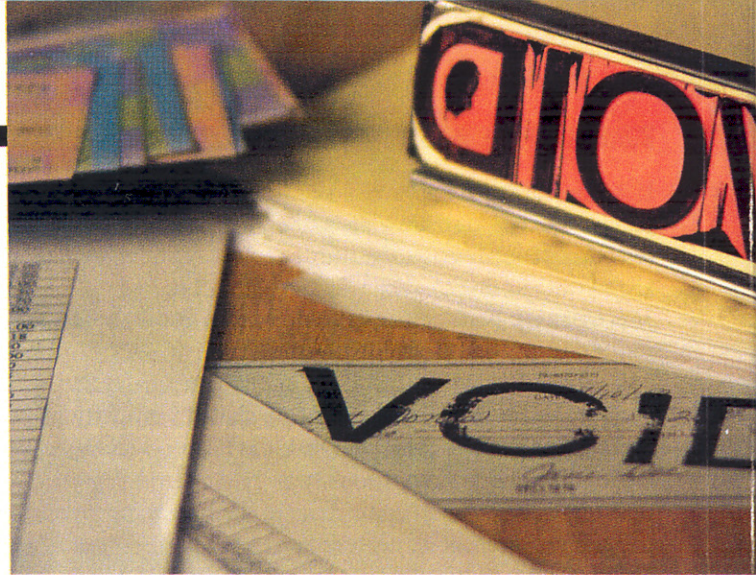
In preparing a license agreement, the licensee should attempt to define what constitutes adequate assurance of future performance if the license is ultimately assigned to a third party in a bankruptcy case. For example, it might explicitly state that an assignee must affirmatively assume all of the debtor/licensor's obligations under the agreement and/or that the assignee must meet certain net worth or capital requirements as well as any other identifiable guideposts pertinent to the license at issue, to ensure that service, maintenance, marketing, research and development and other obligations originally bargained for can be fulfilled. Although these kinds of provisions in prebankruptcy agreements may not be enforceable in the event of a future bankruptcy filing by the licensor, they may provide evidence of the intent of the parties and guide the bankruptcy court in addressing this issue if it ultimately arises.

### Nonassignable contracts

Contracts that may not be assigned under applicable nonbankruptcy law may not be assigned postbankruptcy by the debtor over the objection of the other party to the contract. 11 U.S.C. § 365(c)(1). This restriction applies whether or not the executory contract at issue contains such a prohibition. Nonetheless, when appropriate, contracts regarding personal services, unique relationships, or other situations that render them nonassignable pursuant to applicable nonbankruptcy law should contain the parties' agreement that the contract may not be assigned under applicable nonbankruptcy law and that section 365(c) applies to the contract and prohibits its assumption and assignment without the consent of the nondebtor party. The parties may agree that the contract was entered based upon the unique or personal, skill, expertise, experience, or other pertinent qualities and characteristics of the potential debtor. The importance of such qualities and characteristics to the fulfillment of the contract can be detailed. Personal services contracts are generally viewed as the most obvious example of contracts that are not assignable under section 365. Although the classic example of a contract under which performance is nondelegable is a personal service contract, the § 365(c) provision governing assumption and assignment of contracts is applicable to any contract subject to a legal prohibition against assignment. The test is whether under applicable nonbankruptcy law the other party to the contract has the right to refuse performance from an entity *other* than the debtor. See *City of Jamestown v. James Cable Partners, L.P.* (In re *James Cable Partners, L.P.*), 27 F.3d 534, 537-38 (11<sup>th</sup> Cir. 1994); *In re West Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988).

### Restrictive use provisions

General use restrictions in real estate leases are generally unenforceable post-bankruptcy. It has been held that "in order to enforce a restrictive clause, a nonshopping center lessee must establish that the clause is material and that it



or its other lessees will suffer substantial economic detriment as a result of the failure of the bankruptcy court to enforce the clause in issue." See *Joshua Slocum*, 99 B.R. at 260. Accordingly, in order for these provisions to be meaningful, the parties may agree with respect to each use restriction included in the contract that the restriction is significant and that failure to comply with the restriction would constitute a material breach of the contract resulting in substantial economic harm to the nondebtor party. The significance, materiality, and harm that would arise from failure to enforce these provisions should be agreed on and specifically set forth in detail.

### Anticipating avoidance actions

In structuring transactions involving the transfer of any value or property, attention should be given in advance to the potential ramifications of a subsequent bankruptcy filing by the transferor. In particular, the avoidance powers under the Code need to be considered. See 11 U.S.C. §§ 544, 545, 547, 548. In structuring such transactions, recitals supporting the reasonableness of the consideration exchanged can be included. Moreover, appraisals and other data supporting such recitals can be referenced.

Further, a provision may be included in a prebankruptcy contract designed for the event that a transfer made pursuant to the contract is subsequently found to be avoidable. For example, such a provision could be in a settlement agreement under which, among other things, claims between a franchisor and a franchisee are released (as well as the obligations of the franchisee's guarantor), payment is made by the franchisee to the franchisor, and assets are transferred by the franchisee to the franchisor. In such a situation, the franchisor should consider the potential impact of a subsequent bankruptcy commenced by or against the franchisee. The settlement agreement might include a clawback or revival provision under which the parties agree that the release provided by the franchisor to the franchisee and to guarantors of the franchisee is void and the liability of the franchisee and the

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guarantors of the franchisee reinstated in the event that any of the transfers under the settlement agreement are subsequently determined to be avoidable as fraudulent transfers, preferential transfers, or otherwise, in whole or in part, for any reason, under the Code or under any other nonbankruptcy law. The revival provision may also provide that any and all other rights, liens, and security interests will be automatically revived, reinstated, and restored in such amount(s) as is determined to have been an avoidable transfer (including all costs, expenses, and attorneys' fees of the franchisor) and shall exist as though no avoidable transfer had been made. Obviously, a statement should be included setting forth that this language does not constitute an admission that an avoidable transfer was or will be made. The enforceability of this type of provision is uncertain.

### **Exercising caution with regard to bankruptcy remote provisions**

In "securitization" transactions involving the packaging of commercial mortgage loans, credit ratings are frequently assigned to the securities by rating agencies. The rating agencies have apparently generally required that with respect to the mortgage loans included in the securitization each borrower be a "bankruptcy-remote" or "special-purpose" entity. One court, in *In re Kingston Square Assocs.*, 214 B.R. 713, 714 (Bankr. S.D.N.Y. 1997), described this phenomenon as follows:

Fashion has a role not only in the garment industry but in the legal one as well. One of the newest fashions in commercial real estate financing is so-called "mortgage-backed securitization" coupled with the presence of corporate governance provisions known as "bankruptcy-remote provisions" designed to make bankruptcy unavailable to a defaulting borrower without the affirmative consent of the mortgagee's designee on the borrower's board of directors.

The "bankruptcy-remote provisions" seem designed to circumvent the Code's prohibition of provisions barring an entity from commencing a bankruptcy reorganization case, by using corporate governance provisions to prevent the potential debtor from commencing a bankruptcy case. For example the debtor's corporate charter and bylaws might prevent the debtor from commencing a case under the Code without the unanimous consent of the board of directors, and the board might include a so-called "independent director" designated by the secured creditor. One bankruptcy court in *Kingston Square Assocs.*, 214 B.R. at 716 summarized such a provision as follows:

Integral to the...transactions was the inclusion in the charters of each corporate Debtor or the corporate general partner of each limited partnership Debtor of a bylaw, commonly referred to as a "bankruptcy remote" or "bankruptcy proof" provision to prevent

the Debtors from seeking voluntary bankruptcy protection without the unanimous consent of the board of directors of each Debtor or of its corporate general partner and the shareholders.

Parties involved in transactions including such provisions, however, should be cautioned.

In one case, a debtor unable to obtain its board's authorization to commence a voluntary Chapter 11 case, despite impending foreclosure of its assets, orchestrated the filing of an involuntary petition against the debtor by certain of its unsecured creditors. *See id.* at 714-15. Finding the debtor had reason to believe that reorganization was possible, the court declined to grant the secured creditor's motion to dismiss the case and appointed a Chapter 11 trustee in light of what the court found to be the debtor's board of directors' breach of its fiduciary responsibilities owing to its unsecured creditors and interest holders. In *Kingston Square*, the court stated that "it is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors." *Id.* at 735. Both the "independent director" and others sitting on boards of "bankruptcy-remote" entities should consider their fiduciary obligations and how they might be circumscribed by the bankruptcy-remote provisions. The *Kingston Square* court stated:

Because I have not found that the Debtors and the Petitioning Creditors acted collusively in filing these cases, I need not reach the merits of the Respondents' position request[ing] that I nullify the bylaw provision containing the bankruptcy proof provision as void against public policy. In any event, given that none of the Debtors observed corporate formalities and did not prior to the involuntary filings test the directors' mettle by calling a board of directors' meeting to ascertain whether bankruptcy would be authorized, I do not believe that the issue of validity of the bankruptcy proof provision is properly before me. *Id.* at 737.

### **Lessor's damage claim**

Section 502(b)(6) of the Code limits the claim of the lessor for damages resulting from the termination of a lease of real property. Parties to leases, however, generally do not draft them with an eye toward section 502(b)(6). That section sets a cap on "rent reserved by such lease, without acceleration...." 11 U.S.C. § 502(b)(6)(A). The question is whether a tenant's obligations to pay insurance, taxes, utilities, waste disposal charges, fixed annual capital improvement fees, and other obligations not expressly labeled as "rent," come within the definition of "rent reserved" under section 502(b)(6). *See In re Rose's Stores, Inc.*, 179 B.R. 789, 790-

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91 (Bankr. E.D.N.C. 1995); *In re Farley, Inc.*, 146 B.R. 739, 746 (Bankr. n.D. Ill. 1992). Although some courts have held that the obligation need not be denominated as rent in order to come within the "rent reserved" provision, it clearly must be provided for in the lease as the tenant's obligation. See *Rose's Stores*, 179 B.R. at 791. Furthermore, the charge must be related to the value of the property and the value of the lease on the property. See *id.* (citing *Heck's, Inc. v. Cowron & Co. (In re Heck's, Inc.)*, 123 B.R. 544, 546 (Bankr. S.D.W. Va. 1991)).

In any event, it is advisable from the lessor's perspective that the lease provide that in the event of a bankruptcy filing by the lessee, the payment obligations under the lease would constitute "rent reserved" under section 502(b)(6). Specific factual recitals supporting this conclusion should be set forth. One court stated, a "mandatory minimum charge required to preserve the value of the property, if properly documented [in the prepetition lease], would be includable in the rent reserved. The tenants' general maintenance responsibility should not be included in the cap calculation." *Id.* Additionally, in light of the "without acceleration" language included in the section 502(b)(6) cap, lessors may consider including a provision in the lease "to require proration or actual accrual of rent for days of occupancy, or making rent due on one date and payable on a different date...." *Vause v. Capital Poly Bag, Inc. (In re Vause)*, 886 F.2d 794, 803 (6<sup>th</sup> Cir. 1989) (noting that "a less accommodating lessor who had drafted its lease to require up-front payments would receive its full past damages [under the § 502(b)(6) cap].").

### **Conclusion**

The Code is part of every contract. Accordingly, contracts should reflect that the parties have considered the potential impact of the Code on their relationship. If the parties are willing, prebankruptcy agreements designed to minimize the impact of bankruptcy on the nondebtor party to the contract can specifically include stipulated facts that would support the granting of relief likely to be sought by the nondebtor postbankruptcy. Although some courts may find certain prebankruptcy waivers binding, the enforceability of such waivers is questionable.

Moreover, the inclusion of forfeiture provisions without additional stipulated facts supporting anticipated bankruptcy relief may lead to unnecessary or unproductive litigation in the bankruptcy court regarding the effectiveness of the forfeiture provisions. Whether or not a prebankruptcy contract includes specific waivers of bankruptcy rights or powers, an agreement carefully considered and drafted in light of the potential impact of a future bankruptcy case may allow the nondebtor party to the contract to minimize the impact of bankruptcy on its rights and avoid expense, delay and frustration that it might otherwise suffer. ▲