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# Alert

## Third Circuit Holds Film Production Contract Was Not Executory in Bankruptcy Case

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"[B]ankruptcy inevitably creates harsh results for some players," explained the U.S. Court of Appeals for the Third Circuit on May 21, 2021, when it denied a film producer's claim for contractual cure payments. *In re Weinstein Company Holdings, LLC*, 2021 WL 2023058, *9 (3d Cir. May 21, 2021). Affirming the lower courts, it held that a "work-made-for hire" production agreement ("Agreement") with the debtor ("TWC") was "a non-executory contract that is in essence … a liability for [TWC] that can be sold" to an asset purchaser "under … Code § 363 without the need to cure existing defaults." *Id*. In practical terms, the decision means that the buyer of this valuable contract only had to "satisfy post-closing obligations but need not worry about [the debtor's] pre-closing breaches or defaults, which typically remain unsecured claims against the debtor's estate." *Id*. at *1.

"[W]hether a contract is classified as executory or non-executory," said the court, "has significant implications for its treatment in a bankruptcy sale." *Id.* "[A]n executory contract [ordinarily] can be 'assumed' and then 'assigned' to a buyer under § 365 of the Bankruptcy Code provided all existing defaults are cured." *Id*. "At stake" in TWC was whether the buyer of the debtor's contract ("B") had to "cure existing defaults and pay around $400,000 owed to" the non-debtor contracting party ("C") "before the sale's closing," but only if the contract was executory. *Id*. TWC owed the $400,000 to C under the Agreement, but C had "no material obligations left to perform," having produced and released the relevant film years prior to bankruptcy. *Id*. at *9.

**Relevance**

Code § 365(a) governs the treatment of executory contracts, but "does not define that term." The bankruptcy trustee or a Chapter 11 debtor in possession may, subject to court approval, assume or reject any executory contract. To sell or "assign" an executory contract, the debtor's estate or buyer must "assume" it and cure prior defaults, but not if the contract is "non-executory."

Commentators and courts have struggled with a workable definition for "executory." The Third Circuit had previously held that "unless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under § 365." *In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 239 (3d Cir. 1995). Courts determine whether "material unperformed" obligations exist as of the date of bankruptcy, but applicable state law determines the existence of any "material unperformed obligation." *Id*. at *4. Thus, said the court, the test is "whether, under the relevant state law governing the contract, each side has at least one material unperformed obligation as of the bankruptcy petition date." *Id*. "Only where a contract has at least one material unperformed obligation on each side — that is, where there can be uncertainty if the contract is a net asset or liability for the debtor — do we invite the debtor's business judgment on whether the contract should be assumed or

rejected." *Id*., citing *Mission Prod. Holdings, Inc., v. Tempnology, LLC*, 139 S. Ct. 1652, 1658 (2019); *In re Penn Traffic Co.*, 524 F.3d 373, 382 (2d Cir. 2008).

**Facts**

C, a production company entered into an agreement with TWC that was structured as a "work-made-for-hire" contract, meaning C owned none of the intellectual property in the critically acclaimed film ("Film") here. 2021 WL 2023 058, at *1. As a producer, C was essentially a project manager for the Film, "overseeing various aspects of production such as developing a script, and ensuring [the] film is delivered on time and within budget, and marketing the finished product." *Id*., n.1. In exchange, TWC agreed to pay C a fixed initial compensation plus "contingent future compensation equal to" a percentage of the Film's net profits. TWC purportedly owned "all the rights pertaining to the Film [including, the Agreement with C]." *Id*. at *1.

TWC filed its chapter 11 petition in March, 2018. With bankruptcy court approval, it sold its assets to B who assumed certain executory contracts and cured defaults. But B declined to cure any defaults under C's production agreement on the ground that it was not executory. *Id*. at *2. It would thus avoid $400,000 in "previously unpaid contingent compensation." By purchasing C's production agreement "as a non-executory contract," B "would be responsible only for obligations on a go-forward basis after the sale closed." *Id*.

"The stakes became even higher" when other parties with similar work-made-for-hire contracts joined C's dispute with B. They also argued, that their contracts were executory, implying that B had to pay them millions of dollars in additional contingent compensation. *Id*. at *3.

The district court had affirmed the bankruptcy court's holding that the Agreement was not executory, could be sold to B, and that B was not liable for any cure amounts. *Id*. The parties later stipulated to joint briefing of all the appeals.

**The Third Circuit**

The parties agreed on appeal that the Agreement was part of the asset sale. "If it is executory, then it [had to be] assumed and then assigned to" B, and, under the court-approved sale, B had to cure any pre-bankruptcy defaults. *Id*., n.5. If it was not executory, then B "purchased the rights ... under § 363," and only had to pay post-closing compensation. *Id*.

*Applicable New York Law*. The court first had to determine whether the agreement "contained at least one obligation for both [TWC] and [C] that would constitute a material breach under New York law if not performed." *Id*. at *5, quoting *In re Exide Techs.*, 607 F.3d 957, 962 (3d Cir. 2010). Under New York law, "[a] material breach is a failure to do something that is so fundamental to a contract that the failure to perform that obligation defeats the essential purpose of the contract." *Id*., quoting *Feldmann v. Scepter Grp. Pte. Ltd.*, 185 A.D. 3d 449, 450 (N.Y. App. Div. 2020).

TWC "had a least one material obligation left to perform under" its agreement with C: "to pay contingent compensation … ." 2021 WL 2023 058 at *5. But C's remaining obligations were not executory after the Film was made because C had completed its contractual duties. The Agreement essentially required C to "produce the [Film] in exchange for money," which meant that C "contributed

almost all [its] value when [it] produced the movie." *Id*. at *6. On the date of bankruptcy, the Film had already been "released for six years and [C] had not done any further work on it." *Id*.

The remaining obligations of C were "all ancillary after-thoughts" in the Agreement. *Id*. (e.g., agreeing not to seek injunctive relief; to indemnify against third-party claims; and granting TWC a right of first refusal if C assigned its right to receive contingent compensation). According to the court, "none of [C's] remaining obligations go to the 'root of the contract' or 'defeat the purpose of the entire transaction' if breached." *Id*., quoting *Exide*, 607 F.3d at 962-963.

*Substantial Performance Rule Not Violated*. The Third Circuit rejected C's argument that the parties had agreed that all of C's obligations were material. *Id*. at *6. Essentially, C argued that "even [its] breach of a technical provision would excuse [TWC's] obligation to pay contingent compensation." *Id*. But, held the court, "the parties did not clearly … avoid the substantial performance rule for evaluating executory contracts" *Id*. at *7. C relied on a "nine-word phrase buried in a long covenant provision." *Id*. Covenants in a contract merely "address the party's obligations (i.e., what they must and must not do) and typically are not a natural place to look when determining which of those obligations the parties consider to be material." *Id*. (emphasis in original). In other words, "the requirement that [C] not be in breach or default may be better viewed as a condition precedent to TWC's payment obligation … ." *Id.*

*Bankruptcy Code Protections*. The Court of Appeals also rejected C's implied argument that its agreement "would be an executory contract forever, no matter how much [it] has already performed." *Id*. at *8. This position "would contravene the protections" given debtors by the Code, said the court. *Id*. The Code "facilities the debtor's rehabilitation by treating non-executory contracts where only the debtor has material obligations to perform as liabilities of the estate, so the debtor does not accidentally assume them without good reason." *Id*. Thus, "substantial performance" is an essential element in analyzing whether a contract is executory. *Id*., citing *In re Interstate Bakeries Corp.*, 751 F.3d 955, 963-964 (8th Cir. 2014) (en banc) (8-3) (contract not executory because debtor substantially performed its obligations under agreement; remaining obligations of debtor relatively minor and do not relate to central purpose of asset sale agreement). Because C's agreement did not "avoid … New York's substantial performance rule," C's remaining obligations were "immaterial and ancillary to the purpose of the contract … ." 2021 WL 2023058, at *8.

**Comments**

1. TWC is consistent with Third Circuit precedent. *See In re Exide Technologies*, 607 F.3d 957 (3d Cir 2010) (trademark license agreement not an executory contract when it was part of a set of related agreements delivered by debtor when it sold one of its businesses a decade before seeking bankruptcy relief; under applicable state law, neither party had any remaining unperformed material obligations).
2. TWC is also consistent with other appellate decisions. *See* e.g, *In re Interstate Bakeries Corp.*, 51 F3d. 955, 964 (8th Cir. 2014) (en banc) (8-3) (debtor's license agreement not "executory," barring debtor from rejecting it under Code § 365(a); in reversing lower courts, court explained that debtor had "substantially performed its obligations under [relevant agreements], and its failure to perform any of its remaining obligations would not be a material breach of [those agreements].").
3. The definition of an executory contract relied on in TWC referred to the so-called "Countryman test," based on a Harvard law professor's 1973 law review article. V. Countryman, "Executory

Contracts and Bankruptcy: Part I," 57 Minn. L Rev. 439, 460 (1973). *See also* V. Countryman, "Executory Contracts and Bankruptcy: Part II," 58 Minn. L. Rev. 479 (1974). According to Countryman, only a contract with substantial performance due from both parties raises the issues relevant to assumption or rejection. Thus, a debtor's guarantee (i.e., a mere obligation to pay money) to a creditor is simply a claim under Code § 101(5). *See In re Grayson-Robinson Stores, Inc.*, 321 F.2d 500 (2d Cir. 1963) (Act case). *See also*, e.g., *Emps.' Ret. Sys. of the State of Haw v. Osborne*, 686 F.2d 799 (9th Cir. 1982) (indemnity agreement merely a claim) (Act case); *In re Foothills Tex., Inc.*, 2012 Bankr. LEXIS 3322, at *31 (Bankr. D. Del. July 20, 2012) (contract not executory when counterparty only had to collect payments); *In re Calpine Corp.*, 2008 Bankr. LEXIS 2152, at *15 [Bankr. S.D.N.Y. Aug. 4, 2008) (loan agreement not executory after loan made; no remaining performance required).

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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