

BINGHAM

Memorandum

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TO: Financial Accounting Standards Board
International Accounting Standards Board

FROM: Bingham McCutchen LLP

RE: **Legal Status of Industrial and Commercial Real Estate Leases
as Executory Contracts**

Summary:

In the United States, unexpired industrial and commercial real estate leases¹ are executory contracts as a matter of law.

Analysis:

We have been asked by our client, Majestic Realty Company, to address the question whether, in law, industrial and commercial real estate leases fall within the category of “executory contracts.” We understand this point of law to be important for purposes of analysis by the Financial Accounting Standards Board and the International Accounting Standards Board as you consider the appropriate accounting treatment of such leases.

Industrial and commercial real estate leases concern property used for business purposes. Included within the ambit of industrial real estate are (i) land and (ii) buildings thereon such as warehouses, distribution centers, and facilities for manufacturing, production, assembly, research, and storage. Commercial real estate likewise includes (i) land and (ii) buildings thereon such as office parks, office towers, shopping malls, and free-standing structures for purposes such as restaurants, gas stations, and convenience stores. While the lease instruments for such properties take a variety of forms, all multiyear industrial and commercial leases have in common that they consist of a written agreement through which the legal owner of the property *promises* in specified *future* periods to permit its use and in the *future* to maintain it and/or manage it, in return for specified periodic *future* payments of rent and the *future* performance of various obligations of the tenant (e.g., compliance with limitations on use of the property). In recognition of the fact that the payment of rent is a future obligation, leases of industrial and commercial real property almost universally provide for penalties in the case of late

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¹ If a “lease” has the characteristics of a secured loan or sale, it may be recharacterized as such by a court.

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payments, and for termination upon default of payment or breach of any other material condition.

For so long as a material portion of the lease term is unexpired, the laws of every U.S. jurisdiction have traditionally considered leases, including but not limited to industrial and commercial leases, to be executory contracts. An unexpired real estate lease is a prime example of a contract under which performance remains due from both parties, and pursuant to which both parties have ongoing commitments. In such an arrangement, both parties have substantial obligations to perform over time, and at all times prior to the expiration of the lease, their obligations remain only partially performed.

The legal consequences of industrial and commercial leases being executory in nature are most significant in the context of bankruptcy law, and it is in this context that most of the statutory and decisional law has been formed. Section 365 of the U.S. Bankruptcy Code describes these consequences explicitly. Entitled “Executory Contracts and Unexpired Leases,” this section of the Code gives the trustee in bankruptcy or the debtor in possession the legal right and power to assume or reject executory contracts, including specifically unexpired leases.

Because deciding that a particular contract is “executory” provides the debtor or trustee with various advantages, much law has developed concerning exactly how this determination is made.² In this context, it is striking that the question of whether unexpired real estate leases constitute executory contracts has generated little controversy. Given the explicit mention of unexpired leases in the Bankruptcy Code section dealing with executory contracts, however, this must come as no surprise. For over a third of a century since the reform of the Bankruptcy Code in 1978, when Section 365 replaced its predecessor Section 70(b), the question has been settled. Discussions in the case law and scholarly articles have not focused on whether real estate leases fall within the category of executory contracts, but rather on more complex questions regarding the treatment of other kinds of contracts in bankruptcy law. The classification of real estate leases as executory contracts is now essentially black letter law, so that, for example, the American College of Real Estate Lawyers has stated simply:

*Unexpired leases have traditionally been considered executory contracts.*³

Both before and after the 1978 enactment of section 365, courts and scholars have noted that the bankruptcy courts have relied on accretive case law to define the term “executory contract,” as the concision of the Code itself is inadequate to deal with the many types of contracts that can be devised. The U.S. Bankruptcy Court for the Southern District Court

² One scholar noted recently that a 2009 Westlaw search for law review articles with the term “executory” in the title yielded 211 articles. A search for that same term in the synopsis of all federal cases yielded an “astounding” 4,087 results. Carl N. Pickering, *Executory Contracts Revisited*, 83 Am. Bankr. L. J. 63 (2009).

³ American College of Real Estate Lawyers, 2001, *The Development of Section 365*, John R. Knapp Jr., John A. Gose, available at <http://www.acrel.org/Documents/Seminars/a002191.pdf>.

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of New York, for example, stated in *In Re O.P.M. Leasing Services Inc. v. Revlon, Inc.*, 23 B.R. 104 (1982), that:

[A]lthough there is no statutory definition of an executory contract, the legislative history of Section 365 of the Code makes it clear that it “generally includes contracts on which performance remains due to some extent on both sides.”

citing H.R. Rep.No. 595, 95th Cong., 1st Sess. 347 (1977) (House Report); S.Rep.No.989, 95th Cong., 2nd Sess. 58 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5844, 6303 (Senate Report).

As examples, the court provided a lengthy citation to precedent, including *Jenson v. Continental Financial Corp.*, 591 F.2d 477, 481 (8th Cir. 1979) (a contract is executory where obligations of the debtor and the other contracting party remain partially and materially unperformed); *In re Knutson*, 563 F.2d 916, 917 (8th Cir. 1977) (a contract is executory where both sides have substantial obligations to perform); and *In re American Magnesium Co.*, 488 F.2d 147, 152 (5th Cir. 1974) (a contract is executory where both parties have ongoing commitments).⁴

The consistency of this definition in the case law coincides with the specific inclusion of unexpired leases within section 365, and explains why courts have traditionally considered real estate leases to be executory contracts. In addition, there are other reasons that courts have unfailingly reached this conclusion. Beyond the fact that unexpired real estate leases are executory because both parties have ongoing commitments throughout the life of the lease, courts in the past have also relied on the so-called “material breach test” (developed before the 1978 reform of the Bankruptcy Code) to establish this result. The material breach test defined an executory contract as:

*a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.*⁵

Examples of court decisions following the “material breach” test include *Gloria Mfg. Corp. v. International Ladies’ Garment Workers’ Union*, 734 F. 2d. 1020, (4th Cir. 1984) (citing *In Re Cochise College Park Inc.*, 703 F 2d. 1339 (9th Cir. 1983); *In re Brada Miller Freight System, Inc.*, 702 F 2d. 890 (11th Cir. 1983); *In re THC Financial Corp*, 686 F 2d. (9th Cir. 1982); and *In re Select-A-Seat Corp.*, 625 F 2d. 290 (9th Cir. 1980).

⁴ See also *In re Monsour Medical Center*, 8 B.R. 606, 612-613 (Bkrcty.W.D.Pa. 1981); *In re Rovine Corp.*, 5 B.R. 402, 404 (Bkrcty.W.D.Tenn.1980).

⁵ Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 Minn. L. Rev. 439, 460 (1973). This is commonly known as the “Countryman definition.”

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As applied to an unexpired real estate lease, the test reaches the same conclusion as section 365 of the Bankruptcy Code because the obligations of both landlord and tenant, so long as a material portion of the lease term remains unexpired, would be underperformed, and a failure to perform them in the future (e.g., a failure to perform the tenant's obligation to make rent payments, or a failure to perform the landlord's obligations of providing property maintenance or the quiet enjoyment of the property) would be a material breach excusing the other party's future performance. Unexpired industrial and commercial leases thus routinely meet the "material breach" test for identifying whether a contract is executory in nature.

Finally, it is worth noting that Section 70(b) of the predecessor to the current Bankruptcy Act also made explicit reference to unexpired real estate leases. For example, Section 70(b) included the following:

The trustee shall assume or reject an executory contract, including an unexpired lease of real property, within sixty days...

The express inclusion of real estate leases within the statutory category of an "executory contract" has thus been a feature of U.S. bankruptcy law for many decades. With respect to the current Bankruptcy Code in effect since 1978, the rule is stated succinctly in *Collier on Bankruptcy*, the classic treatise on bankruptcy law that has been published continuously since the passage of the Bankruptcy Act of 1898:

*unexpired leases have been expressly included within Section 365 of the Code to preclude any uncertainty as to whether an unexpired lease is an executory contract which is subject to rejection or assumption by a trustee within the exercise of his business judgment.*⁶

Conclusion

Unexpired commercial and industrial real estate leases fall squarely within the definition of an executory contract that has consistently appeared in the U.S. Bankruptcy Code for nearly a century and that has consistently been applied by the courts and legal scholars over many decades. Leading authorities on the matter, including the American College of Real Estate Lawyers and the pre-eminent treatise on bankruptcy law, view unexpired leases as executory contracts. This conclusion is firmly supported by case law, the legislative history of relevant statutes, and leading scholars.

⁶ 2 *Collier on Bankruptcy* ¶ 365.02 at 365-12, 365-13 (15th ed. 1982); P. Murphy, *Creditors Rights in Bankruptcy* §9-01 at 9-2 n. 1 (1981).