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On the Edge

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BAP: A Settlement Agreement Is Not an Executory Contract

One of the most potent weapons a debtor in possession has under the Bankruptcy Code is its power under § 365[1] to assume, reject and/or assign executory contracts and unexpired leases to which it is a party, even when contractual language states otherwise. As one court found, "By permitting debtors to shed disadvantageous contracts but keep beneficial ones, § 365 advances one of the core purposes of the Bankruptcy Code: 'to give worthy debtors a fresh start.'"[2]

A threshold question that can often arise is whether a particular contract is executory. In the absence of a statutory definition, most jurisdictions have adopted the restrictive Countryman definition, under which a contract is executory only if the "obligation[s] 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 performance of the other."[3]

A recent decision from the Ninth Circuit Bankruptcy Appellate Panel (BAP) is the latest applying the Countryman definition. In *In re Svenhard's Swedish Bakery*,[4] the court held that a pre-petition settlement agreement pursuant to which a creditor agreed to release the debtor in exchange for completion of a stream of payments was not an executory contract that could be assumed and assigned to a third party in bankruptcy. As a result, the debtor, which defaulted on the settlement agreement before the petition date, could not escape liability for the full original amount by paying the settlement amount to the creditor and assuming the settlement agreement.

This decision, which is being appealed to the Ninth Circuit,[5] may strengthen the position of a creditor that does not wish to be bound by a deferred settlement agreement where the other party defaults and subsequently files for bankruptcy protection. The creditor would be free to assert in the bankruptcy case an unsecured claim for the full amount owed to it before the settlement agreement was entered into or, more critically, potentially pursue a third party for the entire outstanding debt.

Background

Svenhard's Swedish Bakery sold Swedish pastries in Oakland, Calif. It participated in the Confectionery Union and Industrial Pension Fund, a multi-employer pension fund governed by the federal Employee Retirement Income Security Act. The pension fund provides benefits to workers in the baking and confectionery industries. Svenhard's was obligated by collective-bargaining agreements to contribute to the pension fund.

In 2015, Svenhard's closed its Oakland facility and ceased participation in the pension fund. In response, the pension fund asserted that under applicable federal pension law, Svenhard's had incurred a withdrawal liability in the amount of $50 million. Svenhard's never contested its liability, but instead advised that it could not afford to pay this uncontested amount.

After extensive negotiations, the parties reached a settlement agreement, under which Svenhard's would make 240 monthly payments of $12,500 each, for an aggregate amount of

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1 *See* 11 U.S.C. § 365.
2 *Eagle Ins. Co. v. BankVest Capital Corp. (In re BankVest Capital Corp.)*, 360 F.3d 291, 296 (1st Cir. 2004).
3 *In re Weinstein Co. Holdings LLC*, 997 F.3d 497, 504 (3d Cir. 2021) (emphasis added; internal citation omitted).
4 *Svenhard's Swedish Bakery v. United States Bakery (In re Svenhard's Swedish Bakery)*, 653 B.R. 471 (B.A.P. 9th Cir. 2023).
5 *See In re Svenhard's Swedish Bakery v. Confectionery Union and Industrial Pension Fund*, Case No. 23-60045 (9th Cir.).

$3 million, in full satisfaction of its $50 million liability to the pension fund. The agreement provided that when the $3 million settlement amount was paid in full, the pension fund would provide a written release to Svenhard's relieving it of further liability. If Svenhard's failed to make the required payments, the pension fund had the right to declare a default, and the full original balance of $50 million would then be due.

In the meantime, Svenhard's was sold to United States Bakery (USB) and immediately commenced a five-year leaseback of its operations from USB. This transaction permitted Svenhard's to continue to operate in its name. The pension fund contended that Svenhard's withheld this critical fact during the parties' negotiations that resulted in the settlement agreement. It further contended that USB was secretly guiding Svenhard's throughout the negotiations.

In November 2019, USB terminated the leaseback agreement and took control of Svenhard's operations and facilities, and Svenhard's ceased to exist as a going concern. Svenhard's had previously made only six payments under the settlement agreement and had thus paid off only a fraction of the $3 million settlement. In accordance with the terms of the settlement agreement, the pension fund declared a default and accelerated the entire outstanding balance of $50 million.

Days later, Svenhard's commenced a chapter 11 case and did not list the settlement agreement as an executory contract on its schedules. The pension fund filed a proof of claim for the entire balance of $50 million, in view of Svenhard's breach and the pension fund's acceleration of the entire debt amount. The pension fund also sued USB in federal district court to hold it jointly and severally liable for the $50 million owed to it under a theory of successor liability. Svenhard's separately commenced an adversary proceeding in bankruptcy court against USB asserting various causes of action, including successor liability, breach of fiduciary duty and fraud.

Several years into the bankruptcy case, Svenhard's, the official committee of unsecured creditors (the pension fund was a member but was recused from the mediation due to its conflict of interest) and USB reached an agreement via mediation. They agreed to undertake a series of steps to limit the pension fund's recovery to the $3 million provided in the settlement agreement rather than the original $50 million, and to relieve USB of any further liability to the pension fund.

The following steps were necessary to accomplish these two goals: (1) USB would provide the $3 million the estate needed to pay off the pension fund under the settlement agreement in exchange for the dismissal of the estate's adversary proceeding against USB; (2) the estate would use the payment from USB to cure its default under the settlement agreement; (3) the estate would then assume the settlement agreement; (4) the estate's liability to the pension fund would thereafter be extinguished in full; and (5) Svenhard's would assign its release under the settlement agreement to USB and allow it to interpose the settlement agreement as a complete defense against the pension fund's successor-liability litigation. The success of this strategy hinged on whether the settlement agreement constituted an executory contract within the meaning of § 365 that could be assumed and assigned.

Executory Contracts

Section 365(a) of the Bankruptcy Code provides that a trustee may, subject to court approval, assume or reject an executory contract or an unexpired lease to which a debtor is a party.[6] This authority to assume or reject an executory contract is also conferred upon a chapter 11 debtor in possession.[7] In a chapter 11 case, the deadline to make the decision is typically before the confirmation of a reorganization plan, which affords the debtor enough time to weigh the pros and cons of its choice.[8]

If the debtor rejects a contract, the counterparty's claim for damages will be treated as a pre-petition claim against the estate on a par with the claims of other general unsecured creditors.[9] In order to assume a contract, the debtor must first cure any existing contractual default and provide adequate assurance of future performance.[10]

Moreover, upon assumption, the debtor may assign an executory contract to a third party over the objection of the contractual counterparty, as long as such a third-party assignee can provide reasonable adequate assurance of its future ability to perform under the contract.[11] The Code expressly provides that a contractual provision restricting assignment does not trump a debtor's statutory right to undertake assignment.[12]

Therefore, the ability to assume, reject and/or assign an executory contract is an important arrow in a debtor's legal quiver once it has filed for bankruptcy, and may be conducive to creative or aggressive reorganization strategies. However, despite the potential key role that executory contracts can play in a bankruptcy case, Congress has never statutorily defined what an "executory contract" is.[13] Over time, two competing judicial approaches to the definition have emerged.

First, under the traditional Countryman test, named after Prof. Vern Countryman, a contract is an executory contract within the meaning of § 365 if, as of the petition date, the "obligation[s] 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 performance of the other."[14] In other words, "unless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under § 365."[15] Applicable state contract law determines whether a breach is material under this test.[16]

A minority of courts have rejected the Countryman test in favor of a results-oriented or "functional" approach, which examines whether the bankruptcy estate will benefit from assumption or rejection of the contract — not

6 11 U.S.C. § 365(a).
7 11 U.S.C. § 1107(a).
8 11 U.S.C. § 365(d)(2).
9 11 U.S.C. § 365(g). Damages arising from the rejection of a lease are subject to caps. *See* 11 U.S.C. § 502(b)(6).
10 11 U.S.C. § 365(b).
11 11 U.S.C. § 365(f).
12 *Id.*
13 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984) (noting absence of statutory definition).
14 *In re Weinstein Co.*, 997 F.3d at 504.
15 *Id.* (quoting *In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 239 (3d Cir. 1995)).

the mutuality of the unperformed material obligations.[17] This method is considered "more flexible and lenient" in the debtor's favor.[18] Under this approach, the fact that an assumption (or a rejection of a contract) would yield a financial benefit for the estate is usually decisive in determining whether it is executory.[19]

The Ninth Circuit BAP Decision

The Ninth Circuit follows the more stringent Countryman test.[20] It held that the settlement agreement was not an executory contract. In its view, this outcome "was grounded in long-standing precedent and application of the Countryman test."[21]

The BAP first explained that there was no mutuality of obligation on the petition date.[22] The only binding obligation on that date under the settlement agreement was Svenhard's obligation to continue making its monthly settlement payments to the pension fund.[23] The pension fund's sole obligation under the settlement agreement was to provide a release to Svenhard's if and when all requisite settlement payments had been made.[24]

However, that condition was not satisfied on the petition date, and the pension fund had no contractual obligation to Svenhard's at that time.[25] Citing controlling state contract law, the BAP concluded that the signing of a release by the pension fund was subject to a performance condition, which is inconsistent with a binding obligation.[26]

Second, the BAP also questioned whether the pension fund's failure to provide a release would have constituted a *material* breach of the settlement agreement.[27] According to the BAP, if Svenhard's had made the required payments in full, then its liability to the pension fund would have been extinguished by operation of the settlement agreement.[28] That fact would have operated as a complete defense in any subsequent action brought by the pension fund, even if it never provided a written release to Svenhard upon receiving the full payment of $3 million.[29]

Therefore, the execution of a formal "release" under the settlement agreement was a mere "ministerial" act.[30] Failure to execute such a ministerial act would not be a material breach of a contract.[31] This was an independent reason that doomed Svenhard's contention that the settlement agreement was an executory contract.

The BAP explained that "an executory contract is one where both parties have something at risk."[32] Because of the mutuality of risk, an estate can determine whether its "remaining performance obligations ... might outweigh the expected benefit of the remaining performance to be received." Because Svenhard's had no "remaining performance to be received" from the pension fund, the settlement agreement was not an executory contract.

For these reasons, the court determined that the settlement agreement was not an executory contract and could not be assumed and assigned pursuant to § 365 of the Bankruptcy Code. Svenhard's could neither limit the pension fund's proof of claim to $3 million, nor provide a defense to USB in the litigation brought against it by the pension fund.

Conclusion

In re Svenhard's Swedish Bakery is important not only for multiemployer funds and employers, but for any creditor contemplating entering into a settlement agreement that requires discounted or deferred payments over a period of time from a counterparty. It remains to be seen how attorneys will craft their settlement agreements to address the possibility of a bankruptcy.

Svenhard's contended that virtually all settlement agreements should be deemed executory. While the court rejected that argument, it did not rule out that a settlement agreement may be executory under some circumstances. The court expressly acknowledged that it is "conceivable" that some contracts with sequential performance may be executory, but not all settlements would satisfy the Countryman test.[33] Interestingly, the decision did not recite the terms of the settlement agreement other than the payment and release terms.

Similarly, the court did not analyze or reference cases in which settlement agreements are found to be executory.[34] Thus, the court left open the possibility that future cases might be distinguishable. abi

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16 *Id.*
17 *See In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 631 B.R. 559, 566 (D.P.R. 2021).
18 *In re WorldCom Inc.*, 343 B.R. 486, 493 (Bankr. S.D.N.Y. 2003).
19 *Id.* at 499 (concluding that contract was executory because "assumption at that point in time was clearly of benefit to the Debtors' estate, as it ultimately permitted the Debtors to recover $3,670,000, thus recouping an additional $2,070,000 above the amount of any claim that Dobie [Properties LLC] might have against the Debtors' estate.").
20 *See, e.g., Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)*, 139 F.3d 702, 705 (9th Cir. 1998).
21 653 B.R. at 479.
22 *Id.* at 477-78.
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.*
27 *Id.* at 478.
28 *Id.*
29 *Id.*
30 *Id.*
31 *Id.*
32 *Id.* at 479.
33 *Id.*
34 *See, e.g., In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 631 B.R. at 566 (settlement agreements were executory contracts under both Countryman and functional approaches); *In re Spoverlook LLC*, 551 B.R. 481, 485-86 (Bankr. D.N.M 2016) (homeowners' association's contingent obligation, if debtor fulfilled its obligations, to release all of its claims against debtor was "material, unperformed obligation," the existence of which made settlement agreement executory); *In re W.B. Care Ctr. LLC*, 419 B.R. 62, 70-71 (Bankr. S.D. Fla. 2009) (finding settlement agreement executory in both Countryman approach and functional approach).