DIVISIBILITY OF EXECUTORY CONTRACTS AND LEASES

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PUBLICATIONS AND PRESENTATIONS

- *I Won't Back Down - Protecting the Artist in Record Company Bankruptcy Proceedings*, Texas State Bar Entertainment Law Seminar, October, 2009
- *Bankruptcy Law for the Non-Bankruptcy Lawyer*; Travis County Bench Bar Seminar, Panelist with Bankruptcy Judge Craig Gargotta, April, 2009
- *Bankruptcy and Financial Restructuring Law 2008, Top Lawyers on Trends and Key Strategies for the Upcoming Year;* Contributing author (2008, Aspatore Press)
- *What Every Collection Lawyer Should Know About Bankruptcy* Speaker and Author Texas State Bar Collections Seminar (2008)
- *Structuring and Negotiating Reorganization Plans, Leading Lawyers on Representing Debtors and Creditors in Bankruptcy and Financial Restructuring Situations;* Contributing author (2006, Aspatore Press)
- *Small Business Reorganizations Under the New Code*; Speaker and Author, Austin Bankruptcy Bar (2005)
- *Successfully Litigating the Dischargability Complaint*; Speaker, Austin Bankruptcy Bar (2004)
- *Discharge and Dischargability: Selected Issues*; Speaker and Author, 14th Annual Advanced Business Bankruptcy Seminar (1996)
- *Creditors' Rights in Bankruptcy*; Speaker and Author, Mortgage Foreclosure in Texas Seminar (1986)
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DIVISIBILITY OF EXECUTORY CONTRACTS AND LEASES

I. INTRODUCTION: AN OVERVIEW OF SECTION 365

In order to relieve the bankruptcy estate of burdensome agreements, Section 365(a) of the Bankruptcy Code ("Section 365") allows a debtor to assume or reject executory contracts and unexpired leases .[1] The debtor's ability to assume a contract or lease is conditioned by Section 365(b), which requires the debtor to (1) cure any defaults in the contract or provide adequate assurance that the default will be cured promptly, (2) compensate or provide adequate assurance that the trustee will compensate for any pecuniary loss resulting from defaults, and (3) provide adequate assurance of future performance under the contract or lease. Thus, in order to assume a contract or lease, a debtor must first cure all material defaults.

Often, debtors choose to assume contracts and leases that they do not intend to perform when they can assign these agreements to a third party for value. Section 365(f) provides that a bankruptcy trustee may assign a contract or lease if it (1) assumes the contract or lease and (2) provides adequate assurance of future performance of the lease by the assignee, whether or not the contract or lease is in default. If the lease is in default, Section 365(f) mandates that the trustee must cure the default pursuant to Section 365(b) before assuming and assigning. Section 365(f)(3) invalidates provisions of a contract or lease or applicable law that would permit termination or modification due to assumption or assignment. Thus, the non-debtor party to a contract or lease may not enforce a clause that restricts assignment by requiring the assignor to obtain consent to assign or that explicitly prohibits assignment.

When assuming and assigning contracts and leases, debtors often wish to "cherry pick" desirable contractual provisions while discarding those that are more burdensome. Bankruptcy doctrine dictates that the debtor must assume or reject a contract in full. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985) ("[The fact that] the debtor must accept the contract as a whole means only that the debtor cannot choose to accept the benefits of the contract and reject its burdens to the detriment of the other party to the agreement."). However, bankruptcy courts do not enforce this doctrine literally. They often allow debtors to divide or sever agreements that constitute one larger contract or lease and to disregard certain contractual provisions that, in the eyes of the court, hinder the debtor's recovery through the bankruptcy process.

This paper will address four types of clauses in executory contracts and unexpired leases that debtors may attempt to evade by arguing that they are either severable from the overall agreement or unenforceable under Section 365. First, it discusses when cross-default provisions may be enforced. Second, it discusses when a court will declare a contractual provision unenforceable as a "de facto" anti-assignment clause under Section 365(f). Third, it addresses whether a court will allow a debtor to escape a guarantee requirement when assigning a contract. Finally, it will discuss noncompetition clauses in employment and franchise contracts, which debtors often seek to avoid through use of Section 365.

The Ability of a Debtor to Sever or Excise Specific Contractual Provisions

A. Cross Default Provisions: Enforcing Cross-Default Provisions v. Preserving the Bankruptcy Estate for Unsecured Creditors

It is often unclear what constitutes a single contract or lease to be assumed or rejected. If a single contract contains multiple severable agreements, the debtor may reject some of the agreements and assume others. *Stewart Title Guaranty Company v. Old Republic National Title Insurance Company*, 83 F.3d 735, 741 (5th Cir.

[1] Courts have found it very difficult to define the term "executory contract," and the Bankruptcy Code does not provide a definition. Courts often use the "Countryman" definition of the term, which defines an executory contract as an agreement in which "the obligations of both the bankrupt and the other party to the contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy, Part 1*, 57 MINN. L. REV. 439, 460 (1973).

1996) ("*Stewart Title*"). Generally, it is a question of state law whether separate agreements within a single contract constitute a single cohesive contract or multiple contracts that may be assumed, rejected, and assigned separately under Section 365. *See Mirant Corp. v. Potomac Elec. Power Co.*, 197 Fed. Appx. 285, 289 (5th Cir. 2006). Texas courts have held that a severable contract "includes two or more promises which can be acted on separately such that the failure to perform one promise does not necessarily put the promisor in breach of the entire agreement." *Stewart Title*, 83 F.3d at 739 (quoting Black's Law Dictionary 1373-74 (6th ed. 1990)).

Under Texas law, a contract's severability depends on the intent and conduct of the parties as well as the subject matter of the agreement. *In re: FFP Operating Partners, LP*, 2004 WL 3007079, *2 (Bankr. N.D. Tex. 2004); *Stewart Title*, 83 F.3d at 739. To determine severability, courts generally consider multiple factors, including:

- Whether the agreements are contained in one document, are separate and incorporated into one another, or are part of one large transaction
- Whether the agreements contain integration and severability clauses
- Whether the separate agreements are conditions precedent to the main agreement
- Whether consideration is apportioned among agreements or in a lump sum
- Whether the agreements have the same duration
- Whether the agreements are signed by the same parties at the same time for the same subject matter
- Whether the agreement is defined to include all aspects of the deal
- Whether the agreements can be assigned separately
- Whether the agreements contain cross default provisions

Jason D. Schauer, *Carving up the Contract Turkey Under Bankruptcy Code Section 365: Severability and Indivisibility, Integration, and Aggregation in Acquisition Transactions*, 15 J. BANKR. L. & PRAC. Art. 3 (June 2006).

The existence of a cross-default provision is merely one factor that a court considers when determining whether a contract is severable into multiple agreements. A cross-default provision states that a default under one of two or more related agreements constitutes a default under all of the agreements. The existence of a cross-default provisions is evidence that the parties intended the agreements in question to constitute one cohesive contract or lease.

Cross-default provisions often come into play when they are included in the franchise agreement of a bankrupt franchisee. For example, if a bankrupt franchisee runs multiple franchise restaurants, all of which are operated under one franchise agreement, it may wish to reject the contract as to certain unprofitable restaurants and assume and assign it as to those that have been more successful. The franchisor will argue that the franchise agreement is not divisible and that the cross-default provision in the franchise agreement requires the debtor to cure the defaults under all of the contracts in order to assume and assign them under Section 365(f).

In the most recent Fifth Circuit case addressing the issue of cross-default provisions, *In re Matter of Liljeberg Enterprises, Inc.*, 304 F.3d 410, 445 (5th Cir. 2002), the court held that cross-default provision are enforceable in certain situations. This Fifth Circuit holding differs from the position of courts in other circuits, which have found cross-default provisions to be simply unenforceable in the bankruptcy context. *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999) ("It is well-settled that, in the bankruptcy context, cross-default provisions do not integrate otherwise separate transactions or leases. . . . The cross-default provisions must be disregarded in the bankruptcy law analysis, because they are impermissible restrictions on assumption and assignment."); *In re Sanshoe Worldwide Corp.*, 139 B.R. 585 (S.D.N.Y. 1992) ("[W]hile the 11th and 12th floor leases do contain cross-default provisions . . . , these provisions do not limit the ability of a debtor to assign one of the leases while

rejecting the other in the course of a reorganization proceeding. Contractual limitations on the ability to assign unexpired leases other than those specified in §365(c) are prohibited under §365(f)."); *In re Braniff, Inc.*, 118 B.R. 819, 845 (Bankr. M.D. Fla. 1990) ("Cross-default provisions are unenforceable in bankruptcy where the provisions restrict the debtor's ability to assume an executory contract . . . . Accordingly, cross-default provisions in the agreements that are the subject of this case are unenforceable") (citations omitted).

In *Liljeberg*, the Fifth Circuit held that various agreements were interrelated and, therefore, not severable: a loan to a hospital for construction of a hospital building, a lease of the building back to an affiliate of the lender to operate the hospital, and a pharmacy agreement with an affiliate of the hospital for hospital services. *Liljeberg Enterprises*, 304 F.3d at 444. The court stated that "[w]here the non-debtor party would have been willing, absent the existence of the cross-defaulted agreement to enter into a contract that the debtor wishes to assume, the cross-default provision should not be enforced, . . ." *Id.* at 445. However, it concluded that the parties would not have entered any of the agreements independently, and so enforced the cross-default provision. *Id.* at 445.

In its discussion of cross-default provisions, the court stated:

> [W]hile "cross-default provisions are inherently suspect," they are not *per se* invalid in the bankruptcy context and "a court should carefully scrutinize the facts and circumstances surrounding the particular transaction to *determine whether enforcement of the provision would contravene an overriding federal bankruptcy policy and thus impermissibly hampers the debtor's reorganization*.
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> *Id* at 445. (Italics added).

Thus, in the Fifth Circuit, cross-default provisions are suspect, but enforceable under certain circumstances. In determining whether cross default provisions are invalid, a court should look to: (1) whether enforcement of the provisions will contravene "overriding federal bankruptcy policy," and (2) whether contravening bankruptcy policy will hamper the debtor's reorganization.

A non-debtor party to a set of agreements containing cross-default provisions may have a good argument for enforcing the provisions if the unsecured creditors in the case will not receive compensation. If the court does not need to preserve the bankruptcy estate for unsecured creditors, there is arguably no "overriding federal bankruptcy policy" preventing enforcement of cross-default provisions. If the estate will compensate unsecured creditors, curing the defaults in all of the debtor's contracts with the non-debtor party to the agreements will reduce their dividend. The bankruptcy estate will be depleted by having to spend money to cure all instead of only select defaults in the contracts.

However, when only the secured creditors will receive compensation from the bankruptcy estate, there is no reason that a court should not follow the plain language of 11 Section 365(b)(1) requiring all defaults be cured before assumption of a contract or lease. The estate is not being preserved for the unsecured creditors, but it is being divided among secured creditors. Arguably, the secured creditors should not benefit at the expense of third parties who contracted with the debtors to protect themselves through cross-default provisions.

The second part of the *Liljeberg* test is whether following the literal language of 11 Section 365(b)(1) "impermissibly hampers the debtor's reorganization." In some cases, it is feasible that requiring the debtor to cure all of a large set of agreements would prevent the debtor from reorganizing effectively and efficiently. However, in cases where the debtor is liquidating its assets, this should not be an issue.

In *In re Ramba, Inc.*, 437 F.3d 457 (5th Cir. 2006), the Fifth Circuit held, *sub silentio,* that when there is no recovery from secured property for the benefit of the unsecureds, there is no overriding federal bankruptcy policy to protect. In

Ramba, the trustee sought to avoid an alleged preferential transfer of assets from the debtor that had been fully encumbered at the time of transfer as to exceed the fair market value of the asset. *Id.* at 458-59. In its analysis, the court focused on Section 547(b)(1) as to whether there had been "a transfer of an interest of the debtor in property. . . ." *Id.* at 459-60. The Court stated in relevant part:

> A debtor has an interest in property if that property would have been part of the debtor's bankruptcy estate had the transfer not occurred. A trustee cannot avoid transfers of property unless the property would have been in the estate and therefore available to the debtor's general creditors. Essentially, a voidable preference must have depleted the estate.
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> *Id.* at 459 (citations omitted).

In disallowing the preference action, the *Ramba* court stated, "Ramba had no equity in the proceeds of the sale, and, therefore, the funds never would have been available to general creditors in the bankruptcy. . . . The consideration from the sale of Citibank's collateral belonged to Citibank, the secured lender." *Id.* at 460-61. In other words, the court found no overriding bankruptcy policy to allow the voidable transfer action; therefore, the court let the transaction stand under state law standards. *Id.* at 461.

The same is true in the case of our hypothetical franchise agreements with cross-default provisions. If the unsecured creditors will receive no compensation, the assignment of the franchise agreements is being conducted primarily for the benefit of secured creditors and the franchisor. There is no overriding bankruptcy policy that justifies Section 365(b)(1) being overridden and denying the franchisor the benefit of its bargain in order to benefit the secured creditors.

Courts have followed a pattern of refusing to enforce cross default provisions when doing so would deplete the bankruptcy estate for the unsecured creditors. For example, in *In re Wolfin Oil, L.L.C.*, 318 B.R. 392, 399 (N.D. Tex. Bankr. 2004), the Bankruptcy Court for the Northern District of Texas held unenforceable a cross-default provision linking the debtor's six leases for Jiffy Lube stations. It reasoned that the six contracts were severable under Texas law and analyzed the leases under federal bankruptcy law pertaining to cross-default provisions as discussed by the Fifth Circuit in *Liljeberg*. *Id.* at 398. The court held that the Chapter 11 debtor could assume and reject each lease independently and that the debtor need not cure the defaults under all of the leases in order to assume an individual lease. *Id.* at 399. However, the unsecured creditors in *Wolfin* were to receive twenty percent of their allowed claim amounts, so the court had a significant interest in relieving the debtor from its obligation to cure contractual defaults in order to preserve the bankruptcy estate for the unsecured creditors. Similarly, in each bankruptcy case that the authors could find in which a court held multiple related contracts severable and cross-default provisions unenforceable, the court had an interest in preserving the bankruptcy estate for the unsecured creditors.[2] *See, e.g.*, *In re Szenda*, 406 B.R. 574, 581 (Bankr. D. Mass. 2009) (unsecured creditors to receive 6.67% of allowed claims); *In re American Home Mortgage Holdings, Inc.*, 402 B.R. 87, 100 (Bankr. D. Del. 2009) (unsecured creditors to receive a percentage of their allowed claims); *In re The IT Group, Inc.*, 350 B.R. 166, 181 (Bankr. D. Del. 2006) (unsecured creditors to receive approximately 1.4% of their allowed claims); *In re Adelphia Business Solutions, Inc.*, 322 B.R. 51, 63 (Bankr. S.D.N.Y. 2005) (unsecured creditors to receive a percentage of their allowed claims); *FFP Operating Partners*, 2004 WL 3007079 at *7 (disclosure statement predicted that unsecured creditors' recovery "may exceed" 15% of allowed claims); *In re Cafeteria Operators, L.P.*, 299 B.R. 384, 392 (Bankr. N.D. Tex. 2003) (disclosure statement estimated that unsecured creditors would receive 6% to 12% of their allowed unsecured claims); *but cf.*, *In re*

[2] The authors can only make this assessment for bankruptcy cases decided from approximately 2003 due to the fact that the pertinent documents for cases filed before this time are not available on Pacer.

Buffet Holdings, Inc., 387 B.R. 115, 128 (Bankr. D. Del. 2008) (holding that debtor could not assume restaurant leases as to certain locations and reject them as to others because master leases were indivisible agreements, where unsecured creditors were to receive approximately 4% of their allowed claims).

Thus, courts may be more inclined to enforce cross-default provisions and to find that franchise agreements, leases, and other contracts that contain multiple connected agreements are not divisible where the unsecured creditors will not receive anything from the bankruptcy estate regardless of the severability of the contract at issue. However, the authors could find no case addressing this issue directly. Therefore, it remains unclear whether a court would be more likely to honor the overriding bankruptcy policy under Section 365(b)(1) requiring that all defaults be cured before assumption and/or assignment in a situation involving cross-default provisions where unsecured creditors will receive nothing. Nonetheless, parties to agreements with bankrupt debtors have a good argument that their cross-default provisions should be enforced when the unsecured creditors will receive no compensation from the estate.

B. De Facto Anti-Assignment Clauses

Section 365(f)(1) of the Bankruptcy Code authorizes a bankruptcy trustee or debtor-in-possession to assign an executory contract or unexpired lease notwithstanding a provision in the contract or lease that "prohibits, restricts, or conditions the assignment of such contract or lease." Courts have held that provisions other than those that explicitly restrict assignment can be so restrictive in effect that they constitute "de facto" anti-assignment provisions that are unenforceable under Section 365(f).

Section 365(b) requires a debtor to cure all defaults in a contract and assume a contract subject to its benefits as well as its burdens. *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45, 49 (Bankr. M.D. N. Carolina 2003) ("When an executory contract or lease is assumed, it must be assumed *cum onere*, with all of its benefits and burdens."). Section 365(f) requires a debtor to cure a default pursuant to Section 365(b) before assigning. Thus, a debtor cannot assume an executory contract and then choose not to comply with its more onerous provisions when assigning to another party.

The principal that the debtor must assume the benefits and burdens of a contract conflicts with the de facto anti-assignment doctrine, which allows debtors to ignore certain contractual provisions that render assignment too difficult. This friction makes it difficult to determine what provisions constitute unenforceable de facto anti-assignment clauses. *See In re Trak Auto Corp.*, 367 F.3d 237, 243 (4th Cir. 2004) (discussing "the conflict between § 365(f)(1), a general provision that permits lease assignment notwithstanding anti-assignment clauses, and § 365(b)(3)(C), a more specific provision that requires the assignee of a shopping center lease to honor a clause restricting the use of the premises"). There is an elusive point at which a provision in a contract or lease stops being simply onerous and becomes unenforceable by rendering the agreement too difficult to assign.

Only a handful of cases discuss the circumstances in which a contractual provision constitutes a de facto anti-assignment clause. The determination is generally very fact specific. Courts attempt to deduce whether the assignment of the contract or lease is rendered impossible by the provision in question. For example, if a lease requires premises to be occupied by a certain type of store such as an automotive parts store and there is no market for an automotive parts store in that location, the lease may be essentially un-assignable and the use provision may be unenforceable. Courts have held that cross-default provisions as well as lease provisions requiring payment of a portion of the proceeds or profit realized upon assignment are de facto anti-assignment clauses. *See E-Z Serve*, 289 B.R. at 50 (discussing de facto anti-assignment clauses in general). However, courts hesitate to disregard contractual provisions simply because they make it difficult for the debtor to find someone to assume the contract. *See id.* at 51 ("A bankruptcy court's authority to excise a bargained for element of a contract is questionable and modification of a nondebtor contracting party's rights is not to be taken lightly.").

The following is a list of cases in which courts have addressed whether a specific contractual provision constitutes an unenforceable de facto anti-assignment clause.

Cases in which courts have found that certain provisions did not act as de facto anti-assignment clauses:

- *In re Sun TV and Appliances, Inc.*, 234 B.R. 356, 370 (Bankr. D. Del. 1999) – Restrictions regarding use and tenant mix for shopping center leases were material to the leases and were not de facto anti-assignment clauses even if they prevented the debtor from selling its lease.
- *E-Z Serve*, 289 B.R. at 51-52 – Right of first refusal to purchase buildings that debtor constructed on property was not a de facto anti-assignment clause because, among other things, it did not restrict the bidding process or compel the property owner to sell at a price below market price. The bankruptcy trustee was free to assign the lease at any time and the bankruptcy estate would receive the full benefit of the best offer that the trustee could negotiate.
- *In re The IT Group Inc.*, 302 B.R. 483, 488 (D. Del. 2003) – Right of first refusal under operating agreement for LLC was enforceable because this type of clause is often enforced in the bankruptcy context and enforcing the right would not hamper the debtor's ability to assign the property or prevent the estate from realizing the full value of the debtor's interest in the LLC.
- *In re Trak Auto Corp.*, 367 F.3d 237, 244 (4th Cir. 2004) – Shopping center lease provision that prohibited debtor from using premises for anything other than an auto parts store was enforceable and was not an invalid restriction on assignment.
- *In re Ames Department Stores, Inc.* 316 B.R. 772 (Bankr. S.D.N.Y 2004) – Restriction in commercial lease that premises could not be used for a supermarket was not an unenforceable de facto anti-assignment provision because it "merely prohibit[ed] one of the many uses to which the [property] could be put."
- *In re: Fleming Companies, Inc.*, 499 F.3d 300, 307-08 (3rd Cir. 2007) – Provision in a contract that the supplies for a supermarket must be "from the Tulsa Facility" was a material term of the contract and not a de facto anti-assignment provision because the term could have been performed by any party and did not completely prevent assignment.
- *In re Town, LLC*, 2009 WL 2883047, *4 (Bankr. S.D.N.Y. 2009) (Slip Copy) – Termination clause that granted lessor the right to terminate the lease at its discretion if the operation of the restaurant located on the leased property in the lessor's hotel was unsatisfactory, not only if the lease was assigned, was not a de facto anti-assignment clause.
- *Dewey Ranch Hockey, LLC*, 406 B.R. 30, 36-37 (Bankr. D. Arizona 2009) – Restriction in debtor's contract with hockey league requiring a franchise team to play home games in a certain city was not an unenforceable restriction on assignment.

Provisions that constitute de facto anti-assignment clauses:

- *In re Peaches Records and Tapes, Inc.*, 51 B.R. 583, 590 (9th Cir. BAP 1985) – Provision granting lessors right to cancel lease if lessee ceased to do business on leased premises was an unenforceable de facto anti-assignment clause because it went beyond merely precluding cessation of business and prevented the trustee from assigning the lease.
- *In re Rickel Home Centers, Inc.*, 240 B.R. 826, 831-32 (D. Del. 1998) – Use restrictions in a debtor's shopping mall lease that required leased premises to be operated as a home improvement center was an unenforceable de facto anti-assignment clause because it prevented the debtor from assigning the lease. The market for home improvement centers was "non-existent or in dire straits," so it would have been almost impossible to comply with this provision.

- *In re: Crow Winthrop Operating Partnership*, 241 F.3d 1121, 1123-24 (9th Cir. 2001) – Change in ownership provision that would terminate parking and parking management provisions of a contract for the use of certain property was a de facto anti-assignment clause because the parking and management rights under the agreement were "interwoven with the rights of the owner" of the facility in question.
- *La Salle National Trust, N.A.*, 288 B.R. 114 (E.D. Virg. 2003) – Provision of commercial lease allowing premises to be used only for one of the debtor's stores to sell automotive parts was a de facto anti-assignment clause. Court discussed the market for auto part stores and the fact that no auto part store had bid on the lease.
- *In re Adelphia Communications, Corp.*, 359 B.R. 65, 86-87 (Bankr. S.D.N.Y. 2007) – When cable operator's franchise agreements were being assigned by debtor, court held that the right of first refusal was not enforceable because it "thwart[ed] the fundamental policy of maximizing estate assets for the benefit of all creditors" by discouraging potential assignees from making bids before the court to be matched by the party with the right of first refusal. (citing *Ames Dep't Stores*, 316 B.R. at 796).

At first glance, there do not appear to be clear guidelines as to when a provision qualifies as an unenforceable de facto anti-assignment provision under Section 365(f). For example, courts have found use restrictions to be unenforceable in some instances and enforceable in others. *Compare Sun TV*, 234 B.R. 356 (use restriction enforceable) and *Trak Auto*, 367 F.3d 237 (same) to *Lasalle National Trust*, 288 B.R. 114 (use restriction unenforceable). Courts have also been inconsistent in their treatment of rights of first refusal. *Compare The IT Group Inc.*, 302 B.R. 483 (right of first refusal enforceable) to *Adelphia Communications*, 359 B.R. 65 (right of first refusal unenforceable).

Courts use a very fact-specific inquiry into whether a provision renders a contract unassignable. For example, in *Rickel*, the court looked to evidence regarding the market for home improvement centers to determine whether the use restriction in the lease rendered it unassignable. 240 B.R. at 831-32. A court will also look to the extent to which a provision hampers a debtor's ability to assign, whether it would prevent the estate from realizing the value of its assets, and potential detriment to the non-debtor party to the contract. *E-Z Serve*, 289 B.R. at 50. It will attempt to "ensure that a proper balance is reached between the interest of the debtor . . . and the economic detriment to the non-debtor." *See Ames Dep't Stores*, 316 B.R. at 796. A court will also consider whether the provision in question is an "integral part of an assumed agreement," or whether it is immaterial. *Fleming Companies*, 499 F.3d at 308. As the *Lasalle* court explained, "[d]e facto anti-assignment clauses are typically those lease restrictions that can only be met by the original tenant." *Id.* at 123.

Case law does demonstrate that a few types of contractual provisions are at risk for being considered de facto anti-assignment clauses. For example, debtors often challenge use restrictions in leases, cross-default provisions, and rights of first refusal. However, a debtor may challenge any number of contractual provisions that render a contract difficult to assign.

Some scholars suggest that in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA"), Congress amended Sections 365(b) and 365(f) "to curb the tendency of some judges to rewrite leases as part of the assumption and assignment process." Valerie P. Morrison & Rebecca L. Saitta, *Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act on Franchisee Reorganizations Under Chapter 11*, 27-Fall FRANCHISE L.J. 125, 127 (2007). In fact, some suggested that the purpose of amending Section 365(f)(1) was to override cases like *Rickel* in which courts permitted debtors to assign leases notwithstanding provisions that limited tenant mix, usage, and so on because these provisions constituted de facto anti-assignment clauses. Sally S. Neely, *BAPCPA Provisions Directly Affecting Executory Contracts*

and Unexpired Leases in Chapter 11 Cases (With Hypothetical), SM014 ALI-ABA 295 (2007). Among other things, Congress added the cross-reference to Section 365(b) into Section 365(f) to explicitly require debtors to cure defaults in accordance with Section 365(b) before assigning a contract or lease.

Bankruptcy practitioners speculated that after the enactment of the BAPCPA it would be more difficult for franchisee debtors to hold onto leases indefinitely and to eliminate requirements such as use and operational restrictions under Section 365(f). *Id.* at 128. It remains to be seen whether the changes to Section 365 in the BAPCPA have deterred courts from treating contractual provisions that make assignment difficult as de facto anti-assignment clauses.

C. Guarantee Requirements

Contracts and leases often require a party to provide a personal guarantee. Naturally, when a debtor would like to assume and/or assign a contract that contains a guarantee requirement, it may request that the court consider this requirement unenforceable. For example, a debtor may argue that the guarantee requirement is a de facto anti-assignment provision because it makes it very difficult for the debtor to find a party that will both assume a contract and guarantee its performance.

The authors could find no case in which a court held that a provision of an executory contract requiring a guarantee was unenforceable as a de facto anti-assignment clause. In fact, courts have considered the existence of a guarantee for an assigned contract as a factor in determining whether a trustee has provided adequate assurance of future performance under the contract for purposes of Section 365(f)(2)(B). *In re Resource Technology, Corp.*, 2008 WL 4876846 at *4 (N.D. Ill. 2008) (citing *In re Embers 86th Street, Inc.*, 184 B.R. 892, 902 (Bankr. S.D.N.Y. 1995)). Moreover, in several cases, courts have found that adequate assurance was provided by financial documents or other items similar to a guarantee, none of which violated the de facto anti-assignment principle. *See In re Prime Motor Inns, Inc.*, 166 B.R. at 997 (finding adequate assurance based on substantial capital investments); *In re The Casual Male Corp.*, 120 B.R. 256, 264-65 (Bankr. D. Mass.1990) (finding adequate assurance based on six-month rent deposit, irrevocable letter of credit, financial statement showing considerable liquid assets, and extensive business experience of assignee's CEO); *In re Westview 74th Street Drug Corp.*, 59 B.R. 747, 755 (Bankr. S.D.N.Y. 1986) (finding adequate assurance based on two-month security deposit that would allow landlord to cover its losses); *In re Alipat, Inc.*, 36 B.R. 274, 277-78 (Bankr. E.D. Mo.1984) (finding adequate assurance where irrevocable letter of credit was issued in favor of contractual counter-party and contract was guaranteed by third parties whose financial condition had not deteriorated); *In re Sapolin Paints, Inc.*, 5 B.R. 412, 416-17, 420 (Bankr. E.D.N.Y. 1980) (finding adequate assurance where economic conditions definitively demonstrated that assignee would perform on contract and assignee submitted statements showing positive net worth and income). In each of these cases, considerably stronger evidence concerning the adequacy of future performance was offered in support of a motion to assume and/or assign an executory contract.

Furthermore, in two cases, courts have approved the assumption and assignment of contracts that contained a guarantee of future performance. Neither case discussed whether the guarantee prohibited assignment in violation of Section 365(f)(3). *See Sanshoe Worldwide*, 139 B.R. at 592-93 (in holding that a debtor/sublessor provided adequate assurance of an assigned sublease, noting that the lessee guaranteed the sublessee's performance of obligations under the sublease); *Rickel*, 240 B.R. at 828, 836 (holding that use restrictions in leases for 41 stores were de facto anti-assignment clauses, but allowing the assignment by an assignee in which it agreed to unconditionally guarantee all of its obligations under the agreement).

D. Covenants Not to Compete

Many employment contracts and franchise agreements contain noncompetition agreements or covenants not to compete that forbid an employee or franchisee from competing with an employer or franchisor for a certain time period in a certain

geographic area after the terms of the agreement have been fulfilled or breached. If the employee or franchisee files for bankruptcy, it may attempt to escape the restrictions of the covenant not to compete by rejecting the contract under Section 365(a). It may argue that by rejecting the agreement, its completely terminates its rights and duties under the agreement and no longer has any obligations thereunder, including the obligation not to compete with the non-debtor employer or franchisor.

Courts consistently have held that debtors cannot rid themselves of the restrictions of covenants not to compete simply by rejecting the contracts into which they are incorporated. There is little authority to support the assertion that a covenant not to compete is severable from the agreement to which it is attached because there is no reason to believe that two parties would enter a noncompetition agreement absent other related agreements. Courts have required debtors to comply with covenants not to compete by finding (1) that the employment or franchise agreement is not executory and thus may not be rejected or (2) that the covenant must be honored even if the contract is rejected.

In *In re Noco Inc.*, 76 B.R. 839 (Bankr. N.D. Fla. 1987), the debtor sought to reject a franchise agreement that contained a covenant not to compete. The court concluded that the the covenant not to compete was the sole remaining obligation on the contract. *Id.* at 840-41. Because only one party had obligations remaining under the contract, the court held that the agreement did not qualify as an executory contract, so the debtor could not reject it under the terms of Section 365. *Id.* at 843. Therefore, the debtor could not evade compliance with the covenant.

Many courts have allowed debtors to reject franchise and employment agreements as executory contracts, but have held that the covenants not to compete contained in those agreements bind the debtor after rejection. *See In re Don & Lin Trucking Co., Inc.* 110 B.R. 562, 568 (Bankr. N.D. Al. 1990) (a covenant not to compete in the debtor's agreement with a trucking company was enforceable after the debtor rejected the agreement); *Klein v. Kwik-Kopy Corp.*, 218 B.R. 787, 790-91 (Bankr. W.D. Penn. 1998) (debtor could not escape the requirements of a covenant not to compete in a franchise agreement for a copying store by rejecting the agreement); *In re Steaks to Go, Inc.*, 226 B.R. 35, 38 (Bankr. E.D. Mo. 1998) (rejection by the debtor of a restaurant franchise agreement did not relieve the debtor and other parties of complying with the covenants not to compete contained in that agreement); *Sir Speedy, Inc. v. Morse*, 256 B.R. 657 (Bankr. D. Mass. 2000) (covenant not to compete in franchise agreement of a debtor operating a Sir Speedy copying and printing center was enforceable after the debtor rejected the agreement).

Section 365 outlines why a covenant not to compete survives the rejection of a franchise or employment agreement. When a debtor rejects a contract or lease under Section 365(a), the rejection does not serve as a complete termination of the contract, but as a breach of the contract. 11 U.S.C. § 365(g). "Rejection does not cause a contract magically to vanish." *Sir Speedy*, 256 B.R. at 659. The rights and obligations of both parties to the contract are the same as they would have been if the debtor had breached the contract before filing for bankruptcy. Because the covenants not to compete in these agreements are meant to be in force after a breach of the contract, debtors should not expect to escape their terms upon rejection. *Klien*, 218 B.R. at 790 ("[T]he very purpose of the covenant [not to compete] is to govern the relationship between the parties *after* the demise of the underlying contract, even though the covenant is not an executory contract in and of itself.").

After rejection, a claim of the non-debtor party to the contract for monetary damages becomes a general unsecured claim subject to discharge and the non-debtor party may seek injunctive relief. *In re Don & Lin Trucking Co., Inc.* 110 B.R. 562, 567 (Bankr. N.D. Al. 1990). A non-debtor party to a rejected contract with a covenant not to compete could seek recovery for monetary damages from guarantors as well as non-debtor officers and other agents of a corporate debtor. William L. Medford, *Enforcing Covenants Not to Compete After Rejection*, 20-SEP AM. BANKR. INST. J. 26, 27 (2001).

Thus, it would be difficult for a debtor to escape the requirements of a noncompetition agreement using the tools provided to it by the Bankruptcy Code. Courts have not found these clauses to be unenforceable restrictions on assignment or subject to termination by rejection. Instead, they hold that covenants not to compete generally are not severable from the contracts with which they are associated and that the debtor must follow their terms regardless of whether it chooses to assume or reject the contract.

Conclusion

Despite the seeming pervasiveness of the general rule that debtors must either accept or reject an entire contract subject to both its benefits and burdens, courts often allow debtors to ignore the literal language of contracts. It is often a challenge for bankruptcy practitioners and non-debtor parties to contracts with debtors to predict which provisions are essential and enforceable and which may be brushed aside. Courts disfavor the enforcement of cross-default provisions, but may be more inclined to enforce them if the unsecured creditors will not receive compensation from the bankruptcy estate. Precedent regarding de facto anti-assignment clauses is not well developed, so it is difficult to predict when a court will find a contractual provision unenforceable under this doctrine. Finally, case law suggests that courts are very likely to enforce both guarantee requirements and covenants not to compete.