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Rights of First Refusal: Contending with Rejection

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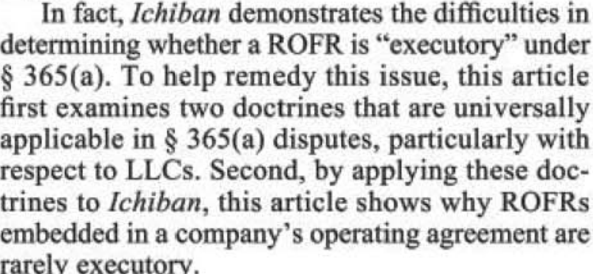
Rights of first refusal (ROFRs) are commonly used by small businesses, which include limited liability companies (LLCs), LP and LLPs, and are often in an operating agreement[1] to ensure that ownership in the business enterprise is restricted to trusted individuals. A ROFR is usually a right by the business or the other owners to buy a member's equity upon an unpermitted transfer or a proposed third-party sale. However, bankruptcy courts have the power to upset many contractual arrangements; one such power is § 365(a) of the Bankruptcy Code, which gives the trustee or debtor in possession (hereinafter, the "debtor") the ability to reject or assume "executory contracts."[2]

In *In re Ichiban Inc.*,[3] the U.S. Bankruptcy Court for the Eastern District of Virginia recently held that the bankruptcy estate of a member of a profitable LLC could reject a ROFR provision embedded in the LLC's operating agreement.[4] At first glance, this holding appears to be just another example of a jurisprudential split, as courts have long debated whether ROFRs and options contracts in general are "executory."[5]



In fact, *Ichiban* demonstrates the difficulties in determining whether a ROFR is "executory" under § 365(a). To help remedy this issue, this article first examines two doctrines that are universally applicable in § 365(a) disputes, particularly with respect to LLCs. Second, by applying these doctrines to *Ichiban*, this article shows why ROFRs embedded in a company's operating agreement are rarely executory.

The Problematic State of § 365(a)

Under § 365(a) of the Bankruptcy Code, "the trustee ... may assume or reject any executory contract or unexpired lease of the debtor." The Code does not specifically define "executory contract," and the legislative history offers little guidance.[6] However, every circuit[7] has embraced the definition proposed by Harvard Prof. Vern Countryman that an executory contract is one in "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 the performance of the other*."[8]

Despite the unanimous embrace of the Countryman definition, § 365(a) jurisprudence remains troubled. The Countryman approach is difficult to apply; it requires a fact-intensive analysis and the application of technical rules that are derived from contract law. As a result, § 365(a) decisions have been wildly inconsistent. Nevertheless, two doctrines have gained wide acceptance in executory contract analysis: (1) it is universally accepted that integrated agreements must be assumed or rejected in their entirety; and (2) most circuits have held that a debtor cannot assume or reject a contract if either party has already substantially performed its obligations.

Integrated Agreements and Substantial Performance

The first doctrine is a fundamental pillar of § 365(a) jurisprudence: Integrated agreements "must be assumed or rejected in [their] entirety."[9] In practice, this requires that the non-severable portions of a contract must be assumed or rejected *in toto*.[10] State law governs whether individual provisions of a contract can be severed, and this inquiry is fact-intensive.[11] In *Ichiban*, proper application of

1 This includes partnership agreements, shareholders' agreements and LLC operating agreements.

2 11 U.S.C. § 365(a).

3 06-10316-RGM, 2014 WL 2937088 (Bankr. E.D. Va. June 30, 2014).

4 In so doing, the court (1) severed the ROFR provision from the operating agreement, (2) held that the ROFR provision was an executory contract subject to rejection and (3) consequently allowed the interest to be sold at auction free and clear of the ROFR. *See generally id.*

5 For an example of this split, *compare In re Nat'l Fin. Realty Trust*, 226 B.R. 586 (Bankr. W.D. Ky. 1998) (option contracts are not executory), *with In re AbitibiBowater Inc.*, 418 B.R. 815, 830 (Bankr. D. Del. 2009) (option contracts are executory).

6 "[Al]hough there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. A note is not usually an executory contract if the only performance that remains is repayment." H.R. Rep. No. 95-595, p. 347 (1977).

7 *See, e.g., Enterprise Energy Corp. v. United States (In re Columbia Gas Sys.)*, 50 F.3d 233, 239 (3d Cir. 1995); *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043, 1045 (4th Cir. 1985); *Phoenix Exploration v. Yaquinto (In re Murexco Petroleum)*, 15 F.3d 60, 63 n.8 (5th Cir. 1994); *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989); *In re Texscan Corp.*, 976 F.2d 1269, 1272 (9th Cir. 1992).

8 Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973) (emphasis added). The Eleventh Circuit approved, as an alternative, the "functional test," which asks what "purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, the agreement is not a[n] ... executory contract." *Sipes v. Atlantic Gulf Communities Corp. (In re General Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996). Provided that "the functional approach ignores the statutory requirement that the contract to be assumed or rejected must be executory" and "rewrites the statute in a fundamental way," it is not discussed here. *In re Rodizio Inc.*, 204 B.R. 417, 422 (Bankr. S.D.N.Y. 1997).

9 *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996) (quoting *In re Camptown Ltd.*, 96 B.R. 352, 355 (Bankr. M.D. Fla. 1989)). *See also In re Convenience USA Inc.*, No. 01-814782002, 2002 WL 230772, at *6 (Bankr. M.D.N.C. Feb. 12, 2002); *United Air Lines Inc. v. HSBC Bank USA (In re United Air Lines Inc.)*, 453 F.3d 463, 467 (7th Cir. 2006).

10 "If a single contract contains separate, severable agreements ... the debtor may reject one agreement and not another." *In re Buffets Holdings Inc.*, 387 B.R. 115, 120 (Bankr. D. Del. 2008) (quoting 2 William L. Norton, Jr. and William L. Norton, III, *Norton Bankr. L. & Prac.* § 39:11 (2d ed. 1999)). *See also United Air Lines*, 453 F.3d at 467; *Byrd v. Gardinier Inc. (In re Gardinier Inc.)*, 831 F.2d 974, 975 (11th Cir. 1987).

this doctrine should have changed the outcome. The court failed to inquire into whether the ROFR was severable from the operating agreement; if it had, the answer should have been "no" — the ROFR was part and parcel of the formation document of the company and part of the consideration that the debtor had to give in order to become a member. Thus, the debtor would either have had to assume the ROFR along with his membership interest or reject his membership interest entirely.

The second doctrine — substantial performance — derives from a basic rule of contracts: "When a breaching party has substantially performed before breaching, the other party's performance is not excused."[12] As the Eighth Circuit noted in *In re Interstate Bakeries*, an executory contract is one in which "the failure of either [party] to complete performance would constitute a material breach *excusing the performance of the other*."[13] Thus, "[s]ubstantial performance is the antithesis of material breach."[14] Prof. Countryman recognized the doctrine of substantial performance explicitly in his seminal article,[15] and this doctrine has been adopted by five circuit courts and implicitly adopted by others.[16]

11 *Lewis Bros. Bakeries Inc.*, 751 F.3d at 961 (8th Cir. 2014); *Foothills Tex. Inc. v. MTGLQ Investors LP (In re Foothills Tex. Inc.)*, 476 B.R. 143, 153 (Bankr. D. Del. 2012); *In re CellNet Data Systems Inc.*, 327 F.3d 242, 249 (3d Cir. 2003); *In re Buffets Holdings Inc.*, 387 B.R. at 120; *United Air Lines*, 453 F.3d at 468.

12 *Restatement (Second) of Contracts* § 241-42 (1981).

13 *Lewis Bros. Bakeries v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 751 F.3d at 962 (quoting Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* at 460).

14 *Id.* (quoting 15 Richard A. Lord, *Williston on Contracts* § 44:55 (4th ed. 2000)). For a detailed look, *see* Clay Roberts, "*Lewis Brothers Bakeries*: The Moving Target of Executoriness," XXXIII *ABI Journal* 8, 56-57, 88, August 2014.

15 "[A] contract so nearly performed ... that failure to complete performance would not be sufficiently material to excuse performance ... should not be treated as an executory contract in bankruptcy." Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* at 457.

The primary purposes of an operating agreement are, at a minimum, to (1) establish a business enterprise, (2) set forth the members of the entity, (3) arrange for capital contributions and (4) provide directions as to ongoing management. At the time of a member's bankruptcy, these purposes have usually been accomplished and the members are enjoying the benefits of the business enterprise established by the operating agreement. Consequently, an ROFR should be included in the operating agreement, which is the larger fundamental commitment of the parties, and not as a separate unperformed contract to be accepted or rejected by the trustee. In the corporate context, this argument may be less persuasive where the ROFR is embodied not in an organic formation document, but in a buy/sell agreement with few purposes other than to create the ROFR.

Inchoate Obligations

Ichiban again raises the issue of whether option contracts such as ROFRs can be treated as executory. *If* the option is exercised, both sides now have material obligations,[17] which arguably means that the contract is executory under the Countryman definition.[18] In other words, do contingent obli-

16 For courts explicitly adopting the doctrine, *see Exide*, 607 F.3d at 963; *Lewis Bros. Bakeries*, 751 F.3d at 962; *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 n.4 (4th Cir. 1984); *Texscan*, 976 F.2d at 1272; *Stewart Title*, 83 F.3d at 741. For courts implicitly adopting the doctrine, *see In re Terrell*, 892 F.2d 469, 471 (6th Cir. 1989); *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989).

17 *Ichiban*, 2014 WL 2937088.

18 Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* at 439, 460.

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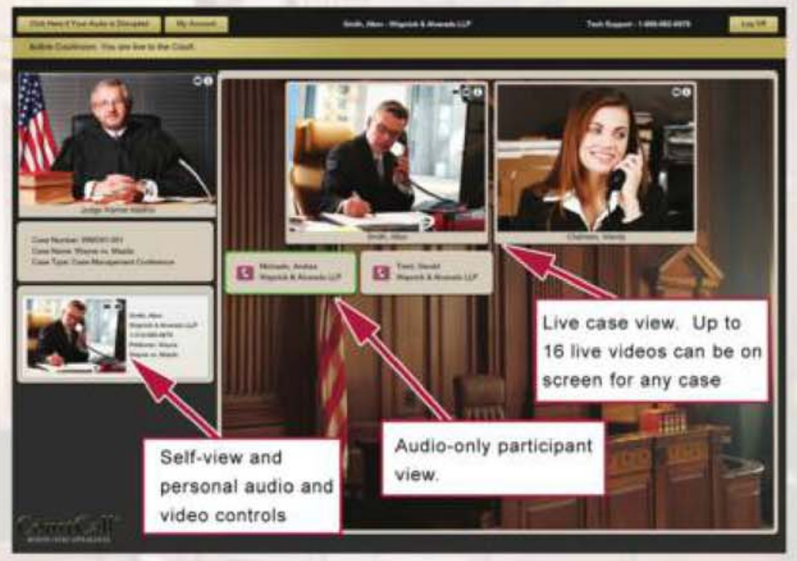

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gations make a contract executory? After all, the party holding the option has no duty to exercise it.[19] Arguably, as long as the holder has no duty to exercise the option, no breach by the option-holder for failure to exercise is possible, and the unexercised option contract cannot be executory under the Countryman definition.[20]

However, while inchoate mutual obligations do not necessarily fit Countryman's definition of an "executory contract," it is not clear that a policy argument cannot be made to lump in contracts with inchoate mutual obligations with the more common classes of executory contract. As stated in *In re CB Holding Corp.*,[21] "[n]umerous other courts have determined that contingent option agreements are executory when material obligations will arise on each side if the option is exercised."[22]

Ichiban tracks this conclusion but illustrates the analytical pitfalls of using inchoate obligations as a basis for concluding that a contract is executory. In *Ichiban*, the holder of the ROFR contended that it had the right, following the trustee's auction of the debtor's membership interest, to match the highest bid.[23] In other words, the holder had not yet exercised the option, but indicated that it might at the auction's close.

The court focused on a number of provisions that it contended would place a "material obligation" on the holder of the ROFR or the remaining LLC members if the ROFR was exercised. First, "[t]he failure of the company to give the required notice in conformity to [the operating agreement] is a material breach."[24] Second, if the attempted transfer was made other than "pursuant to a bona fide offer" and the members were unable to agree on a price, the members had to select two appraisers to determine the value of the membership interest.[25] Finally, the members had to execute such paperwork as necessary "before, upon, or after the Transfer ... to preserve the limited liability of the members."[26]

Two of these so-called obligations either are not duties or are insufficiently "material" so that a failure to perform them would not constitute a material breach. The holder has no obligation to exercise its ROFR, and its failure to properly send the notice of intent to exercise the ROFR at most would void the ROFR. The ROFR is not a duty; it is a right. The holder's failure to perfect its ability to exercise its right could never give rise to a material breach. As previously noted, on that basis alone, an unexercised or "naked" ROFR should not be rejectable under Countryman.

The obligation of other LLC members to complete appropriate documents in connection with a membership transfer is arguably not material to the transaction but relates to the ongoing obligations of the LLC members to each other to preserve the integrity of the corporate enterprise. Identifying this contingent obligation cuts against the argument that the ROFR is a severable obligation, but *Ichiban* then ignores any analysis of severability in reaching its conclusions.

The last obligation identified in *Ichiban* is more closely related to a sale transaction, as it is triggered if the ROFR is exercised, transforming the ROFR into a bilateral contract for the sale of the debtor's LLC interests to the LLC. At that point, the LLC would have an obligation to pay the purchase price and the debtor would have the obligation to deliver the asset. Consequently, the failure of the second obligation — to name an appraiser — could be seen as a material breach because it would thwart the sale by preventing a price to be determined. Nevertheless, even assuming that inchoate or contingent obligations might create an executory contract, this lone contingent obligation seems a thin reed on which to hang the conclusion that the as-yet-unexercised ROFR at issue in *Ichiban* could be rejected.

Conclusion

Whether a contract is executory under § 365(a) is always a fact-intensive question. Proper application of the first two doctrines — widely accepted by the circuit courts — would likely have protected the ROFR at stake in *Ichiban* and other LLCs where the ROFR is more than a secondary contract but rather a fundamental element of the contract among the parties. By utilizing these doctrines correctly, practitioners representing LLCs and partnerships will be much more successful in protecting their clients' interests, and § 365(a) jurisprudence should gradually become more coherent and consistent with respect to entities such as LLCs and partnerships, which are typically formed through their operating agreements. However, the court may always analogize to the corporate context where the ROFR is not as closely tied to the parties' relationship and use the inchoate obligations analysis to find the ROFR both severable and rejectable as a separate executory contract. For the draftperson, the lesson is that the more closely the ROFR is tied to the operating agreement as a whole, the less ammunition that will be provided for its rejection in bankruptcy. abi

19 *Nat'l Fin.*, 226 B.R. at 589.
20 *Id.*
21 448 B.R. 684 (Bankr. D. Del. 2009).
22 *Id.* at 689 (quoting *AbitibiBowater*, 418 B.R. at 830-31). The court's conclusion that most courts find that ROFRs are executory relies primarily on cases reviewing the issue in the corporate context.
23 *Ichiban*, 2014 WL 2937088, *1.
24 *Id.* at *2.
25 *Id.*
26 *Id.*