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NOTES AND COMMENTS

REJECTION OF UNEXPIRED OIL AND GAS LEASES IN BANKRUPTCY PROCEEDINGS: *IN RE J.H. LAND & CATTLE CO.*

I. INTRODUCTION

In oil and gas transactions, various hazards can cut short an oil and gas lease.¹ In an unsteady economy, the bankruptcy² of a lessor is

1. An oil and gas lease is an instrument by which a lessor grants to a lessee "the exclusive right to enter the described premises to explore . . . drill . . . and remove oil and gas . . . in consideration for . . . rents and royalties Myers, *Interests in Oil and Gas Creation and Transfer*, 54 MICH. ST. B.J. 96, 96 (1975) (citations omitted). A typical lease has a primary term and a provision for the continuation of the lease beyond the primary term by the commencement of drilling operations and production. *Id.*

2. Upon the payment of a fee as required by 28 U.S.C. § 1930(a) (1982), a voluntary bankruptcy is commenced by the filing of a bankruptcy petition under the chapter selected. 11 U.S.C. § 301 (1982). See generally 2 COLLIER ON BANKRUPTCY ¶ 301.01 (15th ed. 1983) (discusses commencement of voluntary bankruptcy proceedings); D. EPSTEIN, DEBTOR-CREDITOR LAW IN A NUTSHELL 144-46 (1980) (discusses commencement of a voluntary case); P. MURPHY, CREDITOR'S RIGHTS IN BANKRUPTCY § 3.02 (1982) (discusses voluntary bankruptcy proceedings).

The chapter under which a debtor files the petition governs the relief received. A chapter 7 bankruptcy initiates liquidation and distribution of the debtor's assets. A chapter 11 bankruptcy serves to reorganize and rehabilitate an individual, partnership, or corporate debtor so his debts can be paid on a pro rata basis within a ten year period. A chapter 13 bankruptcy allows an individual, with a certain kind and amount of debt and a regular income, to reorganize and make payments to his creditors. In a chapter 11 reorganization proceeding the creditors are generally paid out of the debtor's future earnings, not out of the property the debtor owns at the time the petition was filed. See D. EPSTEIN, *supra*, at 134-36; Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 494 (1963) (theory behind reorganization is that creditor, by making sacrifice now, will receive more later). This Note will focus only upon reorganization proceedings under chapter 11 of the Bankruptcy Code, and on reorganization proceedings in general under the Bankruptcy Act of 1898 (Bankruptcy Act), Act of July 1, 1898, ch. 541, 30 Stat. 544 (amended 1938); Act of July 24, 1970, Pub. L. No. 354, 84 Stat. 468 (*repealed* by Bankruptcy Reform Act of 1978, Pub. L. No. 598, 92 Stat. 2549). See generally Shanker, *The Treatment of Executory Contracts and Leases in Bankruptcy Chapter X and XI Proceedings*, 18 PRAC. LAW. 15, 16 (1972) (describes reorganization chapters under Bankruptcy Act). A "person" may file a chapter 11 voluntary bankruptcy petition under 11 U.S.C. §§ 109(d), 301 (1982). "Person" is defined in *id.* § 101(30) to include an individual, partnership or corporation. See also 2 COLLIER ON BANKRUPTCY ¶ 109.04, at 109-18 (15th ed. 1983) (discusses who may be a debtor under chapter 11). Two events occur upon the filing of a petition under chapter 11: First, an estate is created for the benefit of the creditors. 11 U.S.C. § 541(a) (1982). See 4 COLLIER ON BANKRUPTCY ¶ 541.04, at 541-21 (15th ed. 1983). Second, an automatic stay operates to stop actions against the debtor by all entities with claims against the debtor. 11 U.S.C. §§ 301, 362(a) (1982).

one potential hazard confronting a nondebtor-lessee. Upon a lessor's bankruptcy, the trustee³ may reject⁴ or assume⁵ the debtor-lessor's executory contracts or unexpired leases under section 365(a)⁶ of the Bankruptcy Reform Act of 1978⁷ (Bankruptcy Code or Code). The ra-

3. A trustee is a "representative of the estate," and is authorized to "operate the debtor's business." 11 U.S.C. §§ 323, 1108 (1982). Certain basic standards must be met for one to serve as a trustee. *Id.* §§ 321, 322 (person must be competent, never have served as examiner in current case, and be bonded with court to qualify as trustee). The duties of a trustee are enumerated in *id.* § 1106 and consist essentially of the operation of the debtor's business and the formulation of a chapter 11 plan. See D. EPSTEIN, *supra* note 2, at 141. In a chapter 11 proceeding, the debtor exercises the trustee powers and is called a "debtor in possession." 11 U.S.C. §§ 1101(1), 1107 (1982). See Bienenstock, *The Bankruptcy Code and Landlords and Tenants*, 3 LEGAL NOTES & VIEWPOINTS Q. 9, 11-12 (1982) (discusses debtor in possession as trustee). On the filing of a chapter 11 petition, the debtor in possession is automatically authorized to operate the business pursuant to 11 U.S.C. §§ 1107(a), 1108 (1982). As to the power of a debtor in possession as trustee to reject under *id.* § 365(a), see *Bistran v. Easthampton Sand & Gravel Co.* (*In re Easthampton Sand & Gravel Co.*), 25 Bankr. 193, 198 (Bankr. E.D.N.Y. 1982) (section 365(a) as applied in conjunction with § 1107 affords debtor in possession the discretionary right to assume or reject); *In re California Steel Co.*, 24 Bankr. 185, 186 & n.4 (Bankr. N.D. Ill. 1982) (debtor in possession exercises § 365(a) right pursuant to § 1107 which grants debtor in possession the rights of a trustee). At any time after the commencement of the case, but before the confirmation of the plan, a trustee can be appointed upon request of a "party in interest." 11 U.S.C. § 1104(a) (1982). However, the "party in interest" must prove one of the grounds listed in *id.* § 1104(a)(1)(2) to have the debtor in possession replaced by a disinterested third party trustee. See generally 5 BANKR. SERV. (L. ED.) § 41:29-31, at 21-22 (1979); 5 COLLIER ON BANKRUPTCY ¶ 1104.01[7], at 1104-15 to 24 (15th ed. 1983) (analysis of § 1104(a)); D. EPSTEIN, *supra* note 2, at 283-84 (debtor in possession continues to operate business unless request is made for appointment of a trustee).

4. The trustee's power to reject or renounce an executory contract or unexpired lease is subject to approval by the court. 11 U.S.C. § 365(a) (1982). (Other limitations on the trustee's power to reject, beyond the scope of this paper, are set forth in § 365). See generally Bienenstock, *supra* note 3, at 33 (discusses debtor-lessor's power to reject); Creedon & Zinman, *Landlord's Bankruptcy: Laissez Les Lessees*, 26 BUS. LAW. 1391 (1971) (discusses rejection powers under the Bankruptcy Act); Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341, 377-80 (1980) (discusses trustees rejection powers under Bankruptcy Code); Shanker, *supra* note 2 (discusses rejection powers under the Bankruptcy Act); Silverstein, *supra* note 2 (discusses rejection by trustees under Bankruptcy Act).

5. The trustee's decision to retain or assume an executory contract or unexpired lease which the debtor made prior to bankruptcy is governed by § 365(a), and is "subject to court approval." 11 U.S.C. § 365(a) (1982). See generally P. MURPHY, *supra* note 2, § 9.0, at 9 (discusses effect of rejection); B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 7.10[3], at 7-39 (discusses requirements for assumption); Comment, *Chapter X Trustee Adoption of Executory Contracts: The Bankruptcy Act Speaks Through Its Silence*, 115 U. PA. L. REV. 937 (1967) (discusses adoption of executory contracts); Fogel, *supra* note 4, at 346-60 (same).

6. 11 U.S.C. § 365(a) (1982) allows the trustee to reject executory contracts and unexpired leases. Section 365(a) provides: "The trustee, subject to court approval, may assume or reject an executory contract or unexpired lease of the debtor." *Id.* See generally A. NAMDAR, CONTRACTS IN BANKRUPTCY (1977) (discusses history and theory underlying executory contracts in bankruptcy proceedings); 2 COLLIER ON BANKRUPTCY ¶ 365.03, at 365-13 to -16 (15th ed. 1983) (discusses trustee's power to assume or reject under § 365(a)); Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439 (1973) (thorough discussion of executory contracts) (hereinafter cited as Countryman I); Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479 (1974) (same) (hereinafter cited as Countryman II).

7. Bankruptcy Reform Act of 1978 (Bankruptcy Code or Code), Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in scattered sections of the U.S.C. (Supp. II 1978, Supp. III 1979, Supp.

tionale underlying this power is twofold: First, to insulate the trustee from executory contracts and unexpired leases which do not enhance the debtor's estate; and second, to enable the trustee to take advantage of executory contracts and unexpired leases which benefit the estate and effectuate the purposes of a reorganization proceeding under chapter eleven of the Bankruptcy Code, namely, the rehabilitation and continued operation of the debtor.⁸ In a reorganization under chapter eleven, the trustee's power to reject "is especially important . . . [because] it is used to relieve the debtor in possession of unperformed obligations that would otherwise hamper the . . . opportunity to make a fresh start."⁹

The United States Bankruptcy Court for the Western District of Oklahoma recently held in *In re J.H. Land & Cattle Co.*¹⁰ that an unexpired oil and gas lease is within the meaning of section 365(a) of the Bankruptcy Code.¹¹ The court concluded that the trustee may reject one unexpired oil and gas lease in favor of another "preferable oil and gas lease."¹² The court also held that a Kansas oil and gas lease is personal property,¹³ and therefore, the nondebtor-lessee's sole remedy for rejection of the unexpired lease is a claim for damages.¹⁴

IV 1980, Supp. V 1981 & 1982)). The Bankruptcy Code was enacted on November 6, 1978, but was not effective until October 1, 1979. Bankruptcy Reform Act of 1978, Pub. L. No. 95-498, § 402(a), 92 Stat. 2682. Cases filed before October 1, 1979 are decided under the Bankruptcy Act. Cases filed on or after October 1, 1979 are governed by the Bankruptcy Code. *See* Central Trust Co. v. Official Creditors' Comm. of Geiger Enter., Inc., 454 U.S. 354, 354 (1982).

8. *See* Vilas & Sommer, Inc. v. Mahony (*In re* Steelship Corp.), 576 F.2d 128 (8th Cir. 1978). The court in *Steelship* stated:

One purpose of . . . [the Bankruptcy Act's power of rejection] is to allow the trustee an opportunity to determine which of the bankrupt's contracts are beneficial to the estate and on that basis make an election whether to assume or . . . reject A parallel purpose is to clarify the effect of an assumption of liabilities by the trustee. It is well settled that the trustee cannot accept the benefits . . . without assuming . . . [the] burdens as well.

Id. at 132 (citations omitted).

9. B. WEINTRAUB & A. RESNICK, *supra* note 5, ¶ 7.10, at 7-37. In *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934), the Court stated:

One of the primary purposes of the bankruptcy act is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." [The debtor should be provided with] . . . a new opportunity in life and a clear field for the future effort, unhampered by the pressure and discouragement of preexisting debt.

Id. at 244 (citations omitted).

10. 8 Bankr. 237 (Bankr. W.D. Okla. 1981) (Kline, J.).

11. *Id.* at 239.

12. *Id.*

13. *See infra* notes 168-95 and accompanying text.

14. *See infra* note 25 and accompanying text.

This Note addresses the effect of *In re J.H. Land & Cattle Co.*¹⁵ on Oklahoma oil and gas lessees. It also explores the circumstances by which a trustee's decision to reject a nondebtor-lessee's oil and gas lease might be approved by a court, examines the nature of an oil and gas lease in Oklahoma, and suggests various options attorneys may consider in protecting the rights of a nondebtor oil and gas lessee.¹⁶

II. DECISION OF THE BANKRUPTCY COURT

Prior to the debtor's bankruptcy petition being filed in Oklahoma, two cases were commenced against J.H. Land & Cattle Company which resulted in the Kansas District Court appointing two receivers.¹⁷ Subsequently, orders were entered specifically authorizing the two receivers to negotiate oil and gas leases for the benefit of the receiver-ships.¹⁸ The lessee entered into several oil and gas leases with each state receiver.¹⁹ In exchange, the lessee gave each receiver a one-eighth royalty interest and promised to drill six wells on or before August 19, 1981.²⁰ In addition, the lessee paid approximately \$25,335.00 as lease bonus for all the leases.²¹ Approximately one month after the leases were transacted but before any actual drilling activity, the lessor, J.H. Land & Cattle Company, filed a bankruptcy petition under chapter eleven of the Code.²²

The trustee²³ as debtor-lessor made application and notice of mo-

15. 8 Bankr. 237 (Bankr. W.D. Okla. 1981).

16. *In re J.H. Land & Cattle Co.* is the only reported case that interprets the rejection of a lessee's unexpired oil and gas lease under 11 U.S.C. § 365 (1982). One other case, decided under the Bankruptcy Act, discusses the rejection of an oil and gas lease in the context of a reorganization proceeding. See *Hill v. Larcon Co.*, 4 OIL & GAS REP. 1701 (W.D. Ark. 1955) (trustee rejected the oil and gas lease by failure to take affirmative action within 60 days under § 110(b) of title 11 of the Bankruptcy Act).

17. Letterbrief for Lessee at 2, 8 Bankr. at 238. Mr. Rogers was appointed as a receiver for J.H. Land & Cattle Company on July 18, 1980. Subsequently, on August 29, 1980, Mr. Perkins was appointed as a receiver for the same.

18. *Id.* The Kansas District Court orders were final and nonappealable prior to the date J.H. Land & Cattle Company, through its president, filed a chapter 11 bankruptcy petition.

19. In September, 1980, the lessee, Mr. Masek, negotiated five oil and gas leases covering approximately 760 acres with the first receiver, Mr. Rogers. The lessee negotiated six oil and gas leases in October 1980 with Mr. Perkins, the second receiver. These leases covered approximately 1,250 acres. *Id.*

20. *Id.* at 3, 8 Bankr. at 238.

21. The lessee, Mr. Masek, also paid approximately \$5,278.13 as a lease broker fee. *Id.* A bonus is the "cash amount paid to a lessor as consideration for the execution of an oil and gas lease." See Meyers, *supra* note 1, at 97.

22. J.H. Land & Cattle Company, the debtor-lessor, filed bankruptcy on November 4, 1980. Letterbrief at 2, 8 Bankr. at 238. The lessee, prior to the debtor's bankruptcy, "expended time, effort and expense in preparing to develop the properties leases." *Id.* at 3, 8 Bankr. at 238.

23. The president of J.H. Land & Cattle Company filed the bankruptcy petition and subse-

tion in seeking²⁴ to reject the unexpired oil and gas leases entered into by the state receivers.²⁵ Rejection of the existing leases was sought because a new, more "preferable" oil and gas lease was available to the debtor's estate.²⁶ After notice and a full evidentiary hearing the court stated that the unexpired oil and gas leases were within the confines of section 365(a)²⁷ and applied the business judgment test,²⁸ concluding that the debtor-lessor as trustee could reject the existing leases in favor

quently became the debtor in possession as trustee. *See supra* note 3 for discussion of power of a debtor in possession, as trustee, to reject under 11 U.S.C. § 365 (1982).

24. Bankruptcy Judge Ralph Mabey explained the procedure for rejection of an executory contract or unexpired lease in *Summit Land Co. v. Allen (In re Summit Land Co.)*, 4 COLLIER BANKR. CAS. 2D (MB) 1431 (Bankr. D. Utah 1981):

Issues surrounding the rejection of executory contracts are usually treated as contested matters under Rule 914, Fed. R. Bankr. P., rather than as adversary proceedings under Rule 701, Fed. R. Bankr. P.: "Where a debtor in possession seeks leave to reject an executory contract . . . such proceeding should be brought on by application and notice of motion. This is so because the relief contemplated . . . is not one of those . . . touching Adversary Proceedings and, therefore, must under Rule 914 be considered to be a contested matter not otherwise governed by the rules with the result that relief is to be requested by motion and reasonable notice and opportunity for hearing is to be afforded the party against whom relief is sought The hearing is an evidentiary hearing.

Id. at 1435 n.4 (citing 14 COLLIER ON BANKRUPTCY ¶ 11-53.04[1], at 11-53-10 to -13 (14th ed. 1976)); *see also* 8 BANKR. SERV. (L. ED.) §§ 71:136, 71:138 (1979) (forms for petition to reject and order to reject an executory contract or unexpired lease). The rules for procedure relating to rejection can be found in COLLIER ON BANKRUPTCY, PRELIMINARY DRAFT OF PROPOSED BANKRUPTCY RULES AND OFFICIAL BANKRUPTCY FORMS 165 (1982) (Hereinafter cited as PROPOSED RULES) (these rules became effective August 1, 1983).

25. 8 Bankr. at 239. 11 U.S.C. § 365(g) (1982) provides that rejection of an unexpired lease or executory contract "constitutes a breach of such contract or lease." Section 365(g)(1) allows the breach caused by the rejection to be treated as if it had occurred immediately before the date of the filing of the petition. Therefore, the lessee's claim for damages is treated in the same manner as an unsecured prepetition claim. *Id.* § 502(g).

26. The debtor-lessor's original lease obligated the lessee to drill six wells, and additional wells as commercially feasible in exchange for the grant of a one-eighth royalty interest and a bonus of approximately \$25,335.00. 8 Bankr. at 238. By contrast, American Drilling Inc. offered the debtor-lessor considerably more for the leases. American Drilling offered the debtor-lessor three wells drilled "immediately", twenty-two wells as commercially feasible, \$4,000 a month bonus payable for up to six months, and a three-sixteenth royalty interest. *Id.*

27. 8 Bankr. at 239 (referring to 11 U.S.C. § 365(a) (1982)). The court did not specifically state that an expired oil and gas lease falls within the unexpired lease category of executory contracts under *id.* § 365(a). However, it can be inferred that the court classified the unexpired oil and gas lease as a lease under *id.* § 365(a) because the issue of whether the lease was a lease of real or personal property under *id.* § 365(h) was reached. It should be noted that all kinds of unexpired leases, real or personal, can be rejected by a trustee under the Bankruptcy Code. *See id.* § 365(a); Cook, *Judicial Standards for Rejection of Executory Contracts in Bankruptcy Code Reorganization Cases*, 4 ANN SURV. AM. L. 689 (1980). Professor Cook states: "The provisions of section 365 are not limited to real property leases, thereby permitting rejection of any kind of a lease, including leases of personal property and equipment." *Id.* at 690; *see, e.g.*, *Rhode Island Hosp. Trust Nat'l Bank v. Elliott Leases Cars, Inc. (In re Elliott Leases Cars, Inc.)*, 20 Bankr. 893, 896 (Bankr. D.R.I. 1982) (executory contract under Code includes automobile lease or personal property lease).

28. *See infra* notes 113-36 and accompanying text.

of the preferred leases.²⁹ Discussing the issue of "court approval" as required by section 365(a), the court stated:

For court approval the Code may well only require the court to find that . . . the debtor's (trustees) business judgment as exercised is not clearly erroneous However, if the pre-Code rule still prevails which seems to require the court as distinguished from . . . [the] trustee to apply the "business judgment" test . . . the court . . . is satisfied that [the original] leases should be rejected.³⁰

Furthermore, the court held that because oil and gas leases in Kansas are personal property,³¹ the nondebtor-lessee could not take advantage of section 365(h)(1) to stop the trustee from rejecting the unexpired leases.³²

III. REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

The law surrounding the rejection of executory contracts and unexpired leases is not uniform.³³ Adding to this nonuniformity is the

29. 8 Bankr. at 239.

30. *Id.*

31. *Id.* Although the case was decided by the Oklahoma Bankruptcy Court, the applicable law was Kansas law as the situs of the property at issue was in Kansas. Under Kansas law, rights created by oil and gas leases "constitute intangible personal property except when that classification is changed for a specific purpose by statute." *Ingram v. Ingram*, 214 Kan. 415, —, 521 P.2d 254, 257 (1974) (emphasis deleted). Similarly, oil and gas lease rights in Oklahoma are personal in nature. *See generally* 2 COLLIER ON BANKRUPTCY ¶ 365.02, at 365-12 & n.5 (15th ed. 1983) (law of situs of property governs); W. THORTON, 1 THE LAW OF OIL AND GAS § 51, at 153 (4th ed. 1925) (the rights of the parties must be determined by the law of the state where the leased premises lie, although it be executed in another state where lessor or lessee reside); Silverstein, *supra* note 2, at 488 (bankruptcy court applies property law of the state where leased premises are located).

32. 8 Bankr. at 239. Section 365(h)(1) provides:

If the trustee rejects an unexpired lease of *real property* of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable non-bankruptcy law.

11 U.S.C. § 365(h)(1) (1982) (emphasis added). *See generally* H.R. REP. NO. 595, 95th Cong., 2d Sess. 349, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6305-06; 2 COLLIER ON BANKRUPTCY ¶ 365.09, at 365-42 (15th ed. 1983) (discussing lessee remaining in possession pursuant to § 365(h)(1)). The predecessor to § 365(h)(1) was § 70(b) of the Bankruptcy Act. The purpose behind both of these sections is to ensure that the nondebtor-lessee is not deprived of his estate in real property in "the term for which he bargained." H.R. REP. NO. 595, *supra* at 349, 1978 U.S. CODE CONG. & AD. NEWS at 6305-06.

33. *See Shanker, supra* note 2, at 16-17 which states:

Going beyond . . . [the] statutory provisions, we are in a largely uncharted area of law In fact, there is only one section . . . [section 70(b) of the Bankruptcy Act, which is the predecessor of § 365 of the Bankruptcy Code] that really tells us anything on how

unique problem of a lessor in reorganization proceedings, as illustrated by *In re J.H. Land & Cattle Co.*³⁴ Historically lessors seldom file bankruptcy, accordingly, case law concerning their rejection of executory contracts and unexpired leases is scarce.³⁵ Compounding the inconsistent and sparse statutory and judicial guidance is the fact that "the power of rejection has never . . . been reexamined by the courts . . . [and courts] have merely elaborated on the received rules."³⁶

The rationale underlying the power of rejection is to aid in the augmentation of the estate³⁷ and is an attempt "to strike a balance between two . . . competing considerations: the right of a nondebtor to get the performance for which he bargained; and the right of the general creditors to get the benefit . . . of the debtor's bargain."³⁸ Generally, "[t]he power of rejection is an anomaly to contract or property law The power of rejection is a valuable weapon . . . in the armory of the trustee in protecting the rights of creditors Inevitably . . . [the] two attitudes are at war with one another."³⁹ The effects of rejection cannot be tempered by permitting rejection of only a part of the executory contract or unexpired lease. It is well established that rejection must be "in its entirety or not at all."⁴⁰

to deal with executory contracts in bankruptcy—and, unfortunately, that . . . does not tell us very much.

Furthermore, . . . few decisions [deal] with the problems . . . and many . . . [cases] were decided under the old equity receiverships rather than under the Bankruptcy Act [or the Bankruptcy Code]. . . . This then is . . . the legal wilderness upon which small fortunes may depend when an executory contract is up for consideration in . . . [reorganization] proceeding[s].

Id.; see also P. MURPHY, *supra* note 2, § 9.03, at 9-4 (case law uncertainty will probably continue in light of recent nonuniform decisions).

34. 8 Bankr. 237; see also *In re Mykleburst*, 26 Bankr. 582 (Bankr. W.D. Wisc. 1983) (debtor-lessor sought to reject unexpired lease); *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38 (2d Cir. 1979) (same); *Group of Institutional Investors v. Chicago R.R.*, 318 U.S. 523 (1942); *American Brake Shoe & Foundry Co. v. New York R.R.*, 278 F. 842 (S.D.N.Y. 1922) (same).

35. See H. MILLER & M. COOK, *A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT* 149 (1979) (debtor-lessor who seeks disaffirmance faces unique situation); Cook, *supra* note 27, at 689 (concise and thorough analysis of debtor's rejection under 11 U.S.C. § 365 (1982)).

36. Silverstein, *supra* note 2, at 472, 467-68 & n.5 (all the provisions of the Bankruptcy Act are declaratory of preexisting case law).

37. Krasnowiecki, *The Impact of the New Bankruptcy Reform Act on Real Estate Development and Financing*, 53 AM. BANKR. L.J. 363, 382 (1979) (purpose of power to reject is to augment the debtors estate).

38. Fogel, *supra* note 4, at 388.

39. Silverstein, *supra* note 2, at 468 (citation omitted); see also Shanker, *supra* note 2, at 15 (absent bankruptcy proceedings, law required people to perform their contracts or required them to pay damages).

40. *In re Silver*, 7 COLLIER BANKR. CAS. 2D (MB) 1107, 1110 (Bankr. E.D. Penn. 1983) (citation omitted); see, e.g., *In re California Steel Co.*, 24 Bankr. 185, 188 (Bankr. N.D. Ill. 1982) (an executory contract must be rejected in its entirety); *Cottman Transmissions, Inc. v. Holland*

Upon postpetition rejection by the trustee, a debtor-lessor is freed from prior valid but unperformed prepetition obligations. The rejection does not extinguish the estate's liability for the obligations, but only "alter[s] the type of obligation for which the estate is liable."⁴¹ The rejection of the executory contract or unexpired lease is statutorily construed as a prepetition breach giving rise to a claim for damages.⁴² Once rejected, the nondebtor-lessee's claim is relegated to an unsecured status⁴³ for which the debtor's estate will be responsible on a percentage distribution scheme.⁴⁴

The basis for rejection is the judicially created doctrine of abandonment of valueless assets.⁴⁵ This doctrine simply represents the principle that receivers or liquidators "are not bound to accept property which, in their judgment, is of an onerous and unprofitable nature, and would burden instead of [benefit] the estate."⁴⁶ The abandonment doctrine first evolved into a nonstatutory judicial doctrine governing equity receiverships,⁴⁷ and then into the bankruptcy statutes governing

Enter., Inc. (*In re* Holland Enter., Inc.), 25 Bankr. 301, 303 (Bankr. E.D.N.C. 1982) (same); *In re* Rovine Corp., 6 Bankr. 661, 666 (Bankr. W.D. Tenn. 1980) (same).

41. Leonard v. Commonwealth Nat'l Bank (*In re* Middleton), 3 Bankr. 610, 613 (Bankr. E.D. Penn. 1980); see also Control Data Corp. v. Zelman (*In re* Minges), 602 F.2d 38, 45 (2d Cir. 1979) (rejection increases value of general unsecured creditor's rights but simultaneously generates claims by lessee against the estate for rejected lease); 2 COLLIER ON BANKRUPTCY ¶ 365.03, at 365-14 (15th ed. 1983) (rejection is important because of consequences to estate).

42. 11 U.S.C. §§ 365(g)(1), 502(g) (1982). See Solon Automated Servs., Inc. v. Georgetown of Kettering, Ltd. (*In re* Solon Automated Servs., Inc.), 22 Bankr. 312, 316 (Bankr. S.D. Ohio 1982) (post petition rejection is construed as prepetition breach).

43. 11 U.S.C. §§ 365(g)(1), 502(a), (b), (g) (1982); see *In re* International Coins & Currency, Inc., 6 COLLIER BANKR. CAS. 2D (MB) 309, 313 (Bankr. D. Vt. 1982) (if lease is rejected, claim against estate is reduced to unsecured status).

44. 11 U.S.C. § 726 (1982); see Shanker, *supra* note 2, at 15-16 (debtor's ability to reject facilitates the debtor's rehabilitation by allowing percentage rate of distribution, but also has effect of shattering economic expectations of party whose contract was rejected).

45. See A. Namdar, *supra* note 6 (discusses history and theory underlying executory contracts in bankruptcy proceedings); Cook, *supra* note 27, at 692; Countryman I, *supra* note 6, at 440-50 (discusses how power to reject grew out of power to abandon); Fogel, *supra* note 4, at 343 & n.4 (trustee's power to reject stems from power to abandon); Silverstein, *supra* note 2, at 468-72 (historical background of rejection discussed). See generally 2 COLLIER ON BANKRUPTCY ¶ 365.01 [1], at 365-6 (15th ed. 1983) (concept of rejection had its roots in principle that trustee could abandon burdensome property); B. WEINTRAUB & A. RESNICK, *supra* note 5 ¶ 7.10[2], at 7-39 (power to reject grew out of power to abandon burdensome property).

46. Dushane v. Beall, 161 U.S. 513, 515-16 (1896) (assignee and receivers can abandon worthless assets); see also Butterworth v. Degnon Contracting Co., 214 F. 772, 773 (2d Cir. 1914) (receiver has right to abandon nonbeneficial asset); American File Co. v. Garrett, 110 U.S. 288, 295 (1884) (it is a recognized rule that assignee "is not bound to accept property of onerous or unprofitable character"); Bourdillon v. Dalton, 170 Eng. Rep. 340 (1794) (assignee may abandon an interest that produces nothing for the estate).

47. See, e.g., Quincy, Mo. & Pac. R.R. v. Humphreys, 145 U.S. 82 (1892); American Brake Shoe & Foundry Co. v. New York R.R., 278 F. 842 (S.D.N.Y. 1922); Coy v. Title Guarantee &

reorganization proceedings,⁴⁸ both of which allowed the rejection of onerous or unprofitable executory contracts or unexpired leases. In analyzing whether an executory contract in the form of an unexpired lease should be rejected in a reorganization bankruptcy, four levels of analysis are addressed: First, does the unexpired lease fit within the statutory language of section 365(a)? Second, what standard should be applied in the trustee's decision to reject? Third, in reviewing the trustee's decision to reject what standard should the bankruptcy court apply? Fourth, what are the consequences of rejection of the unexpired lease, and how should the equities be balanced as between the nondebtor-lessee, and the general creditors of the estate?

It should be noted that a rejection can be approved or disapproved by the bankruptcy court in two levels of the analysis. In the second level of its analysis, the bankruptcy court may disapprove a trustee's attempted rejection of an unexpired lease when it feels the trustee has not applied the correct standard in his decision to reject. Also, even if the trustee has applied the correct standard in level two, the court, in its final analysis, reserves authority to overturn the trustee's rejection when it is deemed necessary to balance the equities between the parties. For example, although not recorded in the opinion of *In re J.H. Land & Cattle Co.*,⁴⁹ Judge Kline approved the trustee's rejection of the unexpired leases because, as of the bankruptcy petition date, the nondebtor-lessee had not commenced the physical operations for development of the leases.⁵⁰ Judge Kline stated that if the facts had been different, i.e., had there been actual production of oil and gas, "an entirely different issue would be presented to the court."⁵¹ Judge Kline implied that equitable considerations may have warranted a different result had the nondebtor-lessee begun actual production of oil and

Trust Co., 198 F. 275 (D. Ore. 1912); see also Silverstein, *supra* note 2, at 471 & n.18 (general law regarding rejection delineated and developed in equity receivership cases in federal courts).

48. See *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38, 42 (2d Cir. 1979) (power to reject under § 70(b) of Bankruptcy Act derived from doctrine of abandonment of burdensome assets); *In re Sapolin Paints, Inc.*, 20 Bankr. 497, 499 (Bankr. E.D.N.Y. 1982) (section 365 replaces § 70(b) of the Bankruptcy Act); 2 COLLIER ON BANKRUPTCY ¶ 365.01[2], at 365-9 & n.10 (15th ed. 1983) (Bankruptcy Act codified preexisting case law); B. WEINTRAUB & N. RESNICK, *supra* note 5, ¶ 7.10, at 7-36 & n.142 (Bankruptcy Code § 365 follows Bankruptcy Act § 70(b) in allowing trustee to reject).

49. 8 Bankr. 237.

50. Telephone interview with the Honorable David Kline, Bankruptcy Judge for the Western District of Oklahoma (January 24, 1983).

51. *Id.* It should be noted that if the nondebtor-lessee had started actual production of oil and gas, the debtor in possession as trustee would probably not have wanted to reject the unexpired oil and gas lease as it would be contributing to the value of the estate.

gas.⁵²

A. Executory Contracts and Unexpired Leases

Neither bankruptcy statutes⁵³ nor their legislative histories⁵⁴ have explicitly defined executory contracts,⁵⁵ other than to say that the term "generally includes contracts on which performance remains due to some extent on both sides,"⁵⁶ a common example of which is an unexpired lease.⁵⁷ Consequently, prior case law is the instrument by which the meaning of "executory contracts" is determined.⁵⁸ The classification of each individual transaction is, as Professor Countryman describes, somewhat similar to "one method of sculpting an ele-

52. *Id.*

53. See Bankruptcy Act of 1898, Act of July 1, 1898 ch. 541, 30 Stat. 544 (amended 1938); Act of July 24, 1970, Pub. L. No. 354, 84 Stat. 468 (*repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 598, § 402(a), 92 Stat. 2682); 11 U.S.C. § 365 (1982).

54. H.R. REP. NO. 595, *supra* note 32, at 347-50, 1978 U.S. CODE CONG. & AD. NEWS at 6303-06; S. REP. NO. 989, 95th Cong., 2d Sess. 58-60, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5844-46; *see also* Turner, *Bankruptcy and Executory Contracts*, 41 TITLE NEWS 114 (1962).

55. Black's defines an executory contract as "[a] contract that has not yet been fully completed or performed." BLACK'S LAW DICTIONARY 512 (5th ed. 1979) (citation omitted); *see also* Ozark-Mahoning Co. v. American Magnesium Co. (*In re* American Magnesium Co.), 488 F.2d 147, 152 (5th Cir. 1974) ("An executory contract is one in which a party binds himself to do or not do a particular thing, whereas an executed contract is one in which the object of the agreement is already performed.") (citations omitted); 4A COLLIER ON BANKRUPTCY ¶ 70.43[2], at 522 (14th ed. 1978) (as long as any part of contract remains unperformed, contract is executory).

56. H.R. REP. NO. 595, *supra* note 32, at 347, 1978 U.S. CODE CONG. & AD. NEWS at 6303; *cf.* Cottman Transmissions, Inc. v. Holland Enter., Inc. (*In re* Holland Enter., Inc.), 25 Bankr. 301, 302-03 (Bankr. E.D.N.C. 1982) (executory contract is one in which performance remains due for both parties); *Hassett v. Revlon, Inc.* (*In re* O.P.M. Leasing Servs., Inc.), 23 Bankr. 104, 117 (Bankr. S.D.N.Y. 1982) (same). One authority points out:

[B]y treating as executory only those contracts in the . . . reorganization context where some performance is still due from both the debtor and the nondebtor party, the courts have applied a commonsense view because if the trustee treated as executory a contract that had been fully completed by the debtor, rejection would be meaningless because the other contracting party would have no damages. . . .

H. MILLER & M. COOK, *supra* note 35, at 144. "If the other party to the contract had fully performed its obligation but the debtor had not, rejection would merely give the nondebtor . . . a claim that it has already." *Id.*; *see also* Countryman I, *supra* note 6, at 458 (contract fully performed by debtor is not executory).

57. See 2 COLLIER ON BANKRUPTCY ¶ 365.02, at 365-12 to -13 (15th ed. 1983) (neither Code nor Act define executory contract other than by referring to unexpired leases); 4A COLLIER ON BANKRUPTCY ¶ 70.44, at 548 & n.18a (14th ed. 1978) ("[u]nexpired lease is but a form of executory contract" and rules relating to leases follow much the same pattern as those relating to executory contracts); Countryman I, *supra* note 6, at 450 ("What is an executory contract, other than an unexpired lease . . .?"); Silverstein, *supra* note 2, at 479 (history shows unexpired lease is archetype of rejectable contract); *cf.* Weil v. Lansburgh (*In re* Garfinkle), 577 F.2d 901, 903 (5th Cir. 1983) (whether debtor is lessor or lessee, the Act permits rejection of unexpired lease but different equitable principles apply where debtor is lessor rather than lessee).

58. See Cook, *supra* note 27, at 689-90 (existing case law helps determine executory contract status as legislative history and Code do not define it).

phant."⁵⁹ Cases interpreting an executory contract rely on the threshold inquiry set forth by Professor Countryman: Is this "a contract under which the obligations of the [debtor] 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 the performance of the other?"⁶⁰ In line with the Bankruptcy Commission's intentional omission of a definition,⁶¹ most courts agree that executory contracts should be defined in light of the policy underlying the power of rejection in conjunction with the goals of the reorganization trustee, in order that equity may be served.⁶² As stated by one court, the consequences of rejection of a contract or unexpired lease are measured "in terms of benefit to the estate and the protection of creditors, [it is] not the form of [the] contract . . . which controls."⁶³ "[I]n the final analysis, execu-

59. Countryman I, *supra* note 6, at 460 n.85 (to sculpt an elephant, "[o]btain a large piece of stone. Take hammer and chisel and knock off everything that doesn't look like an elephant.>").

60. *Id.*; see, e.g., *In re Silver*, 7 COLLIER BANKR. CAS. 2D (MB) 1107, 1109 (Bankr. E.D. Penn. 1983) (Countryman definition accepted by weight of authority); *In re California Steel Co.*, 24 Bankr. 185, 187 (Bankr. N.D. Ill. 1982) (crucial factor in executory contract is existence of unperformed obligations at time of bankruptcy petition); *In re Gladding Corp.*, 22 Bankr. 632, 634 (Bankr. D. Mass. 1982) (Countryman definition is briefly stated as any contract which is materially breachable by both sides) (emphasis in original).

61. The Commission on Bankruptcy Laws suggested an executory contract should not be defined as "[i]ts general meaning is well understood, any succinct statutory language risks an unintended omission or inclusion." REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, pt. I, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. 198-99; see also *In re Gladding Corp.*, 22 Bankr. 632, 634 (Bankr. D. Mass. 1982) (intentional omission so court can be flexible in construction of Bankruptcy Act); H. MILLER & M. COOK, *supra* note 35, at 141.

62. See, e.g., *Chattanooga Memorial Park v. Still* (*In re Jolly*), 574 F.2d 349 (6th Cir., cert. denied, 439 U.S. 929 (1978)). The court in *Jolly* stated:

The key . . . to deciphering the meaning of the executory contract rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished . . . through rejection, then the contract is not executory. . . .

Id. at 351. Professor Countryman states that a trustee's power to reject "is an option to be exercised when it will benefit the estate. . . . [I]t should not extend to situations where the only effect of its exercise would be to prejudice other creditors of the estate." Countryman I, *supra* note 6, at 450-51; see also *Creedon & Zinman*, *supra* note 4, at 1401 ("Rarely can a legal question . . . *in vacuo* be answered with confidence. . . . In order to determine . . . whether any particular contract . . . is executory . . . we must know why the question is asked and what would be the consequences of the answer.") (citations omitted) (emphasis in original); *In re Gladding Corp.*, 22 Bankr. 632, 635 (Bankr. D. Mass. 1982) (court should not be bound by static definition of executory contract); *In re Booth*, 19 Bankr. 53, 54-57 (Bankr. D. Utah 1982) (thorough analysis of development of Countryman definition with conclusion that "the exceptions virtually swallow the Countryman rule").

63. *In re Booth*, 19 Bankr. 53, 57 (Bankr. D. Utah 1982) (Mabey, J.) (discusses judicial erosion of Countryman's definition of executory contracts). Judge Mabey remarks:

There are many examples of the use of "policy," rather than a rule like the Countryman test, in determining what is an "executory contract"

. . . .
This approach may be criticized for being result oriented [H]owever, . . .

tory contracts are not measured by a mutuality of commitment but by the nature of the parties and the goals of reorganization."⁶⁴ For example, in *King v. Baer*⁶⁵ the court held a contract for the purchase of an interest in an oil and gas permit to be executory, despite the fact that the property interest had vested under the contract prior to the debtor's bankruptcy. The court upheld the executory nature of the contract based upon the "complex obligations" of each party, the "highly speculative probability of success and the additional expenditure of large sums of money which made the continued performance of the contract . . . 'risky.'"⁶⁶ Other courts have found that an executory contract exists where "[b]oth parties [have] ongoing commitments,"⁶⁷ but have limited this definition in situations where "[a] party . . . has not fully performed the terms of a written contract, [or] when it admits that it will never be able to perform those terms."⁶⁸ According to one court: "Although 'the unexpired lease is the archetype of the rejectable contract' . . . its treatment has varied depending on the policies at stake."⁶⁹

Thus far, two courts have considered the classification of an unexpired oil and gas lease in a bankruptcy reorganization proceeding. First, by dictum, in *Hill v. Larcon*⁷⁰ an unexpired oil and gas lease was deemed rejected under section 70(b), the Bankruptcy Act's predecessor to section 365,⁷¹ as an unexpired lease. Second, an unexpired oil and gas lease was deemed rejected as an unexpired⁷² lease under section

[being result oriented] is endemic to the policymaking which has determined what is an executory contract. . . . Indeed, the Countryman test, which is predicated on the policy of benefit to the estate, is result oriented.

Id. at 57-58 & n.6.

64. *Id.* at 56.

65. 482 F.2d 552 (10th Cir.), *cert. denied*, 414 U.S. 1068 (1973).

66. *Id.* at 557 (citing *Workman v. Harrison*, 282 F.2d 683, 699 (10th Cir. 1960)).

67. *E.g.*, *Ozark-Mahoning Co. v. American Magnesium Co.* (*In re American Magnesium Co.*), 488 F.2d 147, 152 (5th Cir. 1974).

68. *In re Biron, Inc.*, 23 Bankr. 241, 242 (Bankr. S.D. Ohio 1982) (purchase agreement for sale of percentage of oil and gas leasehold interests was not executory contract because debtor knew he would not be able to acquire the required percentage).

69. *In re Booth*, 19 Bankr. 53, 57 & n.6 (Bankr. D. Utah 1982).

70. 4 OIL & GAS REP. 1701, 1707 (W.D. Ark. 1955).

71. Section 70(b) of the Act was replaced by 11 U.S.C. § 110(b) (Supp. IV 1963), which was replaced by 11 U.S.C. § 365 (1982).

72. 11 U.S.C. § 365 (1982) will not apply to a lease which was not in existence at the time the bankruptcy petition was filed; *see, e.g.*, *Allied Technology, Inc. v. Brunemann & Sons, Inc.* (*In re Allied Technology, Inc.*), 25 Bankr. 484, 495 (Bankr. S.D. Ohio 1982) (threshold question is whether lease existed at time petition filed); *In re Horace Jones, Inc.*, 8 COLLIER BANKR. CAS. (MB) 215, 218 (Bankr. M.D. Fla. 1976) (sublease was no longer executory because debtor no longer had duty to perform under lease).

365 of the Code by the court in *In re J.H. Land & Cattle Co.*⁷³ In analyzing whether an unexpired oil and gas lease should be classified as an executory contract, it is important to note the corresponding rights and duties of oil and gas lessors and lessees in conjunction with the fundamental goals and policies underlying the rejection power in the context of reorganizations.

An oil and gas lease is "both a conveyance of mineral rights . . . and a contract between the lessor and lessee relating to the development of minerals."⁷⁴ At first glance it would appear that once the debtor-lessor, J.H. Land & Cattle Company, executed the lease and accepted the bonus money it had no future obligations to satisfy under the lease contract, and therefore the unexpired oil and gas lease should not have been held to be executory. In addition, the nondebtor-lessee arguably had no future obligations to perform under the lease since with modern oil and gas lease forms⁷⁵ a covenant to drill an exploratory well is not implied by the courts.⁷⁶ However, neither of these

73. 8 Bankr. at 239.

74. J. LOWE & C. ARNOLD, ANATOMY OF MODERN OIL AND GAS LEASE, DELAY RENTALS AND LEASE ADMINISTRATION 16 (1983).

75. The duty to drill an exploratory well "is of less importance because of the modern leasing practices." 5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 57.1, at 47 (1978) (citation omitted); 5 H. WILLIAMS & C. MEYERS, A TREATISE ON THE LAW OF OIL AND GAS § 812, at 63, 67 (1982) provides:

Very little litigation over the covenant to drill an initial exploratory well is now encountered . . . [because] the covenant has been rendered a dead letter by the development of the oil and gas lease form . . . [which contains an "unless" or "or" clause that] eliminates the implied covenant. . . .

It is uniformly held that a covenant to drill an initial well is not implied in such leases . . . [because] [t]he express rental clause fully covers the subject matter of drilling an initial well, thus precluding the raising of an implied covenant.

Id. See generally 5 E. KUNTZ, *supra* at 48, 50 (drilling delay rental clause in primary term deals with implied duty to drill exploratory well, and is designed to supercede implied duty to drill an exploratory well by payment of drilling delay rentals in lieu of drilling an exploratory well); J. LOWE & C. ARNOLD, *supra* note 74, at 15, 17-19 (fundamental goal of oil and gas lease is to preserve right to develop leased land but without obligation, at least for the primary term; function of drilling delay rental clause is to negate inference of an implied obligation to test the premises during the primary term; effect of drilling delay rental clause is to hold lease conditioned on periodic delay rental payments or conduct of drilling operations).

76. In Oklahoma, a duty to drill an exploratory well exists if the lease does not contain provisions to the contrary. *Hiitt v. Henderson*, 112 Okla. 194, 197, 240 P. 745, 747 (1925). However, parties can remove implied covenant to drill an exploratory well by lease provision. 5 E. KUNTZ, *supra* note 75, at 49; see also *Chapman v. Kendall*, 145 Okla. 107, 110, 291 P. 97, 99 (1929) (where lease contains express stipulation for delaying development in primary term by payment of delay rentals, no implied covenant arises); *Southwestern Oil Co. v. Kersey*, 80 Okla. 135, 136, 195 P. 120, 120 (1921) (payment of drilling delay rentals is sufficient to postpone development); *Eastern Oil Co. v. Beatty*, 71 Okla. 275, 277, 177 P. 104, 105 (1918) (no covenant to develop will be implied in face of express stipulation for payment of periodic delay rentals).

views is acceptable. Professor Kuntz, in describing the nature of an unexpired oil and gas lease, remarks:

[An oil and gas lease] is unique. It is a conveyance of an interest in real property, with conditions and special limitations, which create a continuing relationship between the parties. It is also an executory contract in that it contains elaborate contractual provisions which continue in force between the lessor and the lessee during the life of the interest granted.⁷⁷

Therefore, in situations similar to the facts presented in *In re J.H. Land & Cattle Co.*⁷⁸—where the nondebtor-lessee holds the lease by payment of delay rentals—a “continuing relationship”⁷⁹ exists between the parties which contains “elaborate contractual provisions”⁸⁰ sufficient to place continuing future duties upon the lessor and lessee which are characteristic of an executory contract.⁸¹

B. *Standards for Trustee's Decision to Reject*

Bankruptcy statutes have been silent regarding the circumstances under which a trustee may properly reject an executory contract or unexpired lease.⁸² Therefore, existing case law provides the only relevant guidelines for determinations under section 365(a).⁸³ Differing standards emerge in considering whether an executory contract or

77. 2 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 18.2, at 4 (1964).

78. 8 Bankr. 237.

79. See *supra* note 67 and accompanying text.

80. See *supra* note 66 and accompanying text.

81. An unexpired “paid up lease” or an unexpired “top lease” would probably still have the characteristic “future performance” element of an executory contract. A “paid up” lease is one without a drilling delay rental clause, “which grants the lessee the rights for a full primary term in return for a single payment. The shorter the primary term and the larger the bonus, the more likely it is that the paid up form will be used.” J. LOWE & C. ARNOLD, *supra* note 74, at 20. A “top lease” is a “lease granted on property already subject to an oil and gas lease . . . to become effective if and when the existing lease expires.” J. LOWE, FUNDAMENTALS OF OIL AND GAS LEASING 774 (1982).

82. Cook, *supra* note 27, at 689-90; see also 1A BANKR. SERV. (L. ED.) § 6.186, at 280 (1981) (Code is silent regarding when trustee may reject); 2 COLLIER ON BANKRUPTCY ¶ 365.02[1], at 365-13 (15th ed. 1983) (11 U.S.C. § 365 contains most of statutory materials dealing with rejection); H. MILLER & M. COOK, *supra* note 35, at 145 (Code leaves to courts task of formulating standards for rejection); P. MURPHY, *supra* note 2, § 9.03, at 94 (Code does not prescribe standards for trustee's decision to reject); Shanker, *supra* note 2, at 16 (Act gives no statutory guidance on how to deal with rejection).

83. 11 U.S.C. § 365(a) (1982). See 3 COLLIER ON BANKRUPTCY ¶ 502.07, at 87 (15th ed. 1983); H. MILLER & M. COOK, *supra* note 35, at 146 (courts have established different standards for permitting rejection); P. MURPHY, *supra* note 2, § 9.03, at 9-4; Cook, *supra* note 27, at 698 & n.62 (no good reason why Act standard should not be applied to cases under Code); Shanker, *supra* note 2, at 21 (nothing under Code § 365 suggests different result than result reached under the Act).

unexpired lease should be rejected.⁸⁴ The standards applied have all used some type of "benefit or burden to the estate" analysis,⁸⁵ under which a trustee desiring to reject the executory contract or unexpired lease would be wise to "make a meaningful cost-benefit analysis and, if necessary, be able to substantiate that analysis in court."⁸⁶ However, the exact standard to be applied by the trustee to reject a contract remains uncertain. It has never been clear from the case law whether the burdensome standard, the business judgment standard, some type of equitable standard, or some combination thereof should be used in the rejection process. Uncertainty also surrounds the question of whether the trustee or the court should apply the standard.

As previously discussed, the concept of rejection stems from the historical right of a trustee to abandon property which burdens the debtor's estate.⁸⁷ The interpretation of what results in a "burden to the debtor's estate" has been and remains the focal point of the rejection controversy. At the heart of this controversy is the issue found in *In re J.H. Land & Cattle Co.*, that is, whether the trustee should have the power to reject an executory contract or unexpired lease that "while profitable or generally beneficial, could be, if rejected, replaced by a more attractive arrangement."⁸⁸ The court in *In re J.H. Land & Cattle Co.* utilized the business judgment test in approving the rejection of a profitable unexpired oil and gas lease.⁸⁹ The trustee sought to reject the original lease in favor of another arrangement which was "preferable," in that it would provide the estate with a larger royalty interest resulting from the "immediate" drilling of wells. In contrast, the original leases did not require immediate development. The original lessee held the leases for approximately thirty days prior to the debtor-lessor's bankruptcy and had done nothing to develop the premises. Applying the business judgment test, the court approved the trustee's rejection of

84. 2 COLLIER ON BANKRUPTCY ¶ 365.03, at 365-14 (15th ed. 1983) ("There are several schools of thought concerning standard to be applied in rejecting executory contract. . . . This issue is one of the extent to which other parties . . . may second-guess the decision on the ground that the contract is not in fact burdensome"); Cook, *supra* note 27, at 693 (courts have established a variety of standards for permitting rejection).

85. Cook, *supra* note 27, at 698 (the initial question is whether the contract imposes a burden on the debtor's estate). Professor Countryman states: "Whether in a given case the trustee will assume or reject depends, presumably, on his comparative appraisal of the value of the remaining performance by the other party and the cost to the estate of the unperformed obligation of the . . . [debtor]." Countryman I, *supra* note 6, at 461.

86. Cook, *supra* note 27, at 699 & n.67.

87. See *supra* notes 45-48 and accompanying text.

88. 2 COLLIER ON BANKRUPTCY ¶ 365.03, at 365-14 (15th ed. 1983).

89. 8 Bankr. at 239.

the original leases based upon the "reasonable likelihood of substantial benefit to the debtor's estate."⁹⁰

1. Burdensome Contract Test

The burdensome contract test was first presented in the equity receivership case of *American Brake Shoe & Foundry Co. v. New York R.R.*⁹¹ where it was held that a trustee's right to reject an executory contract or unexpired lease could be preserved only if it was onerous and burdensome in the sense that continued performance would constitute a positive loss to the estate.⁹² In *American Brake Shoe*, the debtor-lessor of an unexpired real property lease, through the trustee, sought to reject the lease's heat and electricity covenants, even though the leased property with all its covenants was profitable.⁹³ In disallowing the rejection of the unexpired lease, the court stated:

[A] court of equity should not disaffirm . . . a lease . . . merely because the . . . lessor made what . . . [became] a bad bargain, although a good enough bargain originally. It is the duty of the receiver to make every proper effort to increase the assets of an estate, but not at the expense of fundamental principles of fair dealing. . . . [A] lease presupposes continuance, even in the face of a receivership of the landlord, so long as the landlord's receivership estate is not burdened or put to loss, and by "burdened" is not meant that the lease could be more profitable, but that it entails a positive loss or encroachment on the corpus or capital of the estate.

. . . .

In the case at bar there is no evidence that the lease is a burden . . . i.e., that . . . the estate suffers an actual loss as distinguished from the obtaining of a more profitable rental.⁹⁴ In a recent case, *In re Overmeyer*,⁹⁵ a trustee was again seeking rejection of a contract in favor of a more profitable one. The trustee wanted to reject leases of warehouse space because the overall profitability of

90. *Id.*

91. 278 F. 842 (S.D.N.Y. 1922). See generally Bienenstock, *supra* note 2, at 33 (discusses *American Brake Shoe*); Shanker, *supra* note 2, at 20-21 (same).

92. 278 F. at 843-44.

93. "The trustee apparently felt the lease was nevertheless burdensome since the estate could make more money if it was not required to supply electricity and heat." Creedon & Zinman, *supra* note 4, at 1397.

94. 278 F. at 843-44; see also Creedon & Zinman, *supra* note 4, at 1397 (discussing *American Brake Shoe*); Silverstein, *supra* note 2, at 485-86 (same).

95. 1 COLLIER BANKR. CAS. (MB) 516 (S.D.N.Y. 1974).

the warehouse was being impaired by the unreasonably low yearly rental.⁹⁶ The court did not allow rejection of the leases, finding the dispute involved a desire by a landlord to terminate the lease "purely because the provisions have, after 8 years, turned out to yield less income than is desired."⁹⁷ In the opinion of the *Overmeyer* court, the burdensome test could be satisfied where performance of the contract would "[constitute] a drain on the debtor's assets in the sense that . . . continued performance would require an outlay of funds for a no longer needed purpose."⁹⁸

In cases where the trustee did not want to disaffirm in order to adopt a more profitable executory contract or unexpired lease, but rather desired only to reject the "burdensome" contract, the burdensome test has been stated in various ways. One court focused on the equitable nature of rejection and noted that the rejection should be permitted "if disaffirmance . . . is 'advantageous to the debtor' [A]ny disadvantage of keeping the contract in force must be weighed against the liability that may be created by its rejection."⁹⁹ A second court described the burdensome test as a balancing process, since the "power [of the bankruptcy court is] to rid the . . . estate of exorbitant unjustified expenditures and thereby . . . protect . . . the creditors."¹⁰⁰ Other courts have emphasized rejection which facilitates

96. *Id.* at 518. The debtor operated a long-term warehouse space leasing business. The debtor leased the space and then as sublessor, sublet the space to another lessee in excess of what was paid to the original lessor. The debtor made a ten year lease with its sublessee, West Cash & Carry, for \$.60 per square foot per annum. The trustee argued the fair and reasonable value of the warehouse space was \$1.10 per square foot per annum.

97. *Id.* at 520. The court noted that rejection of an executory contract is generally "based upon a debtor's desire to terminate a commitment which presents a financial drain on a company seeking to rehabilitate itself . . . [without reorganization proceedings]." *Id.* The equity court would not permit the debtor-lessor to reject an unexpired lease which "with changing circumstances, . . . [had] become less attractive." *Id.* at 521.

98. *Id.* at 521 (citations omitted). See also *In re Royal Inns of America, Inc.*, 2 BANKR. CT. DEC. (CRR) 593 (Bankr. S.D. Cal. 1973) (if contract is burdensome and onerous, rather than simply unprofitable, then trustee can reject); accord *In re Redi-cut Carpets, Inc.*, 21 COLLIER BANKR. CAS. (MB) 401, 407 (Bankr. S.D.N.Y. 1979) (Court using business judgment test determined rejection was not an exercise of good business judgment; holding was substantiated by the "proposition that a debtor, having made a good bargain for itself before filing of a petition, does not have automatic right to reject . . . merely because passage of time . . . rendered the bargain less attractive.").

99. *Van Dyk Research Corp. v. SCM Corp.* (*In re Van Dyk Research*), 13 Bankr. 487, 507 (Bankr. D.N.J. 1981).

100. *Chicago Junction R.R. v. Sprague* (*In re Chicago Rapid Transit Co.*), 129 F.2d 1, 4 (7th Cir. 1942) (court has power to discard "disastrous financial entanglements," *id.* at 5); see also *In re Pennsylvania Fruit Co.*, 6 COLLIER BANKR. CAS. (MB) 537 (Bankr. E.D. Pa. 1975) (rejection should be allowed if it is essential to reorganization and would be in best interests of persons affected by rejection).

reorganization.¹⁰¹

2. Business Judgment Test

In comparison, the business judgment test does not obligate the trustee to assume an executory contract or unexpired lease even where it is marginally profitable if assumption is not advantageous to,¹⁰² or otherwise in the best interests of, an estate.¹⁰³ The business judgment standard was first enunciated by the United States Supreme Court several years after *American Brake Shoe*¹⁰⁴ in *Group of Institutional Investors v. Chicago, M. St. P. & Pac. R.R.*¹⁰⁵ In *Institutional Investors*, the Court allowed the reorganization debtor to reject an unexpired lease which was "a valuable asset of the estate"¹⁰⁶ because "the question [of] whether a lease should be rejected . . . is one of business judgment."¹⁰⁷ In light of this Supreme Court decision, most jurisdictions reject the burdensome test as "questionable authority" and instead favor the business judgment test.¹⁰⁸ One court stated that its reliance on the business judgment test was "dictated by logic as much as precedent."¹⁰⁹ One authority remarked that:

Whatever the support for . . . [the burdensome test], it does not seem to be too persuasive. The purpose of the power to reject is to augment the estate of the debtor. For this purpose,

101. *E.g.*, *Bradshaw v. Loveless (In re American Nat'l Trust)*, 426 F.2d 1059, 1064 (7th Cir. 1970) (if executory contract is detrimental to effective reorganization, rejection should be authorized).

102. *E.g.*, *In re United Cigar Stores Co.*, 69 F.2d 513 (2d Cir.), *cert. denied*, 293 U.S. 566 (1934); *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38 (2d Cir. 1979).

103. *See, e.g.*, *In re 1430 Equities, Inc.*, 18 COLLIER BANKR. CAS. (MB) 289, 295-98 (Bankr. S.D.N.Y. 1978).

104. *See supra* notes 91-94 and accompanying text.

105. 318 U.S. 523 (1942). The Court held, "The question whether a lease should be rejected . . . is one of business judgment." *Id.* at 550 (citations omitted).

106. *Id.* at 549.

107. *Id.* at 550.

108. *See In re Florence Chi-Feng Huang*, 9 BANKR. CT. DEC. (CRR) 972, 974 (9th Cir. 1982) (virtually all recent Code cases follow business judgment test); *Hassett v. Revlon, Inc. (In re O.P.M. Leasing Servs., Inc.)*, 23 Bankr. 104, 118 & n.10 (Bankr. S.D.N.Y. 1982) (under Code, business judgment is prevailing test); *In re National Sugar Refining Co.*, 21 Bankr. 196, 197 (Bankr. S.D.N.Y. 1982) (under Act, majority of courts applied business judgment test); *In re Marina Enter., Inc.*, 5 COLLIER BANKR. CAS. 2D (MB) 434, 441 (Bankr. S.D. Fla. 1981) (no doubt business judgment test controls). *See generally* 2 COLLIER ON BANKRUPTCY ¶ 365.03, at 365-18 (15th ed. 1983) (business judgment test more likely to be applied than burdensome test); P. MURPHEY, *supra* note 2, § 9.04, at 9-4 (business judgment test remains good law); *Bienenstock*, *supra* note 2, at 34-35 (discussing business judgment rule). *Countryman I*, *supra* note 6, at 461 & n.87 (authorities that advocate burdensome test overlook Supreme Court decision on *Institutional Investors*); *Shanker*, *supra* note 2, at 21-22 (decision of *Institutional Investors* may have cast doubt on *American Brake Shoe*).

109. *In re Florence Chi-Feng Huang*, 9 BANKR. CT. DEC. (CRR) 972, 974 (9th Cir. 1982).

there seems to be no difference between an obligation which consumes cash, and an obligation which, because of its depressive effect on a particular asset or because of its undervaluation of that asset consumes a part of the value of that asset. In the end the latter will turn up as a net reduction in cash to pay the creditors.¹¹⁰

A common law court which considered the business judgment standard found that the business judgment test is "a question of business policy, upon which the minds of reasonable men might differ."¹¹¹ The court concluded that any reasonable basis which supports the rejection of an unexpired lease will be approved by a court since:

It is a question, not of law, but of business judgment, which requires for its intelligent answer an extended experience, a special knowledge, and an intimate acquaintance with every vein and artery of the entire system . . . [of the debtor's business] which no court that ever sat or ever will sit could possibly acquire from affidavits, however voluminous, or from arguments, however extended.¹¹²

Although the Court in *Institutional Investors*¹¹³ did not determine the "scope of authority" to reject leases,¹¹⁴ the authority to use the business judgment test in rejecting leases was confirmed in *In re Minges*.¹¹⁵ In *Minges*, the court allowed rejection of an unexpired lease in the form of an executory contract despite the fact that the debtor could have received a net financial benefit by assuming it.¹¹⁶ Under the *Minges* rationale, the fact that a profit could be made under an unexpired lease will not prevent rejection¹¹⁷ because the standard should be flexible.¹¹⁸

110. Krasnowiecki, *supra* note 37, at 382.

111. *Mercantile Trust Co. v. Farmers' Loan & Trust Co.*, 81 F. 254, 258-59 (8th Cir. 1897) (the issue presented by the court is a question of business policy, and not a question of law) (*cited with approval in Institutional Investors*, 318 U.S. at 550).

112. *Park v. New York, L.E. & W.R.R.*, 57 F. 799, 802-03 (C.C.S.D.N.Y. 1893) (*cited with approval in Institutional Investors*, 318 U.S. at 550).

113. 318 U.S. 523.

114. *Id.* at 549.

115. 602 F.2d 38 (2d Cir. 1979). See *Bienenstock*, *supra* note 3, at 34. Professor Cook notes that Justices Feinberg (majority) and Mansfield (conurrence) "provide excellent bases from which to derive flexible criteria for the rejection of executory contracts under the Code." Cook, *supra* note 27, at 690.

116. In *Minges*, the debtor-lessor was obligated to provide utilities and janitorial services to the lessee. Because, the lessee's rental payment was only half of the market rental value of the premises and because the covenants to provide utilities and janitorial services consumed a "very large portion" of rental income, the court permitted rejection of the leases as the "property [was] clearly capable of producing more income without them." 602 F.2d at 43.

117. The *Minges* court noted that other courts have utilized the flexible business judgment test without calling it that by "emphasizing potential greater profit for the debtor's estate in deciding whether to permit rejection of an executory contract." *Id.*

118. The *Minges* court noted:

A rigid test, permitting rejection only where the executory contract will cause a net loss

"It is enough, if, as a matter of business judgment, rejection . . . may benefit the estate."¹¹⁹ One member of the court contended that: "[T]he standard governing the trustee should be whether there is a reasonable likelihood that the general creditors will derive any substantial or significant benefit."¹²⁰ The *Minges* court emphasized the factual nature of determining whether rejection will "enhance a debtor's estate,"¹²¹ thereby yielding a "substantial or significant benefit"¹²² to the general creditors.¹²³ Therefore, the court remanded "to make specific findings after giving the parties an opportunity to present further evidence."¹²⁴

C. Standard Applied in Reviewing Decision to Reject

The trustee's power to reject an executory contract or unexpired lease is not absolute.¹²⁵ The legislative history of section 365¹²⁶ suggests that the procedure for court approval of a trustee's rejection will

to the debtor's estate if performed, might work a substantial injustice in cases where it can be shown that the non-debtor contracting party will reap substantial benefits under the contract while the debtor's creditors are forced to make substantial compromises of their claims.

Id.; see also *In re Mykleburst*, 26 Bankr. 582, 586 (Bankr. W.D. Wisc. 1983) (court adopts a flexible test); *In re Hurricane Elkhorn Coal Corp. II*, 15 Bankr. 987, 989 (Bankr. W.D. Ky. 1981) (same); *In re Redi-Cut Carpets, Inc.*, 21 COLLIER BANKR. CAS. (MB) 401, 404-05 (Bankr. S.D.N.Y. 1979) (same).

119. 602 F.2d at 43 (J. Feinburg, Majority); see also *In re National Sugar Refining Co.*, 21 Bankr. 196, 198 (Bankr. S.D.N.Y. 1982) (court allows rejection if estate may be benefited); *Carey v. Mobil Oil Corp.* (*In re Tilco*), 558 F.2d 1369, 1372 (10th Cir. 1977) (same); *King v. Baer* (*In re King Resources Co.*), 482 F.2d 552, 557 (10th Cir.), *cert. denied*, 414 U.S. 1068 (1973) (same).

120. 602 F.2d at 44 (J. Mansfield, concurring).

121. *Cf. Allied Technology, Inc. v. Brunemann & Sons, Inc.* (*In re Allied Technology, Inc.*), 25 Bankr. 484, 495 (Bankr. S.D. Ohio 1982) (court will approve assumption of lease if it appears to enhance estate).

122. 602 F.2d at 44; see *Hassett v. Revlon, Inc.* (*In re O.P.M. Leasing Servs., Inc.*), 23 Bankr. 104, 118 (Bankr. S.D.N.Y. 1982) (trustee must only show rejection will benefit estate); *In re Silver*, 7 COLLIER BANKR. CAS. 2D (MB) 1107, 1110 (E.D. Penn. 1983) (same); *Summit Land Co. v. Allen* (*In re Summit Land Co.*), 4 COLLIER BANKR. CAS. 2D (MB) 1432, 1436 (Bankr. D. Utah 1981) (same); *cf. Cadillac Vending Co. v. Haynes* (*In re Haynes*), 19 Bankr. 849, 852 (Bankr. E.D. Mich. 1982) (debtor can reject solely on grounds that it is "a reasonable exercise of its business judgment").

123. Cook, *supra* note 27, at 701. Professor Cook states that Rule 914 of the Federal Rules of Bankruptcy Procedure "gives the bankruptcy judge the power to make pretrial discovery available to the parties." *Id.* at n.83; see also H. MILLER & M. COOK, *supra* note 35, at 149 (need a strong factual showing that substantial or significant benefit will result from rejection in reorganization context).

124. 602 F.2d at 44.

125. B. WEINTRAUB & A. RESNICK, *supra* note 5, ¶ 7.10, at 7-38; Cook, *supra* note 27, at 702-03 (rejection is not automatic but is a matter in the court's discretion).

126. 11 U.S.C. § 365 (1982).

be dealt with by the Rules of Bankruptcy Procedure¹²⁷ or by local court rules.¹²⁸ The rules promulgated for bankruptcy procedure offer little guidance regarding the standards for court approval.¹²⁹ A split of opinion exists as to precisely who reviews the decision to reject, and what standard is applied in the review process.

By the terms of section 365(a), the decision to reject an executory contract or unexpired lease is "subject to court approval."¹³⁰ Despite a majority belief that rejection cannot occur without court approval, disagreement surrounds the standard for court approval.¹³¹ For example, the Tenth Circuit Court of Appeals in *In re Tilco*¹³² faced a fact situation similar to that in *In re J.H. Land & Cattle Co.*; the court was reviewing a rejection of income producing executory contracts.¹³³ The court remanded the case, holding that the lower court should apply the business judgment test after an evidentiary hearing to establish the facts.¹³⁴ The *Tilco* court held that it was within the power of the lower court to approve the trustee's decision to reject, "[a]bsent [any] abuse of discretion."¹³⁵

Other courts, in interpreting the standard for a court's review of a

127. See PROPOSED RULES, *supra* note 24.

128. H.R. REP. NO. 595, *supra* note 32, at 295, 1978 U.S. CODE & AD. NEWS at 6252.

129. See PROPOSED RULES, *supra* note 24.

130. 11 U.S.C. § 365(a) (1982). *E.g.*, *In re California Steel Co.*, 24 Bankr. 185, 187 (Bankr. N.D. Ill. 1982) (trustee's rejection must be presented to court for approval); *In re Flying Airways, Inc.*, 328 F. Supp. 1256, 1258 (E.D. Penn. 1971) (rejection requires a judicial act); *Videon, Inc. v. Marple Publishing Co. (In re Marple Publishing Co.)*, 20 Bankr. 933, 935 (Bankr. E.D. Penn. 1982) (rejection of unexpired lease is devoid of validity without court approval); 2 COLLIER ON BANKRUPTCY ¶ 365.01, at 365-11 (15th ed. 1983) (under Bankruptcy Act, trustee's rejection requires court approval); *id.* ¶ 365.03, at 365-13 (power of trustee to reject must be made with approval of court); *cf. In re Sapolin Paints, Inc.*, 20 Bankr. 497, 507-08 (Bankr. E.D.N.Y. 1982) (approval of court can be manifested in "variety of ways," including "in court coalescence of repudiation by the trustee").

131. *In re Price Chopper Supermarkets, Inc.*, 19 Bankr. 462, 466 (Bankr. S.D. Cal. 1982) (decision to reject should be approved by court but parties disagree on manner and timing of court supervision); *Summit Land Co. v. Allen (In re Summit Land Co.)*, 4 COLLIER BANKR. CAS. 2D (MB) 1431, 1436 (Bankr. D. Utah 1981) (authorities differ regarding standard of review to be applied by the courts).

132. *Carey v. Mobil Oil Corp. (In re Tilco)*, 558 F.2d 1369 (10th Cir. 1977).

133. *Id.* at 1373.

134. *Id.*; see also *In re Hurricane Elkhorn Coal Corp. II*, 15 Bankr. 987, 989 (Bankr. W.D. Ky. 1981) (court is the party ultimately charged with duty of applying business judgment test to facts of each case); *In re National Sugar Refining Co.*, 21 Bankr. 196, 198 (Bankr. S.D.N.Y. 1982) (it is the courts duty to apply the business judgment test after it has been presented with the facts).

135. 558 F.2d 1369, 1373; see, e.g., *In re New York Investors Mut. Group, Inc.*, 143 F. Supp. 51, 56 (S.D.N.Y. 1956) (business judgment is discretionary and will not be disturbed unless clear abuse of discretion); *cf. In re Sun Ray Bakery, Inc.*, 5 Bankr. 670, 672 (Bankr. D. Mass. 1980) (despite courts opinion that a better procedure existed the court deferred to the exercise of the debtor in possession's business judgment).

debtor's rejection, have given slightly different interpretations to this same standard. For example, in *In re Allied Technology, Inc.*¹³⁶ the court remarked:

Court approval of a debtor in possession's judgment that [rejection] of a lease is in the best interest of the debtor's business should not be withheld on the basis of a second-guessing of the debtor's judgment, unless the matter is presented in the context of 11 U.S.C. § 1104(a)(1) for determination of the larger question of the competency of debtor in possession's business judgment. . . . As long as assumption of a lease appears to enhance a debtor's estate, court approval . . . should only be withheld if the debtor's judgment is clearly erroneous, too speculative, or contrary to the provisions of the Bankruptcy Code¹³⁷

Other courts have based the standard of court approval on the theory that the debtor's business judgment "is entitled to . . . approval, absent extraordinary circumstances, as a matter of course."¹³⁸ Four reasons are presented in support of court approval "as a matter of course":

[First,] this rule places responsibility for administering the estate with the trustee, not the court, and therefore furthers the policy of judicial independence considered vital by the authors of the Code. Second, this rule expedites the administration of estates, another goal of the [Code] Third, the rule encourages rehabilitation by permitting the replacement of marginal with profitable business arrangements. Fourth, the rule is supported by pre-Code cases in [the Tenth] Circuit.¹³⁹

136. *Allied Technology, Inc. v. Brunemann & Sons, Inc. (In re Allied Technology, Inc.)*, 25 Bankr. 484 (Bankr. S.D. Ohio 1982).

137. *Id.* at 495; *see, e.g., In re Fashion Two Twenty, Inc.*, 16 Bankr. 784, 787 (Bankr. N.D. Ohio 1982) (court approved debtor's "exercise of sound business judgment"); *In re International Coins & Currency, Inc.*, 6 COLLIER BANKR. CAS. 2D (MB) 309, 313 (Bankr. D. Vt. 1982) ("Court is satisfied . . . that the Debtor did in fact exercise good business judgment" in rejection).

138. *See, e.g., In re Sapolin Paints, Inc.*, 20 Bankr. 497, 508 (Bankr. E.D.N.Y. 1982) (debtor is entitled to court approval, absent extraordinary circumstances, as matter of course); *In re Farrar McWill, Inc.*, 26 Bankr. 313, 316 (Bankr. W.D. Ky. 1982) (court should approve rejection as matter of course); *Summit Land Co. v. Allen (In re Summit Land Co.)*, 4 COLLIER BANKR. CAS. 2D (MB) 1431, 1437 (Bankr. D. Utah 1981).

139. *Summit Land Co. v. Allen (In re Summit Land Co.)*, 4 COLLIER BANKR. CAS. 2D (MB) 1431, 1437 (Bankr. D. Utah 1981) (citations omitted). Bankruptcy Judge Mabey argues that because rejection of an executory contract or unexpired lease can be achieved via two different procedural methods, "No reason . . . [exists] for distinguishing between these [two] situations." *Id.* One of the two procedural roads by which a chapter 11 reorganization debtor can reject is set forth in 11 U.S.C. § 365(a), (d)(2) (1982). This section allows rejection to occur at any time before the confirmation of the plan; or if a party in interest requests, the court may set a time within which the trustee must accept or reject. The second procedural mode for rejection is provided for

In *In re J.H. Land & Cattle Co.*,¹⁴⁰ Judge Kline concluded that the trustee's business judgment was not "clearly erroneous"¹⁴¹ and then concluded that if the court itself was required to apply the business judgment test, it was satisfied the test had been met.¹⁴² Based on the equivocal position taken by the bankruptcy court, it appears the contours of the standard to be applied in overseeing a trustee's decision to reject remain unclear.¹⁴³

D. *Equitable Considerations by the Bankruptcy Court*

Whatever the standard applied in reviewing the decision to reject, it is clear that the rejection of an executory contract or unexpired lease in a chapter eleven reorganization must be construed in accordance with the broad purposes of the entire Code. In theory, the Bankruptcy Code serves three main goals: it provides the debtor a fresh start; maximizes the value of the debtor's property as an ongoing concern; and affords fair treatment to creditors, shareholders, and others with rights and interests in the debtor's property.¹⁴⁴ It is well established that there is an "overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."¹⁴⁵ A bankruptcy court is both a court of law and a court of equity.¹⁴⁶ The bankruptcy judge must balance the rights of all parties¹⁴⁷ while carrying out the underlying pur-

in *id.* § 1123(b)(2), which allows rejection to occur as part of the chapter 11 plan. Judge Mabey states: "The plan is confirmed with judicial oversight [in that the court must approve the debtor's plan which contains the proposed rejection] but the . . . rejection . . . is not approved in the sense contemplated by Section 365(a)." 4 COLLIER BANKR. CAS. 2D at 1437.

140. 8 Bankr. 237.

141. *Id.* at 239.

142. *Id.*

143. Compare two cases in which the court did not enunciate a standard for reviewing the trustee's decision to reject. Rhode Island Hosp. Trust Nat'l Bank v. Elliott Leases Cars, Inc. (*In re Elliott Leases Cars, Inc.*), 20 Bankr. 893, 896 (Bankr. D.R.I. 1982); LHD Realty Corp. v. Metropolitan Life Ins. Co. (*In re LHD Realty Corp.*), 20 Bankr. 717, 721 (Bankr. S.D. Ind. 1982).

144. Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 AM. BANKR. L.J. 223, 223 (1981).

145. Bank of Marin v. England, 385 U.S. 99, 103 (1966) (citations omitted); Pepper v. Litton, 308 U.S. 295, 304-05 (1939).

146. *E.g., In re El Patio, Ltd.*, 6 Bankr. 518, 523 (Bankr. C.D. Cal. 1980) (bankruptcy court is both a court of law and a court of equity).

147. *E.g., In re Loiselle*, 1 Bankr. 74, 76 (Bankr. D.R.I. 1979) which provides:

It can be stated safely without citation that [the Bankruptcy Court] is a Court of Equity which must consider the rights of all parties including the bankrupt, the estate, and both general and unsecured creditors This equitable flexibility permits the Court in each case to examine and weigh the positions of the parties, and to exercise its judicial discretion . . . to accomplish common sense results. . . .

In re Sung Hi Lim, 7 Bankr. 316, 318 (Bankr. D. Hawaii 1980) (as an equity court, bankruptcy court must seek equity not only for the debtors, but also for the creditors).

pose of the Bankruptcy Code.¹⁴⁸ Even if it appears the trustee's decision to reject will benefit the estate, the bankruptcy court can override the decision and issue whatever orders will best serve the equities in each individual case.¹⁴⁹ Its equitable powers are "necessarily quite broad and flexible, so that the Court may fashion the appropriate relief."¹⁵⁰ The court in *In re Roger Williams Building Corp.*¹⁵¹ held that a bankruptcy court can order the abrogation of leases made by a prior state court receiver if such an order was equitable for the protection of the bankruptcy estate and its general creditors.¹⁵²

The consequences of rejection will be more closely examined by the court where the estate would not have lost money by continuing performance under the executory contract or unexpired lease rejected in favor of a more beneficial one.¹⁵³ Professor Cook has concluded that there are no hard rules in determining what constitutes a significant benefit to the debtor's estate; the trustee must consider the extent to which the claims and encumbrances on the debtor's property are relevant to whether the relief sought will yield a benefit and the nature and extent of damages flowing from the rejection.¹⁵⁴ Professor Cook also notes that the *Minges* court¹⁵⁵ and its predecessors have confirmed that the rejection process should be equitable in nature and that "[b]efore granting any motion seeking contract rejection, the reorganization court should have all the relevant facts before it."¹⁵⁶

The *Minges* court stressed the necessity of a flexible test for deter-

148. See Cook, *supra* note 27, at 693.

149. One court notes that the bankruptcy court:

In exercising its equitable jurisdiction . . . must consider the circumstances surrounding any claim emphasizing substance over any technical considerations and form, to see that injustice or unfairness is not done in the administration of the . . . estate; however, these equitable powers must be exercised within . . . limit established by the bankruptcy court, to further its purpose, and is subject to its specific provisions.

In re Supreme Plastics, Inc., 8 Bankr. 730, 731 (Bankr. N.D. Ill. 1980). For example, in *In re Roger Williams Bldg. Corp.*, the court held that in reorganization proceedings, a bankruptcy court can abrogate leases by a state receiver if "such orders [are deemed] equitable." 99 F.2d 212, 217 (7th Cir. 1939).

150. *Flushing Sav. Bank v. Parr (In re Parr)*, 1 Bankr. 453, 456 (Bankr. E.D.N.Y. 1979); see *Leonard v. Commonwealth Nat'l Bank (In re Middleton)*, 3 Bankr. 610, 614 (Bankr. E.D. Penn. 1980); see also *In re Cannady Supply Co.*, 6 Bankr. 674, 678 (Bankr. D. Kan. 1980) (court can issue any order to serve equities of case).

151. 99 F.2d 212 (7th Cir. 1939).

152. *Id.* at 217. The court stated, "It must be borne in mind that the contract was not entered into by the debtor but by . . . the state court receiver." *Id.*

153. *E.g.*, *Flushing Sav. Bank v. Parr (In re Parr)*, 1 Bankr. 453, 456 (Bankr. E.D.N.Y. 1979).

154. Cook, *supra* note 27, at 701.

155. *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38 (2d Cir. 1979).

156. Cook, *supra* note 27, at 705; see also H. MILLER & M. COOK, *supra* note 35, at 149 (emphasis on equitable principles leads to sounder results).

mining when an executory contract may be rejected in bankruptcy proceedings.¹⁵⁷

[T]he court [and the trustee] must exercise their discretion fairly in the interest of all who have had the misfortune of dealing with the debtor. A rigid test . . . might work a substantial injustice in cases where it can be shown that the non-debtor . . . will reap substantial benefits . . . while the debtor's creditors are forced to make substantial compromises of their claims.¹⁵⁸

The bankruptcy court must exercise its discretion to preclude rejection of a contract or unexpired lease where no benefit would accrue to the creditors from the rejection.¹⁵⁹ For the proper exercise of this discretion, meaningful evidence must be presented to the court illustrating how rejection would substantially benefit the estate. For example, the court in *In re Mykleburst*,¹⁶⁰ after reviewing the evidence, did not allow rejection of an unexpired lease because the potential advantage to the debtor in rejecting the lease and the considerable risk of loss of a new lease did not sufficiently offset damages involved in the rejection.¹⁶¹ In *In re Penn Central Transportation Co.*,¹⁶² the court's denial of the trustee's attempted rejection of unexpired leases was based on equitable considerations: the lessees were not creditors of the estate, there were no burdensome covenants, and the leases were negotiated at arms length.¹⁶³ "The bankruptcy laws are intended as a shield, not as a sword. Their purpose is to minimize fiscal chaos . . . not to aggravate

157. *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38, 43 (2d Cir. 1979).

158. *Id.*; see *Cook, supra* note 27, at 702 (notes that rejection will invariably have an adverse affect on third parties. The question the court should consider in balancing the equities is the extent and nature of the harm produced versus the benefits the estate will receive in rejection. *Id.*); see also *In re Florence Chi-Feng Huang*, 9 BANKR. CT. DEC. (CRR) 972, 974 (9th Cir. 1982) ("[a]ny rejection will inevitably entail the disappointment of legitimate expectations. A basic policy of the Bankruptcy laws is to spread the burden evenly among both those who may have loaned the debtor money and those who might have obtained a profit from dealing with him"); *Cook, supra* note 27, at 703 n.92 (adverse consequence for third parties that could be caused by the debtor's rejection would be the bankruptcy of the third party); accord *In re Hurricane Elkhorn Coal Corp. II*, 15 Bankr. 987, 989 (Bankr. W.D. Ky. 1981) (Court should use a flexible test because flexibility is inherent in "bankruptcy court's exercise of its discretionary and equity powers in determining what contracts do and do not promote the best interest of an estate.").

159. See *In re Florence Chi-Feng Huang*, 9 BANKR. CT. DEC. (CRR) 972, 976 (9th Cir. 1982).

160. 26 Bankr. 582 (Bankr. W.D. Wisc. 1983).

161. *Id.* at 585; cf. *Allied Technology, Inc. v. Bruneman & Sons, Inc. (In re Allied Technology, Inc.)*, 25 Bankr. 484, 497 (Bankr. S.D. Ohio 1982) (court approved assumption of unexpired lease to avoid arguably greater liability as good exercise of business judgment).

162. 458 F. Supp. 1346 (E.D. Penn. 1978).

163. *Id.* at 1356.

it."¹⁶⁴

In comparison, the court in *In re O.P.M. Leasing Services*¹⁶⁵ sanctioned rejection of an unexpired lease when it enabled the estate to re-lease its equipment at a more reasonable and profitable rate.¹⁶⁶ A trustee can properly anticipate that an attempted rejection of an executory contract will be denied on equitable grounds when it is "apparent that the motion [for rejection] was made in bad faith or as a part of a larger fraudulent scheme."¹⁶⁷

IV. PERSONAL PROPERTY CHARACTERIZATION OF OIL AND GAS LEASES IN OKLAHOMA

The classification of an unexpired oil and gas lease as real or personal property determines the nondebtor-lessee's rights and interests in the debtor-lessor's bankruptcy estate. If an oil and gas lease is characterized as real property, the nondebtor-lessee will have the right to remain in possession for the remainder of the lease term, even though the debtor-lessor has filed for bankruptcy and rejected the lease.¹⁶⁸ If the nondebtor-lessee does not want to remain in possession for the remainder of the lease, he can accept the debtor's rejection, and file a claim against the estate.¹⁶⁹ In comparison, if an oil and gas lease is characterized as personal property, the nondebtor-lessee will not have the right to remain in possession.¹⁷⁰ In such an instance, the nondebtor-lessee's sole remedy is to file a claim against the debtor's estate.¹⁷¹

State law determines whether an oil and gas lease is classified as real or personal property.¹⁷² Oklahoma is a nonownership or qualified ownership state¹⁷³ with respect to oil and gas. In essence, under these

164. *Id.*

165. *Hassett v. Revlon, Inc. (In re O.P.M. Leasing Servs., Inc.)*, 23 Bankr. 104, 118 (Bankr. S.D.N.Y. 1982).

166. *Id.*

167. *Siedlecki v. Casale (In re S & R Serv. Inc.)*, 26 Bankr. 865, 868 (Bankr. S.D. Fla. 1983).

168. *See* 11 U.S.C. § 365(a), (h)(1) (1982).

169. *Id.* §§ 365(a), (h), 502(g).

170. *Id.*

171. *Id.*

172. *Butner v. United States*, 4 BANKR. CT. DEC. (CRR) 1259 (1979) ("property interests are created and defined by state law, [and] [u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding"); S. GLASSMIRE, *THE LAW OF OIL AND GAS LEASES AND ROYALTIES* § 28, at 97 (1938) (estate classification of oil and gas lease as realty or personalty depends on *lex loci* or local law); W. THORTON, *supra* note 31, § 51, at 133 ("[T]he rights of the parties must be determined by the law of the state where the leased premises lie, although . . . executed in another state where lessor or lessee reside.").

173. The nonownership theory of oil and gas has been expressed as a license to search.

theories no person owns oil and gas until it is produced.¹⁷⁴ The possessor of title to a mineral interest in Oklahoma holds no title to oil and gas that may be under the surface, instead, the mineral interest owner has an "exclusive hunting license" to search, develop and capture any oil and gas that may exist under the surface.¹⁷⁵ In Oklahoma, as in Kansas,¹⁷⁶ an individual can not own a severable possessory estate in oil and gas "in place."¹⁷⁷

Under Oklahoma law, the classifications of oil and gas leases are numerous and inconsistent.¹⁷⁸ Courts are, however, in agreement that

Oil and gas, while in the earth, unlike solid minerals, are not the subject of ownership distinct from the soil, and the grant of the oil and gas, therefore, is a grant, not of the oil that is in the ground, but of such a part as the grantee may find The lease . . . does not vest . . . title to the oil and gas in said land and is not a grant of any estate therein, but is simply a grant of a right to prospect for oil and gas, no title vesting until such substances are reduced to possession . . . an incorporeal hereditament.

Kolachny v. Galbreath, 26 Okla. 772, 776, 110 P. 902, 906 (1910). The court in *United States v. Standolind Crude Oil Purchasing Co.*, 113 F.2d 194, 198 (10th Cir. 1940) stated: "Because of the vagrant and fugitive nature of oil and gas, the owner of land has no absolute right or title He has only a qualified interest therein. . . ."

See, e.g., *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61, 70 (10th Cir. 1957) ("oil and gas is not subject to strict ownership in its natural state under Oklahoma law"); *Meeker v. Ambassador Oil Co.*, 303 F.2d 875, 882 (10th Cir. 1962) (nonownership theory of oil and gas); see also 17 Op. Att'y Gen. 2 (1965) (Oklahoma is qualified or nonownership theory state); I E. KUNTZ, *TREATISE ON THE LAW OF OIL AND GAS* § 3.1, at 78 (1962) (in nonownership state, landowner owns valuable rights with respect to oil and gas which he may exercise to exclusion of all others); Emery, *Real Property Mineral Interests in Oklahoma*, 24 OKLA. L. REV. 337, 338 (1971) ("no dissent among scholars that Oklahoma is either qualified or nonownership state").

174. The Supreme Court depicting the qualified ownership theory stated:

Although in virtue of his proprietorship the owner of the surface may bore wells for the purpose of extracting natural gas and oil until these substances are actually reduced to him to possession, he has no title whatever to them as owner. That is, he has the exclusive right on his land to seek to acquire them, but they do not become his property until the effort has resulted in dominion and control by actual possession.

Ohio Oil Co. v. Indiana, 177 U.S. 190, 208 (1900).

175. An oil and gas lease does not vest title to the oil and gas beneath the land, but "only the right to explore for and take from the earth any oil and gas found. . . ." *Hitt v. Henderson*, 112 Okla. 194, 197, 240 P. 745, 748 (1925) (rule of capture); S. GLASSMIRE, *supra* note 172, § 37, at 128 (Oklahoma courts state lessee has right to explore for oil and gas).

176. Kansas courts have determined that "[a] conventional oil and gas lease generally does not create any present vested estate in the nature of title to land which it covers, but merely creates a license to enter on the land and explore for minerals." *Reese Enter., Inc. v. Lawson*, 220 Kan. 300, 303, 553 P.2d 885, 889 (1976). However, a license is not tantamount to outright ownership of real property; see, e.g., *Holland v. Shaffer*, 162 Kan. 649, 170 P.2d 631 (1947); *Skelly Oil Co. v. Savage*, 202 Kan. 239, 447 P.2d 395 (1968). The Supreme Court of Kansas has placed one limitation on oil and gas lease construction. In *Ingram v. Ingram*, 214 Kan. 415, 521 P.2d 254 (1974) the court held that "an oil and gas lease is personal property . . . [and] the rights created by oil and gas leases . . . constitute intangible personal property *except when that classification is changed for a specific purpose by statute.*" *Id.* at 416, 521 P.2d at 255 (emphasis in original).

177. "Since oil and gas while in the earth are not subject to ownership distinct from the soil, it follows that all the land owner can convey is the right to develop and explore the land and take the oil and gas therefrom". *Melton v. Sneed*, 188 Okla. 388, 390, 109 P.2d 509, 512 (1941).

178. I H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 214, 154 (1981) (typically leasehold

oil and gas is personal property when reduced to possession.¹⁷⁹ Nevertheless, when oil and gas are still in the ground, the interest created by an oil and gas lease may vary depending upon the purpose for which the classification is being made, the type of ownership theory used to describe the interest received,¹⁸⁰ and the definition applied by a particular statute.¹⁸¹

In situations where courts have had no statutory definition to guide them, they have unanimously held an oil and gas leasehold interest to represent a vested interest in land¹⁸² or an "estate in land."¹⁸³ Courts have held that an oil and gas lease is not "per se real estate,"¹⁸⁴ and the distinction between real estate and an estate in real property

interest is realty, but in Oklahoma and Kansas, a pattern of inconsistency appears in classification).

179. *See, e.g.*, *Ohio Oil Co. v. Indiana*, 177 U.S. 190, 205 (1900); *Rich v. Doneghey*, 71 Okla. 204, 207, 177 P. 86, 89 (1918).

180. 2 E. KUNTZ, *supra* note 77, § 23.23, at 192.

181. Notwithstanding the fact that Oklahoma adheres to the rule that an oil and gas lease is an incorporeal hereditament, partaking of the characteristics of personal property, there are certain states under which the courts have construed leasehold interest as real property; *see, e.g.*, *Jones v. Tower Prod. Co.*, 120 F.2d 779. (10th Cir. 1941) (oil and gas lease is interest in real property for purpose of tax statute); *Nicholson Corp. v. Ferguson*, 114 Okla. 116, 243 P. 195 (1925) (oil and gas lease is estate in realty for statute setting out damages for breach of covenants). *See generally* 1 H. WILLIAMS & C. MEYERS, *supra* note 178, § 214.2, at 167-70:

The cases . . . [which] classify an interest in oil and gas as realty rather than personalty fall within one of the following categories:

- 1) Statutes phrased in such terms as "interests in real property" or "conveyances affecting real property". . . .
- 2) Federal tax statute . . . designed to have general application throughout the several states despite the technical differences . . . in classification of oil and gas interests.
- 3) Federal statute dealing with Indian lands. . . .
- 4) A rule said normally to be applicable in the particular case for reasons other than the classification of the oil and gas interest as realty or personalty.

Id. (Citations omitted). *But see, e.g.*, *Duff v. Keaton*, 33 Okla. 92, 124 P. 291 (1912) (oil and gas lease is not conveyance of real estate under probate statute); *First Nat'l Bank of Healdton v. Dunlap*, 122 Okla. 288, 254 P. 729 (1927) (interest of lessee is not real estate within meaning of Oklahoma judgment lien statute). *See generally* 2 E. KUNTZ, *supra* note 77, § 23.23, at 193 (oil and gas leases are personal property under certain statutes).

182. 2 E. KUNTZ, *supra* note 77, § 23.23, at 192.

183. *See, e.g.*, *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 699 (Okla. 1979) ("Oil and gas lease creates an interest or estate in realty"). *Contra* *Smith v. Kerr*, 100 Okla. 172, 228 P. 951 (1924) (lease of land for oil and gas purposes is not a grant of any estate in land); *Phillips Petroleum Co. v. Jones*, 176 F.2d 737 (10th Cir. 1949) ("It may be conceded that when judged by the laws of the states of Oklahoma and Kansas . . . an oil and gas lease is not realty or an estate therein." *Id.* at 740).

184. *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 699 (Okla. 1979). The court in *De Mik v. Cargil*, 485 P.2d 229 (Okla. 1971) stated:

[I]n the character of property created by an oil and gas lease, there is a recognizable distinction between *real estate* and an *estate in real property*. Not every kind of estate recognized in law as an interest in real property is real estate. Although an oil and gas lease creates an *interest* or *estate* in realty, such interest in not per se real estate.

Id. at 232 (emphasis in original).

has been recognized in the law.¹⁸⁵ Because of the classification of an oil and gas lease as an "estate in land," courts have not been able to clearly classify this interest as either real or personal property but instead have classified it as a "personal property right pertaining to real property."¹⁸⁶ Oklahoma courts have described an oil and gas leasehold interest as an incorporeal hereditament, as a profit a prendre, and as a chattel real.¹⁸⁷ An incorporeal hereditament encompasses an intangible, nonpossessory interest in land,¹⁸⁸ or the grant of a right or privilege to go on another's land.¹⁸⁹ A profit a prendre "implies a concrete benefit . . . and is not strictly incorporeal in character . . . [It is] a French civil law term defined as [t]he rights exercised by a person in the soil of

185. *Hinds*, 591 P.2d at 699.

186. S. GLASSMIRE, *supra* note 172, § 37, at 126.

187. The legal incidents of land ownership with respect to oil and gas lease rights have been described by the Oklahoma Supreme Court as follows:

The owners in fee simple of the land . . . [have] no absolute right or title to the oil or gas which might permeate the strata underlying the surface of their land, as in the case of coal or other solid minerals fixed in, and forming a part of, the soil itself But with respect to such oil and gas, they had certain rights designated by the same courts as a qualified ownership thereof, but which may be more accurately stated as exclusive right, subject to legislative control against waste and the like, to erect structures on the surface of their land, and explore therefor by drilling wells through the underlying strata, and to take therefrom and reduce to possession, and thus acquire absolute title and personal property to such as might be found and obtained thereby. This right is the proper subject of sale, and may be granted or reserved The right so granted or reserved, and held separate and apart from the possession of the land itself, is an incorporeal hereditament; or more specifically, as designated in the ancient French, a profit a prendre, analogous to a profit to hunt and fish on the land of another Considered with respect to duration, if the grant be to one and his heirs and assigns forever, it is of an interest in fee An interest of less duration may be granted, and that for a term of years has been denominated by this court a chattel real Such right is an interest in land.

Rich v. Doneghey, 71 Okla. 204, 206-07, 177 P. 86, 89 (1918) (citations omitted); *see also* *Mohama Oil Co. v. Ambassador Oil Co.*, 474 P.2d 950, 960 (Okla. 1970) (oil and gas lease is chattel real, incorporeal hereditament and profit a prendre); *Meecker v. Ambassador Oil Co.*, 308 F.2d 785, 882 (10th Cir. 1962) (Oklahoma oil and gas leasehold interest is "presently vested interest in the land of another . . . an incorporeal interest, or a profit a prendre.") (citations omitted); *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61, 70 (10th Cir. 1957) (oil and gas lease gives incorporeal hereditament, a profit a prendre); *Continental Supply Co. v. Marshall*, 152 F.2d 300, 305 (10th Cir. 1945) (oil and gas lease "a chattel real, an incorporeal hereditament and a profit a prendre"); *Francis v. Superior Oil Co.*, 102 F.2d 732, 734 (10th Cir. 1939) (oil and gas lease in Oklahoma for a term of years estate in real estate which is an incorporeal hereditament or profit a prendre); *Ewert v. Robinson*, 289 F. 740, 745 (8th Cir. 1923) (lessee receives incorporeal hereditament); *Priddy v. Thompson*, 204 F. 955, 956 (8th Cir. 1913) (Oklahoma lease is grant of incorporeal hereditament); E. BROWN, *THE LAW OF OIL AND GAS LEASES* § 3.02, at 3-8 n.22 (oil and gas leasehold interest is incorporeal hereditament).

188. *See generally* 42 AM. JUR. 2D *Corporeal and Incorporeal* § 11, at 194 (1942); *id.* *Hereditaments* § 17, at 199 (discusses incorporeal hereditaments).

189. S. GLASSMIRE, *supra* note 172, § 28, at 96; *see also* *McElroy, Unless vs. Or: An Appraisal*, 6 BAYLOR L. REV. 415 (1954) ("Incorporeal hereditaments were not corporeal things. They existed only in contemplation of law, were said to lie in grant and affiliated with chattel interests. The distinction [between incorporeal and corporeal interests] is, for example, between land and the profit arising from land called rent." *Id.* at 423-24 & n.28) (citations omitted).

another, with a participation . . . in the profits thereof.'” A chattel real is less than a freehold interest in real estate, and generally is personal property, except as modified by statute.¹⁹¹ While an oil and gas leasehold interest is a hybrid estate deriving its legal characteristics from both real and personal property, “it is actually neither.”¹⁹² Scholars and Oklahoma courts have been consistent, however, in treating oil and gas interests as a personal property right rather than as a real property right.¹⁹³

The bankruptcy courts have yet to determine whether an Oklahoma oil and gas lease should be considered real or personal property under section 365(h) of the Code.¹⁹⁴ It is likely, however, that the courts will be persuaded by the holding in *In re J.H. Land & Cattle Co.*, finding a Kansas oil and gas lease to be a personal property right. Therefore, an Oklahoma nondebtor-lessee will probably not be able to rely on section 365(h) of the Code to protect his remaining interest in an unexpired lease when the debtor-lessor files a motion to reject.¹⁹⁵

V. IMPLICATIONS FOR OKLAHOMA OF *IN RE J.H. LAND & CATTLE CO.*

Under section 365(a) of the Code,¹⁹⁶ a trustee can reject an unexpired oil and gas lease when there is a reasonable likelihood that the creditors will derive a significant or substantial benefit from the proposed lease rejection. In jurisdictions where oil and gas leases are characterized as real property, the nondebtor-lessee can avoid the trustee's rejection power and remain in possession for the remainder of the unexpired term. In Oklahoma, however, oil and gas leases are characterized as personal property and the nondebtor-lessee is therefore denied the benefits of section 365(h)(1), which would enable him to remain in possession of the leasehold interest for the remainder of the unexpired lease term.¹⁹⁷

When it appears that a debtor-lessor is hopelessly insolvent, an

190. S. GLASSMIRE, *supra* note 172, § 28, at 4, 95-96; McElroy, *supra* note 189, at 423 & n.28 (profit a prendre is “right to remove part of the substance of land, which is an estate in realty in the nature of an incorporeal hereditament”) (citations omitted).

191. 42 AM. JUR. 2D. *Chattels Real* § 25, at 206 (1942) (discusses chattel reals).

192. *Continental Supply Co. v. Marshall*, 152 F.2d 300, 305 (10th Cir. 1949) (citation omitted).

193. I H. WILLIAMS & C. MEYERS, *supra* note 178, § 214, at 167.

194. 11 U.S.C. § 365(h) (1982).

195. *Id.*

196. *Id.* § 365(a).

197. *Id.* § 365(h)(1).

attorney can protect her nondebtor-lessee client in several ways. First, the attorney should oppose the debtor-lessor's rejection and insist on an evidentiary hearing to determine whether the trustee can meet the business judgment or equity tests.¹⁹⁸ Second, because it may often be uncertain whether the chapter eleven debtor-lessor will opt to reject the unexpired lease, the nondebtor-lessee's attorney should move to have the court set a definite time by which the debtor must reject or assume the lease,¹⁹⁹ preferably before the confirmation of the plan. Third, the attorney should advise her nondebtor-lessee client to keep informed regarding the financial status of the lessor. Should the nondebtor-lessee suspect that the lessor is approaching financial jeopardy, certain good faith acts such as commencement of drilling operations can provide equitable arguments for the nondebtor-lessee defending the unexpired lease. Equitable considerations may prevent rejection in certain circumstances. Judge Kline suggested that had there been production of oil and gas in the facts of *In re J.H. Land & Cattle Co.* the bankruptcy court may have disallowed the trustee's rejection, as such a result would have been inequitable to the nondebtor-lessee.²⁰⁰ At the very least, the nondebtor-lessee should attempt to "look busy" so that if the lessor does file bankruptcy the equities will be in the nondebtor-lessee's favor and he will be in a better position to preserve the "benefit of his bargain" under the lease.

While it remains unclear what factors the bankruptcy court will consider in determining whether the business judgment or the equity test is met, courts have, nevertheless, been influenced by certain equitable factors in making their determination to disallow the rejection of a lease by a trustee. Courts have emphasized the importance of such factors as the presence of an eager lessee who would willingly enter into a lease that is more profitable than the one sought to be rejected; the length of time the unexpired lease has been in effect; the chronological nearness of the execution of the lease sought to be rejected and the filing of the lessor's bankruptcy; and, in general, a lack of bad faith by

198. H. MILLER & M. COOK, *supra* note 35, at 171.

Counsel for the nondebtor . . . will receive notice of a proposed rejection . . . and should be prepared . . . to litigate the propriety of the disaffirmance. . . . [R]ejection is not automatic in a reorganization case, but is a matter within the court's discretion. In a case where the client has bargained in good faith . . . and the contract will not impair the . . . proposed reorganization . . . [the nondebtor-lessee's attorney] should insist upon an evidentiary hearing.

Id.

199. *Id.*; see also 11 U.S.C. § 365(d)(2) (1982).

200. See *supra* note 50.

the nondebtor-lessee or a fraudulent attempt to reject by the debtor-lessor.

VI. CONCLUSION

A nondebtor-lessee client may be properly indignant to discover that despite his regular timely tenders of delay rental payments and substantial royalty payments, an Oklahoma bankruptcy court may properly void his lease, instructing him to "stand in line" to collect his damages from the debtor's estate after first being reduced to the status of an unsecured creditor. The client will predictably turn his wrath on his lawyer, seeking to ameliorate the loss of his bargain by extracting a "pound of flesh" from the one person totally responsible for his loss. While the rejection of an unexpired lease is often an unavoidable occurrence which an attorney is powerless to prevent, disclosure is the key. When a client bargains with a quasi-solvent lessor and thus acquires a favorable lease, it would behoove the prudent attorney to advise her client that good fortune may not last. A general caveat to all clients entering into contracts with parties of questionable solvency, as a measure of preventative lawyering, would serve and protect attorneys and clients alike.

J. Devereaux Jones