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To Assume or Reject: Unexpired Real Property Leases in Bankruptcy

BB&K Attorney Cathy Ta Discusses Executory Contracts in *Riverside Lawyer Magazine*

By Cathy Ta

When a debtor files for bankruptcy, certain contracts that are executory such as unexpired real property leases may be assumed or rejected as part of the bankruptcy process. This ability to assume or reject has significant implications in the context of a debtor who is a lessor or a lessee – from offering a debtor-lessor or lessee a way to continue business operations wherein the lease is an essential component to its operations to relieving a debtor-lessee from future performance obligations that have become too burdensome.

What is an Executory Contract?

The Bankruptcy Code provides that a contract may be assumed or rejected *only if* it is an executory contract or an unexpired lease, subject to bankruptcy court approval and certain limitations.¹ If a contract or lease has terminated prior to the bankruptcy filing date, otherwise known as the Petition Date, it would be non-executory and incapable of assumption or rejection.

While the Bankruptcy Code does not define what is an executory contract, the Ninth Circuit has adopted Countryman's² definition, which is a "contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."³ This means that if one party has substantially performed its side of the bargain, such that that party's failure to perform further would not constitute a material breach excusing performance by the other party, the contract is *not executory* and cannot be assumed or rejected. Whether a lease is unexpired and otherwise executory would be determined by this definition.

Significance of Assumption or Rejection

If a real property lease is unexpired and otherwise executory, a debtor in possession or a trustee charged with administering the bankruptcy estate could assume or reject it.

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If assumed, the lease would resume in full force and effect, despite the bankruptcy filing and even when the debtor has defaulted under the lease as long as the default is cured or adequate assurance of future cure is provided. Further, if assumed, the lease may be sold and assigned for value, too. Typically, the rights of the non-debtor party to the lease are limited to challenging whether or not the assignee of the lease can provide adequate assurance of future performance or the adequacy of any cure. Thus, the power to assume and assign an unexpired lease allows a debtor in possession or trustee to maintain and maximize whatever value there may be left of the bargain under the lease.

Conversely, if the lease is rejected, the debtor in possession or trustee would be able to walk away and otherwise be relieved from future performance obligations under the lease. This includes having to surrender the real property almost immediately. Under the Bankruptcy Code, the rejection would be treated as if a breach of the lease had occurred immediately before the Petition Date, regardless of when the actual rejection is made. The non-debtor party would have a claim for damages which would be administered as part of the bankruptcy process, including being subject to payment of pennies on the dollar and to the debtor's discharge should there be one.

Limits on the Decision to Reject or Assume

While a debtor in possession or trustee exercises the decision to assume or reject an unexpired lease, there are certain time limits after which automatic rejection occurs. Generally, in a chapter 7 case and with respect to a residential lease, a debtor or trustee has 60 days after the Petition Date to assume or reject it, after which, the lease is deemed rejected. In all other cases, the general time limit to assume or reject before automatic rejection occurs is at any time prior to confirmation of a plan of reorganization. Similarly, as a lessee under a nonresidential lease, a debtor in possession or trustee has until the earlier of 120 days after the Petition Date or the entry of an order confirming a plan to assume or reject the lease before it is deemed rejected.

Further, while a debtor in possession or trustee, as the lessor may reject an unexpired lease and walk away from the lease, that decision would not extinguish all the rights a lessee may have under the lease. That is because under the Bankruptcy Code, the lessee will have a *choice* between treating the lease as terminated as a result of the rejection, or if the term of the lease has commenced, retaining their rights under the lease, such as the rights of possession and quiet possession, until the end of the term, including any rights of renewal or extension.

Bankruptcy Goals

While the bankruptcy power to assume or reject unexpired real property leases is not unfettered, the power does serve the central goals of bankruptcy law,

which is to provide a debtor a financial fresh start and to maximize the value of a bankruptcy estate for the benefit of creditors. Should that include continuing with an unexpired real property lease through assumption or disposing of the lease through rejection would be up to the debtor in possession or trustee.

¹ 11 U.S.C. § 365(a).

² Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

³ *Pac. Express, Inc. v. Teknekron Infoswitch Corp. (In re Pac. Express, Inc.)*, 780 F.2d 1482, 1488-89 (9th Cir. 1986).

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