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Courts' Treatment of Executory Contracts When Both Parties Are Debtors

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The Bankruptcy Code generally grants a debtor authority to assume or reject an executory contract, subject to the court's approval.[1] Once termed a "bramble-filled thicket,"[2] the proper treatment of executory contracts becomes especially thorny when both parties to the contract are debtors. This article examines the handful of cases analyzing executory contracts in this "dual debtor" situation.

General Rules Breakdown in the Dual-Debtor Situation

Daniel W. Linna Jr.

During the "limbo period" before an executory contract is assumed or rejected, the general rule is that the debtor may enforce the contract against the nondebtor, but the nondebtor may not enforce the contract against the debtor.[3] This reflects "the Code's overall effort to give a debtor-in-possession some flexibility and breathing space" to reorganize successfully.[4] If the debtor decides to reject the contract, the court will typically defer to the debtor's business judgment,[5] authorizing rejection upon a showing that the rejection will benefit the debtor's estate.[6] The court will generally uphold the debtor's decision unless it is "so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice."[7]

Suppose Debtor A and Debtor B are parties to an executory contract. What if, during the limbo period, Debtor A wishes to stop performing—as it ordinarily could do under the general rules? Can Debtor B compel Debtor A to perform—as it too ordinarily could do under the general rules? Further, if Debtor A takes the position that it may stop performing, can it simply refuse to perform? Or, given that its actions affect another debtor, must Debtor A obtain court approval first? What if Debtor B objects to Debtor A's rejection? Is Debtor A's decision subject only to the scrutiny afforded under the business-judgment test? What if Debtor B's successful reorganization depends on Debtor A's continued performance, even if for only a short time? The Code provides no clear answers to these questions, so we turn to the few cases involving dual-debtor situations.

Does One Debtor's Action Regarding An Executory Contract Violate the Other Debtor's Automatic Stay?

Melanie A. Van Antwerp

There are three decisions addressing this issue. In *In re Old Carco LLC*,[8] the U.S. Bankruptcy Court for the Southern District of New York adopted the holding of the U.S. Bankruptcy Court for the Middle District of Florida in *In re Sun City Inv. Inc.*[9] In *Old Carco*, the court held that one debtor's rejection of an executory contract did not violate the other debtor's automatic stay.[10] There, certain Chrysler dealers that were also in bankruptcy objected to Chrysler's rejection of their dealership contracts on the grounds that the rejection violated the automatic stay in their bankruptcy cases.[11] The court noted that when both parties to an executory contract are debtors in separate bankruptcy proceedings, neither needs relief from the other's automatic stay to reject the contract.[12] On the other hand, the court observed that "unilateral termination by one debtor of a contract with another debtor violates the automatic stay of the second debtor."[13]

This latter observation seems inconsistent with the holding in *In re National Steel Corp.*[14] There, the U.S. Bankruptcy Court for the Northern

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1 11 U.S.C. §365(a); 11 U.S.C. §1107(a).
2 *Cohen v. Drexel Burnham Lambert Group Inc. (In re Drexel Burnham Lambert Group Inc.)*, 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992).
3 *See NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984).
4 *Id.* at 531-32.
5 *Id.* at 523.
6 *See, e.g., In re Chi-Feng Huang*, 23 B.R. 798, 801 (9th Cir. 1982) ("The primary issue [under the business-judgment test] is whether rejection would benefit the general unsecured creditors.").
7 *Lubrizol Enter. Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985), overruled on other grounds by 11 U.S.C. §365(n) (1988).
8 406 B.R. 180 (Bankr. S.D.N.Y. June 19, 2009).
9 89 B.R. 245 (Bankr. M.D. Fla. 1988).
10 2009 Bankr. LEXIS 1382 at *81.
11 406 B.R. at 211-12.
12 *Id.* at *81 (citing *Sun City*, 89 B.R. at 249).

District of Illinois held that one debtor did not violate the other debtor's automatic stay when it unilaterally imposed a price increase during the limbo period, to which the second debtor acquiesced.[15] *National Steel* involved a contract for the supply of steel used to make wheels.[16] Both the supplier and the manufacturer filed chapter 11 petitions,[17] but the supplier did not move to assume or reject the contract; rather it increased its prices after notifying the manufacturer that the price increase was necessary to enable it to continue shipping steel.[18] The manufacturer contended that the price increase was not appropriate, but nevertheless paid the higher price until the contract expired.[19] The manufacturer later filed a motion seeking allowance of an administrative expense[20] and alleging, among other things, that the supplier's unilateral price increase violated the manufacturer's automatic stay.[21]

At the outset, the court remarked that the contract was the property of both the supplier's and the manufacturer's bankruptcy estates.[22] The court reasoned, however, that "the [c]ontract was not enforceable against [the supplier] because it had not been assumed. Hence, the submission of the [price increase] to the [manufacturer] did not constitute an act to obtain possession of property of the [manufacturer's] bankruptcy estate or to exercise control over property of its estate in violation of §362(a)(3)."[23] Therefore, the court held that the supplier had not violated the manufacturer's automatic stay.[24]

At first, *Old Carco* and *National Steel* appear inconsistent. The *National Steel* court held that one debtor's unilateral price increase did not violate the second debtor's automatic stay.[25] The *Old Carco* court stated that one debtor's unilateral termination would violate the second debtor's automatic stay.[26] These cases appear to disagree as to whether one debtor's unilateral action respecting an executory contract may violate the other debtor's automatic stay. Further analysis of the court's reasoning in *National Steel* reveals more common ground than is first apparent.

The *National Steel* court reasoned that because the manufacturer could not enforce the contract against the supplier, the contract was not the property of the manufacturer's bankruptcy estate. This determination appears inconsistent with the court's earlier statement that the contract was property of both estates. While the court alluded to the general rule that, during the limbo period, an executory contract is enforceable by the debtor but not against the debtor, the court did not acknowledge that the manufacturer was also a debtor. As a debtor, the manufacturer ordinarily could enforce the contract against the supplier.

The court did observe that the manufacturer had "several avenues it could have timely pursued," but failed to seek redress in either bankruptcy case.[27] The court specifically noted that the manufacturer could have filed a motion in (1) the supplier's bankruptcy case to compel the supplier to assume or reject the contract, (2) its bankruptcy case to assume the contract or (3) its bankruptcy case to seek damages for the supplier's alleged willful violation of the automatic stay.[28] This indicates that perhaps the driving force behind the court's decision was not its determination that the contract was not enforceable against the supplier, but the fact that the manufacturer had failed to take timely action and only later complained about the price increase.

National Steel arguably leaves open the possibility that, in the dual-debtor situation, one debtor's unilateral price increase may violate the other debtor's automatic stay. Read this way, *Old Carco* and *National Steel* seem reconcilable: Whether one debtor's action regarding an executory contract violates the other debtor's automatic stay depends on whether the first debtor follows proper procedures or acts unilaterally without court approval.

Does the Business-Judgment Test Apply to Contract Rejection in This Situation?

When both parties to an executory contract are debtors, should the court consider the impact of one debtor's rejection on the other debtor's reorganization? There are two reported cases addressing this issue, each applying a different test.

In *In re Midwest Polychem Ltd.*,[29] the U.S. Bankruptcy Court for the Northern District of Illinois implied that a "balancing-of-equities" test[30] applies in this situation.[31] In this case, a manufacturer-debtor moved to reject its supply agreement with a supplier that was also in bankruptcy.[32] In determining the standard applicable to the rejection motion, the court stated that the "balancing of the equities is especially necessary where, in a case like the instant one, one Chapter 11 debtor formally requests rejection of an executory contract and another Chapter 11 debtor effectively seeks assumption."[33] Nevertheless, the court claimed not to embrace any particular test.[34] In denying the manufacturer's motion, the court observed that "the proposed expansion of [the manufacturer's] services could very well *mortally wound* [the supplier] with speculative benefit to [the manufacturer]."[35] By considering the harm to the supplier, it appears that the court did not simply apply the deferential business-judgment standard, but also balanced the equities.[36]

On the other hand, the *Sun City* court suggested that the business-judgment test applies.[37] In that case, a seller-debtor moved to reject its asset purchase agreement with a buyer that was also in bankruptcy. The court recited the business-judgment test and said it would not consider the impact rejection that would have on the purchaser's business. That said, the court still refused to approve rejection because it found that rejection would result in a damage claim so large that it would exceed any potential benefit to the seller's estate.[38] Although the court denied the debtor's motion, it appears that the court adhered to the traditional business-judgment test,

13 *Id.* (citing *In re Computer Commc'ns Inc.*, 824 F.2d 725, 728 (9th Cir. 1987)). *Computer Commc'ns,* however, did not involve two debtors. A nondebtor unilaterally terminated its contract with a debtor, after the debtor filed for bankruptcy, under a contractual provision that allowed termination upon "the filing by either party of any voluntary petition in bankruptcy." *Computer Commc'ns,* 824 F.2d at 725-26. The court held that "even if §365(e)(2) allowed [the nondebtor] to terminate the contract, §362 automatically stayed termination." *Id.* at 730.

14 316 B.R. 287 (Bankr. N.D. Ill. 2004).

15 *Id.* at 311-12.

16 *Id.* at 294.

17 *Id.* at 295-96.

18 *Id.* at 296.

19 *Id.* at 297-99.

20 *Id.* at 292.

21 *Id.* at 310-11. The manufacturer also claimed economic duress in response to the supplier's allegation that the manufacturer "was precluded from seeking an administrative expense claim because it voluntarily paid the higher price." *Id.* at 308. The court rejected both the administrative expense and economic duress claims. *Id.* at 307, 310.

22 *Id.* at 311.

23 *Id.*

24 *Id.*

25 *Id.* at 311-12.

26 2009 Bankr. LEXIS 1382 at *81.

27 406 B.R. at 212.

28 *Id.*

29 61 B.R. 559 (Bankr. N.D. Ill. 1986).

30 Under the balancing-of-equities test, courts approve rejection of an executory contract only if the debtor can show that (1) the contract burdens its estate; (2) considering the effect of rejection on both parties to the contract, the equities favor rejection; and (3) rejection would further the chapter 11 goal of facilitating the successful reorganization of debtors. *See Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.),* 378 F.3d 511, 525 (5th Cir. 2004) (citing *Bildisco,* 465 U.S. at 526-27).

31 61 B.R. at 562.

32 *Id.* at 561.

33 *Id.* at 562.

34 *Id.*

35 *Id.* at 562-63 (emphasis added).

36 The U.S. Bankruptcy Court for the Eastern District of Arkansas cited *Midwest Polychem* for the proposition that, when a debtor seeks to reject an executory contract with another chapter 11 debtor, "[t]he court ha[s] to balance the effect of rejection upon both debtors." *In re Jr. Food Mart of Ark. Inc.,* 131 B.R. 116, 120 (Bankr. E.D. Ark. 1991).

37 89 B.R. at 249.

38 *Id.*

since it only considered the impact of rejection on the other debtor to the extent that its damages claim would affect the resulting benefit to the rejecting debtor's estate. Since *Midwest Polychem* and *Sun City* seem to disagree about the applicable standard, we looked beyond the dual-debtor cases for guidance.

Are Bildisco *and* Mirant *Applicable in Dual-Debtor Situation?*

Bildisco and *Mirant* establish that in certain situations courts should balance the equities. In *Bildisco,* the Supreme Court held that a balancing-of-equities test applies to the rejection of certain collective-bargaining contracts.[39] The Court explained that "because of the special nature of a collective-bargaining contract, and the consequent 'law of the shop' which it creates, a somewhat stricter standard [than the business-judgment standard] should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement."[40] Similarly, in *Mirant,* the Fifth Circuit suggested that the balancing-of-equities standard could apply to rejection of a contract for the purchase of electricity.[41] The court reasoned that "[u]se of the business judgment standard would be inappropriate...because it would not account for the public interest inherent in the transmission and sale of electricity."[42]

In *Old Carco,* the court explained how to identify situations when the equities should be balanced: "[B]oth the *Bildisco* and *Mirant* courts found that a heightened standard for contract rejection was warranted because the authority to reject under §365(a) conflicted with the policies designed to protect the national public interest underlying other federal regulatory schemes." In *Bildisco,* the "national labor policies of avoiding labor strife and encouraging collective bargaining"[43] are explained under the National Labor Relations Act (NLRA). In *Mirant,* the national "public...interest in the transmission and sale of electricity"[44] is outlined under the Federal Power Act (FPA).[45]

The *Old Carco* court applied this interpretation of *Bildisco* and *Mirant* to the dealers' arguments that Chrysler's rejection of their contracts should be subject to the balancing-of-equities test.[46] The dealers asserted that the existence of "state statutes designed to protect automobile dealers and franchisees" (dealer statutes) warranted heightened scrutiny.[47] The court disagreed[48] and distinguished the dealer statutes from the NLRA and FPA: "[W]hile policies designed to protect the public interest may, in part, underlie the Dealer Statutes, those statutes have been enacted by *state legislatures, not Congress,* and by their very terms protect the public interest of their respective states rather than the national public interest."[49] In other words, since the public interest at stake was not national, the court declined to apply the balancing-of-equities test.

The dealers also asserted that the Automobile Dealers Day in Court Act (ADDCA)[50] evidenced "a [c]ongressional intent to protect the national public interest by allowing dealers to bring a federal cause of action for monetary damages against manufacturers who fail to act in good faith."[51] The court rejected this argument because it found that the protections under the ADDCA did not conflict with, but were "at most coextensive" with, the rejection power under §365.[52] *Old Carco* did not address whether a different standard should apply to executory contracts between Chrysler and its dealers that were also in bankruptcy.

When both parties to an executory contract are debtors, the right of one debtor to reject an executory contract under §365 may interfere with chapter 11's principal goal to "prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."[53] Recognizing a national public interest in the "successful rehabilitation of debtors,"[54] Congress granted both debtors certain protections and rights under §365, but if one debtor finds it in its interest to reject the contract and the other debtor finds it in its interest to assume the contract, the first debtor's authority to reject conflicts with the second debtor's authority to assume that very same contract. In light of this tension, *Bildisco* and *Mirant* may support application of the balancing-of-equities test in the dual-debtor situation.

Conclusion

We return to the hypothetical executory contract between Debtor A and Debtor B. What if Debtor A wishes to stop performing during the limbo period? *Old Carco* holds that rejection does not violate the other debtor's automatic stay, but observed that unilateral termination does. On the other hand, *National Steel* holds that one debtor's unilateral price increase does not violate the other debtor's automatic stay, which suggests that one debtor's refusal to perform also does not (but it is possible that the result in *National Steel* would have been different if the manufacturer had made a timely claim).

If Debtor A moves to reject the contract, *Midwest Polychem* provides some support for application of the balancing-of-equities test, while *Sun City* purports to adhere to the business-judgment test. Beyond those cases, *Bildisco* and *Mirant* lend support to an argument that the equities should be balanced, given that both debtors are seeking to reorganize under chapter 11. If Debtor B's successful reorganization depends on Debtor A's continued performance, and Debtor A's continued performance would not jeopardize its own reorganization, the balancing-of-equities test would permit the court to consider these factors and—where appropriate—foster an outcome that would provide Debtor B with the opportunity to successfully reorganize.

Finally, we note that the limbo-period rules in the dual-debtor situation should probably be consistent with the test applied to a debtor's rejection motion. If the balancing-of-equities test applies, a debtor should not be permitted to simply refuse to perform, but should be required to move to reject the contract. Otherwise, the court could be deprived of the opportunity to balance the equities. For now, we leave the "thicket" of executory contracts without all of the answers, but having shed some light on several issues that are sure to arise in the dual-debtor situation. ■

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39 465 U.S. at 525-26. *Bildisco's* rejection standard for collective-bargaining contracts was superseded by 11 U.S.C. §1113 (1984).
40 *Id.* at 524.
41 378 F.3d at 525. The court remanded the case and instructed the district court to consider application of this standard. *See* 318 B.R. 100, 107-8 (N.D. Tex. 2004).
42 *Id.*
43 465 U.S. at 526 (internal citation omitted).
44 378 F.3d at 525.
45 406 B.R. at 189.
46 *Id.* at 188.
47 *Id.* at 188.
48 *Id.* at 189.
49 *Id.*
50 15 U.S.C. §1222.
51 406 B.R. at 190.
52 *Id.*
53 *Bildisco,* 465 U.S. at 528 (internal citation omitted).
54 *Id.* at 527.