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A Failure to Assume

The Ride-Through Doctrine And the Consequences of Not Assuming or Rejecting An Executory Contract or Unexpired Lease in a Chapter 11 Case

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In most Chapter 11 cases, the debtor (or trustee if one is appointed), either prior to or in connection with plan confirmation, will move to assume or reject its executory contracts, unexpired leases, or both (collectively "Executory Contracts") pursuant to § 365 of the Bankruptcy Code. This article discusses the "ride-through" doctrine, which courts have developed to resolve the ambiguity resulting from a debtor's failure to assume or reject an Executory Contract under § 365 prior to plan confirmation. Under this doctrine, "executory contracts that are neither affirmatively assumed or rejected by the debtor under § 365, pass through bankruptcy unaffected." *In re Hernandez*, 287 B.R. 795, 799 (Bankr. D. Ariz. 2002); see also *In re Polysat, Inc.*, 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993).

This article will not deal with leases of non-residential real property because the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended § 365(d)(4) and imposed an outside limit of 210 days for a debtor-lessee to assume or reject a pre-petition lease of non-residential real estate. Thus, under amended § 365(d)(4), a non-residential real estate lease where the debtor is the

lessee is deemed rejected if the debtor has neither assumed nor rejected it: a) within 120 days of the bankruptcy filing, subject to one 90-day nonconsensual extension by court order (additional extensions require the lessor's consent), or b) before plan confirmation, whichever is earlier. Accordingly, non-residential leases can no longer ride through a Chapter 11 bankruptcy case.

Pursuant to § 1141(b), all property of a debtor's estate, whether scheduled or unscheduled, vests in the reorganized debtor upon plan confirmation, unless a court order or the plan provides otherwise. Because a debtor's rights under its Executory Contracts become property of its bankruptcy estate, those rights simply re-vest in the debtor upon plan confirmation if they are not otherwise modified in the bankruptcy. See *Hernandez*, 287 B.R. at 799; see also *Consolidated Gas, Elec. Light and Power Co. of Baltimore v. United Ry. and Elec. Co. of Baltimore*, 85 F.2d 799, 805 (4th Cir. 1936) (holding that an Executory Contract not rejected "continues in place between the parties, passing through the bankruptcy to the reorganized debtor"). The ride-through doctrine follows a fundamental tenet of Chapter 11, the "policy of allowing the [debtor] freedom to run the business without having to obtain court approval at every step." *In re Penn Traffic Co.*, 322 B.R. 63, 72-73 (Bankr. S.D.N.Y. 2005).

EXAMINING § 365(A)

Courts addressing this issue start by examining § 365(a), which provides that

a trustee or debtor "may assume or reject any executory contract or unexpired lease of the debtor." (Emphasis supplied.) The language of § 365(a) is permissive, not mandatory, and thus "the Code leaves open the 'no-action' possibility of neither assuming or rejecting an Executory Contract." *In re JZ L.L.C.*, 371 B.R. 412, 422 (9th Cir. B.A.P. 2007). Likewise, § 1123(b)(2) of the Code states that "a plan may" provide for assumption or rejection under § 365, further emphasizing that action is not mandatory.

In contrast to the flexible treatment of Executory Contracts in Chapter 11, § 365(d)(1) makes clear that if a Chapter 7 trustee does not assume or reject an Executory Contract within 60 days after the order for relief, "then such contract or lease is deemed rejected." Noting this distinction, the *JZ L.L.C.* court stated as follows:

[P]ertaining to Chapter 7 and to leases of nonresidential real property is that they illuminate the greater flexibility that Congress afforded in chapter 11 (and 9, 12 and 13) cases with respect to executory contracts. An executory contract that is not assumed in a chapter 11 case is not 'deemed rejected.' As a matter of straight forward statutory construction, it follows that some other alternative, i.e. 'ride-through,' must be available.

Id. at 423-24; see also *In re Silver Fox, LLC*, No. 07-19443 (NLW) (Bankr. D.N.J. June 24, 2010) slip op. at 10-11; Bankruptcy Code §§ 901(a), 1222(b)(6), 1322(b)(7) (treating acceptance and rejection of Ex-

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ecutory Contracts as permissive in Chapter 9, 12, and 13 cases, respectively).

THE RIDE-THROUGH DOCTRINE

The First, Second, and Fifth Circuits have addressed the ride-through doctrine, each holding that the doctrine applies to Executory Contracts that a Chapter 11 debtor has neither assumed nor rejected prior to plan confirmation. *See Stumpf v. McGee (In re O'Connor)*, 258 F.3d 392, 404 (5th Cir. 2001); *Boston Post Rd. Ltd. P'ship v. FDIC (In re Boston Post Road Ltd. P'ship)*, 21 F.3d 477, 484 (2d Cir. 1994); *Pub. Serv. Co. of N.H. v. N.H. Electric Coop., Inc. (In re Public Service Co. of N.H.)*, 884 F.2d 11, 14-15 (1st Cir. 1989). In addition, in *NLRB v. Bildisco & Bildisco*, Justice William J. Brennan's concurrence noted that an Executory Contract that is neither assumed nor rejected "will 'ride through' the bankruptcy proceeding and be binding on the debtor even after a discharge is granted." 465 U.S. 513, 546 n. 12 (1984).

Certain cases also posit an alternative basis for the ride-through doctrine: Not all contracts are executory. Where a contract is not executory, it need not be assumed in order to remain in effect post-confirmation. Sections 365 and 1123(b) are titled Executory Contracts, making no mention of contracts that are not executory. As the *JZ L.L.C.* court noted:

The absence of a bright-line boundary between executory and non-executory contracts creates a zone of uncertainty that would be a trap for the unwary without the 'ride through' alternative. At best, the concepts of executory and non-executory share the same boundary as the difference between contract breaches that are material and not material — easy to say, but hard to apply.

371 B.R. at 425.

Courts have held that the ride-through doctrine "applies any time a debtor fails to address an executory contract, whether that failure is inadvertent or intentional." *In re Hernandez*, 287 B.R. at 803; *see also In re Penn Traffic Co.*, 322 B.R. at 72-73. The ride-through doctrine thus applies

automatically to: a) Executory Contracts that the debtor does not affirmatively assume or reject, and b) contracts that are not executory and therefore will be unaffected by the bankruptcy unless expressly dealt with by the plan or a court order (except for non-residential real property leases post-BAPCPA as noted above).

Section 365 presents debtors with two options for treating their Executory Contracts: assumption or rejection. Ride-through thus does not invoke any of the provisions of § 365. If a debtor fails to assume or reject an Executory Contract, which in turn rides through the bankruptcy, the parties are not entitled to any of the benefits afforded by § 365, such as the right to cure pre-petition arrearages, adequate assurance of future performance, and insulation from *ipso facto* provisions. Likewise, if the debtor does not seek to assume the Executory Contract, the debtor will not be afforded any of the rights granted under § 365(e). "The ride-through theory allows the debtor to retain the benefits as well as the burdens of the contract, and not the benefits of assumption. Consequently, ride-through is not the equivalent of formal assumption under § 365." *Id.* at 801; *see also In re Texaco Inc.*, 254 B.R. 536, 557 (Bankr. S.D.N.Y. 2000).

An Executory Contract that rides through a bankruptcy case is unaffected by the bankruptcy proceeding, a result that may negatively impact either the debtor or the non-debtor counterparty. For example, the Fifth Circuit, in *Matter of Greystone III Joint Venture*, 995 F.2d 1274 (5th Cir. 1992), *cert. denied*, 121 L. Ed. 2d 37 (1992), held that a debtor's failure to assume or reject a lease with a non-debtor left the lease intact, but the non-debtor counterparty had no claim in the bankruptcy case and thus no right to vote on the plan or share in plan distributions. *Id.* at 1281. Similarly, the Ninth Circuit has held that, unless a debtor has rejected it, an Executory Contract "continues in effect and the non-bankrupt party ... is not a creditor with a provable claim against the bankrupt estate." *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1352 (9th Cir. 1983). Therefore, a non-debtor party that

realizes that a debtor has not moved to assume or reject its Executory Contract prior to or in connection with the plan confirmation process should object if it determines that the benefits of assumption or rejection will outweigh the consequences of simply letting the contract ride through the bankruptcy.

GRAVE RISKS

Failure to assume or reject an Executory Contract either prior to or during plan confirmation poses grave risks for the debtor and its estate, and potentially for non-debtor counterparties. Although the ride-through doctrine provides a fall-back position in the event a Chapter 11 debtor fails to assume or reject an Executory Contract, a debtor that fails to act under § 365 does so at its peril. Such a debtor might unwittingly burden itself post-reorganization by letting an unfavorable Executory Contract ride through the bankruptcy, placing the success of its reorganization in jeopardy. Likewise, a non-debtor counterparty might be better served by the debtor's affirmative acceptance or rejection of a particular Executory Contract than by simply letting the contract ride through the bankruptcy. Before plan confirmation, counsel to both sides of an Executory Contract that has not yet been formally assumed or rejected should weigh carefully the risks and benefits of ride-through.