

# What Is Contract Rejection, When Does It Happen, and What are the Consequences?

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In every bankruptcy case, a bankrupt debtor (or trustee in certain cases) must address its existing executory contracts and unexpired leases. An executory contract is a contract under which both sides have material ongoing obligations. Put another way, an executory contract is a contract where if either side stopped performing, it would be a breach of the contract. If a debtor no longer wishes to receive the benefits of or the burdens associated with an executory contract or unexpired lease, Section 365 of the Bankruptcy Code permits the debtor to reject such agreement.

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## Key Issues

- **Consequence of Rejection.** Rejection of an agreement under the Bankruptcy Code does not terminate the agreement. Rather, rejection is treated as a breach of the contract, and any damage claim arising from that breach is treated as if it arose immediately before the bankruptcy was filed.
- **Procedure.** A debtor may reject an executory contract or unexpired lease by motion or operation of a chapter 11 plan. In larger bankruptcy cases, rejection notices often contain schedules listing numerous contracts to be rejected in a single pleading.
- **Performance.** A contract counterparty must continue to perform its obligations under an executory contract or unexpired lease while the debtor determines whether to assume or reject the agreement. Where continued performance would result in material inequity or harm to the non-debtor party (for example, where the party will have to incur substantial costs to perform, without knowing whether the debtor ultimately will reject the contract), parties may file a motion asking the Bankruptcy Court to compel the debtor to make an early decision on assumption or rejection. The court has considerable discretion on such a motion, but will not grant such relief if the harm to the debtor would outweigh the harm to the other party.
- **Partial Rejection.** A debtor cannot cherry-pick which portions of an agreement it wishes to reject. The debtor must assume or reject the agreement in its entirety. Nuanced exceptions to this general rule may apply to certain kinds of contracts, such as master leases to which schedules are added from time to time.

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- **Automatic Rejection.** The Bankruptcy Code dictates when certain contracts will be rejected if none are earlier assumed:
    - *Unexpired Leases of Non-residential Property.* In all bankruptcy cases, these agreements will be deemed rejected if they are not assumed or rejected by the earlier of: (i) 120 days after the order for relief; or (ii) the date of entry of an order confirming a plan. That 120-day deadline may be extended by the bankruptcy court for up to 90 days.
    - *Executory Contracts and Unexpired Leases of Residential Real and Personal Property.* In a chapter 7 bankruptcy case, these agreements will be deemed rejected if they are not assumed within 60 days after the order for relief. In chapter 11 and 13 bankruptcies, the debtor is provided with more leeway, and may reject these agreements at any time before the confirmation of a plan. A debtor or trustee may move to extend this deadline.
  - **Special Rights Upon Rejection of Certain Contracts.** Counterparties to certain kinds of contracts, such as leases under which the debtor is a landlord and license agreements under which the debtor is a licensor of intellectual property, enjoy special rights upon rejection. Subject to certain limitations, a tenant whose lease is rejected by a debtor may retain certain rights that do not require action by the debtor, including the right to remain in possession, and the licensee under a rejected IP license agreement may retain certain IP rights. As with most issues involving the bankruptcy code, the availability of those special rights, and the desirability of exercising them given the associated limitations, will depend on the facts and circumstances of each case.
  - **Filing a Claim.** Upon rejection of its agreement, a contract counterparty should file a claim in the bankruptcy case asserting damages arising from the debtor's breach of the contract. There will often be a fairly short deadline to file that claim. Unless the contracting party holds a perfected lien on collateral to secure any damage claim, a claim on account of a rejected agreement is treated as a general unsecured claim. Counterparties who lease real property to the debtor may also assert lease rejection damages, the value for which is determined and capped by a specific formula outlined in the Bankruptcy Code. Amounts due and owing under the contract between the date when the bankruptcy was filed, and the rejection date may qualify as an administrative expense claim.

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## Takeaway

Contract counterparties must act quickly to discern and preserve their rights in bankruptcy.

Competent counsel should be retained to ensure the contract counterparty places itself in the best position for optimal recovery.

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