THE ULTIMATE DOWNSIDE OF OUTSOURCING: BANKRUPTCY OF THE SERVICE PROVIDER

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INTRODUCTION

Outsourcing involves contracting for services from third parties that would historically have been done in-house by a business' employees. Strategic outsourcing is the concentration of a business' own resources on "core competencies" while outsourcing other activities (i.e., extraneous or peripheral subparts) to companies which specialize in them. While the term "core competencies" is hard to define consistently, one useful definition is that "core" activities are those that offer a "long-term competitive advantage" which need to be controlled and protected.[1] Peripheral activities would be those that are "not critical to the company's competitive edge."[2]

The risks and benefits of "strategic outsourcing" have been succinctly described as follows:

> Most companies can substantially leverage their resources through *strategic outsourcing* by: (1) developing a few well-selected core competencies of significance to customers and in which the company can be best-in-world; (2) focusing investment and

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1 James Brian Quinn & Frederick G. Hilmer, *Strategic Outsourcing,* 1 THE MCKINSEY Q. 48, 51, 56 (1995); *see also* Michael W. Mutek, *Implementation of Public-Private Partnering*, 30 PUB. CONT. L.J. 557, 558–65 (2001) (discussing public-private partnering by federal agencies, including outsourcing, and characterizing core competencies as fundamental abilities, skills, or expertise creating marketplace strength).

2 *See* Quinn & Hilmer, *supra* note 1, at 48, 51, 56 (discussing strategic outsourcing in depth and attempting to rationally define "core competencies" and types of activities that should be considered for outsourcing); *see also* Des Dearlove, *Outsourcing: The Debate Rages On,* TIMES (London), Aug. 30, 2001, at Features (citing survey of over 650 U.S., U.K. and European companies by Professor Andrew Kakabadse and Dr. Nada Korac-Kakabadse at Cranfield School of Management for information as to activities companies outsource and why). Dearlove states:

> The Cranbankeld survey found that the most popular areas for outsourcing are: Basic services, such as cleaning, catering and printing, followed by human resource systems and processes, IT services and telecommunication services. The next group includes facilities management, e-commerce, call centers, logistics, finance and accounting. Significantly, manufacturing also features in this group. Least likely to be outsourced are information and knowledge management, purchasing, fund management, securities and asset management.

Id.

> management attention on them; and (3) strategically outsourcing many other activities where it cannot or need not be best.
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> There are always some inherent risks in outsourcing, but there are also risks and costs associated with insourcing. When approached within a genuinely strategic framework, using the variety of outsourcing options available, and analyzing the strategic issues developed here, companies can overcome many of the costs and risks. When intelligently combined, core competency and extensive outsourcing strategies provide improved returns on capital, lowered risk, greater flexibility, and better responsiveness to customer needs at lower cost.[3]

Outsourcing is now a "fact of life" in the business world as companies have accepted that they cannot do everything themselves. Whether a specific outsourcing decision is a wise strategic move for a business or a recipe for disaster is dependent on many factors, including the business' ability (or lack of ability) to perform internally the operations being outsourced. It also depends on the service provider selected and whether that service provider, in fact, is financially stable and has the ability to perform the services outsourced in the manner anticipated by the business.[4]

Businesses enter into outsourcing arrangements expecting the service provider to perform the outsourced services in certain ways. The downside of outsourcing arises in those situations where the service provider does not perform as anticipated by the business.[5] The *ultimate downside* of outsourcing occurs where the service

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[3] Quinn & Hilmer, *supra* note 1, at 69.

[4] *See* ROBERT KLEPPER & WENDELL O. JONES, OUTSOURCING INFORMATION TECHNOLOGY, SYSTEMS & SERVICES, 55–70 (1998) (providing thorough overview of outsourcing risks); Michael Skapinker, *'Outsiders' With a Key Role at the Heart of Business,* FIN. TIMES (London), Sept. 20, 2002, at I (describing history and trends in business process outsourcing); *see also Outsourcing: A Decision Of Trust*, *at* http://www.hssworld.com/whitepapers/whitepaper_pdf/service6.pdf (last visited Nov. 13, 2002) (describing steps to be taken and factors to be considered in deciding whether or not to outsource).

The specific risks depend on the functions/activities outsourced and some consequences are more serious than others. For example, if a data processing company providing basic servicing functions (i.e., transaction processing, statement generation, statement mailing, and payment processing) has financial or operational difficulties the consequences to the user may be far more severe than if similar problems develop with a service provider providing call-center services. However, regardless of the functions outsourced, some potential problems with outsourcers are relatively generic including: loss of control over the timely delivery and quality of services and costs; the business is not provided with the services that it thinks it is entitled to despite a finely crafted contract - i.e., the service provider is not performing in the manner that the business contemplated; breach of contract by the service provider; decline in processing/operational efficiency and performance at the service provider (but not to a level that is in breach of the standards defined in service level agreements) accompanied by difficulty in retaining or hiring employees; reduction in flexibility; and disclosure of confidential corporate information and intellectual property.

[5] *See* Peter Martin, *Lessons From Railtrack: The collapse has demolished some of the untested assumptions about outsourcing,* FIN. TIMES (London), Oct. 9, 2001, at 21 (reporting "The fall of Railtrack,

provider experiences financial difficulties and goes bankrupt. The service provider's bankruptcy instantly crystallizes the inherent risks present with outsourcing – once the bankruptcy filing has occurred, it becomes obvious that these risks may be difficult (if not impossible) to manage effectively.

The possibility that this *ultimate downside* will occur must be considered by any business considering outsourcing. This becomes critical if the outsourcing of core-processing services is under discussion, particularly if such core processing is performed on a relatively effective in-house system. A perhaps self-evident observation is that once core processing is transferred to a service provider and an in-house processing system is shut down, it is difficult to restart it – the option of

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Britain's rail infrastructure, has many lessons. But one that may resonate longest is the failure of its attempt to rely on a web of subcontractors to carry out maintenance and other routine tasks.") Martin further writes:

> Railtrack had about a dozen prime contractors, which in turn farmed out the work to about 2,000 subcontractors. Getting this web of relationships to work properly was a daunting task. Gaps in communication, and the consequent "blame culture," are thought to be important causes of the track problems that led to the Hatfield crash which undermined Railtrack's credibility. In adopting this approach, however, Railtrack was merely taking 1990s orthodoxy to its logical conclusion. It was focusing on its core competence - managing and rebuilding the railway network - and outsourcing the routine, low-value tasks.

Id.; *see also* Kevin Ferguson, *Out of Service*, BUS. WK., Apr. 2, 2001, at SB14 (discussing various negative experiences with outsourcing service providers in what is described as "squishy world" of Web). Ferguson further states:

> [T]he lesson here: No business ever stands on completely solid ground in the squishy world of Web-based services. In practice, it means you have to treat all outsourced service providers the same - with caution - whether they call themselves an isp (internet service provider), asp (application service provider), or bsp (business service provider).

Id. But see David J. Bryce & Michael Useem, *The Impact of Corporate Outsourcing on Company Value,* 16 EUROPEAN MGMT. J. 635, 641 (1999) (discussing risks and downsides of outsourcing). The article states that:

> Management experience and academic research on outsourcing to date, however, shows little sign of confirming any of the worst fears about its downsides for corporate performance.
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> The research reviewed here does not paint an unblemished picture. Company managers frequently complain about the downsides, companies sometimes retrieve what they had contracted out, and outright failures can be seen here and there. And the long-term potential consequences of becoming too hollow, of outsourcing too much, are yet to be seen. Still the weight of the evidence points in the affirmative direction. When well designed and well managed, outsourcing reduces operating costs, enhances competitive strategy, and enlarges shareholder value.

Id. See generally David E. Brown, Jr., *Strategic Alliances: Why, How, and What to Watch For*, 3 N.C. BANKING INST. 57, 66 (1999) (describing: (1) various forms of strategic bank alliances (including outsourcing), (2) legal and regulatory considerations inherent in entering into them, and (3) various "tools" which should be considered in structuring and documenting such transactions). Among the downsides to the alliances described is that:

> [A] party seeking a technology or product solution from a third-party risks dependence on another company. This dependence may cause the larger company to fail to undertake its own efforts in areas that are critical to its future. This failure can have devastating effects if the small company defaults on its obligations because of financial problems, lack of experience or capability, or if the smaller company is acquired by one of the larger company's competitors.

Id.

in-house servicing may well disappear. During the go-go days of the 90's outsourcing seemed to work relatively well (assuming that growth in expenditures for outsourced services is any indication),[6] and this *ultimate downside* drew relatively little attention. Whether that will continue to be the case is far from clear inasmuch as the economic climate is less robust and additional companies face financial difficulties and stagnant growth. In the current economic climate, companies frequently announce layoffs, revise earnings estimates downward, and see their stock downgraded by analysts. In 2002, there were 38,540 business bankruptcy filings (an 8.65% increase over 2000);[7] 11,270 of these were filed under chapter 11 (an increase of 14% over 2000).[8] During 2001, over 225 public companies were among those filing.[9] An unanswerable question at this time is whether the *ultimate downside* of outsourcing will become more apparent as increasing numbers of struggling companies find it difficult to obtain new infusions of capital and run out of cash.[10]

Many articles and books have been written analyzing the outsourcing phenomenon from many different perspectives.[11] Numerous other articles address the impact of the Bankruptcy Code provisions dealing with executory contracts and

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[6] *See, e.g.*, Sana Siwolop, *Outsourcing: Savings Are Just the Start*, BUS. WK., May 13, 1996, at 24 (citing 1993 Coopers & Lybrand survey showing companies using outsourcing reported revenues 22% greater than those that didn't, fatter margins, and healthier cash flows -- additionally 22% reported cost savings averaging 7.8% over cost of providing same services in-house); Marq R. Ozanne, *Dun & Bradstreet Barometer of Global Outsourcing*, *at* http://www.dnbcollections.com/Library/kbarom.htm (last visited Nov. 21, 2002) (discussing growth of outsourcing during decade of 90s on worldwide basis). *But cf.* John A. Byrne, *Has Outsourcing Gone Too Far?*, BUS. WK., April 1, 1996, at 26 (calling outsourcing a growth industry and most sweeping trend of 1990's, but pointing out that "it's a trend has a decided downside.").

[7] News Release, Administrative Office of the U.S. Courts, Record Breaking Bankruptcy Filings Reported in Calendar Year 2002*, at* http://www.uscourts.gov/Press_Releases/cy02.pdf (Feb. 14, 2003).

[8] *Id.*

[9] Janet Kidd Stewart, *Turning Red Ink Into Gold,* CHI. TRIB., Dec. 16, 2001, at 5.1. The author further notes:

> As public companies lurch toward a second year of record bankruptcy filings, wounded shareholders should brace themselves for similar shocks in coming years - even if the economy improves dramatically.
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> Corporate leaders have never had such strong incentives to choose bankruptcy as a way out of their often self-inflicted financial problems, a Tribune review of the bankruptcy system shows.
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> The excesses of the past decade play a key role, including a swelling appetite for leverage and an erosion of discipline in financial reporting. In addition, a fast growing market for distressed corporate debt is encouraging companies to emerge from bankruptcy proceedings with enormous liabilities that often lead them right back into trouble.

Id.

[10] *See id.* (discussing various factors contributing to "skyrocketing number of corporate bankruptcies" and various parties impacting outcome after company files for bankruptcy).

[11] *See generally* Outsourcing Center, *at* http://www.outsourcing-books.com/book-list.html#outsourcing (last visited Nov. 13, 2002) (providing over fifty book titles dealing with outsourcing in general, and legal and security aspects of outsourcing).

the automatic stay.[12] This Article has a very limited focus: it reviews the practical and legal problems facing a bank that has an outsourcing arrangement with a service provider that goes bankrupt. The discussion centers on the impact of Bankruptcy Code provisions dealing with executory contracts and the automatic stay on such outsourcing arrangements. Rather than providing an exhaustive analysis of the case law relevant to each of the Bankruptcy Code sections, readers are generally directed to various law review and journal articles that provide such case law analysis with respect to individual statutory sections. While the focus is on *bank* outsourcing, the risks described and the conclusions drawn are also applicable to many other types of businesses encountering the bankruptcy of a service provider. The goal of this Article is quite simple and modest, however, the implications of service provider bankruptcy discussed in it on specific outsourcing arrangements may be quite significant.

I. WHAT IS THE CURRENT STATE OF OUTSOURCING?

Outsourcing of various business activities has been around for many years. However, in the 1990's enthusiasm grew and use of service providers by businesses increased dramatically.[13] The ultimate outsourcing scenario, where virtually all non-core functions are performed by various third-party service providers (sometimes described as the "virtual organization" or "outsourcing on speed") popped up – a few isolated examples of this were seen in the banking industry.[14] At the peak of the

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[12] *See, e.g.*, John P. McNicholas, *Prepetition Agreements and the Implied Good Faith Requirement*, 1 AM. BANKR. INST. L. REV. 197, 201 (1993) (evaluating "the potential impact of prepetition workout agreements that stipulate that the debtor waives its right to protection from the automatic stay when it files a chapter 11 petition.").

[13] *See* KLEPPER & JONES, *supra* note 4, at 5, 23–43 (noting while various forms of information technology ("IT") outsourcing have been around for past fifty years, "use of outsourcing services has exploded in the last 10 years"); *see also* Bryce & Useem, *supra* note 5, at 635, 641 (indicating "outsourcing has become a standard management device at many U.S. firms, and corporate expenditures on it have rapidly accelerated."); Richard L. Huber, *How Continental Bank Outsourced its 'Crown Jewels'*, HARV. BUS. REV., Jan.-Feb., 1993, at 121 (discussing Continental Bank's 1991 decision to outsource almost all of its IT, becoming first money-center bank to do so). Continental signed a ten-year multimillion-dollar outsourcing contract after identifying significant problems with in-house IT. Management concluded that: Continental's core competencies were "intimate knowledge of customers' needs and relationships with customers," rather than IT; competitive advantages "no longer accrue naturally to institutions that have internal technological resources" rather, they "accrue to institutions with the flexibility to tap the source of the best technology at an acceptable price"; and IT outsourcing would give it "better access to cutting-edge technologies; cut the development time for new technology-driven products; and transform the bank's IT costs from fixed to variable." *Id.*; Caitlin Mollison, *Tom Tunstall: The KPMG Consulting Senior Manager Discusses His Dissertation on IT Outsourcing Trends Over the Past Decade (Interview)* INTERNET WORLD, Jan. 1, 2001, at 43 (reviewing development of and increase in IT outsourcing).

[14] *See, e.g.*, Claire Moore Dickerson, *Spinning Out of Control: The Virtual Organization and Conflicting Governance Vectors,* 59 U. PITT. L. REV. 759, 803 (1998) (describing "virtual organization" and concluding it is "a governance nightmare"); Philip Manchester, *Rise of the Virtual Corporation: The Question Is Not If, but When*, FIN. TIMES (London), June 4, 1997, at 12 (defining virtual corporation as organization that "co-ordinates economic activity to deliver value to customers using resources outside the traditional boundaries

Internet boom, this ultimate manifestation of outsourcing was conceptualized as follows:

> [With the Internet,] each business component or process can be individually farmed out and reconnected, Lego-like, to process elsewhere at unprecedentedly low cost. This is outsourcing on speed. If there's another company that can more efficiently perform a function your company once did, turn that component over. The Web makes integrating the work of multiple partners nearly seamless. With this outsourcing in place, only business functions through which your company can add genuine value will remain."[15]

According to Dun & Bradstreet, third-party providers of routine operational services (e.g., payroll processing, provision of extra manufacturing capacity) took in more than $1 trillion around the world in 2000, with the market more than doubling in size from 1997 to 2000.[16] The Gartner Group has recently projected a 15.6 per cent annual growth rate worldwide in outsourcing from 2000 to 2005 and estimates that by 2002 the IT outsourcing market could be worth as much as $120 billion.[17] These trends are also seen in the banking industry.[18] Specific examples can be

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of the organization"). *See generally* Sandra Sucher & Daniel Galvin, *WingspanBank.com*, Harvard Business School Case Study No. 9-600-035 (Rev. July 29, 2002) (case study of new product development process for Wingspanbank.com, an Internet start-up bank created in roughly 120 days through team of 30 vendors).

[15] David Kirkpatrick, *From Davos, Talk of Death,* FORTUNE, Mar. 5, 2001, at 180. *But see* Dickerson, *supra* note 14, at 803–04, in which the author concludes that:

> The virtual organization is a governance nightmare.
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> Indeed, it is an internally inconsistent concept. The providers are adversaries of the hub for cost allocation, but partners for purposes of increasing the providers' productivity for the hub's benefit. In order to satisfy the requirements of the hub, the providers have to be affirmatively motivated to cooperate. However, the purely contractual nature of the relationships, coupled with the lack of unity among the constituent parts, destroys any incentive to work together—and actively drives the parties toward the disintegration of their relationships.

Id.

[16] Ozanne, *supra* note 6.

[17] *See* Dearlove, *supra* note 2 ("The idea behind outsourcing is as old as business itself. What has made it hot topic in recent years is its application to IT."); *see also* Louis Lavelle*, First Kill the Consultants,* BUS. WK., Jan. 14, 2002, at 122 (discussing estimates of outsourcing revenues and describing outsourcing as a "pocket[ ] of growth in an otherwise dismal professional services landscape.").

[18] *See, e.g.*, David Breitkopf, *Amex, IBM: Financial IT Outsourcing is Back,* AM. BANKER, Feb. 26, 2002, at 1 (describing major IT outsourcing deals involving financial services companies); Amanda Fung, *Bank Outsourcing Trend Seen Helping Processors,* AM. BANKER, Dec. 10, 2001, at 22 (reporting on interview with analyst at Prudential Securities concerning accelerating use of outsourcing by financial services companies); Jennifer A. Kingson, *Chase Mulls Even More Outsourcing,* AM. BANKER, Apr. 26, 2002, at 1 (discussing major IT outsourcing evaluation being conducted at J.P. Morgan Chase & Co.); Joe Shalleck, *What's the Right Back Office Solution?*, A.B.A. BANKING J., Dec. 1, 2001, at 48 (discussing high cost of banks' "back office" operations, growth of inexpensive non-bank transaction processing companies, and strategic alternatives available to banks to overcome "the problem posed by the back office cost structure."); Bill Stoneman, *Have Outsourcers Made CIOs Obsolete?*, AM. BANKER, July 2, 2002, at 14A ("According to a recent survey conducted by the American Bankers Association and its ABA Banking Journal, 46.5% of

found in the retail payments card arena and banks' online activities where more and more frequently important functions are performed by service providers.[19]

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community banks outsource data processing services."); Thomas P. Vartanian, *When You Outsource Your Technology You Don't Outsource Responsibility*, AM. BANKER, Apr. 26, 2002, at 6 (describing exponential increase in banks' reliance on non-bank technology providers and bank management's responsibility for managing risks arising from third-party business relationships); *see also Bank For International Settlements*, *Risk Management Principles for Electronic Banking*, BASEL COMM. ON BANKING SUPERVISION [hereinafter BASEL COMM.], May, 2001, at 12, *at* http://www.bis.org/publ/bcbs82.-pdf10/2/2001*,* stating:

> Historically, outsourcing was often limited to a single service provider for a given functionality. However, in recent years, banks' outsourcing relationships have increased in scale and complexity as a direct result of advances in information technology and the emergence of e-banking. Adding to the complexity is the fact that outsourced e-banking services can be sub-contracted to additional service providers and/or conducted in a foreign country. Further, as e-banking applications and services have become more technologically advanced and have grown in strategic importance, certain e-banking functional areas are dependent upon a small number of specialized third-party vendors and service providers. These developments may lead to increased risk concentrations that warrant attention both from an individual bank as well as a systemic industry standpoint.

Id.

Reflecting this trend, the Banking Industry Technology Secretariat ("BITS") Information Technology Service Provider Working Group in 2001 set forth a banking industry approach to risk management strategies for IT service provider outsourcing and articulated recommendations for managing IT service provider relationships. *See* BANKING INDUSTRY TECHNOLOGY SECRETARIAT, *BITS Framework: Managing Technology Risk For Information Technology (IT) Service Provider Relationships* (Oct. 2001), *at* http://www.bitsinfo.org/serviceproviders.html [hereinafter *BITS Framework*].

[19] *See, e.g.*, Eugene M. Katz & Theodore F. Claypoole, *Willie Sutton is on the Internet: Bank Security Strategy in a Shared Risk Environment*, 5 N.C. BANKING INST. 167, 195, 206 (2001) (discussing growing complexity of banking and increasing reliance by banks on outsource contractors for electronic banking and to support other technology initiatives); Press Release, Banking Industry Technology Secretariat (BITS), BITS Endorses Framework for Managing Outsourcing Risk (Oct. 25, 2001), *at* http://www.bitsinfo.org/serviceproviders.html (referencing Gartner Group projection for average annual growth rate in outsourcing retail financial services as 27% for 1998-2002).

In February 2002, American Express Co. announced a $4 billion seven-year agreement with IBM Global Services for IBM to handle most of its technology operations. *See* Breitkopf, *supra* note 18; *American Express hires IBM to run its IT operations,* CHI. TRIB., Feb. 26, 2002, at Business 13 (reporting American Express' decision to outsource). Compare this with Bank One Corp.'s retreat in 2002 from the nearly $2 billion outsourcing arrangement that ranked among the banking industry's biggest when entered into in 1998 with IBM and AT&T Corp. Bank One's chief information officer indicated the following philosophical shift: "Information technology is at the heart of financial services. It's a strategic, important part of our company that should be owned by the company." Chris Costanzo, *Outsourcing Reversal at Bank One,* AM. BANKER, Apr. 4, 2002, at 1; *see also* Chris Costanzo, *The Tech Scene: In Outsourcing, Vendors Adjust to Control Issue,* AM. BANKER, May 1, 2002, at 1 (analyzing recent outsourcing trends); Chris Costanzo, *The Tech Scene: Embracing Outsourcing's Middle Ground,* AM. BANKER, Apr. 17, 2002, at 1 (noting compromises regarding control in outsourcing relationships); Jennifer A. Kingson, *Dimon: More Deals But Less Outsourcing,* AM. BANKER, Apr. 16, 2002, at 1 (describing Bank One's conversion of an outsourcing arrangement with IBM and AT&T into more traditional vendor/client relationship); *BITS Framework*, *supra* note 18, at 2 (defining outsourcing as "any circumstance where customer information or critical company data is outside the direct control of the financial services company" and giving as examples: "aggregation; development, enhancement and maintenance of an application in the context of an outsourced service; . . . authentication; core processing; online banking and other Internet-related services; security monitoring; storage or processing of customer information; . . . and storage or processing of critical company data.").

In the payment card arena, First Data Corp. (which serves approximately 2.8 million merchant locations and 1,400 card issuers, processing transactions for over 315 million cardholder accounts) has as its strategic

II. WHAT APPROACH DO FEDERAL BANKING REGULATORS TAKE TO OUTSOURCING ARRANGEMENTS?

In recent years, federal regulatory authorities have tried to assist banks in understanding and managing the risks involved with third-party relationships such as outsourcing.[20] This guidance generally discusses what federal examiners look for in the examination process.[21] Failure to follow it may cause regulatory concern that the bank is not adequately protecting itself against risks.[22]

Among the most recent guidance is an OCC Bulletin on Third-Party Relationships dated November 1, 2001 ("OCC Bulletin 2001-47").[23] The last two pages list thirty documents previously issued by federal regulators which provide additional guidance.[24] Generally, federal regulators have articulated basic principles to follow in connection with outsourcing arrangements. The most basic guidance given is that: the board of directors and management of regulated financial institutions are expected to properly oversee and manage third-party relationships and to adopt risk management processes/systems reflecting the complexity of the third-party activities and the overall level of risk involved.[25] Federal regulators have generally left it to the banks to determine (1) the specific service providers to use, (2) precisely how to conduct due diligence, (3) the exact terms that must be in contracts, and (4) how best to manage those relationships. The OCC's primary concern in reviewing third-party relationships is "whether the bank is assuming more risk than it can identify, monitor, manage, and control."[26]

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objective: "To process every electronic payment transaction worldwide from the point of occurrence to the point of settlement." *See* First Data Corp.'s web site, *at* http://www.firstdata.com (last visited Nov. 21, 2002). Total System Services, Inc., another major payment card service provider, describes itself as servicing more than 200 million cardholder accounts for many of the banks and retailers in the U.S. and around the world. Total System Services, Inc.'s web site*, at* http://www.tsys.com/company (last visited Nov. 21, 2002).

[20] *See* FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL (FFIEC), *Guidance on Risk Management of Outsourced Technology Services*, *at* http://www.ffiec.gov/exam/InfoBase/documents/02-ffi-risk_manag_outsourced-tech-service-001128.pdf (Nov. 28, 2000) (providing guidance on risk management process of identifying, measuring, monitoring, and controlling risks associated with outsourcing technology services) [hereinafter FFIEC Guidance]; *see also* FFIEC, *Information Systems Examination Handbook*, *at* http://www.ncua.gov/ref/ffiec/vol1bm.pdf (1996) [hereinafter *Examination Handbook*]. The *Examination Handbook* is a reference source that further discusses and explains the concepts addressed in the FFIEC Guidance.

[21] *See generally* John L. Douglas, *Cyberbanking: Legal and Regulatory Considerations for Banking Organizations*, 4 N.C. BANKING INST. 57, 119 (2000) (noting outsourcing arrangements will be subject to intense scrutiny by regulators); Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of "Deconstruction" Of Banking Functions*, 5 N.C. BANKING INST. 135, 147–50 (2001) (authors, Chief Counsel and Assistant Chief Counsel at the OCC, discuss trends in bank outsourcing and federal regulatory guidance).

[22] *See* Douglas, *supra* note 21.

[23] Office of the Comptroller of the Currency, *OCC Bulletin on Third-Party Relationships*, *available at* http://www.occ.treas.gov/occ_current.htm (Nov. 1, 2001) [hereinafter *OCC Bulletin*].

[24] *Id*. at 16–17.

[25] *Id.* at 1.

[26] *Id.* at 6.

While federal regulators have authority to examine service providers' performance under the Bank Service Company Act,[27] regulatory guidance repeatedly emphasizes that managing and identifying/controlling the risks from such relationships is the responsibility of the bank's board and management.[28] OCC Bulletin 2001-47 provides an overview of the risks inherent in third-party relationships and the general risk management principles that should be followed to minimize and manage them. It provides a basic understanding of the federal banking regulators' concerns with third-party relationships, and recommends practical, broad-based principles for banks to follow in entering into and managing them.[29]

In contrast to OCC Bulletin 2001-47 and other federal regulatory guidance, which list in general terms the various risks facing banks entering into outsourcing arrangements, this Article describes with particularity specific risks facing a bank having an outsourcing arrangement with a bankrupt service provider.

III. WHAT CAN A BANK DO TO AVOID THE "ULTIMATE DOWNSIDE" PRIOR TO ENTERING INTO AN OUTSOURCING RELATIONSHIP WITH A SERVICE PROVIDER?

Clearly, a bank should perform due diligence and review the proposed service provider's financial condition prior to signing an outsourcing contract. However, as demonstrated by the recent Enron and WorldCom implosions, reviewing any entity's financial condition can be a very tricky undertaking.[30] Given the difficulty some of the world's most sophisticated lenders and accountants have had in understanding Enron's financial statements or in detecting the mischaracterization of transactions by WorldCom, a banker would be naïve to think that he necessarily has a perfect understanding of a service provider's financial condition.[31] Just as enormous losses can be suffered in the stock market or on commercial loans where

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[27] 12 U.S.C. § 1867(c) (2001 & Supp. 2002) (providing authorization for appropriate Federal banking agency to regulate and examine services performed for bank by third-party).

[28] *See, e.g.*, FFIEC Guidance, *supra* note 20, at 1.

[29] *See OCC Bulletin, supra* note 23, at 8 (indicating, to manage third-party risks, banks should: use due diligence to select qualified, competent third-party providers; ensure expectations of each party are clearly defined; monitor third parties' activities and performance; "measure long-term stability and viability against potential short term profits or cost savings;" and develop appropriate exit strategies and contingency plans).

[30] *See* Chapter 11 No. 02-13533 (AJG) (reviewing WorldCom filing); *In re* Enron Corp., 274 B.R. 327 (Bankr. S.D.N.Y. 2002) (reviewing Enron filing). *See generally* James P. Miller, *WorldCom Audit Finds More Lapses; $4 Billion Default Pushes Firm Closer to Bankruptcy,* CHI. TRIB., July 2, 2002, at 1 (discussing accounting irregularities at WorldCom); *Senate Chastises Ratings Agencies For Lack of Aggression on Enron,* POWER MARKETS WK., March 25, 2002, at 5 (discussing Senate Governmental Affairs Committee's criticism of credit-ratings agencies for failure to discover and warn investors about Enron earlier).

[31] *See* Mitch Zacks, *Profit Estimates Were the Real Problem at Enron,* CHI. SUN-TIMES, Feb. 3, 2002, at 40 (outlining questionable accounting methods used by Enron). *But see* Editorial, *Auditing the Auditors,* ST. LOUIS POST-DISPATCH, Jan. 12, 2002, at 34 (arguing auditors should have been aware of "bizarre schemes" used by Enron to finance its energy trading business).

financial statements are not understood, so too can the bank face enormous problems and losses if a service provider's financial condition is not understood. Additionally, the "death spiral" concept is relevant in thinking about the possibility that a business will experience financial difficulties and file bankruptcy.[32]

During due diligence, an assessment must be made of the proposed outsourcing arrangement's risks including a reasoned judgment as to whether the service provider will be in business a year or five years from now. The bank must determine the practical alternatives available to it and make a judgment as to whether outsourcing is really the best solution.[33] Alternatives considered might include attempting to identify a different service provider, building operational capability in-house, or simply doing nothing and maintaining the status quo (e.g., continue servicing a product in-house or simply pass on offering a proposed new product line).

Additional challenges arise during due diligence if it is determined that the chosen service provider is financially weak. Occasionally, the bank may perceive that the alternative of doing business with a financially weak service provider is better than not engaging in a new line of business at all or than retaining the processing in-house. Before electing this alternative a review should be performed of the operational and legal consequences if the service provider were to go bankrupt or out of business.

The terms of outsourcing arrangements are generally defined by a contract. In it, the bank and service provider identify and address the issues raised by the particular arrangement and set the governing terms. It may be prudent to

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[32] The "death spiral" concept involves the interrelationship of negative economic conditions, business decisions, and negative press reports resulting in the worsening of a company's financial condition on a daily or weekly basis and ultimately bankruptcy. If a company looks to be in a death spiral (as both Enron and WorldCom did prior to their bankruptcy filings), some employees, suppliers, and clients may simply walk away from the deteriorating situation *if* they have the ability to do so, rather than waiting for the bankruptcy filing. Such pre-bankruptcy terminations/abandonment may leave other third parties who are locked into contracts (e.g., banks with long-term outsourcing contracts) dealing with service providers that can no longer perform optimally or even adequately.

[33] Ozanne, *supra* note 6, at 34. Ozanne notes that during each of the four years Dun & Bradstreet has sponsored the "Barometer of Global Outsourcing," companies have reported that between 20–25% of all outsourcing relationships fail in any two-year period and that half of the relationships will fail within five years. Apparently, reasons given for failure are similar across all types of relationships, with nearly 70% of the respondents noting that the outsourcing supplier "didn't understand what they were supposed to do" and "the cost was too high and they provided poor service." *Id.*; *see also* Quinn & Hilmer, *supra* note 1, at 56, who concluded:

> If supplier markets were totally reliable and efficient, rational companies would outsource everything except those special activities in which they could achieve a unique competitive edge, that is, their core competencies. Unfortunately, most supplier markets are imperfect and do entail some risks for both buyer and seller with respect to price, quality, time, or other key dimensions. Moreover, outsourcing entails unique transaction costs - searching, contracting, controlling, and re-contracting - that at times may exceed the transaction costs of having the activity directly under management's in-house control.

Id.

conceptualize a contract as simply sheets of paper with writing on them that are given life during the course of the arrangement; the writing may or may not mean precisely what the drafters/negotiators thought that it did originally. The meaning of a contract (and whether or not it works) depends to a significant extent on the people who are interpreting its provisions.[34] Among other factors, the meaning applied to the terms turns on whether: the people managing the relationship ever actually refer to the written terms of the contract in guiding their activities; the written words are interpreted expansively or literally, and on whether the written words made sense initially and were adequate to define the parties' relationship.[35]

If the service provider selected is financially weak (either initially or during the course of the contractual relationship), even finely crafted contract provisions may not provide the bank with much protection and the contract's words will not necessarily determine what will happen during the course of the relationship.[36] A bank can't collect a damage award if the service provider has no money or assets with which to pay it. A service provider can't provide a contractually required level of service if it has no money to pay employees. As a practical matter, if the service provider is experiencing financial difficulties and is providing a service that is critical to the bank, the bank may be forced to invest capital or provide other assistance to keep the service provider in business until an acceptable substitute can be found *even though this was never contemplated in the written words of the contract.*

OCC Bulletin 2001-47 articulates that the contract should deal with default; it should define what constitutes default, identify remedies, and allow for

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[34] This conclusion reflects practical reality in a working relationship, i.e., in the non-litigation/pre-court context where lawyers are not actively involved on a day-to-day basis in interpreting a written contract. Once a relationship turns antagonistic and lawyers/courts are involved in interpreting the contract, certain rules and theoretical constructs come more directly into play. *See* RESTATEMENT (SECOND) OF CONTRACTS § 202 (1981) (providing rules in aid of contract interpretation); *see also* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1819–27 (1991) (noting "an important set of practical constraints limits the completeness of contracts," discussing difficulties of contract interpretation, and providing framework for determining "interpretive conventions"); Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1712 (1997) (noting "[n]o contract can fully and unequivocally address every question that may arise regarding its performance or nonperformance" and discussing various rules and models used by courts in interpretation and supplementation of contracts).

[35] Uniform contracts and annotated interpretations might help in ensuring that mutual misunderstandings do not lead to financial disaster. However, to date, many large outsourcing contracts and the services provided under them have been viewed as too unique to lend themselves to standardized documentation and uniform interpretation. Until standardized and uniform documents are established and become commonplace, there is always the possibility that the outsourcing contract is a living misunderstanding set to unravel in a distressed situation.

[36] *Cf. OCC Bulletin*, *supra* note 23 (discussing, generally, risks associated with reliance on third-party relationships). Obviously, the protections offered a bankrupt service provider by the Bankruptcy Code may impact what happens during the course of an outsourcing relationship in a manner at odds with the contract's words. *See* 11 U.S.C. § 524 (2002) (defining effects of debtor's discharge through bankruptcy); 11 U.S.C. § 1141(d)(1)(A) (2002) (specifying effects of chapter 11 reorganization plan confirmation).

opportunities to cure default.[37] The OCC guidance suggests that termination rights may be sought for such contingencies as bankruptcy, insolvency, or if the OCC formally objects to the particular third-party arrangement.[38] It further recommends that the contract should state termination and notification requirements with time frames to allow for the orderly conversion to another third-party service provider.[39] These recommended contract provisions obviously are logical rights that the bank would like to have. However, it must be remembered that just because a contract provides for certain rights or a certain outcome, it doesn't necessarily mean that the provisions will work as planned by the parties. Well-drafted contracts generally do include exit strategies by which the parties attempt to define how they can extricate themselves from arrangements that don't work (rather than be pulled into the court system).[40] However, because of various protections afforded by the U.S. Bankruptcy Code, once a service provider has filed bankruptcy the contractually specified rights and remedies may not work as originally agreed upon by the bank

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[37] *OCC Bulletin*, *supra* note 23, at 12.

[38] *Id*.

[39] *Id.* The *BITS Framework* recommends considering contractual provisions for notification to the bank in the event of "financial difficulty that may result in an impact to service[.]" *BITS Framework*, *supra* note 18, §§ 5.2, 5.13.3. This is nice, but one might ask what it really achieves. If the recommendation as written is reflected in the outsourcing contract, the bank might be able to call the service provider in breach for failing to give such notification (but not for the negative financial condition itself). *See also OCC Bulletin*, *supra* note 23, at 10. The sense that one gets from the regulatory guidance and the *BITS Framework* is that while *various processes* are recommended, the realities of dealing with a nitty-gritty melt-down of a large scale provider of core processing services have not been fleshed out or anticipated in a meaningful way. The words seem to assume that the service provider will cooperate and play nice at a point in time when it is fighting for its very survival and may have interests at odds with those of its bank clients.

[40] *See, e.g.*, Dennis M. Kennedy, *Key Legal Concerns in E-Commerce: The Law Comes to the New Frontier*, 18 T.M. COOLEY L. REV. 17, 24, 34 (2001) (noting in e-commerce transactions an emphasis on "exit strategies so the parties can extricate themselves from e-commerce arrangements that do not work rather than be pulled into the court system"); Richard Raysman & Pete Brown, *Computer Law: Renegotiation and Exit Strategies in an Outsourcing Relationship*, N.Y.L.J., Aug. 13, 2002, at 3 ("The typical outsourcing transaction has a term of five to seven years. Much can happen during the course of those few years to cause the parties to re-evaluate the arrangement and examine their respective exit options.").

Experience in working with the bankruptcies of service providers in the business of collecting charged-off credit card accounts suggests that it would be helpful to have a protocol for transitioning servicing agreed upon up front. In the bankruptcies of Commercial Financial Services, Inc. (CFS) and Credit Trust Corporation ("Credit Trust"), protocols for the transition of portfolios were developed during the course of the proceedings. For the transition protocols as stipulated by the parties and ordered by the court, *see In re* Commercial Fin. Servs., Inc. and CF/SPC NGU, Inc., No. 98-05162R and 98-05166R (Bankr. N.D.Okla. Jul. 27, 1999) (order approving stipulation regarding transition of servicing – CFS); *In re* Credit Trust Corp., No. 00-5-7812-JS (Bankr. Md. Dec. 21, 2000) (consent order granting motion for relief from automatic stay and to establish servicing transition procedures filed by Wells Fargo Bank Minnesota, N.A., as Trustee). Likewise in the recent bankruptcy of Ameriserve Food Distribution, Inc. ("Ameriserve"), a food distribution entity, there was developed and established a protocol for default servicing of the securitized receivables. *See* the servicing protocol as agreed to and so ordered in *In re* Ameriserve Food Distrib., Inc., No. 00-0358 (PJW) (Bankr. Del. Mar. 17, 2000) (final order approving stipulation between Norwest Bank Minnesota, N.A., as Trustee, the Debtors, and Ameriserve Funding Corp.).

and service provider.[41] This fact may result in severe business disruption for the bank and a loss of expected control over the outsourced activity in the event of a service provider's bankruptcy.

To summarize, in some situations the bank may have no practical means of ensuring that the service provider will be able to continue providing contractually agreed upon services. While understanding the service provider's financial situation and ability to provide contractually agreed upon services are critical objectives, occasionally, in hindsight, the bank's original understanding may prove to have been imperfect. In very simple terms, occasionally the worst happens and a bank's service provider goes bankrupt.[42] The threshold question prior to signing any

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[41] It has long been apparent that once a debtor has filed for bankruptcy, the creditor may find a number of unpleasant changes in the nature of the obligations between the parties. *See* Railway Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 466 (1982) ("The grant to Congress [under the Bankruptcy clause of the Constitution] involves the power to impair the obligation of contracts . . ."); Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 517 (1938) ("Bankruptcy proceedings constantly modify and affect the property rights established by state law."); Coleman Oil Co. v. Circle K Corp. (*In re* Circle K Corp.), 127 F.3d 904, 910 (9th Cir. 1997) (stating "all kinds of interferences with contractual rights occur in bankruptcy proceedings"); *see also* David S. Kupetz, *The Bankruptcy Code is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 BUS. L. 55, 57 (1998) (stating upon filing of bankruptcy by service provider, Bankruptcy Code may "interfere with and override the ordinary exercise of contractual rights"):

> The Bankruptcy Code (Code) embodies the power to alter contractual rights and is itself part of every contract. Many lawyers fail to address the potential of bankruptcy when drafting contracts . . . . [C]ontract drafters should consider including provisions that specify, to the extent permitted, how the parties' respective rights will be affected by the commencement of a chapter 11 bankruptcy reorganization case. Although such provisions in pre-bankruptcy contracts may not be binding after the commencement of a chapter 11 case, they may influence many judges addressing post-bankruptcy issues and disputes between parties to the contract. Furthermore in some circumstances, a lawyer may be able to save a party to a contract months of heartache and thousands of dollars of damages, fees and costs simply by addressing bankruptcy issues at the time the contract is drafted and not strictly in a reactive manner after the bankruptcy petition has been filed.

Id. at 56. Mr. Kupetz suggests that specifying factors necessary to provide adequate protection in the event of the service provider's bankruptcy, or defining specific non-monetary defaults (together with details as to their materiality and economic significance) might maximize protection of the bank's contractual rights. While such provisions may not be enforceable, they may (1) give evidence of the parties' intent and guide the bankruptcy court in addressing the issues if they ultimately arise or (2) increase the likelihood that assumption of the outsourcing contract post-bankruptcy will be prevented. *Id.* at 70–92.

[42] For example, the demise and subsequent bankruptcy of Pilot Network Services, an outsourcing vendor which managed network security for over 200 customers (including PeopleSoft, The Washington Post Co., and Providian Financial), has been reported in the following terms:

> On April 25, Pilot Network Services went out of business, abandoning 200 customers that relied on them for something rather important: security . . .
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> . . . .
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> . . . [T]he end came quickly. Pilot employees received four e-mails in rapid succession. The first said the phones would be disconnected. The second added that pagers and mobiles would be taken away. The third said the CFO had resigned. And for anyone who couldn't see the elephant not just in the room but squirting river water in their faces the last e-mail said, 'At 4:30 p.m., you're fired.' [Note: apparently these four e-mails were received on the same day]
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> . . . .

outsourcing contract is whether the risks of entering into the arrangement with a service provider are worth the benefits that the bank thinks it will get.

IV. WHAT HAPPENS IF THE SERVICE PROVIDER GOES BANKRUPT?

Despite a bank's superb due diligence and contingency planning, the worst case scenario occasionally occurs. When a service provider goes bankrupt, the deal between the bank and the service provider is subject to review by parties not involved in the original negotiations. The Bankruptcy Code, bankruptcy court, and competing players with competing goals all impact the bankrupt service provider's performance.[43] These competing players include creditors, distressed investors, investment bankers, employees, unions, trade creditors, high-yield bond funds, work-out specialists, accountants, consultants, attorneys, vendors, and other customers.[44]

The service provider files its bankruptcy petition under either chapter 7 ("Liquidation") or chapter 11 ("Reorganization") of the Bankruptcy Code. Chapter 7 is available to businesses that plan to liquidate and terminate their activities.[45] The

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> With no one watching their networks and an outage threatening at any moment, Pilot customers felt naked. They were suddenly wide open to hackers and viruses. Because some companies routed office-to-office traffic through Pilot, they were at risk of losing secure virtual private network (VPN) connections and remote access. Pilot had hosted entire Web networks for other companies, making them even more vulnerable to a complete meltdown . . .
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> . . . .
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> One week after the implosion, Pilot filed Chapter 7 in Oakland Bankruptcy Court . . .
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> . . . .
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> On May 9, Exactly Two Weeks after Pilot disbanded, it was liquidated. There was a Hail Mary as several managed security vendors tried to take over the business but that collapsed. Emergency operations and support were halted. AT&T finally cut the circuits . . .
>
> On the same day, Pilot's homepage finally changed its cheerful, 'Yes, we're open' message. 'Pilot Networks has filed for bankruptcy' was all it said.

Scott Berinato, *What You Can Do If Your Security Vendor Fails,* CIO MAGAZINE (Aug. 1, 2001), *at* http://www.cio.com/archive/080101/exposed.html. The unexpectedness of the collapse was highlighted in a description of the actions taken by several Pilot Network clients (including Providian Financial) to deal with the sudden bankruptcy and of what one former client wanted in a substitute provider ("She'll sacrifice only as much of it [(expertise)] as is necessary in order *to find a company that won't go out of business and forget to tell her.*"). *Id*. (emphasis added).

[43] *See* 11 U.S.C. §§ 101–1330 (2000); *see also* Kupetz, *supra* note 41, at 58–59, n.21 (discussing competing players in bankruptcy proceeding); Janet Kidd Stewart, *Competing Players Pursue Myriad Goals,* CHI. TRIB., Dec. 16, 2001, at 5.1 (discussing how bankruptcy has become more complicated, involving more players).

[44] *See, e.g.*, Kupetz, *supra* note 41, at 58–59, n.21; Stewart, *supra* note 43.

[45] *See* Merry-Go-Round Enterprises, Inc. v. Simon DeBartolo Group, L.P. (*In re* Merry-Go-Round Enterprises, Inc.), 180 F.3d 149, 160 (4th Cir. 1999) (explaining chapter 7 trustee has little incentive to assume post-petition lease since purpose of chapter 7 proceedings is liquidation); Bilzerian v. SEC (*In re* Bilzerian), 276 B.R. 285, 288 (M.D. Fla. 2002) ("[T]he purpose of [c]hapter 7, to wit: to provide an honest debtor with a fresh start in exchange for the debtor's handing over to a trustee all of the debtor's non-exempt assets for liquidation for the benefit of the debtor's creditors."); *In re* Blanton, 105 B.R. 811, 824 (Bankr.

goal of a chapter 11 case is the reorganization of the service provider and its emergence from bankruptcy as an operating entity with a different capital structure.[46] It is used by businesses that simultaneously continue operating the business and repaying creditors pursuant to a court-approved reorganization plan.[47] However, it must be emphasized that not every chapter 11 reorganization is successful -- many cases originally filed under chapter 11 are converted to chapter 7 and/or end with the sale or liquidation of the business. The precise impact of the service provider's bankruptcy upon the bank depends heavily on whether the proceeding is filed under chapter 7 or chapter 11. The impact of a bankruptcy filing can range from neutral to very negative. For example:

- At the "neutral" end is the recent bankruptcy of Anacomp Inc., a provider of document management services that filed chapter 11 bankruptcy in October 2001 in order to restructure its debt obligations.[48] The bankruptcy court approved the plan of reorganization effective year-end 2001. Press reports of this filing did not indicate problems with the outsourcing services being provided to customers.[49]
- In contrast, the July 2001 bankruptcy of Simplified Employment Services (SES) was reported to have had a direct, immediate, negative impact upon its clients.[50]

W.D. Tex. 1989) (stating purpose of chapter 7 corporate bankruptcy is to "distribute any assets equitably among existing creditors before laying the defunct corporation to rest").

[46] *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("[T]he fundamental purpose of the reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); Cedar Shore Resort, Inc. v. Mueller (*In re* Cedar Shore Resort, Inc.), 235 F.3d 375, 379 (8th Cir. 2000) ("The purpose of chapter 11 reorganization is to restructure business's finances so it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for stockholders."); Kupetz, *supra* note 41, at 59 ("A primary goal of chapter 11 is rehabilitation of the debtor.").

[47] *See Administrative Office Of The United States Court, Bankruptcy Basics - Public Information Series Of The Bankruptcy Judges Division* 3, 11 (2d ed. 2000), *available at* http://www.uscourts.gov/bankbasic.pdf [hereinafter *Bankruptcy Basics*] (providing basic overview and explanation of federal bankruptcy laws and how bankruptcy process works); *see also* COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 90.52 (2002) (discussing reorganization plans); COLLIER BANKRUPTCY MANUAL ¶ 1129.01 (3d ed. 2002) (addressing confirmation process for court reorganization plan).

[48] *See* News Release, Anacomp, Inc., Anacomp Files Ch. 11 Prepackaged Reorganization Plan To Complete Debt Restructuring, *at* http://www.anacomp.com/news/newswire01/oct19-01.asp (Oct. 19, 2001).

[49] *See, e.g.*, Mike Allen, *Restructuring Plan OK'd for Anacomp,* SAN DIEGO BUS. J., Dec. 17, 2001, at 8 (describing reorganization plan approved for Anacomp); *Anacomp Completes Chapter 11 Restructuring*, N.Y. TIMES, Jan. 4, 2002, at 3 (reporting completion of Anacomp's reorganization); Kim Peterson, *Anacomp Files for Chapter 11 a Second Time,* SAN DIEGO UNION-TRIB., Oct. 20, 2001, at C-1 (reporting Anacomp's chapter 11 bankruptcy filing); News Release, Anacomp, Inc., Anacomp Emerges from Chapter 11 Debt Restructuring, *at* http://www.anacomp.com/Newswire02/Financial/jan03-02.html (Jan. 3, 2002); News Release, Anacomp, Inc., Court Confirms Anacomp Debt Restructuring Plan, *at* http://www.anacomp.com/newswire0/dec11-01.html (Dec. 11, 2001); News Release, Anacomp, Inc., Anacomp Receives Approval of Court Motions Benefiting Suppliers, Customers and Employees – Business to Continue Without Interruption During Chapter 11 Process, *at* http://www.anacomp.com/Newswire01/oct25-01.html (Oct. 25, 2001).

[50] *See* Shannon Buggs, *Payroll Check Company Files for Bankruptcy,* HOUSTON CHRON., July 11, 2001, at Bus. Sec.2 (reporting SES bounced more than $30 million in checks and subsequently filed for bankruptcy); *SES' Bankruptcy a Lesson For Us All,* CRAIN'S DETROIT BUS., July 16, 2001, at 8 (noting that SES' bankruptcy has been "a disaster in the making for months," that the IRS believes that it is due "$100 million in back taxes" and questioning whether those back taxes could be liabilities of SES' clients); Brent Snavely,

SES oversaw payroll administration, workers' compensation benefits, 401(k) plans, and health insurance coverage for small and midsize businesses. It had been hired by roughly 3,000 employers to issue payroll checks to more than 20,000 workers. Newspapers reported that immediately prior to the bankruptcy filing more than $30 million in SES checks bounced, many of which had been issued to pay clients' payroll obligations to their employees. At the time of the filing, SES reported $77.9 million in debt and no assets. Its clients faced issues that included whether health insurance for their employees was active, how health claims filed pre-petition would be paid, how to get payroll checks for their employees issued (and who would fund them), and whether the client or SES would be liable for payment of various back payroll taxes totaling millions of dollars. A reorganization plan was confirmed in April 2002.[51]

- The difficulties facing customers of financially challenged service provider WorldCom were the subject of numerous press reports.[52] For example, newspapers pointed out that the majority of WorldCom's largest clients (including many Wall Street powerhouses, large manufacturers and government agencies) had long-term contracts with big penalties for switching to another provider, even when WorldCom filed for bankruptcy.[53] Apparently penalties ran as high as fifty percent of the cost of staying in the contract and only about twenty percent of WorldCom's big corporate customers had the contractual right to walk away pre-bankruptcy if its financial condition deteriorated below a certain point. Among the problems facing customers are more and longer outages, and a gradual decline in service levels. A switch in providers by a customer to a WorldCom competitor can take months, depending upon the complexity of the customer's system. Written a few weeks before WorldCom filed for bankruptcy, one article pointed out that if it did file

Clients Fear Fallout of SES, CRAIN'S DETROIT BUS., July 16, 2001, at 1 (discussing problems faced by SES' clients as result of bankruptcy filing).

[51] *See* Brent Snavely, *Troy Design buys SES on installment plan: Price could top $15m over 10 years*, CRAIN'S DETROIT BUS., June 17, 2002, at 29 (reporting sale of SES to Troy Designs and noting SES' reorganization plan was approved April 24, 2002). *See generally In re* Aapex Sys., Inc., 273 B.R. 35 (Bankr. W.D.N.Y. 2002) (holding payroll tax payments made to IRS/state taxing authorities for clients by bankrupt service provider in business of providing payroll and related services, for which funds had been provided to bankrupt by clients, were avoidable preferential transfers which could be recovered by trustee from clients.)

[52] *See, e.g.*, Yochi J. Dreazen, *FCC Chief Cites Internet Weak Spot - U.S. Might Be Powerless to Prevent WorldCom From Stopping Web Service,* WALL ST. J., July 31, 2002, at A2 (indicating the government "might be unable to prevent WorldCom Inc. from abruptly terminating its Internet services."); Crayton Harrison, *EDS seeking payment; Plano firm asks court to make WorldCom return $14.7 million*, DALLAS MORNING NEWS, Sept. 10, 2002, at 1D (noting specific economic effect on Electronic Data Systems Corp (EDS), a local business); Joseph Menn, *WorldCom Clients Scramble for Alternative Suppliers,* CHI. TRIB., July 6, 2002, at 1 (Business Section) ("Some of WorldCom Inc.'s big corporate customers are scrambling to line up alternate suppliers for systems that transmit company data internally and to business partners and customers, but analysts predict that many companies will suffer one way or another from WorldCom's problems.").

[53] *See* Menn, *supra* note 52; Joseph Menn, *Big WorldCom Customers Eye Alternatives; Some of Company's Corporate Clients Are Debating Paying Breakup Fees or Staying Put Through a Possible Reorganization*, L.A. TIMES, July 4, 2002, at 3.3; Joseph Menn, *WorldCom Clients Race to Line Up Other Suppliers*, TORONTO STAR (Ontario Ed.), July 5, 2002, at E06.

"[l]egal rules could make moving to another service provider even more complicated. For that reason, those customers that can afford to get out soon may choose not to wait."[54]

The primary subject of this Article is identification of the practical issues and legal rules facing bank customers of a bankrupt service provider. Among the many questions facing the bank are whether:

> (1) the service provider has the realistic practical capability of continuing to provide contractually agreed upon services;[55]
> (2) the service provider has any legal obligation or any legal right to continue providing contractually agreed upon services;[56]
> (3) there is another alternative available to the bank if the service provider cannot or will not continue to provide contractually agreed upon services (e.g., can the bank provide the services for itself in-house or is there another third-party with the capability and inclination to provide the services);[57]
> (4) the bank can force the service provider to terminate the contract without incurring significant penalties for breach of contract or for violation of the automatic stay;[58]
> (5) the bank can obtain reimbursement for money paid by it pre-petition for which services have not been provided;[59]

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[54] Menn, *supra* note 52, at 1. WorldCom's problems have resulted in increased scrutiny of big outsourcing deals. *See, e.g.*, Elliott Spagat, *For EDS, Big Contracts Mean Big Risks – Outsourcing Deals Bring Revenue Growth, But Also High Expenses, Complex Accounting,* WALL ST. J., July 1, 2002, at B4 (discussing potential losses at some companies from big outsourcing deals); *see also* Elliott Spagat, *EDS Withdraws Its Bid to P&G For Outsourcing – Exposure to WorldCom Fuels Concern Over Risks in Unusually Big Contracts,* WALL ST. J., July 2, 2002, at A3 (discussing risks to EDS from big outsourcing contracts); Elliott Spagat, *EDS, Already Suffering, Faces a New Headache,* WALL ST. J., June 27, 2002, at A9 (pointing out EDS signed agreements in 1999 with WorldCom, valued at $12.4 billion over 11 years — apparently EDS receives about $600 million/year, 2.8% of its 2001 revenue, to manage WorldCom's computer networks and it pays WorldCom similar amount each year to operate its own telecom network and those of its customers). The WorldCom meltdown had an impact on entities that provide outsourcing services *to it.* For example, Electronic Data Systems Corp. came under scrutiny with reports surfacing that WorldCom was one of EDS' largest customers and that EDS expected "to have booked about $150 million in WorldCom revenue at June 30 for which it hasn't been paid." Also, as a result of increasing concerns about the risks and accounting issues tied to super-size contracts, EDS at one point withdrew its bid for another giant outsourcing contract.

The *BITS Framework*, *supra* note 18, at 21, recommends that as part of due diligence the bank should determine the service provider's reliance on other third-party service providers. Once this determination is made, it appears obvious that a bank should make judgments as to how third-party relationships will impact the ability to provide services for the bank. It would also seem logical that banks should make value judgments as to how much outsourcing by service providers and *their service providers* is too much? However, one might ask whether this is really occurring in a meaningful way and whether potential problems with multiple subordinate service providers are being meaningfully identified.

[55] *See* discussion *supra* notes 50–51 and accompanying text.

[56] *See* discussion *infra* notes 70–81, 93–115 and accompanying text.

[57] *See* discussion *infra* notes 64–68 and accompanying text.

[58] *See* discussion *infra* notes 93–115 and accompanying text.

[59] *See* discussion *infra* notes 108–11 and accompanying text.

(6) the bank has any rights against the service provider post-petition if the bank is involved in litigation with third-parties related to services provided by the bankrupt service provider, particularly if the service provider has provided indemnification against such claims;[60]
(7) the service provider can assign its obligations to provide services to a third-party;[61]
(8) the contractually agreed upon services are adequate to meet the bank's needs;[62] and
(9) the bank will fall behind its competitors if the service provider disbands or slows down its research and development efforts.[63]

Of critical importance to the bank in dealing with the above questions is analyzing the various alternatives that are realistically available and determining their impact on the bank's bottom line and ability to run its business.

Probably the first question that the bank must address is whether, realistically, the service provider is *able* to provide the agreed upon services. Then the bank must decide whether the bank wants the service provider to continue to do so (if indeed it has the continuing capability), and then what are the available alternatives (regardless of whether or not the service provider has the capability).

A. Does the bank have any realistic alternative to a continued relationship with the bankrupt service provider?

The major issue that must be resolved is whether another service provider or an in-house alternative can be substituted for the bankrupt service provider. Two primary considerations are relevant, the first involving practical restrictions and the second involving legal restrictions. The first consideration is whether, *as a strictly practical matter,* the services provided under the outsourcing arrangement are actually available from another service provider or can actually be performed by the bank in-house. The second consideration is whether, *as a legal matter,* the bankruptcy court will permit the bank to terminate its existing contract with the service provider given the restrictions imposed upon the bank and the protections provided to the service provider by the Bankruptcy Code.

With respect to the practical restrictions/limitations on what the bank can do, one must carefully question the idea that it is simple to substitute services and providers.[64] In the Internet world of the late 1990's, "plug and chug" strategies for

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[60] *See* discussion *infra* notes 129–32 and accompanying text.
[61] *See* discussion *infra* notes 117–27 and accompanying text.
[62] *See* discussion *supra* note 34 and accompanying text; *see also infra* notes 113–14 and accompanying text.
[63] *See* discussion *infra* notes 113–14 and accompanying text.
[64] This issue is equally important in the non-bankruptcy oversight by the bank of third-party relationships. *See, e.g.*, *OCC Bulletin, supra* note 23, at 13 (recommending performance monitoring and evaluation of third-party's financial condition annually). However, the challenge in any outsourcing arrangement is

getting into new lines of business and outsourcing business operations appeared.[65] Such strategies were based on the idea that a business could instantly "plug" in a new service provided by a service provider and "chug" along by rolling it out instantly to the businesses' customers; they contemplated switching service providers by simply unplugging the old one and plugging in a new one. A reality check suggests that actual implementation of such strategies is rarely as easy as the "buzz" words make it sound. Detailed contingency planning should make it clear that substitution is often not simple.[66]

The more concentrated the outside processing capabilities are for the particular product line or business operation being outsourced, and the larger the operations being outsourced to the bankrupt service provider, the more difficult it may become to identify acceptable solutions and alternatives in the event of a service provider's bankruptcy.[67] If there is no other service provider capable of providing the outsourced services, and if it would take multiple months or years to develop the capability to perform the work in-house, the bank faces a practical dilemma.

In recent years, there has been a consolidation of technology companies and core processors providing services for the banking industry.[68] To put this in perspective, one might think about the outsourcing of payment card processing and

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determining what to do if the service provider's financial condition or performance is unsatisfactory or deteriorating, i.e., what are the *practical, as well as, legal restrictions* on the bank's ability to act. *See* discussion *infra* notes 64–115 and chart labeled "Worst Case Scenario" immediately following note 115.

[65] *See supra* notes 13–19 and accompanying text.

[66] Servicing and transition of servicing in bankruptcy is measured by significant lead time and less than instantaneous transitions. For example, servicing issues were present in the recent bankruptcies of CFS, Credit Trust and Ameriserve. In each of these, transition protocols (CFS and Credit Trust) or operating protocols (Ameriserve) were developed to attempt to successfully realize on the operating revenues in bankruptcy. Transition of servicing is generally measured by weeks if not months rather than hours or days. *See generally supra* note 40.

[67] Outsourcing service providers in some parts of the financial institution retail payments space (*e.g.*, electronic bill payment and presentment, aggregation, large-scale credit card issuer processing) are quite concentrated. *See, e.g.*, Steve Bills, *'Lean, Mean' CheckFree Draws Praise From Street*, AM. BANKER, Apr. 29, 2002, at 18; First Data website, *supra* note 19; Total System Services, Inc. website, *supra* note 19; Yodlee web site, *at* http://www.yodlee.com (last visited Oct. 28, 2002). The Electronic Banking Group of the Basel Committee on Banking Supervision has examined electronic banking risk management issues for bank supervisors and has articulated that:

> Perhaps more than any other industry development relating to e-banking, banks' increased reliance on outsourcing is having a significant impact on the risk profiles of all banking organizations . . . . Large banks are outsourcing many activities as they are increasingly focusing on their core businesses and partnering with other organizations for solutions outside of their core competencies . . . . *Preliminary indications from surveys tend to indicate that financial institutions rely upon a relatively small number of third-party providers . . . . This apparent reliance on a concentrated number of third parties, which the EBG will investigate further, could have systemic implications if a major problem would arise with one of these service providers . . ..*

BASEL COMM. ON BANKING SUPERVISION, ELECTRONIC BANKING GROUP INITIATIVES AND WHITE PAPERS 20 (2000), *available at* http://www.bis.org/publ/bcbs76.pdf. (emphasis added).

[68] *See generally* Yochi J. Dreazen et al., *Why the Sudden Rise in the Urge to Merge and Form Oligopolies?*, WALL ST. J., Feb. 25, 2002, at A1 (discussing general economic forces pushing American industries to consolidate into oligopolies).

ask how many service providers can be identified that are competent to effectively handle the provision of basic computer services (e.g., billing/statementing, transaction processing, card issuance, authorization, etc.) for a payment card portfolio with over 15–25 million accounts. A follow-up question is whether the answer changes if multiple large-scale portfolios need a new service provider at one time. The number of service providers in the U.S. with this capability would appear to be extremely small. It could take an extended period of time (multiple months, not days) for a large- scale portfolio to transfer from one service provider to another, if in fact it could be done at all. Experience suggests that years (not months) are needed to create and develop the sophisticated in-house system required to bring a large-scale payment card portfolio in-house for processing. This time-frame assumes that an experienced development staff is available and that intellectual property issues would not make such development impossible.

In the scenario just described, the imminent liquidation of a service provider in chapter 7 or the rejection of the outsourcing contract by a service provider in chapter 11 can have potentially disastrous consequences for the bank if it is not possible to develop a viable contingency plan to substitute services for those provided by the bankrupt service provider. Just as it is occasionally asked if any of the country's largest banks is "too big to fail," one might ask whether any of the bank technology service providers providing core processing services has become "too big to fail." To prevent such failure, the bank (or a consortium of banks) might be faced with deciding whether to assume control of the service provider through acquiring a significant ownership interest. Such acquisition might have a higher price than the bank (or the consortium) is willing or able to realistically pay. Even if they were to decide to do so, other players in the bankruptcy proceeding with competing goals and objectives might not be willing to permit this to happen.[69] Further, whether the key management and employees of a bankrupt service provider are permitted or willing to hang around long enough for a rational solution to be reached could be problematic; if key people leave, there may not be much left to buy.

B. Assuming that the bank has realistic practical alternatives to a continuing relationship with the bankrupt service provider, what is the effect of the automatic stay upon the bank's ability to terminate the outsourcing relationship?

Even if alternative service providers are available and the bank wants to switch service providers, the bankruptcy filing removes this decision from the bank's control; under both chapter 7 and chapter 11, the automatic stay is instantly effective.[70] While it might be comforting to think that the bank has the choice of

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[69] *See supra* notes 43–44 and accompanying text.

[70] *See* 11 U.S.C. § 362(a)(3) (2000) (providing in part that automatic stay "operates as a stay, applicable to all entities of . . . any act to obtain possession of property of the estate or of property from the estate or to

instantly or automatically terminating an outsourcing arrangement if the service provider goes bankrupt, the automatic stay prohibits this from happening.

Because of the automatic stay, no action can be unilaterally taken by the bank to terminate the outsourcing relationship or to enforce performance of the outsourcing contract absent a court order providing relief from the stay.[71] Choices are suddenly taken out of the hands of the bank and placed in the hands of the bankrupt service provider or the bankruptcy trustee (for simplicity, both are referred to as the trustee) and the bankruptcy court.[72] Any action that the bank wants to take with respect to the outsourcing arrangement becomes subject to bankruptcy court review.[73]

The automatic stay is crucial to the bankruptcy process. In simple terms:

> (1) it arises by operation of law upon the filing of a bankruptcy petition and no additional judicial action is necessary in order for it to be effective;
> (2) its primary purpose is to allow the service provider to operate during reorganization to preserve value in the estate for the benefit of all creditors;
> (3) it acts as an injunction preventing the bank from taking any action to collect or recover pre-petition claims without court approval;
> (4) it provides relief for the service provider from harassment by creditors and time to permit it to focus on reorganization;

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exercise control over property of the estate."); *see also* 11 U.S.C. § 103(a) (stating "chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11 . . . of this title."); Nelson v. Taglienti (*In re* Nelson), 994 F.2d 42, 44 (1st Cir. 1993) (noting general rule that filing of bankruptcy petition operates as stay, effective on filing, against actions affecting property of bankruptcy estate).

[71] *See* 11 U.S.C. § 362 (a), (d) (providing for automatic stay and, upon request by party and approval by bankruptcy court, subsequent relief therefrom); *see also In re Nelson,* 994 F.2d at 44 (remarking that party must ask bankruptcy court for and receive relief from stay before proceeding against debtor's estate); Richard v. City of Chicago, 80 B.R. 451, 453 (N.D. Ill. 1987) (explaining automatic stay lasts for duration of bankruptcy proceeding, absent any modification by bankruptcy court); DOUGLAS BAIRD, THOMAS JACKSON & BARRY ADLER, BANKRUPTCY: CASES, PROBLEMS AND MATERIALS 88 (3d ed. 2000) (stating stay can be lifted under § 362(d) by going to court).

[72] *See generally* BANKRUPTCY BASICS, *supra* note 47, for a description of the bankruptcy process. The parties that the bank will be dealing with after the bankruptcy filing are described in it as follows:

> Upon the filing of a voluntary petition for relief under chapter 11 or, in an involuntary case, the entry of an order for such relief, the debtor [service provider] automatically assumes an additional identity, as the "debtor-in-possession." 11 U.S.C. § 1101. The term refers to a debtor that keeps possession and control of its assets while undergoing a reorganization under chapter 11, without the appointment of a case trustee. A debtor will remain a debtor-in-possession until the debtor's plan of reorganization is confirmed, the debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as "debtor-in-possession," operates the business and performs many of the functions that a trustee performs in cases under other chapters. 11 U.S.C. § 1107(a).

Id. at 24–25.

[73] 11 U.S.C. § 362(a), (d); *see also* Norton v. Hoxie State Bank, 61 B.R. 258, 261 (D. Kan. 1986) (stating bankruptcy court, as a court of equity, can review/balance hardships of parties and accordingly fashion relief from automatic stay); Bruce White, *The Enforceability of Pre-Petition Waivers of the Automatic Stay,* 1996 ABI JNL. LEXIS 664, at *3 (explaining that while some courts have enforced pre-petition waivers of automatic stay, many others have held such waivers unenforceable on grounds only bankruptcy court has power to grant such relief).

> (5) it protects creditors by preventing the dismemberment of the service provider's assets by individual creditors seizing them, and promotes the bankruptcy goal of "equity of distribution"; and
> (6) it prohibits any action after the filing of the bankruptcy petition where one creditor would attempt to be preferred over other similarly situated creditors and stays virtually all judicial activity against the service provider.[74]

One might ask why the automatic stay is applicable to the outsourcing relationship between a service provider and a bank. The reason is that by its very nature, the outsourcing contract would be considered an "executory contract," i.e., a contract on which performance remains due to some extent on both sides until termination.[75] The service provider agrees to provide processing services on an ongoing basis and the bank agrees to pay for the services received, again on an ongoing basis. A number of courts have found that a debtor's rights under executory contacts are valuable property of the estate.[76] As such, unilateral termination or modification by the bank post-petition or the bank's refusal to perform under the pre-petition terms of an outsourcing contact without approval by the bankruptcy court would violate the automatic stay.

The Bankruptcy Code explicitly states that an executory contract may not be terminated or modified post-petition solely because of a contractual provision that is conditioned on the insolvency or deteriorating financial condition of the debtor (a so-called "ipso facto" provision) or the filing of bankruptcy.[77] Courts read the

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[74] 11 U.S.C. § 362; *see also* S. REP. NO. 95-989, at 49–51 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5835–37 (describing purposes of automatic stay, including protection of creditors). *See generally White, supra* note 73, at *4–5 (noting automatic stay was designed to protect creditors' interests as well as debtors and allowing one creditor to enforce pre-petition waiver of such stay might cause depletion of other creditors' interests).

[75] *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984) ("The Bankruptcy Code furnishes no express definition of an executory contract, *see* 11 U.S.C. § 365(a) (1982 ed.), but the legislative history of § 365(a) indicates that Congress intended the term to mean a contract 'on which performance remains due to some extent on both sides.'"); Unsecured Creditors' Comm. of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Constr. Dev., Inc.), 139 F.3d 702, 705 (9th Cir. 1998) (defining contract as executory "if the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other"); Griffel v. Murphy (*In re* Wegner), 839 F.2d 533, 536 (9th Cir. 1988) (describing executory contract as contract on which performance is due to some extent on both sides); H.R. REP. NO. 95-595, at 347 (1977); S. REP. NO. 95-989, at 58 (1978).

[76] 11 U.S.C. § 541(a) (2000). *See, e.g.*, Computer Communications, Inc. v. Codex Corp. (*In re* Computer Communications, Inc.), 824 F.2d 725, 730 (9th Cir. 1987) (stating contract falls within definition of property of estate); Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp. (*In re* Minoco Group of Cos., Ltd.), 799 F.2d 517, 518 (9th Cir. 1986) (finding that liability policies were property of estate because Bankruptcy Code definition of property is "broad and all inclusive"); Harsh Inv. Corp. v. Bialac (*In re* Bialac), 712 F.2d 426, 430 (9th Cir. 1983) (describing property of estate as including "all legal or equitable interests of the debtor in property" since scope of definition was intended to be broad and all inclusive).

[77] *See* 11 U.S.C. § 365(e)(1) (2000). *See, e.g.*, Superior Toy & Mfg. Co. v. Steege (*In re* Superior Toy & Mfg. Co.), 78 F.3d 1169, 1174 (7th Cir. 1996). The court noted:

statutory language to invalidate provisions in contracts that lead to the "same effect as a clause triggered by bankruptcy, without mentioning bankruptcy."[78] The automatic stay and the bankrupt service provider's right to accept or reject executory contracts work together to require approval from the bankruptcy court in order to terminate the contract. To restate:

> (1) the simplest example is a provision in the outsourcing contract that provides for termination in the event of bankruptcy – this contractual provision is unenforceable post-petition;[79]
> (2) more subtle contract provisions, such as one providing for termination upon a material adverse change in the service provider's financial condition, are also invalid post-petition;[80]
> (3) the fact that an outsourcing contract was terminable at will prior to the bankruptcy filing is irrelevant post-petition – it may no longer be immediately terminated solely because of the bankruptcy filing;[81] and

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> Prior to the [Bankruptcy Reform Act of 1978], bankruptcy clauses were deemed valid. Section 365(e) invalidates bankruptcy clauses. Noting that the parties no longer can contract freely to terminate their arrangement upon bankruptcy, both the House and Senate reports said: 'If the trustee is to assume a contract or lease, the court will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.' Senate Rep. No. 989, 95th Cong., 2d Sess. 59 (1978) . . . ; H.R. Rep. No. 595, 95th Cong., 2d Sess. 348 (1978) . . . .

Id.; *see also* Reloeb Co. v. LTV Corp. (*In re* Chateaugay Corp.), 1993 U.S. Dist. LEXIS 6130, at *15 (S.D.N.Y. 1993) (noting § 365(e) of Bankruptcy Code invalidates ipso facto or bankruptcy termination clauses).

[78] COLLIER ON BANKRUPTCY ¶ 365.07 (15th ed. Rev.); *see also* Joseph Steinfeld, *On the Edge: The Negotiated Rates of 1993: Did Congress Sidestep the Bankruptcy Code's Anti-forfeiture Provisions?*, 1994 ABI. JNL. LEXIS 2705, at *3 (discussing Bankruptcy Code's anti-forfeiture provisions and stating § 365 prevents automatic termination of executory contracts based on debtor's financial condition); *cf.* Yates Dev., Inc. v. Old Kings Interchange, Inc. (*In Re* Yates Dev., Inc.), 256 F.3d 1285, 1289 (11th Cir. 2001) (indicating contractual provision contingent on passage of time was not ipso facto clause invalidated by operation of § 365(e)(1)).

[79] *See supra* note 77 and accompanying text.

[80] *See supra* note 78 and accompanying text.

[81] *See, e.g.*, Citizens & S. Nat'l Bank v. Thomas B. Hamilton Co. (*In re* Thomas B. Hamilton Co.), 969 F.2d 1013 (11th Cir. 1992) (refusing to allow termination by merchant bank of credit card merchant agreement which by its terms was terminable on ten days notice); *In re* Nat'l Hydro-Vac Indus. Serv., L.L.C., 262 B.R. 781, 786 (Bankr. E.D. Ark. 2001). In *National Hydro-Vac*, the bank entered into a bank card merchant agreement containing a "terminable at will" clause. The court ruled the bank's post-petition termination of the agreement based upon this clause was a violation of the automatic stay and therefore void; it denied bank's motion for relief from the stay in order to terminate the agreement. Regarding the "terminable at will" clause, the court stated:

> [C]ase law considering executory contracts with termination clauses supports the Debtor's position that to enforce the clause in this case would violate the congressional policy undergirding 11 U.S.C. § 365(e)(1). That section 'expressly invalidates ipso facto and other bankruptcy termination clauses' predicated on the financial condition of the debtor, the debtor's bankruptcy filing, or the appointment of a trustee in bankruptcy. 3 COLLIER ON BANKRUPTCY ¶ 365.07 (Lawrence P. King et al. eds., 15th ed. rev. 2000).

In re Nat'l Hydro-Vac, 262 B.R. at 786; s*ee also* Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp. (*In re* Minoco Group of Cos., Ltd.), 799 F.2d 517, 518 (9th Cir. 1986) (holding creditor's cancellation of insurance policies was automatically stayed and of no effect when

> (4) a similar conclusion may apply with respect to a clause authorizing immediate termination if a banking regulatory agency directs the bank to end its relationship with a service provider — there is no binding precedent on this specific question and the determination would involve the weighing by a bankruptcy court of competing regulatory objectives.

However, a bank dealing with a financially weak service provider should keep in mind that these restrictions operate *upon the filing of bankruptcy*.[82] If the contract is terminated pre-petition in accordance with its terms (e.g., upon the giving of notice of termination if that is all that the contract requires), the Bankruptcy Code does not require nor does the bankruptcy court have the authority to reinstate the contract.[83] Additionally, in drafting a contract, one should keep in mind that if a contract by its terms terminates on a set date, the bankruptcy court would not have the power to extend that contract.[84]

If the bank violates the automatic stay after the service provider files for bankruptcy, the trustee could be entitled to specific enforcement of the automatic stay (i.e. injunctive relief). If the violation is willful, the trustee is entitled to compensatory money damages, costs and attorneys' fees; it may also be entitled to punitive damages.[85] If the violation were to result in the complete failure and

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notice of cancellation was given after debtor filed bankruptcy petition); Bruce H. White, et al., *Ipso Facto Clauses and Reality: I Don't Care What the Documents Provide,* 2002 ABI JNL. LEXIS 37, 39 (2002) (discussing ipso facto clauses and other contractual provisions/acts developed by creditors in attempts to alter rights under Bankruptcy Code).

[82] *See* 11 U.S.C. 365(e)(1); *see also In re* Chateaugay Corp., 1993 U.S. Dist. LEXIS 6130, at *15 (discussing § 365(e)(1) and its abrogation of ipso facto clauses); *cf.* Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 611 (1st Cir. 1995) (suggesting use of "solely" in § 365 implies contractual termination clause triggered by condition other than those enumerated in § 365(e)(1) is enforceable and not invalidated).

[83] *See, e.g.*, Moody v. Amoco Oil Co., 734 F.2d 1200, 1213–14 (7th Cir. 1984) ("Where a contract has been validly terminated pre-bankruptcy, the debtors' rights to continued performance under the contract have expired. The filing of a petition under chapter 11 cannot resuscitate those rights."). In this case, Amoco Oil provided notice of termination setting the termination date ninety days later; the debtor filed bankruptcy after receiving notice and prior to the end of the ninety days. The court upheld termination at the end of the stated ninety day period. *See also In re* Nemko, Inc., 163 B.R. 927, 934 (Bankr. E.D.N.Y. 1994) (noting cancellation letter delivered three days before chapter 11 filing effectively terminated contract pre-petition); *In re* COMP III, Inc., 136 B.R. 636, 639 (Bankr. S.D.N.Y. 1992) (expressing view that "where an executory contract has been terminated in accordance with its terms prior to bankruptcy, § 365(e)(1) does not authorize the bankruptcy court to reach beyond the veil of the petition to reinstate the contract"); *In re* Seven Stars Rest. & Diner, 122 B.R. 213, 218 (Bankr. S.D.N.Y. 1990) (concluding landlord's termination of lease in accordance with its terms bars debtor from resurrecting terminated lease or including it in debtor's assets).

[84] *Accord* Moody, 734 F.2d at 1213 (stating automatic stay "does not toll the mere running of time under a contract, and thus it does not prevent automatic termination of the contract"); *see* Douglas W. Bordewieck, *The Post-Petition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197, 201–02 (1985) ("The Bankruptcy Code simply does not authorize the bankruptcy court to extend a contract beyond its stated terms if the debtor would not otherwise have possessed the right to do so."); *see also* Gloria Mfg. Corp. v. Int'l Ladies Garment Workers Union, 734 F.2d 1020, 1022 (4th Cir. 1984) (stating once contract expires by its terms, "there is nothing left for the trustee to reject or assume"); *In re* Janesville Lodging Ltd., I.D.T., 35 B.R. 672, 675 (Bankr. W.D. Wis. 1983); *In re* Anne Cara Oil Co., 32 B.R. 643, 647–48 (Bankr. D. Mass. 1983); *In re* Beck, 5 B.R. 169, 170–71 (Bankr. D. Haw. 1980).

[85] 11 U.S.C. §§ 105, 362(h) (2000). *See, e.g.*, Cuffee v. Atl. Bus. & Cmty. Corp. (*In re* Atl. Bus. & Cmty. Corp.), 901 F.2d 325, 329 (3d Cir. 1990) (citing Goichman v. Bloom (*In re* Bloom), 875 F.2d 224, 227 (9th Cir. 1989)), proposing that § 362(h):

liquidation of the bankrupt service provider to the detriment of the other creditors and in frustration of the purposes of the Bankruptcy Code, compensatory and punitive damages could be significant.

The Bankruptcy Code authorizes the bank to petition the court for relief from the automatic stay.[86] After notice and hearing, the court may continue the stay or modify, condition, or terminate it.[87] Such an order of relief may be granted (1) "for cause" (which would include the lack of adequate protection of the bank's interest in property) or (2) if the bankrupt service provider does not have equity in such property and it is not necessary to an effective reorganization.[88] In finding "cause,"

> . . . provides for damages upon a finding that the defendant knew of the automatic stay and that the defendant's actions which violated the stay were intentional. Whether the party believes in good faith that it had a right to the property is not relevant to whether the act was 'willful' or whether compensation must be awarded.

Id.; *In re* Ionosphere Clubs, Inc., 177 B.R. 198, 208 (Bankr. S.D.N.Y. 1995) (sanctioning willful and continuing violation of automatic stay); *In re* Calstar, Inc., 159 B.R. 247, 259–61 (Bankr. D. Minn. 1993). The court in *Calstar* discusses the split among circuits regarding whether § 362(h) protects corporate debtors or just individuals; the court concludes it is not a source of power to sanction violations of the automatic stay in cases involving corporate debtors, but only in those involving human debtors. It discusses the inherent power of the bankruptcy court to compensate and/or sanction violations of the Bankruptcy Code under § 105(a). It emphasizes § 105(a) is "a clear delegation of authority from Congress to punish creditors or other entities that violate the automatic stay" indicating, at minimum, the trustee is entitled to recover compensatory damages. It also suggests in appropriate cases consequential damages might be proved – and punitive damages might be justified in egregious or outrageous cases. *In re Calstar*, 159 B.R. at 259–61.

The debtor does not have the burden of showing entitlement to an injunction, because the automatic stay is itself in the nature of an injunction. *See, e.g.*, Grella v. Salem Five Cent Sav. Bank, 42 F.3d 26, 33 (1st Cir. 1994) (citing following legislative history of § 362):

> The automatic stay is similar to a temporary restraining order. The preliminary hearing [on a motion for relief from stay] is similar to the hearing on a preliminary injunction. The main difference lies in which party must bring the issue before the court. While in the injunction setting, the party seeking the injunction must prosecute the action, in proceedings for relief from the automatic stay, the enjoined party must move. (quoting H.R. Rep. No. 95-595, 95[th] Cong., 1[st] Sess. 344 (1977), *reprinted* in 1978 U.S.Code Cong. & Admin. News 5787 at 6300).

Id.

Even if the automatic stay were not applicable to a bank's obligation to perform under an outsourcing contract, a bankrupt service provider could rely on § 105(a) as a basis for injunctive relief preventing unilateral termination by the bank. *See generally* 3 COLLIER ON BANKRUPTCY ¶ 362.05, at 362–46 (Lawrence P. King et al. eds., 15th ed. Rev. 2000).

[86] 11 U.S.C. § 362(d) (2000).

[87] *Id*.

[88] *Id.*; *see In re* ACI Sunbow, LLC, 206 B.R. 213, 225 (Bankr. S.D. Cal. 1997) (granting relief from stay for "cause" based on debtor's subjective bad faith in attempting to use bankruptcy process to organize speculative real estate venture at risk of secured creditor); *see also In re* Steffens, 275 B.R. 570, 572 (Bankr. D. Colo. 2002) (denying relief from stay for lack of adequate protection, but granting relief from stay for lack of equity in property and failure to show necessity of property for reorganization). The First Circuit indicated in *Grella v. Salem Five Cent Sav. Bank*, 42 F.3d at 31, "[t]hat the statute set forth certain grounds for relief and no others indicates Congress' intent that the issues decided by a bankruptcy court on a creditor's motion to lift the stay be limited to these matters. *See* 11 U.S.C. § 362(d)." In addition the bank may seek to have the bankrupt service provider assume or reject the executory servicing contract (if assumed the service provider must cure defaults and provide adequate assurance of the ability to provide future performance under the terms of the contract). *See* 11 U.S.C. § 365 (2000). A bank, based on the

bankruptcy courts balance the hardships imposed by the automatic stay on all the parties in interest in light of the overall goals of the Bankruptcy Code.[89] Property cannot be shown to be necessary to an effective reorganization if there is no reasonable likelihood that the debtor can in fact be rehabilitated and the court must grant relief from the automatic stay if a successful reorganization within a reasonable time is impossible.[90] However, as a practical matter it must be remembered that it is very difficult to get a stay lifted in situations involving major assets of the bankrupt's estate. In those situations it is argued that everything is necessary to the reorganization.

"Adequate protection" may be provided by cash payments (to the extent that the stay results in a decrease in value of the bank's interest in such property) or any other means which will result in the realization by the bank "of the indubitable equivalent" of the bank's interest in its property.[91] Despite the descriptions of adequate protection given by the Bankruptcy Code,[92] it is somewhat hard to figure out what could truly "adequately protect" a bank that finds itself with a major line of business dependent upon services being provided by a bankrupt service provider. The trustee's or the bankruptcy court's view of this could well be different from the bank's view.

C. What is the effect of the bankrupt service provider's right to assume or reject executory contracts upon the outsourcing relationship?

The trustee's right to injunctive relief to protect the outsourcing arrangement comes from the right to assume or reject executory contracts, as well as from the automatic stay.[93] Following the filing, the contract may not be terminated or modified without the approval of the bankruptcy court.[94] The trustee is authorized to

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circumstances, may decide that a "motion to lift the stay and terminate" is more appropriate than a motion to assume.

[89] *See, e.g.*, Robbins v. Robbins (*In re* Robbins), 964 F.2d 342, 345 (4th Cir. 1992) (stating prejudice to debtor's estate must be balanced against hardships incurred by nondebtor if relief from automatic stay is not granted); *In re* Peterson, 116 B.R. 247, 249 (D. Colo. 1990) (describing different tests courts have applied to determine if relief from stay for cause is warranted).

[90] *See, e.g.*, United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 376 (1988) (discussing requirements of § 362(d) in context of undersecured creditor's petition for payments for use value of loan collateral); *In re* Building 62 Ltd. P'ship, 132 B.R. 219, 222–24 (Bankr. D. Mass. 1991) (finding debtor demonstrated "terminal euphoria" and failed to meet Timbers "feasibility" test in failing to present court with reasonable prospect of reorganization). *See generally In re* Bloomington HH Investors, Ltd. P'ship, 114 B.R. 174, 175, 177 (D. Minn. 1990) (approving lower court's decision granting relief from automatic stay based upon application of "feasibility" test).

[91] 11 U.S.C. § 361 (2000).

[92] *Id.*

[93] *See* 11 U.S.C. §§ 362(a), 365(a); *see also* Matthew T. Gensburg, *Are Physician Practice Management Agreements Assumable Under Section 365 of the Bankruptcy Code?*, 8 AM. BANKR. INST. L. REV. 77, 81–82 (2000) (noting Practice Management Agreements [outsourcing agreements] are "governed by section 365 of the Bankruptcy Code").

[94] *See* 11 U.S.C. §§ 362, 365. *See generally* Madlyn Gleich Primoff & Erica G. Weinberger, *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including*

assume or reject any of the service provider's executory contracts at any time before the confirmation of a reorganization plan under chapter 11.[95] However, on request of the bank the court may order the trustee to determine within a specified period of time whether to assume or reject such contract.[96]

Once the service provider has filed bankruptcy, the bankruptcy court has the power to order the bank to specifically perform in accordance with the pre-petition agreement until such agreement is assumed or rejected by the bankrupt service provider.[97] If the bankruptcy court grants the bankrupt service provider's petition to assume the outsourcing contract, the bank must continue to perform under the terms of the contract.[98] It cannot unilaterally alter the contract to derive some greater benefit or protection than that offered by the pre-petition contract. Simply stated:

> By enabling a debtor in possession or trustee to assume an executory contract, the Code allows a troubled debtor to take advantage of a contract that, if performed, would benefit the estate. By rejecting a contract, the debtor in possession or trustee may relieve the estate of a burdensome contract – one that, if performed, would be detrimental to the estate. Unless and until the debtor in

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Intellectual Property Agreements, and Related Issues under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code, 8 AM. BANKR. INST. L. REV. 307, 308–14 (2000).

[95] *See* 11 U.S.C. § 365(d)(2). *But cf.* § 365(d)(1) (stating trustee has only sixty days to assume or reject executory contract if bankruptcy filing is made under chapter 7, unless court for cause permits additional time - failure to do so results in contract being deemed rejected); *In re* Benson, 76 B.R. 381, 382 (Bankr. D. Del. 1987) (deeming contract rejected because chapter 7 trustee failed to assume or reject contract or seek extension within sixty day period).

[96] 11 U.S.C. § 365(d)(2). *See, e.g.*, Moody v. Amoco Oil, 734 F.2d 1200, 1216 (7th Cir. 1984) ("A party who cannot afford the uncertainty during the pendency of the reorganization may request the bankruptcy court to order the debtor to decide whether to assume or reject the contract within a specified period."); *In re* Physician Health Corp., 262 B.R. 290, 292, 295 (Bankr. D. Del 2001) (denying motion to compel debtor to decide whether to assume or reject executory contract within specified period and explaining courts balance both parties' interests when making such determination); *In re* Mayer Pollock Steel Corp., 157 B.R. 952, 965 (Bankr. E.D. Penn. 1993); *In re* Dunes Casino Hotel, 63 B.R. 939, 949 (D.N.J. 1986).

[97] *See* Honorable Howard C. Buschman III, *Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts,* 5 BANKR. DEV. J. 341 (1988) (discussing trustee's post-petition relationship with entities pursuant to assumable pre-petition executory contracts prior to their assumption or rejection). Such relationships are described as "uncertain," involving issues of whether unassumed contracts are enforceable post-petition both by and against the trustee, the measure of the trustee's recovery for providing a service pursuant to such an unassumed contract, and the effect of the third-party's pre-petition claims on the amount of the trustee's recovery from the third-party. *See, e.g.*, U.S. Postal Serv. v. Dewey Freight Sys., Inc., 31 F.3d 620, 624 (8th Cir. 1994) (stating after commencement of chapter 11 case, but before assumption or rejection of executory contract, such "contracts remain in existence, enforceable by the debtor but not against the debtor"); *In re* Monarch Capital Corp., 163 B.R. 899, 907 (Bankr. D. Mass. 1994) (noting "nondebtor party may not enforce an executory contract prior to its assumption or rejection"). *See generally* Bordewieck, *Executory Contracts, supra* note 84.

[98] *See, e.g., In re* Superior Toy & Mfg. Co., 78 F.3d 1169, 1172 (7th Cir. 1996) (explaining contracting party must perform under contract bankrupt debtor assumes); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1310 (5th Cir. 1985) (explaining § 365 is intended to provide "a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.").

> possession or trustee elects to assume an executory contract, contracts generally are not enforceable against the trustee. If an executory contract . . . is assumed, it continues in effect according to its terms.[99]

The general rule under the Bankruptcy Code is that the bankrupt's contracts are assumable.[100] While there are a couple of statutory exceptions to this rule and the scope of these exceptions has certainly been the subject of dispute, legislative history and caselaw indicate that the exceptions are intended by Congress to be applied narrowly.[101] Generally, since an outsourcing contract would not be considered a personal service contract or a contract to make a loan or extend other debt financing or financial accommodations, it would probably be assumable by the trustee under either chapter 7 or 11.[102] This would be subject, of course, to court

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[99] WILLIAM C. HILLMAN & MARGARET M. CROUCH, BANKRUPTCY DESKBOOK 11–25 (3d ed. 2000).

[100] 11 U.S.C. § 365. In *Richmond Leasing Co*., the court stated:

> Section 365 is intended to provide a means whereby a debtor can force another party to an executory contract to continue to perform under the contract if (1) the debtor can provide adequate assurance that it, too, will continue to perform, and if (2) the debtor can cure any defaults in its past performance. The provision provides a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so. The section thus serves the purpose of making the debtor's rehabilitation more likely.

762 F.2d at 1310*. See generally* Samuel R. Maizel, *What's New and Different About Executory Contracts and Unexpired Leases in Bankruptcy Proceedings,* Prepared for the Meeting of the Business Bankruptcy Committee, American Bar Association (Apr. 4, 2002), *at* http://www.abanet.org/buslaw/newsletter/0002/materials/bankruptcy.pdf (outlining case law and issues with respect to assumption of executory contracts).

[101] *See* Maizel, *supra* note 100, at 1 (noting in his thirty-plus page outline of law governing executory contracts in bankruptcy):

> It is an area of the law described as a "thicket . . . where . . . lurks a hopelessly convoluted and contradictory jurisprudence." *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (*quoting* Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991)). "[I]n no area of bankruptcy has the law become more psychedelic than in the one titled 'executory contracts.'" *Drexel Burnham*, 138 B.R. at 690 (quoting Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 228 (1989)).

[102] *See* Citizens & Southern Nat'l Bank v. Thomas B. Hamilton Co., (*In re* Thomas B. Hamilton Co.), 969 F.2d 1013, 1020–21 (11th Cir. 1992) (holding credit card merchant agreement was not contract for "financial accommodation" because agreement established contractual business relationship and any financing that was part of the relationship was only incidental to business relationship). The 11th Circuit noted that "[c]haracterization of contracts to make a loan, or extend other debt financing or financial accommodations is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made over time." *Id.* at 1018. *See, e.g., In re* Optimum Merchants Services, 163 B.R. 546, 555 (Bankr. Neb. 1994) (finding contract between bankrupt marketer of bank cards and credit card issuing bank, which was not exclusive to either party, was not in nature of personal services contract and could be assumed by bankrupt service provider as long as it was capable of curing past defaults, compensating bank for its actual pecuniary loss, and assuring its future performance), *vacated and appeal dismissed per stipulation by* 199 B.R. 409 (D. Neb. 1995). *See generally* Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"*

approval and satisfaction of certain provisions in the Bankruptcy Code.[103] The executory contract may not be terminated or modified without the approval of the bankruptcy court; even the bankrupt cannot alter or modify a pre-petition contract without court approval.[104]

The only reason required for the assumption or rejection of a contract is that in the business judgment of the trustee, it will be in the best interest of the bankruptcy estate.[105] In order to assume an executory contract, the trustee must cure any default

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70 AM. BANKR. L.J. 95 (1996) (exploring history of this rule and conflicting interpretations as to ability of "applicable law" to override rule), noting that:

> The general rule under the Bankruptcy Code is that any executory contracts held by an entity filing for bankruptcy relief may be assumed by the trustee or the debtor-in-possession and, under most circumstances, assigned to third parties in order to maximize the value of the estate. However, a significant exception to this general rule is allowed where "applicable law" explicitly prohibits assignment of those contracts. This exception is most often encountered in cases involving government contracts, . . . and in cases involving personal service contracts. However many other types of executory contracts, including almost all other contracts with the federal government and many with state and local governmental bodies, are affected as well. Unfortunately, a decade and a half of conflicting judicial interpretations and statutory amendments make any precise determination of the assignability of such contracts almost impossible.

Id. *But see* Gregory G. Hesse, *On the Edge – The Risk of an Offensive Use of Catapult,* 2001 AM. BANKR. INST. J. LEXIS 65, April 2001, *at* 2001; Primoff & Weinberger, *supra* note 94, at 319–46 (pointing out that executory contracts involving rights to intellectual property are subject to federal patent, copyright and trademark laws, which are "applicable laws" that may excuse non-debtor party from performing or accepting performance from third-party pursuant to § 365(c) without consent of non-debtor party).

[103] For example, the court in *In re Superior Toy & Mfg. Co.*, stated that "a chapter 7 trustee will assume an executory contract if the contract can be transferred for profit. 78 F.3d at 1173. A chapter 11 trustee will assume an executory contract if the contract facilitates the debtor's financial reorganization and emergence from bankruptcy." The court noted that if the debtor is in default, the contract cannot be assumed unless at the time of assumption the trustee cures or provides adequate assurance that the default will be cured, compensates or provides adequate assurance that the other party to the contract will be promptly compensated for any pecuniary damages resulting from the default, and provides adequate assurance of future performance under the contract. *See id.* at 1172. The court indicated, "[w]e believe Congress passed § 365 to insure that a contracting party is made whole before a court can force the party to continue performing with a bankrupt debtor." *See id.* at 1174. Under chapter 7, the bankruptcy court may authorize the trustee to operate the debtor's business for a limited time if such operation "is in the best interest of the estate and consistent with the orderly liquidation of the estate." 11 U.S.C. § 721 (2000).

[104] 11 U.S.C. § 365 (2000). For example, in *Richmond Leasing Co*., the court clarifies:

> [T]he often-repeated statement that the debtor must accept the contract as a whole means only that the debtor cannot choose to accept the benefits of the contract and reject its burdens to the detriment of the other party to the agreement. Similarly, the other party cannot hold out for concessions from the debtor beyond those required to provide adequate assurance.
>
> . . . Nothing in the Code suggests that the debtor may not modify its contracts when all parties to the contract consent.

762 F.2d at 1311. (internal citations omitted); *see also In re* Three Star Telecast, Inc., 93 B.R. 310, 312 (D. P.R. 1988) ("A debtor in possession may not assume part of an executory contract and reject the rest; assumption is an all or nothing proposition.").

[105] *See, e.g*., NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523–26 (1984) (recognizing traditional business judgment rule).

that may exist or provide adequate assurance that the default will be cured.[106] However, defaults that were caused by reason of the institution of the bankruptcy proceeding or the financial condition of the service provider at the time of the bankruptcy need not be cured.[107] Additionally, in order to assume the contract if there has been a contractual default, the trustee must compensate or provide adequate assurance that the bank will be compensated for any actual loss resulting from the default and must provide further adequate assurance that future performance will comply with the contract.[108]

If the service provider "rejects" the executory contract (i.e., refuses to continue providing services under the outsourcing agreement), this constitutes a breach of contract for which the bank has a claim for damages against the bankruptcy estate.[109] This claim is considered to be a general unsecured claim if the contract

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[106] 11 U.S.C. § 365 (b)(1)(A); *see also* L.S.R.C. Co. v. Rickel Home Cts., Inc. (*In re* Rickel Home Centers, Inc.), 209 F.3d 291, 298 (3d Cir. 2000) (noting trustee may assume contracts in their entirety after fulfilling their duties under 11 U.S.C. § 365(b)(1)(A),(B),(C)); Century Indemnity Co. v. Nat'l Gypsum Co. Settlement Trust (*In re* National Gypsum Co.), 208 F.3d 498, 506 (5th Cir. 2000) (explaining § 365 "allows a debtor to 'continue in a beneficial contract provided, however, that the other party is made whole at the time of the debtor's assumption of said contract" and that "this cure requirement is set forth in § 365(b)(1)"); *Richmond Leasing Co*., 762 F.2d at 1310 ("Section 365 is intended to provide a means whereby a debtor can force another party to an executory contract to continue to perform under the contract if . . . the debtor can cure any defaults in its past performance.").

[107] 11 U.S.C. § 365 (b)(2)(A)&(B). *See, e.g.*, *In re* Yates Dev., Inc., 241 B.R. 247, 255 (Bankr. M.D. Fla. 1999) (stating:

> Subparagraphs (b)(2)(A)(B) and (C) . . . provide that defaults in contracts relating to the debtor's insolvency or financial condition, the filing of the bankruptcy case itself, or . . . do not have to be cured. This exception to the general rule requiring the cure of defaults furthers the bankruptcy policy of preventing the enforcement of *ipso facto* or bankruptcy termination clauses. 3 Lawrence P. King, COLLIER ON BANKRUPTCY, ¶ 365.05[4] (15th Rev. Ed. 1999).

Id.), *aff'd on other grounds* 256 F.3d 1285 (11th Cir. 2001).

[108] 11 U.S.C. § 365(b). Obviously, it is possible that the parties to an outsourcing contract will disagree as to what is adequate assurance. *See, e.g., Richmond Leasing Co*., 762 F.2d at 1307–10 (describing challenge by third-parties to bankruptcy court's approval of bankrupt lessee's ability to provide adequate assurance of future performance). The court indicated that assurance of future performance must be determined by consideration of facts of proposed assumption, subject to review under "clearly erroneous" standard. *Id.*; *see also* U.S. v. United States Gypsum Co., 333 U.S. 364, 395 (1948) ("A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.").

[109] 11 U.S.C. § 365(g)(1); *see also In re* Swallen's Inc., 210 B.R. 120, 123 (Bankr. S.D. Ohio 1997) (indicating even if contract is not assumed, claims relating to post-petition transactions may be entitled to administrative expense treatment); *In re* Child World, Inc., 147 B.R. 847, 850 (Bankr. S.D.N.Y. 1992) (discussing significance of rejecting executory contracts); Buschman, *supra* note 97, at 346–48 (discussing liability for breach of executory contract that is rejected or breached post-assumption); Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy,* 46 DUKE L. J. 517, 517 (1996) (analyzing problem of "excessive rejection" of executory contracts and suggesting reputation concerns may not prevent rejection of even a value-creating contract). The court notes:

> [E]xcept for large publicly-traded companies, most firms entering bankruptcy end up being liquidated or sold to new owners. Over 70% of firms entering bankruptcy file under the liquidation provisions of Chapter 7, meaning that they are either liquidated or acquired by new owners . . . Of the remaining 30% that enter bankruptcy through

was not previously assumed by the trustee.[110] In most chapter 7 or chapter 11 cases, general unsecured claims receive mere cents on the dollar.[111] This right to claim for damages as a general creditor with an unsecured claim may be of little comfort to a bank whose business is in disarray as a result of the service provider's bankruptcy and subsequent decision to reject the outsourcing contract.

Courts have long recognized the necessity of (1) giving a trustee time within which to decide whether to assume or reject and (2) ensuring that preemptory conduct by the other parties to an executory contract does not undermine the bankruptcy process. While the trustee is considering whether to assume or reject the outsourcing contract, the bank should consider itself to be prevented from acting in any manner to impair the trustee's option to adopt the contract.[112] The Bankruptcy Code sets no specific deadline for the chapter 11 trustee's election to assume or reject an executory outsourcing contract, other than that the decision must be in compliance with any order for assumption or rejection and made prior to confirmation of a reorganization plan;[113] it is often extended until confirmation of the plan. This effectively places the bank in limbo with respect to making decisions

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> Chapter 11 – that is, the firms most likely to care about their reputations – a majority are either liquidated or sold to new owners before a plan is confirmed. *Id.* Consequently, most firms are likely to discount heavily the future reputational benefit of performing an unfavorable contract – particularly since performance of such a contract may reduce the likelihood that the firm will survive long enough to reap any benefit from this investment.

Id. at 536–37; Kupetz, *supra* note 41, at 62–63; Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 253 (1989) (examining treatment of executory contracts in bankruptcy).

[110] *See, e.g.*, *In re* Spectrum Info. Tech., Inc., 190 B.R. 741, 746 (Bankr. E.D.N.Y. 1996) (stating rejection by trustee gives rise to "prepetition general unsecured claim for damages rather than an administrative expense priority"); *In re Child World*, 147 B.R. at 850. *See generally* Westbrook, *supra* note 109, at 252–55 (discussing rule of pro rata distribution of claims pertaining to unsecured creditors).

[111] *See In re Spectrum Info. Tech., Inc.*, 190 B.R. at 746 (mentioning reality that general unsecured claims may pay out at far less than dollar-for-dollar value); *In re Child World*, 147 B.R. at 850 ("Although general unsecured claims are calculated in full, the payment of these claims, if at all, is made 'in little tiny Bankruptcy Dollars, which may be worth only ten cents in U.S. Dollars.'").

[112] *See, e.g.*, *In re* United Cigar Stores Co. of America, 89 F.2d 3, 6 (2d Cir. 1937). As far back as 1937, the Second Circuit noted that:

> A trustee in bankruptcy is entitled to a reasonable opportunity to determine whether to adopt or reject an executory contract. If he adopts it and performs the bankrupt's duties thereunder, he can insist upon performance by the other party. While the trustee still has the matter of adoption under advisement, it may be assumed that he could restrain the other party from disposing of the subject matter of the contract or otherwise acting in a manner to impair the trustee's option to adopt the contract.

Id.; *see also In re* New England Carpet Co., 18 B.R. 514, 516–17 (Bankr. D. Vt. 1982) (explaining "[t]he relative test of 'reasonableness' depends upon the facts and circumstances of the particular case.").

[113] 11 U.S.C. § 365(d)(2) (2000). *See, e.g.*, Gen. Am. Transp. Corp. v. Martin (*In re* Mid Region Petroleum), 1 F.3d 1130, 1132 (10th Cir. 1993) (noting trustee may assume or reject before confirmation of plan of reorganization); Corporacion de Servicios Medicos Hospitalarios de Fajardo v. Mora (*In re* Corporacion de Servicios Medicos Hospitalarios de Fajardo), 805 F.2d 440, 447 (1st Cir. 1986) (same); *In re* Grant Broadcasting of Philadelphia, Inc., 71 B.R. 891, 898 (Bankr. E.D. Pa. 1987) ("The Code provides the debtor with a certain period wherein he can choose which executory contracts he will accept and which he will reject . . . [w]e believe that the incentive to force a more rapid choice must remain on the obligee.").

relevant to the outsourced services. It is unable to move forward with either replacement of the service provider or development of needed improvements/enhancements to the services since it does not know whether or not the bankrupt service provider will remain in the picture. As its competitors are moving forward with their businesses, the bank is at the mercy of the trustee with respect to any necessary changes in service. The bank, as a non-debtor party to an executory contract, is prohibited from unilaterally terminating the contract and from ceasing its performance thereunder, unless and until the contract is rejected and the automatic stay is lifted.[114] Bankruptcy courts are inherently reluctant to doom a chapter 11 proceeding and may have little interest in forcing assumption or rejection prior to the trustee's proposal of a plan of reorganization. Irrespective of the validity of the legal arguments raised by the bank, a bankruptcy court may not want to ring a death knell for the bankrupt.

Given the above Bankruptcy Code protections provided for the bankrupt service provider, the bank loses control over its relationship with the bankrupt service provider and virtually all decisions that the bank might wish to make with respect to its contractual relationship become subject to the approval of the bankruptcy court.[115] The following chart shows *some* of the issues that might face a bank dealing with a service provider's bankruptcy; it illustrates with simple examples an abbreviated "WORST CASE SCENARIO":

WORST CASE SCENARIO: *The following illustrates some of the difficulties that could face a bank dealing with the financial meltdown and subsequent bankruptcy of its outsourcing service provider:*[116]

1/1/2002	Bank enters into a seven year outsourcing contract with XSP, a large service provider. Bank is a major payment card issuer. XSP is going to perform the following services: Card issuance (embossing) Processing and maintenance of all cardholder records Transaction and statement processing Customer service

[114] *See, e.g.*, U.S. Postal Service v. Dewey Freight System, Inc., 31 F.3d 620, 624 (8th Cir. 1994) (stating that prior to rejection or assumption of executory contracts, those contracts are "enforceable by the debtor but not against the debtor."); *In re* Monarch Capital Corp., 163 B.R. 899, 907 (Bankr. D. Mass. 1994) (concluding that non-debtor party may not terminate contract by reason of debtor's pre-petition defaults).

[115] While it might be theoretically possible for the bank and a trustee to consensually renegotiate the contract during the bankruptcy (ultimately subject, of course, to bankruptcy court approval of the renegotiated contract), the following factors make this difficult: (1) severe time constraints, (2) limited authority of the trustee (in conjunction with managerial turnover), and (3) uncertainty over who will take control of the reorganized business. *See* Fried, *supra* note 109, at 534.

[116] This illustration is theoretical and is not based on an actual case history.

	Payment processing
	Bank will retain the following functions in-house: Marketing Credit policy and decisions Collections General management and financial administration
6/1/2002	Bank converts its payment card portfolio onto the XSP servicing platform.
7/15/2002	XSP announces that its Q2 2002 earnings are below expectations and that it will be firing 10% of its work force.
9/1/2002	Bank begins getting customer complaints about slow error resolution and errors in connection with payment processing.
9/5/2002	Bank contacts XSP and determines that the reduction in staff has resulted in less efficient handling of general processing. Bank checks its contract and determines that XSP is not in breach of the contract because it continues to meet the broad standards set by the contract.
1/15/2003	Bank is the subject of a consumer compliance examination by the OCC. Among the issues raised by the OCC is the significant number of complaints that the OCC is receiving from consumers about inadequate error resolution and erroneous payment processing. The OCC advises Bank that it is concerned with Bank's lack of internal controls/inadequate senior management oversight and that these concerns will be reflected in Bank's examination report.
1/16/2003	Bank advises XSP that it is very dissatisfied with XSP's performance. XSP says it will try to do better. Bank again checks its outsourcing contract and determines that XSP is still not in breach of the "service level agreements" which turn out to have been inadequately crafted; XSP is careful to comply with the precise stated terms of the contract.
1/17/2003	XSP issues a press release indicating that its contract with a major client has expired, that it has failed to meet profit expectations for 2002, and that it will be reducing staff by another 15%.

2/1/2003	XSP's stock price falls significantly; XSP's financial condition is being reported in the financial press/CNBC on a daily basis – accounting irregularities are discovered and the CEO/CFO of XSP both resign. XSP is obviously in a "death spiral."
2/20/2003	XSP files for bankruptcy.
2/28/2003	XSP is running out of cash and because of the accounting irregularities XSP's commercial banks are not willing to provide DIP financing. The trustee indicates that 25% more of XSP's employees will be terminated within the next two weeks. It is beyond dispute that XSP cannot fully perform its outsourcing obligations but it needs the contract with Bank to continue in business and prevent total shut down. The bankruptcy court and official creditors' committee recognize and approve of XSP's position.
3/5/2003	Bank explores its practical options and determines that it has no capability to take the processing back in-house (i.e. it dismantled its in-house operating system for the outsourced functions eight months ago). Bank determines that service provider ABC has the capability to assume the servicing, the price per year will be at least 25% more than that charged by XSP, and conversion of the portfolio to the new system could not occur until June 1, 2003. Because of the overtime and expedited work required to make this happen, ABC will also charge an up-front fee totaling millions of dollars.
3/7/2003	Bank petitions the bankruptcy court for (1) immediate rejection by XSP of the executory contract or, in the alternative, relief from the automatic stay and (2) an order directing XSP to terminate the contract and to assist with conversion of the portfolio to service provider ABC. Bank does not move to compel assumption (as contrasted with rejection of the executory contract) because XSP cannot perform given labor cuts and thus Bank believes XSP cannot provide adequate assurance of performance. The bankruptcy court denies the petition telling Bank that XSP, in the exercise of its business judgment, has not yet made a determination as to whether or not to assume or reject the contract.
3/31/2003	Bank appeals the denial of its petition on grounds that its business is being destroyed by the inability of XSP to properly service the

	portfolio. It turns out that the outsourcing agreement was poorly drafted and the only breach is the fact that XSP has gone bankrupt.
4/15/2003	The district court denies Bank's petition on grounds that (1) Bank has failed to show that XSP has abused the exercise of its business judgment in deferring assumption/rejection, (2) Bank has failed to show that the Bank's interests are not adequately being protected, and (3) the Bankruptcy Code prevents Bank from terminating the relationship merely because XSP has filed bankruptcy.
4/30/2003	Bank is watching its competitors implement a new marketing program. Bank is unable to offer a comparable program because XSP is unable to properly support such program.
5/30/2003	XSP announces that it is selling its payments card processing business to a small competitor. Included among the contracts being assigned is Bank's contract. Bank is unhappy; when it put the contract out for bid a couple of years earlier, it declined to consider a bid from this vendor because of its generally sloppy reputation.
6/10/2003	Bank goes to court petitioning that the bankrupt not be permitted to assign its service contract to the proposed vendor. The bankruptcy court denies the petition declaring that (1) XSP has shown that Bank interests are protected in that the new vendor can, in XSP's opinion, (and so determined by the court could) provide adequate assurance of performance and (2) the anti-assignment clause in the contract is not effective in bankruptcy. The Bank chooses not to appeal given the resulting delay and risk of uncertainty in servicing of portfolio that this would cause.
9/30/2003	Bank's portfolio is converted to the new vendor; the conversion goes poorly and it takes a week after conversion before Bank has any ability to look at its accounts or to generate statements. Bank's contract still has over 5 years to go.
10/31/2003	Bank determines that the new vendor is totally inadequate; there is finally an actual identifiable breach of the contract by the new vendor. However, according to the contractual language the vendor has a period of months within which to cure the breach before Bank has the right to terminate the contract. Bank initiates the termination process. The vendor turns obstreperous and begins to strictly comply with the terms of the contract, it takes steps to cure the breach and performs only those functions that are unarguably

	required by the contract. Bank and the vendor become more dissatisfied with each other on a daily basis and staff find it difficult to discuss/resolve even the smallest issues.
1/31/2004	The cure period expires and the vendor has cured the breach previously identified by Bank; at this time the vendor is arguably in compliance with all written terms in the contract. Bank remains totally dissatisfied with the vendor's performance. Bank and vendor sit down and discuss how much the Bank will need to pay to terminate the contract early and to obtain the vendor's cooperation for a conversion to another service provider. Bank, in an attempt to salvage its once efficiently run business agrees to pay a huge termination fee.

D. Can the bankrupt service provider assign the outsourcing contract?

There is a significant possibility that the outsourcing contract could be assigned by the bankrupt service provider *even if such assignment is prohibited* by specific language in the contract.[117] The general rule under the Bankruptcy Code is that the bankrupt's executory contracts that have been assumed are assignable (subject to a couple of statutory exceptions to assignability).[118] Generally, an executory contract may be assigned after it is assumed by the trustee, unless (1) it is "[a] contract to make a loan, or extend other debt financing or financial accommodations . . ."[119] or (2) applicable non-bankruptcy law excuses the bank from performance to someone other than the service provider without the bank's consent.[120]

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[117] *See* 11 U.S.C. § 365(f); *In re* Pioneer Ford Sales, Inc., 26 B.R. 116, 117 (Bankr. D. R.I. 1983) (stating § 365(f) invalidates non-assignment clause in franchise agreements), *aff'd,* 30 B.R. 458, *rev'd on other grounds,* 729 F.2d 27 (1st Cir. 1984).

[118] *See* 11 U.S.C. § 365(c), (e), (f), & (k); *see also* L.S.R.C. Co. v. Rickel Home Cts., Inc. (*In re* Rickel Home Centers, Inc.), 209 F.3d 291, 299 (3d Cir. 2000) ("The Code generally favors free assignability as a means to maximize the value of the debtor's estate and, to that end, allows the trustee to assign notwithstanding a provision in the contract or lease, or applicable law, prohibiting, restricting, or conditioning assignment."); *In re* Grove Rich Realty Corp., 200 B.R. 502, 507 (Bankr. E.D.N.Y. 1996) (acknowledging "a general rule of assignability" for executory contracts in Bankruptcy Code).

[119] 11 U.S.C. § 365(c)(2). Examples of such non-assumable/non-assignable contracts given in the legislative history include loan commitments and letters of credit. H. REP. No. 95-595, at 348 (1978), *reprinted in* U.S.C.C.A.N. 6304. *See, e.g.*, Farmer v. Crocker Nat'l Bank (*In re* Swift Aire Lines, Inc.), 30 B.R. 490, 496 (B.A.P. 9th Cir. 1983) (finding letter of credit is executory contract to make financial accommodation); *In re* New Town Mall, 17 B.R. 326, 327–28 (Bankr. D.S.D. 1982) (holding "executory contracts such as loan commitments are not assignable or assumable by a debtor-in-possession.").

[120] *See, e.g.*, Everex Sys., Inc. v. Cadtrack Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 680 (9th Cir. 1996) (explaining under 11 U.S.C. § 365(c), non-exclusive patent licenses are not assumable and assignable in bankruptcy absent authorization from patent owner); City of Jamestown, Tenn. v. James Cable Partners, L.P. (*In re* James Cable Partners, L.P.), 27 F.3d 534, 538 (11th Cir. 1994) (finding no applicable state law prohibiting assignment of cable franchise agreement); *In re* West Elecs. Inc., 852 F.2d 79, 83 (3d Cir. 1988) (stating under Nonassignment Act, 41 U.S.C. § 15, debtor in possession is barred from assuming

Neither of these exceptions appears to be relevant to outsourcing contracts generally. Thus, typically, the bank may not be able to prevent a bankrupt service provider from assigning the outsourcing contract if the trustee determined to do so.[121] Typically, under the second exception (i.e. that a contract may not be assigned if applicable non-bankruptcy law excuses the bank from performance to a third-party without its consent), assignment of a contract involving personal services would be prevented.[122] However, as discussed earlier in this Article, outsourcing contracts would generally not be considered to be contracts for personal services.[123] It should be noted that this statutory language referencing "applicable non-bankruptcy law" is equally applicable to any contract subject to a legal prohibition against assignment.[124] How this statutory language would impact the assignment of an outsourcing contract which contained patent or other intellectual property licenses from the bank to the service provider (which are typically not assignable without the owner's consent) is beyond the scope of this Article. The fact that an outsourcing contract contains a provision prohibiting assignment without the bank's consent is irrelevant; once the service provider files bankruptcy, the Bankruptcy

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government contract, which required production of military equipment, without government's consent); *In re* Pioneer Ford Sales, Inc., 729 F.2d 27, 29 (1st Cir. 1984) (stating effect of § 365(c)(1)(A) is not limited to personal service contracts, but rather "it refers generally to contracts that are not assignable under nonbankruptcy law"); Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 943 (5th Cir. 1983) (stating drafters of § 365(c) codified much broader principle than merely limiting it to personal service contracts); *In re* Supernatural Foods, LLC, 268 B.R. 759, 789 (Bankr. La. 2001) (providing extensive discussion of cases ruling on issue of what constitutes "applicable law" under language of § 365(c)(1)).

As a general matter, except with respect to federal government contracts or contracts involving intellectual property, whether a contract is assignable is determined by the applicable state law. While the bank might attempt to argue under 11 U.S.C. § 365(c)(1) that the effect of a contractual prohibition against assignment together with such regulatory guidance as OCC BULLETIN 2001-47, *supra* note 23 (which directs the bank to indicate in its servicing agreements whether the service provider is prohibited from assigning any portions of the contract to other entities) prohibit the bank from honoring a unilateral assignment of the outsourcing contract that it has not consented to; this argument is quite weak and is sure to be contested by the bankrupt service provider.

[121] *See, e.g.*, *In re* Optimum Merch. Serv., 163 B.R. 546, 554 (Bankr. Neb. 1994) (finding contract between bankrupt marketer of bank cards and credit card issuing bank could be assumed by bankrupt service provider), *vacated and appeal dismissed per stipulation by* 199 B.R. 409 (D. Neb. 1995). *But see* Primoff & Weinberger, *supra* note 94, at 314–46 (suggesting under federal patent law, executory contracts involving patent rights licensed by bank client to outsourcing service provider may not be assumable or assignable by bankrupt service provider to third-party).

The conclusion expressed is not free from doubt or case-by-case interpretation. If federal bank regulators were to adopt strong guidance or regulations with respect to the non-assignability of third-party outsourcing agreements, banks might attempt to use this to contest assignment. However, unless and until resolved by legislation or the courts, there would remain an unresolved issue of whether such guidance/regulations would qualify as "applicable law" under 11 U.S.C. § 365(c)(1).

[122] *See supra* note 102 and accompanying text.

[123] *Id*.

[124] *See supra* note 120 and accompanying text.

Code authorizes assignment.[125] Bank regulatory guidance such as that found in OCC BULLETIN 2001-47 (which recommends only that the bank indicate in its servicing agreements *whether* the service provider is prohibited from assigning any portions of the contract to other entities) would most likely *not* qualify as "applicable non-bankruptcy law" sufficient to prevent an assignment without the consent of the bank, if such assignment is made by the trustee and so ordered by a bankruptcy court.

The possibility that its contract might be assigned to an unknown third-party should be troublesome to the bank. The bank may have made its original selection of service providers based upon intangible as well as tangible factors (such as the perceived experience and problem solving abilities of the service provider's employees). The proposed assignee may have been considered by the bank at the time the original outsourcing contract was signed and eliminated from consideration due to a multitude of factors other than price. While the Bankruptcy Code clearly states that an executory contract may be assigned only if "adequate assurance of future performance by the assignee of such contract . . . is provided," the judgment as to what constitutes adequate assurance is not within the control of the bank.[126] Rather, the bankruptcy court is responsible for this determination and such considerations may be largely irrelevant as the bankruptcy court has the ability to discount them.[127]

E. What is the effect of the service provider's bankruptcy on indemnification provisions contained in the outsourcing contract?

An outsourcing contract typically provides for contractual indemnification with respect to certain defined risks.[128] A service provider might indemnify a bank against losses, costs, damages and expenses arising from (1) lawsuits alleging

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[125] *See* 11 U.S.C. § 365(f) (2000); *see also* L.S.R.C. Co. v. Rickel Home Centers, Inc. (*In re* Rickel Home Centers, Inc.), 209 F.3d 291, 299 (3d Cir. 2000),

> Having assumed an executory contract or unexpired lease, the trustee may elect to assign it. The Code generally favors free assignability as a means to maximize the value of the debtor's estate and, to that end, allows the trustee to assign notwithstanding a provision in the contract or lease, or applicable law, prohibiting, restricting, or conditioning assignment.

Id.

[126] 11 U.S.C. § 365(f)(2). *See, e.g., In re* Prime Motor Inns, Inc., 166 B.R. 993, 997 (Bankr. S.D. Fla. 1994) (finding under § 365(b)(1)(C), "the assurance of future performance is adequate if performance is likely (i.e. more probable than not); the degree of assurance necessary falls considerably short of an absolute guaranty."); *In re* Carlisle Homes, Inc., 103 B.R. 524, 538 (Bankr. D. N.J. 1988) (noting under § 365(b)(1)(C) "[t]he phrase 'adequate assurance of future performance'. . . is to be given a practical, pragmatic construction based on the facts and circumstances of each case.").

[127] *See* 11 U.S.C. § 365(f)(2)(B).

[128] *See, e.g.*, Jonathan D. Bennett, *Outsourcing is Risky Business: Proceed with Care*, NAT'L L.J., Jan. 28, 2002, at C.5 (noting indemnification/hold-harmless provisions attempt to contractually shift obligations and liabilities to party intended to bear them).

patent or copyright infringement or (2) class action lawsuits alleging violation of various federal or state statutory duties applicable to the bank under consumer protection statutes. For example, a service provider supplying payment processing services for a credit card issuing bank might agree to process consumer payments on the day of receipt and to indemnify the bank for any losses that the bank suffered because of the service provider's failure to do so.

Where a claim is made against the bank with respect to which the bank has a right of indemnification, the bankruptcy filing could impact the bank's ability to collect. In that situation, if the bank is sued it would generally file a counterclaim against the service provider based upon its contractual indemnification. If the bankrupt service provider rejects the outsourcing contract, the bank's claim would be categorized as a pre-petition unsecured claim.[129] Accordingly, the bank would be required to stand in line with all other general creditors in order to collect from the bankrupt service provider.[130] However, the claim of the third-party against the bank would not be defeated by the bankruptcy. On the other hand, if the contract is assumed, the bankrupt is required to "cure all defaults, both monetary and non-monetary, prior to the assumption and assignment of an executory contract."[131] With assumption, the contract continues as originally written and any indemnification by the service provider would remain in effect. Subsequent payment obligations of the bankrupt based on its contractually agreed upon indemnification would be considered an administrative expense of the bankruptcy estate.[132] This carries with it a much higher probability that the bank will be able to recover significant funds from the bankrupt.

F. What is the impact of the bankruptcy filing upon intellectual property being used by the service provider prior to bankruptcy?

In any outsourcing arrangement, the service provider may be using software or other intellectual property provided by third-parties under licenses. These licenses

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[129] *See* 11 U.S.C. § 365(g); *see also In re* Allied Tech., Inc., 25 B.R. 484, 497 (Bankr. S.D. Ohio 1982) ("A claim based upon rejection . . . is essentially a post-petition claim which is constructively handled as prepetition under the administration of the bankruptcy proceeding."); *In re* Georgetown of Kettering, Ltd., 22 B.R. 312, 316 (Bankr. S.D. Ohio 1982) (concluding in lease situation, rejection amounts to constructive pre-petition breach giving rise to possibility of unsecured pre-petition claim for damages).

[130] 11 U.S.C. § 502(g) (2000); *see also* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 530 (1984) (explaining rejection of executory contract that has not been previously assumed is considered breach of contract relating back to date immediately preceding filing of debtor's bankruptcy petition). A claim resulting from the bankrupt's rejection of the executory contract is therefore a pre-petition unsecured claim. *See, e.g., In re* Spectrum Info. Tech., Inc., 190 B.R. 741 (Bankr. E.D.N.Y. 1996).

[131] 11 U.S.C. § 365(b)(1)(A) (2000); *see supra* notes 106–07 and accompanying text.

[132] 11 U.S.C. § 503(b)(1) (2000). *See, e.g.*, Nostas Assocs. v. Costich (*In re* Klein Sleep Prods., Inc.), 78 F.3d 18, 25–26 (2d Cir. 1996) (indicating breach/rejection of assumed contract gives rise to debt entitled to administrative expense priority); Elliott v. Four Seasons Properties (*In re* Frontier Properties, Inc.), 979 F.2d 1358, 1367 (9th Cir. 1992) ("When a trustee assumes and then rejects an executory contract, however, all of the liabilities flowing from that rejection are entitled to priority as administrative expenses of the estate.").

may not be assumable or assignable by the bankrupt service provider licensee,[133] and in at least one recent appellate court case, the patent holder licensor of intellectual property was held to have the ability to unilaterally dictate whether the bankrupt licensee could assume the license agreement.[134] The determination in a

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[133] For a comprehensive discussion of the law with respect to this issue, *see* Primoff & Weinberger, *supra* note 94, which concludes:

> Bankruptcy Code sections 365(c), 365(e) and 365(n) and the caselaw thereunder: (1) impose limitations on the power of a trustee . . . to assume, assign or reject licenses and executory contracts involving intellectual property; and (2) afford additional protection to non-debtor parties to intellectual property licenses and contracts.
>
> Sections 365(a), (b), (f), and (g) of the Bankruptcy Code are the starting point for analysis of the assumption, assignment and rejection of intellectual property agreements . . . However, with respect to executory contracts involving intellectual property, the Bankruptcy Code imposes certain limitations on the assumption, assignment and rejection . . . .
>
> Even if a license or agreement involving intellectual property is executory, section 365(c) of the Bankruptcy Code, . . . may prohibit the assignment or assumption of an agreement without the consent of the non-debtor party. Section 365(e) . . . enforces ipso facto clauses in executory contracts involving intellectual property under certain circumstances . . . .

Id. at 314–15. Primoff & Weinberger further conclude that:

> Because patent law makes non-exclusive patent licenses unassignable without the consent of the licensor, section 365(c) of the Bankruptcy Code prohibits an assignment, and perhaps even the assumption, of non-exclusive patent licenses by the licensee without the consent of the non-debtor licensor.
>
> Section 365(c) of the Bankruptcy Code does not, however, preclude assumption and assignment of an exclusive patent license by the debtor licensee without the consent of the licensor. Similarly, it appears that Bankruptcy Code section 365(c) does not bar assumption and assignment by a debtor-licensor of a non-exclusive patent license without the consent of a non-debtor licensee, provided that section 365(f)(2)(B) of the Bankruptcy Code's adequate assurance of future performance test is satisfied. The issue of whether, under section 365(c) of the Bankruptcy Code, a debtor licensor may be prohibited from assuming and assigning an exclusive patent license without the consent of the non-debtor licensee does not appear to have been addressed by the relevant case law.

Id. at 323–24.

Of course, as they also point out, a key issue for determination is whether the license arrangement constitutes an executory contract or a sale. *Id. at* 315–19. *See* Marjorie Chertok & Warren E. Agin, *Restart.Com: Identifying, Securing and Maximizing the Liquidation Value of Cyber-Assets in Bankruptcy Proceedings,* 8 AM. BANKR. INST. L. REV. 255, 281–94 (2000) (discussing current state of law and suggesting language licensees might put in contracts to assure its trustee in subsequent bankruptcy might be free to assume or assign software license); Hesse, *supra* note 102. However, it may be unrealistic to expect a bank contracting with a service provider to think to examine underlying licenses relied upon by that service provider for such language. Even if the underlying licenses are examined, it is questionable whether the bank would be able to force changes to an existing license arrangement as a condition to entering into an outsourcing arrangement. *See* Aaron Xavier Fellmeth, *Control Without Interest: State Law of Assignment, Federal Preemption and the Intellectual Property License,* 6 VA. J.L. & TECH.. 8 (2001) (discussing generally whether licensee of federally granted intellectual property rights may freely transfer its rights to third-party in absence of contractual prohibition against such transfer).

[134] Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d. 747, 748 (9th Cir. 1999)

> [W]e are called upon to determine whether, in light of § 365(c)(1) of the Bankruptcy Code, a chapter 11 debtor in possession may assume certain nonexclusive patent

specific situation may depend upon a number of factors including specific wording in the governing agreement and the jurisdiction in which the bankruptcy case is being heard.[135]

If the service provider is relying upon intellectual property (e.g., software) provided by a third-party licensor and that licensor has the ability to terminate the agreement upon the bankruptcy filing without regard to the automatic stay or to the general ability of a bankrupt to assume executory contracts, the ability of the service provider to provide the contractually agreed upon services for the bank may be compromised. Various unpleasant alternatives face the bankrupt service provider and the bank under this interpretation of the law.[136]

CONCLUSION

The bankruptcy of a service provider involved in a significant outsourcing relationship with a bank (i.e., one that supplies core/critical bank functions) may be detrimental to the bank's financial well-being. The economic downturn of the early 21st century raises serious questions as to what the negative consequences inherent in such relationships really are. It is possible that these consequences may involve

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> licenses over a licensor's objection. We conclude that the bankruptcy court erred in permitting the debtor in possession to assume the patent licenses in question.

Id. *But cf.* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997) (affirming confirmation of reorganization plan in which debtor licensee of two patents would sell all its stock to major competitor of licensor). *See generally* Hesse, *supra* note 102; Chertok & Agin, *supra* note 133; Primoff & Weinberger*, supra* note 94, at 315–19.

[135] *See, e.g.*, Daniel J. Bussel & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts,* 74 AM. BANKR. L.J. 321 (2000) (discussing struggle courts have had in interpreting § 365(c)&(f) and existing disarray in cases attempting to apply those sections). Bussel and Friedler critique the confusion surrounding *assumption* of contracts that are *nonassignable* in the following terms:

> For twenty years, courts and Congress have struggled with the question of the extent to which Bankruptcy Code § 365(c)(1) precludes assumption of contracts that are non-assignable under otherwise applicable non-bankruptcy law. The question has sharply divided the courts and resulted in two amendments to the section, which were not only tardy, but also as grossly botched as the original statute they were intended to fix. Numerous academics and law reformers deride the misdrafting of § 365(c)(1). Subsection 365(f) multiplies the confusion. While expressly subject to 365(c), subsection (f) instructs bankruptcy courts to override otherwise "applicable law" restricting assignment while subsection (c) tells them that "applicable law" regarding assignment must be given effect.
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> . . . .
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> But most courts of appeals have followed the literal language of § 365(c) to the conclusion that the bankruptcy estate loses the rights of the prebankruptcy debtor to valuable contracts that would not be assignable under otherwise applicable law even when no assignment is contemplated, and the nondebtor party to the contract, under nonbankruptcy law, could not refuse the performance that is actually offered. Under this "hypothetical test" contracts governed by § 365(c)(1) become one of the very few instances where the debtor's valuable rights against nondebtors are legally forfeited simply because of a bankruptcy filing.

Id. at 321–23, 324.

[136] *See generally* Chertok & Agin, *supra* note 133.

significant operational problems and financial losses for individual banks involved in such relationships.[137] The bankruptcy of a major service provider that is furnishing core/critical processing services for multiple large bank clients could have a ripple effect through the banking industry. The expansion of outsourcing during the 1990s corresponded to a period of economic growth and prosperity. This may have masked the potential negative impact that service provider bankruptcy could have.

With the economy wobbling, it is appropriate to seriously focus on these issues. The fate of some core/critical bank processing functions that have been outsourced could potentially end up in the hands of bankruptcy judges, bankruptcy trustees, unsecured creditors, and other parties in interest *who do not have as their primary goal or mission the safety and soundness of financial institutions.* Two years ago, discussing the prospect of servicing meltdowns by outsourcing service providers would have been viewed as indicative of extreme paranoia, if not delusion. Today, in the aftermath of WorldCom, Enron and Arthur Andersen, the possibility seems more real. Accordingly, there is a need for critical analysis of the actions that might be taken and the legislative initiatives that could be helpful in minimizing disruption/financial losses should a significant outsourcing service provider(s) that supplies core/critical processing functions for the banking industry file bankruptcy.

The first step for a bank to consider is whether its original outsourcing decision remains appropriate in light of experience and changes in economic circumstances; specifically, should critical/core outsourced functions be transitioned back in-house?[138] To provide structure for this consideration, perhaps service provider bankruptcy should be conceptualized as similar to a physical disaster (e.g., a fire or a 9/11 event) and contingency plans (akin to disaster recovery plans) thought through and developed. If the decision is to continue outsourcing, perhaps the bank should actually explore the possibility of arranging for back-up services to be automatically available in the event of the service provider's bankruptcy, or its inability or unwillingness to provide contractually agreed upon services. Such plans would have the benefit of providing a carefully thought out path to follow in the event that the worst case actually happened.

Additionally, in drafting new outsourcing contracts for *core/critical* bank functions, bank counsel should seriously consider setting forth the parties' agreed-

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[137] *See, e.g.*, Raysman, *supra* note 40. This possibility has certainly been recognized by banking regulators. *See* BASEL COMMITTEE (Oct. 2000), *supra* note 67*; OCC Bulletin 2001-47*, *supra* note 23, at 4 ("Reliance on third-party relationships can significantly increase a bank's risk profile, notably strategic, reputation, compliance and transaction risks.").

[138] *See, e.g.*, Darrell A. Fruth, *Economic and Institutional Constraints on the Privatization of Government Information Technology Services*, 13 HARV. J.L. & TECH. 521, 542–43 (2000) (concluding few outsourcing projects have lived up to their goals); Rudy Hirschheim, *Backsourcing: An Emerging Trend?*, Outsourcing Center (1998), *at* http://www.outsourcing-academics.com/backsourcing.html (concluding while firms that outsourced saved money similar savings could have been achieved in-house); *Information Technology: The Lifeblood of an Organization*, Outsourcing Center (1999), *at* http://www.outsourcing-academics.com/information.html (examining findings from research done on IT outsourcing during 1990s).

upon contingency plan detailing precisely, as a part of the contract, how servicing would be transferred in-house or to another entity in the event of service provider bankruptcy.[139] While such agreed upon contingency planning might not be enforced by the bankruptcy court, it would (at a minimum): (1) assist the bank in understanding the consequences of a service provider's bankruptcy, and (2) demonstrate to the bank officers responsible for the business the degree of difficulty in substituting a service provider, should such substitution be permitted by the trustee or by the Bankruptcy Code or court.

Furthermore, legislative action needs to be considered if the risks to the banks from outsourcing service provider bankruptcy have significantly increased in recent years. The Bankruptcy Code is quite lengthy; historically, numerous provisions have been adopted as specific industries have recognized the need for industry specific protections.[140] Perhaps changing times and the increasing dependence on outsourcing by banks[141] make it appropriate to explore whether the Bankruptcy Code provisions discussed in this Article need revision in light of their potentially negative consequences for banks. Banks considering or involved in significant outsourcing arrangements might consider whether to work toward amendment of the Bankruptcy Code to legislatively:

- Mandate that the bank has the right to require transfer of the outsourcing relationship either in-house or to a service provider acceptable to the bank, if the bankrupt service provider remains in breach of the outsourcing contract for a period of thirty days after the bankruptcy filing;[142] and/or

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[139] *See OCC Bulletin 2001-47*, *supra* note 23, at 11, 12 (indicating among topics that should normally be considered when entering into binding contract or agreement include "business resumption and contingency plans" and "default and termination"). It points out that the bank's own contingency plan should address potential financial problems or insolvency of the third-party. *Id*. at 9.

[140] *See* Daniel J. Bussel, *Textualism's Failures: A Study of Overruled Bankruptcy Decisions*, 53 VAND. L. REV. 887, 912–15 (2000) (discussing legislative overruling of court decisions in bankruptcy area); NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT (1997), 303–14, 451–607, *available at* http://govinfo.library.unt.edu/nbrc/reportcont.html (discussing developments in bankruptcy law since 1978 and recommending further changes to chapter 11 of Bankruptcy Code).

[141] *See supra* notes 18–23 and accompanying text. One might argue that legislative action at this time is premature — major banks do not yet appear to have experienced momentous problems resulting from the bankruptcy of one of their significant outsourcing service providers. Possibly the WorldCom bankruptcy will spotlight problems facing parties to an outsourcing arrangement due to protections provided for the bankrupt service provider by the Bankruptcy Code. If outsourcing problems are highlighted by this bankruptcy and legislation is proposed to address them, this might provide a vehicle for the banks to analyze and work toward Bankruptcy Code changes that would be helpful in the event of the bankruptcy of a major bank outsourcing service provider.

[142] This could be accomplished by modification to § 362 providing that the stay as to "critical outsourcing contracts" (to be carefully defined) is automatically lifted in thirty days unless a court for cause determines the rights of the bank are not adversely affected by the bankruptcy and there are no violations of federal regulatory policy caused by the service provider's financial condition. Obviously, the definition of "critical outsourcing contract" would have to be narrowly defined and possibly subject to definition by the OCC or other regulatory body.

- Mandate that the bankrupt service provider has an obligation to assume or reject the outsourcing contract within 30 or 60 days after the bankruptcy filing (this would give the bank some relief from the open-ended period now available to the debtor) – the bank should have the right to contest any claim of assurance of future performance with the burden being upon the debtor to satisfy the bank's concerns;[143] and/or
- Mandate that the bankrupt service provider has a legal obligation to assist in the transition to a new service provider or to in-house servicing within a set period of time; and/or
- Overrule case law pursuant to which bankrupt bank service provider licensees of intellectual property licenses are unable to assume non-exclusive licenses without the consent of the licensor.[144] Note that from the banks' standpoint, the optimal legislation would probably permit the assignment as well as the assumption of such licenses in those situations where the bank requires transfer of the outsourcing relationship back to itself or to a new service provider.[145]

In connection with this review and examination, empirical research into the potential downside of an outsourcing service provider's bankruptcy and steps that might be taken to minimize these risks may be relevant. This might take the form of:

- Reviewing core processing/core function outsourcing by a number of the largest U.S. banks in connection with their major retail business lines (or of the largest credit card issuing banks) and the degree of contingency planning that each has done related to the outsourcing service provider's potential financial deterioration. This could include:
    - A. Identifying the critical functions/processing that has been outsourced by each bank;
    - B. Identifying whether each bank has put any back-up plans in place to deal with the bankruptcy or financial melt-down of a critical service provider and what the content of that plan is;
    - C. Determining whether any thought has been given to whether there is a realistic alternative to a current service provider, how a substitution of service providers would be physically accomplished, what the time frame involved would be, and what the downside of having to change service providers on short notice would be; and
    - D. Determining whether any thought has been given to how the Bankruptcy Code provisions discussed in this article could impact such plan.

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[143] This could be accomplished by modification of § 365 or adoption of a separate code section [comparable to § 1110 (for aircraft leases assumption or rejection) or § 1168 (for railroad leases)] in which prescribed periods (e.g., 30 days) are defined for assumption or rejection of "critical outsourcing contracts" and the bankruptcy court is prohibited from extending the time further without consent of the bank.

[144] *See supra* notes 133–35 and accompanying text.

[145] Section 365(n) could be modified to provide for such assumption of non-exclusive licenses without the consent of the licensor in the case of critical outsourcing contracts.

OR

- Reviewing court papers filed in connection with bankrupt outsourcing service providers in a major geographic area to determine actual treatment of their bank clients, together with follow-up interviews with banks who were purchasing outsourcing services at the time of bankruptcy.

The first recommended study could provide a benchmark as to the extent to which large banks are in fact: (1) outsourcing core processing/core functions and (2) addressing the potential problems with the bankruptcy of their service providers identified in this Article. It could also provide the ability to define best practices based upon what some banks have actually elected to do.

The second recommended study might produce relevant information about: (1) real life problems encountered by banks in outsourcing relationships with financially weak vendors and (2) unanticipated costs related to service provider bankruptcy and their relationship to any prior cost savings and benefits. However, given the relative youth of both the outsourcing phenomenon in the banking arena and the current economic downturn, it may be too early in the evolutionary cycle for such studies to provide much in the way of useful information.

Summary of what happens to the contractual arrangement between a bank and a service provider when the service provider files bankruptcy

When a service provider files bankruptcy, can the bank immediately terminate its contract with the service provider?	*Generally No*
Can the bank immediately terminate if the contract is "terminable at will?"	No
Can the bank immediately terminate if the contract provides for termination in the event of bankruptcy or insolvency?	No
Can the bank immediately terminate if its federal regulator objects to the outsourcing arrangement?	Probably Not
Can the bank immediately terminate if the contract was for a period of years and the stated termination date occurs a week after the bankruptcy filing?	Probably Yes. It should be able to terminate at the expiration of the stated term.

If the bank requests court approval for relief from the automatic stay in order to terminate the contract, will this be granted?	*Uncertain*
What if the service provider advises the court that it elects to reject the contract?	Approval to terminate the contract will be granted.
What if the service provider advises the court that it elects to assume the contract?	Approval to terminate the contract will probably not be granted.