



# LENDING AND RESTRUCTURING ALERT JUNE 2011

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## **Right of First Refusal Held To Be Unenforceable in Bankruptcy**

A Delaware bankruptcy judge recently held that a landlord's right of first refusal to purchase a debtor/tenant's liquor license (the "Option") was unenforceable since the debtor rejected the lease containing the Option.<sup>1</sup> Disagreeing with a ruling of the First Circuit Court of Appeals<sup>2</sup>, the Delaware court held that the Option provision was a non-severable part of an executory contract that was not subject to specific performance.

### The Facts:

The lease provided that, upon its expiration or termination, Tenant had to offer to sell the liquor license to Landlord for \$100,000, and Landlord would have thirty days in which to accept the offer. Tenant filed for bankruptcy and the bankruptcy court subsequently granted Tenant's motion to reject the lease. As a debtor, Tenant then sought to sell the liquor license, and Landlord agreed to purchase it for \$151,000. But a higher bid was received when Tenant asked the bankruptcy court to approve the sale to Landlord. Landlord argued that it held a right of first refusal and no auction should be held. While preserving Landlord's argument that it held a right of first refusal, the bankruptcy court nevertheless ordered that the liquor license be sold at auction. Landlord was the auction's successful bidder at \$407,500, but hardly perceived this as a victory. Not surprisingly, Landlord pressed forward with its argument that it was entitled to purchase the liquor license for only \$100,000.

### Reasons for the Delaware Bankruptcy Court's Ruling:

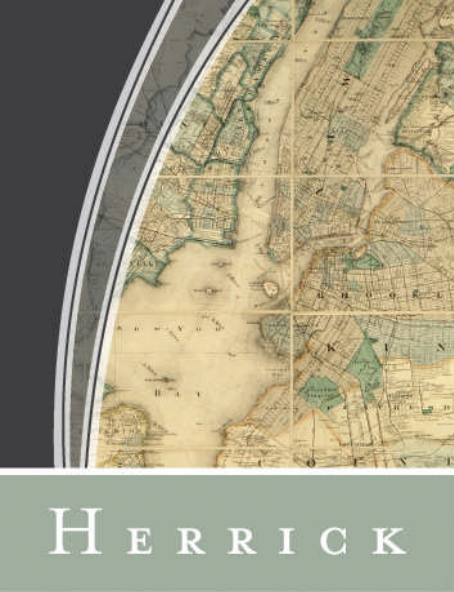
First, the bankruptcy court held that the lease had not expired by its terms or terminated. Rather, rejection of the lease constituted a breach of that agreement. Accordingly, under the express terms of the lease, Tenant was not required to offer the liquor license to Landlord under the contested provision. In so holding, the court declined to follow a prior holding of the First Circuit Court of Appeals that a rejection terminated the debtor's right to use a liquor license, and permitted the landlord to obtain specific performance requiring return of a similar license.

Next, the bankruptcy court rejected Landlord's argument that the Option was a separate agreement that was distinct and severable from the lease provisions relating to rental of premises.

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<sup>1</sup> In re CB Holding Corp., Case No. 10-13683 (MFW), 2011 WL1585558 (Bankr. D. Del. April 27, 2011).

<sup>2</sup> In re The Ground Round, Inc., 482 F.3d 15, 16 (1<sup>st</sup> Cir. 2007)(the "Ground Round").



The Delaware court held that the lease was one integrated agreement, and that the provision requiring Tenant to offer to sell the liquor license to Landlord was just one part of the whole agreement, which could not be assumed in part and rejected in part.

Landlord's argument that the Option was not an executory contract susceptible to rejection under the Bankruptcy Code was also rebuffed. The court held that the Option included material obligations to be performed by each party: Tenant had to offer to sell the license for \$100,000, and Landlord was required to respond to the offer within 30 days. Notably, the court observed that the majority of courts that have addressed this issue have held that a right of first refusal is an executory contract subject to rejection.

Finally, the court held that, once the lease was rejected, Landlord was no longer entitled to specific performance of the right of first refusal. Disagreeing with the First Circuit's holding in Ground Round once again, the Delaware court relied upon a line of cases holding that rejection of an executory contract precludes the non-debtor party's claim for specific performance.

Issues that Might Change the Result: Courts have held that a claim against a debtor for breach of an agreement that presented a unique and inherently irreplaceable commercial opportunity cannot be reduced to money damages, and is thus non-dischargeable in bankruptcy. In such situations, the non-debtor party has been held to be entitled to specific performance. But the bankruptcy court did not consider this possibility. Additionally, this decision does not mention that the Ninth Circuit Court of Appeals has held that, to determine whether an option agreement is executory, one should examine whether further performance is required from each party at the time the petition is filed.<sup>3</sup> It is well-accepted that the requirement to pay money alone does not make a contract executory. Accordingly, if the Option had been exercised before the Bankruptcy Filing, the result may have been different.

#### Conclusion

Whether a debtor may circumvent a right of first refusal by rejecting it is not addressed directly by the Bankruptcy Code. Existing case law does not provide a clear, consistent and definitive answer. This decision demonstrates one--but not the only--approach courts have taken when facing this unsettled question.

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<sup>3</sup> In re Robert L. Helms Constr. and Dev. Co., Inc., 139 F.3d 702 (9<sup>th</sup> Cir. 1998).