When Do Rights of First Refusal Constitute an Unenforceable Restriction on Assignment in Bankruptcy?

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In the chapter 11 cases of Adelphia Communications Corporation and its subsidiaries, Adelphia sought to assume and assign more than 2,000 franchise agreements in connection with the proposed transfer of its cable operations to affiliates of Comcast Corporation and Time Warner Cable. Numerous local franchising authorities objected, arguing, among other things, that they had a right of first refusal under the agreements, and in some cases also under a local ordinance, to purchase the franchise on substantially the same terms and conditions. A resolution of the issues was reached with all but 14 of the local franchising authorities. Although there was no evidence presented that the enforcement of the rights of first refusal of these 14 entities would jeopardize the transaction with Comcast and Time Warner, the U.S. Bankruptcy Court for the Southern District of New York, in a January 2007 opinion, held that the rights of first refusal constituted "forbidden restraints upon assignment" that are unenforceable under section 365(f) of the Bankruptcy Code.

Prior to the *Adelphia* decision, it appeared that courts were moving toward broad enforcement of rights of first refusal. In fact, since the first opinion on the issue in 1987, there had been only one other published opinion in which a court determined that a right of first refusal was unenforceable pursuant to section 365(f) of the Bankruptcy Code. Adelphia serves as a reminder that courts have the ability not to enforce such rights and demonstrates that there remains a considerable degree of uncertainty as to when such rights will be deemed an unenforceable restriction upon assignment.

Section 365(f) of the Bankruptcy Code

Rights of first refusal are granted in a wide variety of contexts and incorporated into a wide variety of agreements, including, for example, leases, partnership and joint venture agreements, franchise agreements, shareholder agreements, and deeds. With the possible exception of a deed, these agreements have universally been held to constitute executory contracts that, subject to the requirements and restrictions of section 365 of the Bankruptcy Code, can be assumed, assumed and assigned, or rejected.

The issue of the enforceability of rights of first refusal most often arises when a debtor seeks to assume and assign an agreement that includes the right as part of a sale of assets. Specifically, debtors have argued, and courts have sometimes found, that section 365(f) of the Bankruptcy Code renders the right of first refusal unenforceable.

Section 365(f)(1) of the Bankruptcy Code provides that, subject to certain exceptions, "notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection." At least one court—the bankruptcy court in *In re Mr. Grocer*—has interpreted this provision as rendering any provision restricting or conditioning assignment unenforceable. The plain language of the statute, however, does not state that any provision restricting or conditioning assignment is unenforceable. Rather, the text states only that the trustee may assign a contract or lease notwithstanding a provision that restricts or conditions the assignment. In other words, a provision restricting or conditioning assignment cannot operate to prevent (or perhaps unduly

burden) the trustee or debtor in possession from assigning the contract. Thus, as most courts have recognized, the question is whether the provision imposes so heavy a burden on the ability to assign the contract that it should be rendered unenforceable—a determination left to the discretion of the court under the particular circumstances presented.

Circumstances in Which Courts Are Likely to Find a Right of First Refusal Unenforceable

The specific enforcement of a right of first refusal is always at least somewhat of a burden on a debtor's ability to sell the assets subject to the right. Although the holder of the right will be required to pay the same price for the assets as the other buyer, at a minimum the right will result in a delay in the sale process because the holder of the right is typically given some period of time in which to exercise the right after another party has agreed to purchase the assets. Furthermore, as discussed below, a debtor will always be able to argue that specific enforcement of a right of first refusal may hamper the debtor's ability to realize the highest value for the assets subject to the right, given at least the possibility that the right may discourage potential purchasers from submitting a bid. In some circumstances, the right will impose a more difficult burden on the debtor than a short delay or a potential discouraging effect on potential bidders, particularly when a debtor is selling a group of assets, only a portion of which is subject to the right of first refusal. It is in these circumstances that a debtor is most likely to succeed in having the court determine that the right of first refusal is unenforceable. Courts, however, have seemingly varied in their assessments of the degree to which the right of first refusal must burden the debtor's reorganization efforts or proposed sale before it should be rendered unenforceable.

Is a Potential Chilling Effect on Bidding Alone Sufficient?

The first case to address the application of section 365(f) to a right of first refusal was *In re Mr. Grocer* in 1987. As noted above, the *Grocer* court interpreted section 365(f) as per se rendering a right of first refusal unenforceable. In this regard, the court concluded:

> It is hard to imagine any restriction or condition upon assignment of a lease more clearly within the legislative language than a lease provision which not only directly refers to assignment of the lease, but also further provides that any assignment is conditioned upon the landlord first having a right of first refusal to take the leasehold interest away from the prospective assignee.

The court, however, also went on to consider certain of the contentions of the parties, including the debtor's allegations that the right of first refusal should not be enforceable in a bankruptcy context because it would have a "chilling" effect on obtaining bids. On that point, the court observed:

> [T]he landlord's argument that "this estate will not be hurt" because in no event will the estate get less than the bid price is essentially specious. That contention begs the question as to whether the eventual effect of enforcing first refusal rights would not discourage prospective purchasers and assignees from making the effort *to initially put a bid before the bankruptcy court to be matched*.

The court concluded that bidding could be chilled, given that potential purchasers must be advised that "the assets in question could be taken away from them even *after* a court order approving the same has been entered—not by virtue of any higher bid but simply at the same price under a first refusal right." The *Grocer* court also described the underlying policy of the section 365(f) anti-assignment provision as "permitting the bankruptcy estate to realize the maximum intrinsic value of the leasehold asset."

The *Adelphia* court cited with approval these statements of the *Grocer* court about chilling bidding, noting that while these bid-chilling considerations may not be applicable in every right-of-first-refusal case—and the court therefore must apply a "facts and circumstances" test rather

than a per se test—"they will be applicable in many right-of-first-refusal cases," and these considerations, among others, "all compel a conclusion in the Adelphia cases that the rights of first refusal 'thwart the fundamental policy of maximizing estate assets for the benefit of all creditors,' and thus are unenforceable."

It is questionable, however, whether the potential of a right of first refusal to discourage potential bidders from submitting a bid is sufficient, in and of itself, to render the right unenforceable. As an initial matter, a debtor can always contend that bidders may be discouraged from submitting a bid by the fact that the holder of the right of first refusal will have the ability to acquire the asset(s) out from under them for the same price. Thus, if this alone were sufficient to render the right unenforceable, it would essentially make section 365(f) a per se rule against enforcement of such rights. And some courts have enforced such rights, concluding that there was not sufficient evidence that enforcing the right would significantly hamper the debtor's ability to realize the full value of the asset. Moreover, both the *Grocer* case and the *Adelphia* case involved other complicating factors: principally, the fact that the right applied to only one component of the assets being sold. Absent such other complicating factors, one can question how much of a chilling effect the existence of the right really has. In any bankruptcy auction, potential purchasers know that they may spend time and money on due diligence and bidding, only to be outbid at the auction. The fact that another party has the ability to match the winning bid after the conclusion of the auction may not have any significant discouraging effect on potential bidders. Moreover, to the extent that a debtor believes that potential purchasers will be reluctant to expend the resources to submit a bid in the face of such a right, the problem potentially could be

addressed by granting a more generous breakup fee or other bid protections to induce potential bidders.

On the other hand, potential bidders have the ability to control their fate in an auction by deciding at each step whether they want to pay more to acquire the asset. With a right of first refusal, a potential bidder could prevail at the auction, only to have the holder of the right purchase the asset for the same price. Thus, a potential bidder could lose out on acquiring the asset even though it was willing to pay more than the ultimate sale price—a risk not normally present in connection with a bankruptcy sale and one that could in fact result in the estate's receiving substantially less for the asset.

Whether the existence of the right is likely to have a negative effect on the willingness of potential bidders to participate and on the value the estate receives may depend upon whether there are likely to be numerous, interested potential purchasers. The more bidders expected, the more unlikely it is that the auction will conclude with a price that the holder of the right of first refusal is willing to match, giving potential bidders the expectation that the ultimate purchaser will in fact be determined by the auction and giving the debtor the expectation that the auction will in fact generate the highest possible value for the estate. In situations where the holder of the first refusal right is considered one of only three or four viable purchasers (or fewer), there may be a much greater risk that the other bidders will be reluctant to bid and, whether they bid or not, that the estate may not realize the highest possible value for the asset. In those circumstances, a debtor will have a better chance of convincing the court that the right of first refusal unduly burdens the debtor's ability to assign the applicable agreement. As discussed below, a debtor

could also argue that the court should effectively modify the right of first refusal by requiring the holder to participate in the auction and exercise its right to match at each step of the bidding.

Multi-Asset Sales

As both the *Grocer* and *Adelphia* courts recognized, a right of first refusal that applies only to a subset of the assets to be sold can create even greater burdens on the debtor. First, there is the question of purchase-price allocation. To comply with the right of first refusal, a portion of the purchase price will have to be allocated to the asset subject to the right so that the holder knows the price at which the right must be exercised. Because for tax and other reasons both the debtor and the potential purchaser have an interest in how the purchase price is allocated, any allocation has to be agreed upon between the debtor and the purchaser. Moreover, depending upon the transaction, a price allocation down to the level of the specific asset subject to the first refusal right (such as one particular lease) may be much more specific than what would be customary or otherwise necessary absent the existence of the right of first refusal. Even once agreed upon between the debtor and the potential purchaser, the allocation may be challenged by the holder of the right, requiring an evidentiary hearing on the matter. These same allocation issues, however, would have to be addressed if the sale occurred outside the bankruptcy context. While some courts have expressed the view that such allocation efforts are too burdensome, other courts have not appeared troubled by the necessity of an allocation.

The potential exercise of the rights of first refusal in *Adelphia*, however, presented problems beyond allocation of the purchase price. In particular, the cable systems that served certain of the local franchising authorities that had rights of first refusal also served subscribers in neighboring communities that had agreed to permit the assignment of their franchises to Time Warner and

Comcast. Thus, if the objecting holders of rights of first refusal were to exercise their rights, it would "require efforts to decouple the interlocking operations." Nonetheless, this problem of interlocking operations was not entirely avoided, because while the court determined that the rights of first refusal were unenforceable in the first instance under section 365(f)(1) of the Bankruptcy Code, the court also found that certain of the applicable local ordinances qualified as "applicable law" under section 365(c)(1) of the Bankruptcy Code and therefore the affected leases could not be assigned absent consent of the local franchising authorities.

A more significant problem is the possibility that potential purchasers may be unwilling to purchase the group of assets if the asset subject to the right of first refusal is excluded. In such a case, the existence of the first refusal right could jeopardize the debtor's ability to recognize a going-concern value for its assets, resulting instead in the sale of assets on a piecemeal basis. These circumstances present perhaps the best case for a determination that the right of first refusal is an unenforceable restriction on assignment. Notably, in *Adelphia* there was no evidence presented that Comcast and Time Warner would not go through with the transaction if the leases subject to the rights of first refusal were excluded (*i.e.*, if the first refusal rights were exercised).

Bargain Purchase Options and *Ipso Facto* Clauses

In some cases, a right of first refusal may give the holder the right to purchase the property at a specified "bargain" price. Such provisions may be held unenforceable, especially if it is apparent that the specified price is significantly less than fair market value. Depending upon how much of a "bargain" the price is, it could be argued that this type of provision operates effectively to preclude assignment to any party other than the holder of the right of first refusal. This type of

provision also will clearly prevent the estate from realizing the highest value—one of the principal considerations courts have focused on in determining whether a first refusal right unduly burdens the ability to assign the agreement. In addition, such provisions are sometimes triggered by an insolvency and are intended to operate as a forfeiture. Any right of first refusal that is triggered upon an insolvency or bankruptcy filing likely will be deemed an *ipso facto* clause that is unenforceable pursuant to sections 541(c) and 363(l) of the Bankruptcy Code. These provisions protect, respectively, the debtor's interest in and the trustee's right to sell property of the estate "notwithstanding any provision" that is "conditioned" on bankruptcy and that effects a modification or forfeiture of the debtor's interest in the property.

Purchase options at a specified price have been upheld in a couple of cases, each of which reasoned that the debtor in possession or trustee has no greater rights in property of the estate than the debtor had prior to bankruptcy. Both of these cases, however, involved stock in a closely held corporation where it was at least questionable whether the shares, which constituted a minority interest, could be sold for an amount significantly higher than the specified buyout price. Indeed, in one case the court pointed out that the accountant for the corporation had testified that the minority interest "would have little, if any, value," and the issue before the court in the other case was a valuation of the shares, which constituted collateral for a secured creditor, and there was no potential purchaser offering to pay more than the buyout price.

Stand-Alone Rights of First Refusal

Rights of first refusal are occasionally set forth in a separate, stand-alone agreement. In such circumstances, a debtor subject to such a right will undoubtedly seek to reject the agreement so that any sale of assets that would otherwise be subject to the right of first refusal can be

accomplished without the burden of complying with the right. At least a couple of courts, however, have concluded that a stand-alone right of first refusal or purchase option that was unexercised on the petition date is not an executory contract. In addition, most courts have held that rejection of an executory contract does not cancel the contract or repudiate the nondebtor party's rights. Rather, rejection is simply a debtor's determination not to assume a burdensome contract and is the equivalent of an election to breach—a breach that section 365(g) of the Bankruptcy Code deems to have occurred immediately prior to the petition date. Thus, the rejection of a right of first refusal does not eliminate the right, which continues to exist whether or not the right constitutes an executory contract. And the enforceability of a stand-alone right of first refusal should not depend upon whether it constitutes an executory contract. Indeed, it would make no sense to conclude that a debtor must comply with a stand-alone right of first refusal only if it is not an executory contract. Such a conclusion would put the holder of that right in a better position than a holder of the same type of right that is included in an agreement that the debtor is actually seeking to assume and assign.

The issue of the enforceability of a stand-alone right of first refusal is one of the remedies available to the holder for a breach. In particular, the issue is whether the holder could obtain specific performance because absent the debtor's agreement to comply with the right, the holder will be compelled to seek an order from the bankruptcy court requiring the debtor to incorporate the right into the sale procedures and to transfer title upon exercise of the right. Specific performance, however, is rarely permitted against a trustee or debtor in possession. In fact, many courts have concluded, as a general proposition, that specific performance is not available as a remedy for a contract rejected in bankruptcy. Other courts recognize that specific performance

could potentially be available, but they hold that if the equitable right to specific performance constitutes a “claim” dischargeable under section 1141(d) of the Bankruptcy Code, the creditor is limited to only a prepetition damages claim. Because the holder of a right of first refusal that may be entitled to specific performance under state law will in all likelihood also have the right under state law to alternatively request money damages, the equitable right to specific performance will likely constitute a dischargeable “claim,” and the holder will not be entitled to specific performance in a bankruptcy context. Rather, the holder will be limited to a prepetition damages claim.

Judicial Modification of Rights of First Refusal

Rights of first refusal typically have a specified time period in which the right must be exercised, designed to give the holder time to do its diligence and determine whether it wants to exercise the right. In some cases, courts have purported to enforce a right of first refusal but then modified the process by which the right is exercised to partially or wholly neutralize its adverse effect. For instance, in certain cases, including *In re Farmland Indus., Inc.*, courts have required the holder of the right to participate in the auction and exercise its right to match the purchase price at each step of the bidding. In another case, *In re Todd*, the court gave the winning bidder at a sale hearing another chance to raise its bid after the holder of the right of first refusal, a right the trustee was apparently unaware of at the sale hearing, sought to exercise the right and tender the same purchase price to the trustee.

Conclusion

Whether a right of first refusal included in an agreement to be assumed and assigned will be determined to be an unenforceable restriction upon assignment is dependent upon the specific

facts and circumstances presented. Arguably, the policy underlying section 365(f) is solely to ensure that provisions that restrict or condition assignment do not operate to outright prevent the debtor in possession or trustee from assigning the applicable contract or lease in bankruptcy. Courts, however, have interpreted the provision more expansively to fulfill the broader, fundamental bankruptcy policy of maximizing the value of estate assets for the benefit of all creditors. Accordingly, while courts have varied in their views as to what circumstances warrant the invocation of section 365(f) to render a right of first refusal unenforceable, a debtor in possession could potentially succeed in having the right rendered unenforceable in any case where it can show that complying with the right will impose significant burdens and jeopardize the estate's ability to realize the maximum value for the assets to be sold.

In re Adelphia Communications Corp., 359 B.R. 65 (Bankr. S.D.N.Y. 2007).

In re Mr. Grocer, 77 B.R. 349, 352 (Bankr. D.N.H. 1987).

In re Baquet, 61 B.R. 495 (Bankr. D. Mont. 1986).

In re Six, 190 B.R. 958 (Bankr. M.D. Fla. 1995).

Unsecured Creditors' Committee of Robert L. Helms Construction and Dev. Co. v. Southmark Corp. (In re Robert L. Helms Construction and Dev. Co.), 139 F.3d 702 (9th Cir. 1998).

In re Bergt, 241 B.R. 17 (Bankr. D. Alaska 1999).

Bonner v. Chenoweth Massie Partnership (In re Nat'l Fin. Realty Trust), 226 B.R. 586 (Bankr. W.D. Ky. 1997).

Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).

Maids Int'l, Inc. v. Ward (In re Ward), 194 B.R. 703 (Bankr. D. Mass. 1996).

In re Farmland Indus., Inc., 284 B.R. 111 (Bankr. W.D. Mo. 2002).

In re Todd, 118 B.R. 432 (Bankr. D.S.C. 1989).

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