

Beware the Executory Contract Bait and Switch

Contributing Editor:

Lisa S. Gretchko
Howard & Howard Attorneys PLLC
Royal Oak, Mich.
lgretchko@howardandhoward.com

The non-debtor party to an executory contract or unexpired lease (the “contract counterparty”) has always been in a delicate position. The typical contract counterparty wants all of its rights protected and enforced when the other party to the contract files for bankruptcy. At the same time, however, most contract counterparties understand that a debtor’s bankruptcy is a sort of “beauty contest” in which the debtor’s assumption of the executory contract represents the ultimate prize. In the current economic climate, contract counterparties are more anxious for assumption than ever before. If a debtor rejects the executory contract or unexpired lease, the contract counterparty might not have an easy time finding a new customer or lessee.



Lisa S. Gretchko

A “bait and switch” scheme preying upon this desire has become increasingly commonplace. The bait and switch scheme goes something like this: Shortly after the debtor files for chapter 11, it files a motion to sell substantially all of the assets as a going-concern. Concurrently, the debtor files a motion to assume executory contracts and unexpired leases (an “assumption motion”), which includes a list of executory contracts and unexpired leases to be assumed (the “assumed contract list”) or provides that such a list will be filed separately at a later date. When the assumed contract list is eventually filed, it contains a cure amount for each contract and lease to be assumed. Contract counterparties are given notice that their contracts or leases are going to be assumed, along with a deadline for objections to either the assumption itself, or to the cure amount. Most contract counterparties are delighted that they are on the assumed contract list, so they certainly will not object to the contract assumption itself. If the cure amount is sufficiently understated, the contract counterparty files an objection and either resolves or litigates the cure amount.

About the Author

Lisa Gretchko is an attorney with Howard & Howard Attorneys PLLC in Royal Oak, Mich. Her practice includes creditors’ rights and commercial litigation, and she has experience in real estate litigation.

For some contract counterparties, having a coveted place on the assumed contract list lures the contract counterparty into complacency. They do not pursue post-petition pre-assumption payments, but instead sit back and wait to receive the cure amount when the sale transaction closes. Other contract counterparties have the opposite reaction: They become anxious about getting tossed off the assumed contract list, so, in order to stay in the debtor’s good graces, these nervous contract counterparties either decline to pursue post-petition pre-assumption payments to which they are entitled, or they acquiesce to requests from the debtor

there is already a court order that requires that the contract be assumed, debtor’s counsel responds that the order approving the sale gives the debtor “wiggle room” to adjust the assumed contract list, and in granting the assumption motion, the bankruptcy court merely authorized the debtor to assume the executory contracts on the assumed contract list that the purchaser wants assumed, and the purchaser no longer wants this contract (or, perhaps only wants to assume the contract if the cure amount is significantly reduced).

What can a contract counterparty do to avoid falling victim to this bait and switch? First, the contract counterparty needs to recognize that its placement on the list of assumed contracts is *not* a prize in and of itself. The contract assumption is not complete until after the cure amount is paid. Until then, the contract counterparty needs to be more circumspect and less complacent. As soon as the debtor files the sale motion and the schedule of leases and con-

Last in Line

to reduce or defer the post-petition pre-assumption payments, even if the closing on the sale is delayed.

Then comes the switch. Shortly before the closing occurs on the sale of the debtor’s business, the debtor files a motion to *amend* the assumed contract list to remove the contract counterparty’s contract from the assumed contract list and add it to the list of rejected contracts. Often, that motion will seek to suddenly reject many of the executory contracts that were originally on the assumed contract list, and recites that the purchaser has “changed its mind” and no longer needs the debtor to assume and assign all of the contracts that originally were on the assumed contract list. Sometimes, this eleventh-hour motion actually recites that the debtor might be willing to *reconsider* and allow the contract to remain on the assumed contract list if the contract counterparty agrees to a significant reduction of the cure amount.

When the contract counterparty protests that this is a “shakedown” and that

tracts to be assumed, the contract counterparty should review those pleadings to get a clear understanding of the conditions to and timing of closing. Generally, the longer the time between the sale motion and closing, the more circumspect the contract counterparty should be: That longer time to closing creates more opportunity for the purchaser to “change its mind” about which executory contracts are valuable to the purchaser. For a contract counterparty who is named on the list of assumed contracts, a quick closing is a much better sign.

Second, the contract counterparty should consider being proactive, rather than reactive. Even if the assumption motion recites the correct cure amount, the contract counterparty should consider filing a response that reminds the debtor of its obligation to pay post-petition, pre-assumption payments. The law is clear that if the debtor elects to continue to receive post-petition benefits from the contract counterparty pending a decision to reject or assume the contract, the debtor must pay for those benefits.¹

It makes sense for the contract counterparty to raise its entitlement to post-petition pre-assumption payment when responding to the cure amount notice. At that point in the sale process, the debtor and purchaser tend to be focused on obtaining bankruptcy court approval for the sale and, consequently, are more likely to view a contract counterparty's request for post-petition payment as a preservation of rights—rather than an “act of aggression.” Also, the debtor will likely try to resolve all objections to the cure amount notice prior to the hearing on the sale motion. Consequently, if the contract counterparty's objection to the cure amount contains a request for post-petition pre-assumption payment upon entry of an order approving the sale, then the contract counterparty will likely have both opportunity and leverage to negotiate with the debtor.

Some contract counterparties on the assumed contract list still prefer to “lie low” and *not* demand any post-petition pre-assumption payments to which they are entitled. These contract counterparties are sometimes motivated by a desire to appear “easy to work with” so that the debtor and the purchaser will be incentivized to keep their contract *on* the assumed contract list; or, perhaps the debtor has asked these contract counterparties to defer or reduce the post-petition pre-assumption payments. No matter what the motivation, contract counterparties who defer or reduce post-petition pre-assumption payment should memorialize this agreement in a stipulation that is filed with the bankruptcy court and confirms that the contract counterparty is giving that deferral or reduction in express reliance upon the assumption motion and assumed contract list, and as an accommodation to the debtor based on the debtor's representations—implicit if not explicit—that there will be sufficient

funds at closing to pay the scheduled cure amount.

If a contract counterparty has agreed to reduce or defer any post-petition pre-assumption payment, that contract counterparty should vigorously object to any motion seeking to remove its executory contract or unexpired lease from the assumed contract list. If there is a filed stipulation regarding those reductions or deferrals, then the record will demonstrate the contract counterparty's detrimental reliance so that the debtor should be estopped from removing the contract from the assumed contract list. In the absence of a filed stipulation, the contract counterparty should provide evidence of its detrimental reliance and make the same estoppel argument.

If the estoppel argument fails, a contract counterparty who has given post-petition concessions should ask a bankruptcy court to order that the debtor immediately pay, as an administrative claim, the amount of any concession or deferral in post-petition pre-rejection amounts owing. Debtor's counsel sometimes responds that the sale proceeds are “so skinny” that there is no money to pay such an administrative claim, and in this situation, the contract counterparty usually regrets having given the concessions. This situation can be especially difficult and painful.

In responding to these issues, bankruptcy courts will be influenced by current economic climate. Bankruptcy judges are painfully aware that if the purchaser at hand declines to consummate the deal because the assumed contract list is too burdensome, then another purchaser might not come along in time for the debtor to be sold as a going-concern. The result could be liquidation, loss of jobs or a taxpaying entity and other concerns extending beyond those of the complaining contract counterparty. From the court's perspective, eleventh-hour revisions to the assumed contract list may be begrudgingly tolerated when weighed against the alternative—even if

they leave behind disappointed contract counterparties who are suddenly tossed off the assumed contract list.

Bankruptcy courts should protect the contract counterparty that has given the debtor post-petition concessions either in reliance on—or in order to keep—a place on the assumed contract list. As a precondition to granting the debtor's request to modify the assumed contract list, the debtor should be ordered to immediately pay the contract counterparty an administrative claim in the amount of all of the post-petition concessions received from the contract counterparty. If the debtor claims to lack money with which to pay those administrative claims, then perhaps the bankruptcy court should require the purchaser to pay the amount of the contract counterparty's concessions as a condition to relieving the purchaser from having to “take” an executory contract or unexpired lease that it no longer wants, because after all, the purchaser also benefits from the eleventh-hour modification of the assumed contract list. In any event, debtors should be required to prove up the *bona fides* of any motion to modify the assumed contract list, which recites a change in circumstances from the filing of the initial list.

Much has been written about the fact that § 363 sales are becoming virtually *de rigeur* in the context of business chapter 11 cases in this troubled economic climate. Debtors are often cash-strapped during the post-petition pre-sale timeframe, and anxious to get whatever concessions they can from contract counterparties. All too often, contract counterparties are lured into giving concessions out of the mistaken belief that those concessions ensure a coveted place on the assumed contract list. When the debtor is selling the business as a going-concern, it is the purchaser—not the debtor—who decides which contracts will be assumed and which will be rejected. Contract counterparties need to understand this dynamic and govern themselves accordingly in order to avoid winding up “last in line.” ■

¹ See 11 U.S.C. § 365(d)(3) and (5). See also *N.L.R.B. v. Bildisco*, 465 U.S. 513, 531, 104 S.Ct. 1188, 79 L.Ed. 2d 482 (1984); *In re Enron Corp.*, 279 B.R. 79, 86 (Bankr. S.D.N.Y. 2002); *In re Cont'l Airlines Inc.*, 146 B.R. 520, 526 (Bankr. D. Del. 1992).

Copyright 2010
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.