"REAL-WORLD" AND "ACADEMIC" QUESTIONS ABOUT "NONMONETARY OBLIGATIONS" UNDER THE 2005 VERSION OF 365(b)

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McLachlan,[1] Countryman,[2] Westbrook.[3] More than most areas of bankruptcy law, the bankruptcy law of leases and contracts has been influenced by law professors.[4] McLachlan is generally credited for inventing the bankruptcy law of leases and executory contracts; specifically, for drafting section 70(b) of the Bankruptcy Act—the predecessor of section 365.[5] Countryman's law review articles based on work he did for the Commission to Study the Bankruptcy Laws of the United States led to the "Countryman definition" of "executory contracts."[6] Additionally, Westbrook's article urging the elimination of the term "executory contract" and a clarification of the consequences of rejection shaped the work of the National Bankruptcy Review Commission.[7]

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[1] In 1948, Professor McLaughlin of the Harvard Law School faculty became Professor McLachlan of the Harvard Law School faculty "correcting an ancestral error made in Scotland about 1835." *See generally* J Hanna & J. MacLachlan, *Cases and Materials on Creditors Rights* viii n.1 (4th ed. 1951).

[2] *See generally* Andrew L. Kaufman, *In Memoriam: Vern Countryman*, 113 HARV. L. REV. 1071 (2000) (eulogizing Professor Vern Countryman and discussing his contribution to bankruptcy law).

[3] *See generally* http://www.utexas.edu/law/faculty (link to Professor Westbrook's biography, detailing his career and achievements in bankruptcy).

[4] There are, of course, other professors and other professionals who have contributed significantly to the development of the bankruptcy law relating to leases and executory contracts. For example, the articles of St. John's own Professor Robert Zinman make the problems of landlord bankruptcy understandable. *See, e.g.*, John J. Creedon & Robert M. Zinman, *Landlord Bankruptcy: Laissez Les Lessees*, 26 BUS. LAW. 1391 (1971); Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of the Bankruptcy Code*, 38 J. MARSHALL L. REV. 97 (2004).

[5] *See generally* James McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583 (1927) (proposing idea encompassed in Section 70(b) of Chandler Act).

[6] *See, e.g.*, *In re* Godsey, 323 B.R. 831, 833 n.1 (Bankr. W.D.N.Y. 2005) (adopting Professor Countryman's definition of executory contracts); Ready Prods., Inc. v. Jarvis (*In re* Jarvis), Nos. 04-10806, 04-01097, 2005 WL 758805, at *4–*5 (Bankr. N.H. Mar. 28, 2005) (finding contracts at issue not executory under Country man definition).

[7] *See generally* David G. Epstein & Steve H. Nickles, *The National Bankruptcy Review Commission's Section 365 Recommendations and the Larger Conceptual Issues*, 102 DICK. L. REV. 679, 683–84 (1998) (emphasizing Westbrook's influence on National Bankruptcy Review Commission's work on executory contracts).

Unfortunately, Congress, in amending section 365(b) in 2005, ignored the work for the National Bankruptcy Review Commission.[8] And McLachlan. And Countryman. And Westbrook.[9] While newly revised section 365(b) can fairly be described as a "piece of work,"[10] it can not be blamed on the work of law professors.

I. WHERE ARE WE NOW?

As a part of the 2005 bankruptcy legislation, Congress added language dealing with "nonmonetary obligations"[11] to section 365(b):[12]

> 365. Executory contracts and unexpired leases
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> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
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> > (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any

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[8] Congress did not ignore all of the work of the National Bankruptcy Review Commission. For example, the small business provisions reflect the Commission's work. *Compare* Commission's recommendations, found in National Bankruptcy Review Commission Final Report, *Bankruptcy: The Next Twenty Years* 635–38 (Oct. 20, 1997), *with* Subtitle B of Title IV of the 2005 legislation, found at Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 § 431, 119 Stat. 23, 109–10 (2005) (incorporating recommendations of the Commission).

[9] Happily, Congress did not ignore Jay Westbrook's work on cross border cases. *See generally* Jay Westbrook, *Chapter 15 and Discharge*, 13 AM. BANKR. INST. L. REV. 503 (2005).

[10] *See, e.g.*, Brown v. Coombe, No. 96-CV-46, 1996 U.S. Dist. LEXIS 12950, at *2 (N.D.N.Y. Sept. 5, 1996) (illustrating use of expression "piece of work"). J.P. Brown brought suit against the Commissioner of the NYS Dept. of Correctional Services along with various mental health professionals. *Id*. at *1–*2. Brown alleged that she was ridiculed by her primary therapist, who stated within earshot of inmates and staff, "Lets get this right. You believe you (sic) a woman in a man's body who likes or prefers woman sexually? Great! A lesbian trapped in a man's body, you're definitely a *piece of work*." *Id*. at *2 (emphasis added) (Did you ever notice that the word "therapist" has the same letters as the words "the rapist"?).

[11] The phrase "nonmonetary obligations" is not defined in the Bankruptcy Code. In her article, *Bankruptcy Reform and Nonmonetary Defaults—What Have They Done Now?* 24-6 AM. BANKR. INST. J. 6 (2005), Risa Lynn Wolf-Smith, a bankruptcy partner in the Denver office of Holland & Hart, suggests the following examples of what might constitute nonmonetary defaults: 'Breaches such as the failure to maintain certifications or licenses, to maintain specified quality or qualification standards, to provide information and to operate continuously without closure . . . ."

[12] Language was also added to section 1124 (2)(A)(D). *See generally* Alan N. Resnick & Henry J Sommer, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: A Section-by-Section Analysis, in* THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005: WITH ANALYSIS 15 (2005) ("Similar kinds of provisions on the obligation to cure nonmonetary defaults are added to section 1124(2) with respect to the impairment of a class of claims.").

> provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;
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> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such contract or lease.
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> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
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> (D) the satisfaction of any penalty rate or penalty provision relating to default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.[13]

As Judge Posner wrote in *Matter of Handy-Andy Home Improvement Centers, Inc.*:[14] "Statutory language, like other language, should be read in context. The context consists not merely of other sentences but also of the real-world situations to which the language pertains . . . . When context is disregarded, silliness results."[15] How would you use the statutory provisions set out above to answer the following questions about "real-world situations" to which section 365(b) pertains?

#1: T leases a building from L. The lease provides for monthly rental payments of $10,000 by the tenth of the month, with an additional charge of $100 a day for

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[13] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 328, 119 Stat. 23, 100 (2005) (to be codified at 11 U.S.C. § 365(b)).

[14] 144 F.3d 1125 (7th Cir. 1998).

[15] *Id*. at 1128.

each day that the payment is late. T does not make a rental payment on January 10. Instead, D files a bankruptcy petition on January 15. T wants to assume the lease; What result under section 365?

#2: T leases a building from L. The terms of the lease make "going dark"[16] for more than 72 hours an event of default. Shortly before filing its 11 petition, T stopped all business operations for 5 days. T wants to assume the lease. What result under section 365?

#3: D is a franchisee of F. The franchise agreement makes "going dark" for more than 72 hours an event of default. Shortly before filing its 11 petition, D stopped all business operations for 5 days, D wants to assume the franchise agreement. What result under section 365?

#4: D rents equipment from O. The lease requires that D obtains and maintains insurance on the equipment, and the lease contains a definition of default which includes "failure to keep the equipment insured at all times." D let the insurance lapse for two months. Fortunately nothing happened to the equipment during that period, and D was able to insure the equipment again before filing for bankruptcy. D wants to assume the lease. What result under section 365?

#5: D buys equipment from O on credit. O retains a security interest in the equipment. The security agreement requires that D obtain and maintain insurance on the equipment and contains a definition of default which includes "failure to keep the equipment insured at all times." D let the insurance lapse for two months. Fortunately nothing happened to the equipment during that period, and D was able to insure the equipment before filing for bankruptcy. D wants to keep the equipment. What result under section 365(b)?

#6: L, a moyl,[17] rents his house in a Jewish neighborhood to T. Because L's work comes from other religious Jews, the lease expressly provides that T is not to hang Christmas decorations in visible places. Nonetheless, T hangs Christmas decorations in visible places. T files for bankruptcy. T wants to assume the house lease. What result under section 365(b)?

[We understand that this sixth question is unrealistic—"academic" not "real-world" but (1) your senior, "academic" author is somewhat defensive about teaching at a school named Southern METHODIST[18] and wanted to be the first to use the

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[16] A "going dark" or continuous operation clause in a lease prohibits the cessation of operations of a tenant at the specified premises. *See In re* Ground Round, Inc., No. 04-11235-WCH, 2004 WL 1732207, at *7 (Bankr. D. Mass July 12, 2004) (noting "any continuous operations provision or 'going dark' clause, or similar clause prohibiting the cessation of operations at the leased premises is unenforceable against the assignee thereof under Section 365(f)").

[17] *See* MOYL: THE STUDY OF A TRAVELING JEWISH RITUAL CIRCUMCISER (National Film Network 2004) (tracking moyl's visits from family to family performing ritual circumcisions).

[18] With the possible exception of "Jewleeard" which Kyle briefly attended, *South Park: The Biggest Douche in the Universe* (Comedy Central television broadcast Nov. 27, 2002), Jews are more subtle about naming their schools. There is a "Southern Methodist University," but not a "Northern Jewish University," a "Texas Christian University" but not a "New York Jewish University." Everyone knows that Cardozo and Emory are "Jewish" law schools but you don't see the word "Jewish" in their school names.

yiddish word "moyl" in a law review article[19] and (2) neither of us could come up with a realistic situation involving breach of a nonmonetary obligation in a residential lease. In a sense, all six of the questions are "academic" because what will actually happen in most "real-world" bankruptcy cases is that the non-debtor party and the debtor will resolve the matter consensually and section 365, at most, will be a factor in the negotiations.]

A. Penalty Rate or Penalty Provisions in Commercial Real Estate Leases

In question #1, there has been a default, so section 365(b) applies. The default does not relate to a "nonmonetary obligation," so the 2005 addition to section 365(b)(1)(A) does not apply. To assume the lease, T is going to have to meet the requirements of section 365(b)(1): (A) cure, (B) compensate, and (C) provide adequate assurance.

A possible litigable issue is whether the $100 a day late fee is covered by section 365(b)(1)(B) as compensation for an "actual pecuniary loss" or covered by section 365(b)(2)(D) as a "penalty rate or penalty provision." While the questions in any such litigation would be primarily fact questions, there are two possible questions of law. First, in applying section 365(b)(1)(B) to question #1, could a court find that while $100 a day is not the right amount to compensate L for "actual pecuniary loss" resulting from late payment, there is an amount that T must pay? Second, in applying section 365(b)(2) to question #2, could a court find that section 365(b)(2) does not apply because (I) section 365(b)(2) only applies to a "default that is a breach of a provision relating to the satisfaction of any penalty rate or penalty provision," (II) T's default was a failure to pay rent by the 15th of the month as required by the lease, and (III) a lease provision requiring payment by the 15th of the month is not "a provision relating to the satisfaction of [a] penalty rate or penalty provision?"

B. Nonmonetary Obligations in Commercial Real Estate Leases

Question #2 involves a nonmonetary obligation in a commercial real estate lease. In the new language of section 365(b)(1)(A), closing restaurant operations was a "default [that] arises from a failure to operate in accordance with a nonresidential real property lease."

While Question #2 unquestionably comes within the language of section 365(b)(1)(A), there are three questions that might be raised in applying that language.

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[19] Regrettably, we are not the first to use "moyl" in a law review article. Professor Wayne LaFave used (or misused) "moyl" in Wayne LaFave, *What Is A Kamisar?* 102 MICH. L. REV. 1732, 1734 n.4 (2004) ("he has a *puter*-wouldn't-melt-in-his-*moyl* look on his *punim*").

First, what does the last clause of new section 365(b)(1)(A)—"pecuniary losses . . . shall be compensated in accordance with the provisions of this paragraph"—add to the language of section 365(b)(1)(B)—"any actual pecuniary loss to such party resulting from such default?"[20] The relevant statutory structure is section, subsection, paragraph, and subparagraph. In this example, that is 365, 365(b), 365(b)(1) and 365 (b)(1)(A),(B), and (c). The conjunction connecting the subparagraphs is "and." If section 365(b)(1)(A) "cure" applies, then section 365(b)(1)(B) "compensation" always applies. And yet, the new, last clause of section 365(b)(1)(A) seems to be saying nothing more than (B) compensation applies.[21] (Unless it is important that section 365(b)(1)(B) uses the phrase "actual pecuniary loss to such party" and section 365(b)(1)(A) uses the phrase "pecuniary losses."[22] But we can't figure out[23] how that could be important. More specifically, we can't "figure out" how a court could figure out losses that are not "actual." And, we can't figure out how a court could "figure out" some one other than "such party" who would have "pecuniary losses.")

Second, if this last clause of section 365(b)(1)(A)—"except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then . . . pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph"—creates a payment obligation that is different from the payment obligation of section 365(b)(1), then some facts may present a question as to whether the default "arises from a failure to operate." Question #2 involving "going dark" in violation of a lease provision requiring "continuous operations" is an obvious example of a "default arising from failure to operate in accordance with a nonresidential real property lease." We cannot come

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[20] *See* Brief for Appellee and Cross-Appellant at 4, Worthington v. Gen. Motors Corp. (*In re* Claremont Acquisition Corp.), 113 F.3d 1029 (9th Cir. 1997) ("Section 365(b)(1)(B) already deals with the cure of monetary defaults (*i.e.*, compensation for "any pecuniary loss"). Section 365(b)(1)(A) cannot be similarly limited to pecuniary damages.").

[21] *Cf.* Daniel A. Lowenthal, *Revisions to Bankruptcy Code Sections 365 and 366*, THE BANKR. STRATEGIST, Apr.–May 2005, at 6:

> [W]ith respect specifically to nonresidential real property leases, if the default arises from a debtor's "failure to operate in accordance" with the lease, then such default will need to be cured at and after the time of assumption. Moreover, a landlord will be entitled to compensation, as required by section 365(b)(1)(B), for pecuniary losses resulting from such default.

Id. *But cf*. Risa Lynn Wolf-Smith, *Bankruptcy Reform and Nonmonetary Defaults—What Have They Done Now?*, 24-6 AM. BANKR. INST. J. 6 ("nonresidential real property leases are singled out for special treatment").

[22] This is of course a sentence fragment. Lisa was (and is) reluctant to have her name on an article with sentence fragments. For more substantive information about "actual pecuniary loss" and section 365(b)(1)(B) *see generally* Jo Ann J. Brighton, *Curing Defaults Prompt Cure May Not Be as Prompt as You Think*, 22-3 AM. BANKR. INST. J. 16 (2003) (noting § 365(b)(1)(B) "speaks to the consequences" of default).

[23] And Lisa was reluctant to have her name on an article with the phrase "figure out" until we did a Westlaw search in the "JLR" data base and got 8897 "hits" for "figure out."

up with an equally obvious example of a default, that is both (I) not excluded by section 365(b)(2) and (II) not arising from a failure to operate in accordance with a nonresidential real property lease except perhaps multiple leases with cross-default provisions.[24]

Third, does this language or any other language of section 365(b)(1) apply if the default was not "material?" The question of materiality becomes more material in an executory contract question like Question #3 or an equipment lease question like Question #4.

C. Nonmonetary Obligations in Executory Contracts

In Question #3 involving the franchisee's default, there is no question that the new language added in section 365(b)(1)(A) is inapplicable—not an "unexpired lease of real property." And, there is no longer any question whether the language of section 365(b)(2)(D) applies—not a "penalty provision." Nor is there any longer any question about whether Congress contemplates that there are incurable defaults that prevent a debtor from assuming executory contracts.[25]

Language in cases and legislative history suggest a couple of possible litigable questions.

First, materiality: was temporarily closing business operations a "material" default? Even though the word "material" does not appear in any of the various

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[24] *See generally* William P. Weintraub, *Historical Defaults and Cross Defaults: Here a Default, There A Default, Everywhere a Default, Default, Default*, 26 CAL. BANKR. J. 286, 294–98 (2003) (examining enforceability of cross-default provisions in multiple leases).

[25] Prior to the 2005 legislation, professors and practitioners questioned (1) whether incurable defaults had to be cured and (2) whether any default was incurable. In his 1997 student text, Professor Charles Jordan Tabb discussed the first of the questions:

> Nothing in the Code answers the Delphic inquiry of whether a trustee is required to cure even an incurable default before assuming. If so, that contract would be unassumable because the trustee would be unable to comply with all of the predicates to assumption . . . . Yet, in order to preserve a valuable contract for the estate, a court might read the "cure" requirement as applying only to the realm of the possible, and allow assumption if the trustee could compensate the non-debtor party for its damages suffered because of the default, and give adequate assurance of future performance.

CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 615 (1997).

In a short article published shortly before the 2005 legislation, Professor Tabb's University of Illinois colleague and casebook co-author, Professor Ralph Brubaker addressed the second of the questions and made a persuasive argument, based on contract law principles, that "[t]he notion that most (if not all) nonmonetary defaults are incurable is therefore misguided." Ralph Brubaker, *Cure of Nonmonetary Defaults as a Prerequisite to Assumption of Executory Contracts and Unexpired Leases: A Lesson in the Nature and Function of the Cure Requirement*, BANKR. L. LETTER, Dec. 2004, at 8; *see also* James J. Stang, *Assumption of Contracts and Leases: The Obstacle of the Historical Default*, 24 CAL. BANKR. J. 39, 42 (1998) (reviewing cases both permitting and refusing to allow debtor to cure nonmonetary defaults).

versions of section 365, there is support in case law and secondary authorities for applying section 365(b) only to "material" defaults.[26]

Second: did L waive the default? By changing "shortly before filing its eleven petition" to "eleven months before filing its eleven petition," it is not hard to envision a court's concluding that D's post-default/pre-bankruptcy actions and F's post-default/pre-bankruptcy inaction, constituted waiver of the defaults so that there were no defaults and no basis for looking to section 365(b).

D. Nonmonetary Obligations in Equipment Leases

In the 2005 amendments to section 365(b) dealing with nonmonetary obligations, Congress made the "conscious choice"[27] to treat equipment leases like executory contracts and not like real estate leases. Congress made the conscious choice that debtors could be barred from assuming executory contracts and equipment leases because of pre-bankruptcy nonmonetary defaults that cannot be cured.

Accordingly, all of the material in C above relating to assumption of the franchise agreement in question #3 applies to the assumption of the equipment lease in question #4. Especially the material about materiality.

E. Nonmonetary Obligations in Equipment Financings

The default in question # 5 is the same as in question #4. In both questions, the default was the lapse in insurance. Additionally, in both questions, there was no "actual pecuniary loss" resulting from the lapse. The difference between question #5 and question #4 is that question #5 is an equipment secured financing transaction governed by sections 1123 et seq. and question #4 is an equipment lease governed by section 365. That is an important difference.

Notwithstanding our question at the end of #5, in any equipment secured financing question there is no section 365(b) question.[28] Section 365(b) does not

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[26] *E.g.*, *In re* Windmill Farms, Inc., 841 F.2d 1467, 1473 (9th Cir. 1988) ("[T]he bankruptcy court found that the alleged nonmonetary defaults were not of sufficient substance to preclude assumption of the lease. This finding is not clearly erroneous."); *In re* Whitsett, 163 B.R. 752, 754 (Bankr. E.D. Pa. 1994) ("[I]t is clear that a bankruptcy court has 'some latitude' in determining whether provisions in a debtor-tenant's lease may be deemed waived and their compliance be deemed insignificant in the assumption process. The determining factor appears to be the 'materiality' of the default in issue." (citing *In re* Joshua Slocum, Ltd., 922 F. 2d 1081, 1090–92 (3d. Cir. 1990))); Ralph Brubaker, *Cure of Nonmonetary Defaults as a Prerequisite to Assumption of Executory Contracts and Unexpired Leases: A Lesson in the Nature and Function of Cure Requirement*, 24 BANKR. L. LETTER No. 12, Dec. 2004, at 7 ("[T]he concept of the 'cure' of defaults, by its very nature, is a material breach concept . . . .").

[27] Arguably the use of the phrase "conscious choice" to describe Congressional action in the bankruptcy area may be something of an oxymoron, albeit not on the top fifty oxymoron list. *See generally* http://www.tnellen.com/cybereng/lit_terms/oxymoron.html (listing top fifty most-used oxymorons).

[28] This article is limited to section 365(b) "nonmonetary obligation" questions. There is a possible question as to whether changes in how section 365(b) default provisions operate should affect how the default

apply to an equipment secured financing—unless the transaction was merely an equipment secured financing in form, but an equipment lease in substance.

Question #5, as stated, is the "academic" or "man bites dog" version of the question. The "real-world" question arises when a transaction is an equipment lease in form and equipment secured financing in substance.

While the law is clear that a transaction that is an equipment lease in form but a secured equipment financing in substance is to be treated like a secured equipment financing, it is often not clear whether a transaction that is a lease in form is in fact a lease in substance.[29] By barring debtors from retaining leased equipment because of a nonmonetary, non-curable, pre-bankruptcy default, Congress has made the unclear question of whether an equipment deal is a lease or a secured financing [and the equally unclear question of whether a real estate deal is a lease or a secured financing[30]] even more important.

F. Nonmonetary Obligations in Residential Real Estate Leases

The last question, question #6, raises no question about the applicability of the 2005 language in section 365(b)(1)(A). It applies. Whatever the phrase "breach of a provision relating to the satisfaction of any provision . . . relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property" means, T's displaying Christmas decorations in question #6 comes within that meaning. And, it is impossible for T to "cure such default by performing nonmonetary acts."

Whether it would be possible for T to cure the default by paying L for "actual pecuniary losses resulting from such default" is a moot question. A question made

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provision in section 1123(a)(5)(G) ("curing or waiving of any default") or in newly-amended section 1124(2)(A) should operate, but that is another article (someone else's article).

[29] *E.g.*, *In re* Pillowtex, Inc., 349 F.3d 711, 717–18 (3d Cir. 2003) (finding petitioner's energy-saving equipment lease was secured financing transaction under New York Uniform Commercial Code); *In re* Bailey, 326 B.R. 156, 162–65 (Bankr. W.D. Ark. 2005) (explaining debtor's tractor lease was secured financing transaction under Missouri Uniform Commercial Code and lease's termination clause).

[30] *See* United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609, 613–14 (7th Cir. 2005):

> No legally sophisticated person writing in 1978 could have thought that the word "lease" in a text that distinguishes between current consumption (which must be paid for in full) and secured debt (which may be written down to ease financial distress) means any transaction in the form of a lease. The need to look through form to substance would be apparent not only from the structure of the statute but also from the fact that many of the leased assets would be covered directly by the UCC. Section 365 in particular deals with leases of both personal and real property; it would not be sensible to read the same word as referring to substance when dealing with personal property and form when dealing with real property. The statute thus must refer to substance throughout section 365. Nothing else respects both the structure of the Bankruptcy Code and the way the legal community understood the distinction between leases and security agreements in the 1970s.

Id.

moot by not only the word "nonmonetary" in section 365(b)(1)(A) but also by the words in section 365(b)(1)(B). If payments by T to L for "actual pecuniary loss" could affect a cure in (A), then wouldn't (B) which requires payment for pecuniary loss be surplusage?[31]

More generally, reading the language of section 365(b)(1)(A) in the context of both "other sentences," *i.e.*, section 365(b)(1)(B) and section 365(b)(1)(C) and "the real-world situation[s] to which the statutory language applies", *i.e.*, questions #1–#4, suggests that in most real-world situations most of the new language of section 365(b)(1)(A) will not add any new obligations to the obligations imposed already imposed by section 365(b)(1)(B) and section 365(b)(1)(C). In "real-world situations" the most important language in new section 365(b)(1)(A) is the language that is not in section 365(b)(1)(A). Specifically, there is no language permitting debtors to assume and assign equipment leases and franchise agreements and intellectual property licenses and other executory contracts notwithstanding some "historical default" by compensating the non-debtor party for "pecuniary losses resulting from such default."

II. HOW DID WE GET TO WHERE WE ARE NOW?

The predecessor to section 365, section 70b[32] of the Bankruptcy Act of 1898 as amended, did not expressly require cure of defaults in order to assume leases or executory contracts. The Commission on the Bankruptcy Laws of the United States drafted a new Bankruptcy Act (of 1973) which it submitted and recommended to Congress for enactment.[33] Section 4-602(b)(2) of the Commission's proposed law expressly required past defaults be cured in order to assume a lease.[34] While the law enacted by Congress in 1978 differs significantly from the law proposed by the Commission on the Bankruptcy Laws of the United States, section 365 retained the Commission's express requirement of cure of defaults.

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[31] In bankruptcy litigation, the word "superfluous" seems to be preferred to "surplusage." *See* Worthington v. Gen. Motors Corp. (*In re* Claremont Acquisition Corp.), 113 F.3d 1029, 1034 (9th Cir. 1997) ("[I]f subsection (D) is a catch-all provision . . . then subsections (A) through (C) of § 365(b)(2) would be superfluous, as they would be encompassed by subsection (D)."); Beckett v. Coatesville Hous. Assocs., No. CIV. A. 00-5337, 2001 WL 767601, at *5 (E.D. Pa. July 5, 2001) ("If Congress intended that all nonmonetary defaults be incurable under section 365, section 365(b)(2) would be rendered superfluous. As such, I conclude that Congress intended section 365 to apply to both monetary and nonmonetary defaults.").

[32] S. DOC. NO. 225, 75th Cong. 3d Sess., at 90, 52 Stat. 840, 880 (1938).

[33] Communication from the Executive Director, Commission on the Bankruptcy Laws of the United States Transmitting A Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 93-137, pt. 1, (1937), *reprinted in* BANKRUPTCY REFORM ACT OF 1978, VOL. 2, DOC. 21 (Alan A. Resnick & Eugene M. Wypyski eds., William S. Hein & Co., Inc. 1979) (summarizing recommendations of Bankruptcy Commission).

[34] Communication from the Executive Director, Commission on the Bankruptcy Laws of the United States Transmitting A Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 93-137, pt. 2, at 152–3.

More specifically, in the 1978 Bankruptcy Code, section 365(b)(1)(A) established a general cure of defaults requirement for assumption of leases or executory contracts, and section 365(b)(2) created three exceptions to that requirement. A trustee was not required to cure a default that is a breach of a provision relating to:

> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title;
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.[35]

These exceptions (together with section 365(e) and (f)) changed the law significantly. Under the 1898 Act, a provision terminating a lease or contract when one of the parties filed for bankruptcy—an ipso facto clause[36]—prevented the assumption of the lease or contract in bankruptcy.[37]

In 1994, Congress added another exception, which became the source of much confusion in bankruptcy cases and led to a circuit split in its interpretation.[38] Under the newly added section 365(b)(2)(D), trustees would not be required to cure a "default that is a breach of a provision relating to . . . the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."[39]

The reported legislative history on this provision is very limited. There is simply a statement in a House Report that section 365(b)(2)(D) was added "to provide that when sought by a debtor, a lease can be cured at a non-default rate (*i.e.*, it would not need to pay penalty rates)."[40]

The confusion over section 365(b)(2)(D) soon arose in the 1995 district court case *Ford Motor Co. v. Claremont Acquisition Corp. (In re Claremont Acquisition*

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[35] 11 U.S.C. § 365(b)(2)(a)–(c) (1978).

[36] Richard I. Aaron, *Hooray for Gibberish! A Glossary of Bankruptcy Slang for the Occasional Practitioner or a Befuddled Judge*, 3 DEPAUL BUS & COM. L.J., 141, 157 (2005) (defining an "ipso facto" clause as a "contract provision automatically terminating the contract upon bankruptcy or insolvency proceeding of a party).

[37] 3 COLLIER ON BANKRUPTCY ¶ 365.07, at 365–68 (Lawrence P. King et al. eds., 15th ed. Rev. 1997) ("Under the former Bankruptcy Act. . . an ipso facto clause that terminated the lease upon the bankruptcy of a party was enforceable.").

[38] *Compare* Worthington v. Gen. Motors Corp. (*In re* Claremont Acquisition Corp.), 113 F.3d 1029, 1035 (9th Cir. 1997) (holding Congress did not intend for 11 U.S.C. section 365(b)(2)(D) to permit debtors to assume unexpired lease or executory contract without first curing nonmonetary defaults), *with* Eagle Ins. Co. v. Bankvest Capital Corp. (*In re* Bankvest Capital Corp.), 360 F.3d 291, 301 (1st Cir. 2004) (holding Congress did intend for 11 U.S.C. § 365(b)(2)(D) to permit debtors to assume unexpired lease or executory contract without first curing nonmonetary defaults).

[39] 11 U.S.C. § 365(b)(2)(D) (1994).

[40] H.R. REP. NO. 103-835 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3359.

Corp.)[41] involving franchise agreements between car dealership operators and automobile manufacturers under which the operators could only cease operating for seven consecutive days.[42] In opposing the operators' assignment of the franchise to a third party because the operators' failed to operate for about thirteen days before filing bankruptcy, the manufacturers argued that section 365(b)(D) only excused "the payment of penalties that a debtor would be required to pay as a result of a pre-petition breach"[43]—that it did not operate to excuse the trustee from curing nonmonetary defaults; it only excused them from paying penalties associated with such a default.[44] They argued that since the failure to operate for more than seven days was an incurable default, the operators could not assign the franchise.[45] The district court, however, held that "the most natural reading [of section 365(b)(2)(D)] supports the interpretation . . . that a trustee or debtor in possession is not required to cure nonmonetary defaults in order to assume or assign executory contracts and leases."[46] It found that the word "penalty" only modified the word "rate" and not the phrase "provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."[47] Therefore, according to the district court, section 365(b)(2)(D) described two separate exceptions to the requirements of section 365(b)(1): one for defaults relating to failure to satisfy penalty rates and one for defaults relating to failure to satisfy nonmonetary obligations.[48]

The first attempt by Congress to clarify the meaning of section 365(b)(2)(D) and the requirement of a trustee to cure nonmonetary defaults before assumption came in 1997. Two bills, H.R. 120 and H.R. 764, referred to and debated collectively as the Hyde-Conyers Amendments,[49] contained identical provisions amending section 365(b). The proposed bills struck subsection (D) and added new subsections (D) and (E) so that section 365(b)(2) would read as follows:

> Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
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> . . . .

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[41] 186 B.R. 977 (C.D. Cal. 1995).
[42] *Id*. at 989.
[43] *Id*. at 989–90.
[44] *See id*. at 990.
[45] *Id*. at 989–990.
[46] *Id*. at 990.
[47] *Id*.
[48] *See id*.
[49] *See* Bankruptcy Law Technical Corrections Act of 1997, H.R. 120, 105th Cong. (1997) (introduced by Rep. Conyers on Jan. 7, 1997); Bankruptcy Amendments of 1997, H.R. 764, 105th Cong. (1997) (introduced by Rep. Hyde on Feb. 13, 1997).

> (D) the satisfaction of any penalty rate in an executory contract or unexpired lease; or
> (E) the satisfaction of any provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under any executory contract or unexpired lease other than an unexpired lease of personal property.[50]

Representative Conyers stated that the provision amending section 365(b) was intended to "make it clear that subsection (b)(2)(D), providing an exception to the obligations which must be cured in order for the trustee to assume a lease, covers penalty rates as well as penalty provisions, thereby overruling *In re Claremont Acquisition Corp.*, 186 B.R. 977, 990 (C.D. Cal. 1995)."[51]

Despite this evidence of legislative intent, subcommittee hearings suggest this new language was still ambiguous. One bankruptcy law expert testifying before the House Judiciary Committee stated that the new provision clarified that "penalty" was never meant to modify "nonmonetary obligations" and that it, therefore, excused the cure of nonmonetary obligations.[52] Another bankruptcy law expert, speaking on the same provision to the same Committee, stated that it sought to clarify that "penalty" was intended to modify both "rates" and "provisions," thereby allowing a trustee to assume a contract without curing penalty provisions, not nonmonetary obligations.[53]

After both witnesses testified, Representative Conyers added that new subparagraph (E) was intended to "clarify that nonmonetary lease obligations need not be cured whether or not they involve penalties, [thereby codifying the district court's opinion in] *In re Claremont Acquisition Corp.*, except . . . with respect [to] unexpired leases of personal property."[54] Thus, the provision was intended to overrule *Claremont* to the extent that the district court interpreted section 365(b)(2)(D) to mean that all nonmonetary defaults were excused from the requirement of cure. But the amendment added subsection (E) to codify the court's holding that defaults of nonmonetary obligations need not be cured, unless it is a personal property lease.

In those same hearings, a representative from the Equipment Leasing Association ("ELA") was heard on the subject of curing nonmonetary defaults of

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[50] H.R. 120, § 11; H.R. 764, § 6.

[51] 143 CONG. REC. E21(1997).

[52] *Bankruptcy Amendments of 1997; and the Bankruptcy Law Technical Corrections Act of 1997: Hearing on H.R. 120 and H.R. 764 Before the Subomm. on Commerical and Admin. Law of the H. Comm. on the Judiciary*, 105th Cong. 37 (1997) [hereinafter *Hearing*] (statement of Kenneth N. Klee, Chairman, Committee on Legislation, National Bankruptcy Conference).

[53] *Id.* at 51 (prepared statement of Roger M. Whelan, Chairman, Legislative Committee, American Bankruptcy Institute).

[54] *Id.* at 128 (prepared statement of Rep. Conyers).

personal property leases.[55] The ELA supported the Hyde-Conyers Amendments because of the language in proposed subsection (E) excluding personal property leases from the exception to the requirement to cure.[56] The ELA was worried that if the amendments did not pass, the district court's holding in *Claremont* would be applied to personal property leases.[57] The ELA complained that applying *Claremont* to personal property leases violated the spirit of compromise of the 1994 amendments, whereby section 365(b)(2)(D) was included as a quid pro quo for the adoption of section 365(d)(10).[58] That is, the ELA supported section 365(b)(2)(D)—which it was told "was limited solely to penalty rates and penalty provisions"—in exchange for the obligations imposed on the debtor by the inclusion of section 365(d)(10), which "requir[ed] debtors to fulfill *all* obligations (*monetary and nonmonetary*), under an unexpired personal property lease, starting 60 days after the filing."[59]

Further, the ELA contended the House was right to exclude personal property leases from the operation of proposed subsection (E) because personal property leases "are of shorter duration and involve rapid depreciation versus real estate leases."[60] The ELA argued that by including section 365(d)(10) along with section 365(b)(2)(D) in the 1994 amendments, Congress attempted to codify the differences between real estate and personal property leases.[61] And the district court's holding in *Claremont* threatened to undermine that distinction. Therefore, the Hyde-Conyers amendments were technical and not substantive in nature, and they were needed to "fulfill congressional intent by clarifying that a trustee does not have to satisfy a penalty rate or penalty provisions prior to assuming an unexpired lease of personal property, but does have to cure a default of nonmonetary obligations before it may assume."[62]

During the same hearings, a representative from the American Bankers Association ("ABA") also stated support of the Hyde-Conyers Amendments.[63] The ABA supported the changes that clarified that penalty provisions in executory contracts and leases are exempted from the requirement that all defaults must be cured before assumption.[64] It noted with approval that the amendments "reverse

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[55] *Id*. at 113–18 (statement of Richard R. Gerken, Vice President and Associate General Counsel, Comdisco, Inc., on behalf of the Equipment Leasing Association).

[56] *Id*. at 113.

[57] *Id*. at 114.

[58] *Id*. at 116.

[59] *Id*.

[60] *Id*. at 114.

[61] *Id*. at 115.

[62] *Id*. at 113.

[63] *Id*. at 122 (prepared statement of Jill M. Sturtevant, Assistant General Counsel, Bank of America, on behalf of the American Bankers Association).

[64] *Id*. (prepared statement of Jill M. Sturtevant, Assistant General Counsel, Bank of America, on behalf of the American Bankers Association) (declaring ABA's backing of amendments expressly including penalty provisions of executory contracts or unexpired leases within exceptions to general rule).

erroneous subsequent court rulings that the section relieves debtors from curing all nonmonetary defaults in the assumption and assignment of executory contracts and leases."[65] It also approved of the amendments' clarifying "that nonmonetary defaults arising under an unexpired lease of personal property would have to be cured prior to such lease's assumption."[66] However, the ABA warned that it would strongly oppose the amendments if a provision were added allowing "real estate interests to seize realty leases for incurable nonmonetary defaults."[67] Specifically, the ABA was concerned about how such a provision would affect lessee retail establishments.[68] If there was no exception for failures to perform nonmonetary obligations in real estate leases, then "it would become impossible for the debtor retailer to retain or assign its lease."[69] Since "leases of bankrupt retailers often have substantially more value than their inventory," the result would be detrimental to all of the debtor's other creditors.[70]

Shortly after the Congressional hearings, in May 1997, the Ninth Circuit overturned the district court's holding in *Claremont.* The court held that the word "penalty" in section 365(b)(2)(D) related to both "rate" and "provision." Under this holding, debtors wanting to assume or assign an unexpired lease or executory contract were relieved of any obligation to pay penalties but not of an obligation to cure nonmonetary, "historical" defaults.

The House Judiciary Committee's report on H.R. 764, submitted on October 21, 1997, amended the bill so that subsection (D) would be struck and replaced with the following three subsections:

> (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from a failure to perform nonmonetary obligations under an executory contract or under an unexpired lease of real or personal property;
> (E) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption; or
> (F) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to

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[65] *Id*. (asserting amendments do not include all nonmonetary defaults within exceptions to general rule).
[66] *Id*.
[67] *Id*.
[68] *Id*. (arguing provision not exempting nonmonetary defaults on unexpired leases on real property would hinder retailer's reorganization efforts and create inequity among its creditors).
[69] *Id*.
[70] *Id*.

> perform nonmonetary obligations under an executory contract, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption and if the court determines, based on the equities of the case, that paragraph (1) should not apply with respect to such default.[71]

The report made clear that subsection (D) was being replaced in response to the Ninth Circuit's opinion in the *Claremont* case.[72] Yet the report does not indicate that the Ninth Circuit misconstrued the subsection. In fact, the report amended subsection (D) to read "penalty rate or penalty provision," as suggested by the Ninth Circuit.[73] Nevertheless, the Committee went on to add subsections (E) and (F) to address incurable defaults in the contexts of unexpired real estate leases and executory contracts.

This change represented the Committee's recognition of "different policy considerations that are implicated in leasing arrangements and executory contracts."[74] The Committee reasoned [as the ELA had suggested] that, for personal property leases, failure to perform nonmonetary obligations was an appropriate bar to assumption because of the potential for rapid deterioration and irreparable harm that nonmonetary defaults, such as failure to follow a maintenance schedule, could do to leased equipment.[75] However, because such a potential for depreciation in value is absent with real estate leases, they are treated differently:

> With real estate leases, a bankruptcy trustee . . . is not to be required to do the impossible and cure incurable defaults before assumption. The debtor's estate . . . for example, should not be deprived of a retail lease that is a valuable asset and may be needed for reorganization merely because the store has conducted a going-out-of-business sale or violated a clause against closing for a period of time.[76]

For executory contracts, especially franchise agreements, the Committee decided the fairest approach is to require all curable defaults be cured and let a bankruptcy judge decide whether incurable defaults should bar assumption.[77] That way a judge can consider such factors as the trustee's ability "to meet the manufacturer's contractual requirements with regard to quality assurance, warranty service, and

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[71] H.R. REP. NO. 105-324, at 3 (1997).
[72] *Id*. at 12.
[73] *Id*. at 3.
[74] *Id*. at 13.
[75] *Id*.
[76] *Id*. at 13.
[77] *Id*. at 13–14.

trademark protection" to determine whether, based on the equities, the incurable default bars assumption.[78]

Finally, the Committee Report made clear that the amendment was not intended to prevent the non-debtor party from obtaining compensation "for actual pecuniary loss resulting from the debtor's incurable nonmonetary default or to obtain adequate assurance of future performance under such contract or lease."[79] While that intent was clear from the legislative history, it was not clear from the location of the provisions.

On November 12, 1997, the House passed the Bankruptcy Amendments of 1997, as amended with a new version of section 365(b).[80] In the version that passed the House, the carve outs for executory contracts and real property leases that had been in subsections (E) and (F) were moved from section 365(b)(2) to section 365(b)(1)(A) as subparagraphs (i) and (ii).[81] Therefore, the version of H.R. 764 that passed in the House changed section 365(b) to read as follows:

> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
>
> > (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to
> >
> > > (i) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption; or
> >
> > > (ii) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an executory contract, if it is impossible for the trustee to cure such default by performing nonmonetary acts at

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[78] *Id*. at 14.
[79] *Id*.
[80] H.R. 764 (as engrossed in House Nov. 13, 1997).
[81] *Id*.

> and after the time of assumption and if the court determines, based on the equities of the case, that paragraph (1) should not apply with respect to such default.
>
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such contract or lease.
>
> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
>
> (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from a failure to perform nonmonetary obligations under an executory contract or under an unexpired lease of real or personal property.[82]

Note that section 365(b)(1)(B) discusses the requirement to compensate the non-debtor party for actual pecuniary loss, and section 365(b)(1)(C) discusses the requirement to provide adequate assurance of future performance. By moving the exceptions to the requirement to cure nonmonetary obligations in executory contracts and real estate leases into section 365(b)(1)(A), the House intended "to clarify that when a trustee or debtor-in-possession is excused from curing a nonmonetary default under a real estate lease or executory contract as a condition to the assumption of the contract or lease, the creditor remains entitled to compensation for actual pecuniary loss resulting from the default and to adequate assurance of future performance."[83] That is, the requirements of section 365(b)(1) do not apply to defaults described in section 365(b)(2). If the exceptions for defaults relating to nonmonetary obligations were included in section 365(b)(2), then those defaults would be exempt from all of the requirements of section 365(b)(1) (including the requirements to compensate for actual pecuniary loss and to provide adequate assurance of future performance), not just from the requirement to cure, which is found in section 365(b)(1)(A). Since the carve-outs provided for defaults of nonmonetary obligations were only meant to excuse the requirement of cure, they were included as exceptions to the provision requiring cure: section 365(b)(1)(A).

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[82] *Id*.

[83] 143 CONG. REC. H10660, 10661 (1997) (statement of Rep. Gekas).

This move to section 365(b)(1) from section 365(b)(2) may have also been prompted by other, related considerations. All the exceptions found in section 365(b)(2) relate to ipso facto clauses in executory contracts and leases.[84] The House may have been clarifying that a default arising from a breach of a nonmonetary obligation is different in kind from any monetary penalty provision that may be associated with that default.[85] In addition, cross-references to section 365(b)(2) appear in other sections of the Bankruptcy Code.[86] In those sections, defaults of nonmonetary obligations would also be exempt from the operation of those provisions if the nonmonetary obligations exceptions had not been removed from section 365(b)(2).

Though H.R. 764 never made it out of the Senate Subcommittee on Oversight and Courts, another House bill to amend the Bankruptcy Code, H.R. 3150, was introduced on February 3, 1998.[87] When it was introduced, it contained no provision regarding the requirement to cure nonmonetary obligations. But on June 10, 1998, the bill was amended to add section 215, which was identical to the provision that amended section 365(b) in H.R. 764.[88]

When H.R. 3150 went to the Senate, the Senate struck everything after the enacting clause and inserted the language of its own bill to amend the Bankruptcy Code, S. 1301, which included no provision amending section 365(b). When S. 1301 was first introduced in the Senate on October 21, 1997, it did include a provision to clarify the requirement to cure nonmonetary defaults, identical to the first version of H.R. 764, which struck section 365(b)(2)(D) and added new subsections (D) and (E). However, the Senate Judiciary Committee reported to the Senate and proposed an amendment to S. 1301 on June 4, 1998, striking the section amending section 365(b)(2) without a written report.[89] Therefore, the version of H.R. 3150 passed by the Senate—which incorporated S. 1301—did not amend section 365(b).

A conference to resolve the differences between the House and the Senate's version of H.R. 3150 produced an agreement to use the provision regarding nonmonetary obligations that was included in the House version but with a parenthetical explaining that intellectual property was not excused from the requirement to cure.[90] The Conference Report's proposed amendment to section

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[84] H.R. REP. NO. 95-595, at 347 (1977) (describing limitations on trustee's powers imposed by section 365(b)).

[85] Lesley A. Truitt, *From the Conflicting Treatment of Nonmonetary Defaults in § 365(b), an Exception for Franchises Emerges*, 17 BANKR. DEV. J. 257, 270 (2000) (noting later, similarly-worded bill was intended to clarify "that only the penalty provision in the contract is considered ipso facto, not the nonmonetary default itself").

[86] *E.g.*, 11 U.S.C. § 1110(a)(1)(B) (2000) (dealing with aircraft equipment and vessels); 11 U.S.C. § 1168(a)(1)(B) (2000) (applying to rolling stock equipment).

[87] H.R. 3150, 105th Cong. (1998) (as introduced in House, Feb. 3, 1998).

[88] 144 CONG. REC. H4397 (1998) (indicating amendment to add section 215 agreed upon).

[89] S. 1301, 105th Cong. (1998) (as reported in Senate, June 5, 1998).

[90] *See* H.R. REP. NO. 105-794, at 44–45 (1998) (Conf. Rep.).

365(b)(1)(A) excluded from the requirement to cure, a default that is a breach of a provision relating to—

> (i) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property (excluding executory contracts that transfer a right or interest under a filed or issued patent, copyright, trademark, trade dress, or trade secret), if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption; or
> (ii) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an executory contract, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption and if the court determines, based on the equities of the case, that paragraph (1) should not apply with respect to such default.[91]

It also changed section 365(b)(2)(D) to exempt from the requirements of section 365(b)(1) a default that is a breach of a provision relating to—

> (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from a failure to perform nonmonetary obligations under an executory contract (excluding executory contracts that transfer a right or interest under a filed or issued patent, copyright, trademark, trade dress, or trade secret) or under an unexpired lease of real or personal property.[92]

No explanation was given for the new language regarding intellectual property. Though the conference report was considered and agreed to by the House on October 9, 1998,[93] the Senate considered but never agreed to it.[94]

In the next session, H.R. 833 was introduced on February 24, 1999.[95] It included the language amending section 365(b) that was contained in the conference report from the previous session.[96] On March 17, 1999, the House Judiciary Committee's Subcommittee on Commercial and Administrative Law held a hearing on H.R. 833. In a prepared statement, a representative from the National

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[91] *Id*.
[92] *Id*. at 45.
[93] 144 CONG. REC. H10239 (1998).
[94] 144 CONG. REC. S12148 (1998).
[95] 145 CONG. REC. H 795 (1999).
[96] H.R. 833, 106th Cong. § 215 (1999).

Bankruptcy Conference expressed that the Conference would support the section on "Defaults based on nonmonetary obligations" if the language referring to intellectual property were deleted.[97] He explained there were two reasons the Conference opposed the intellectual property language:

> First, it ignores the possibility that the debtor is the intellectual property licensor rather than the licensee. If the licensor cannot assume the contract, the non-debtor licensee may be deprived of rights, except to the extent protected under section 365(n). Second, if the debtor is the licensee, there is no reason why a technical prepetition default on a nonmonetary obligation, such as going dark or conducting a going out of business sale, should justify forfeiting the debtor's access to the intellectual property as long [as] any other defaults have been cured.[98]

Nevertheless, the April 29, 1999 report from the House Judiciary Committee did not amend the bill to exclude the intellectual property language.[99] The report restated all the reasons for amending section 365(b) that were provided in its October 21, 1997 report on H.R. 764: in response to the Ninth Circuit's opinion in *Claremont*, the Committee concluded that while the cure of nonmonetary defaults in personal property leases was an appropriate bar to assumption, it is not an appropriate bar in real estate leases and executory contracts when the default is incurable.[100]

This report also included the "Agency Views" from the Department of Justice opposing the amendment to section 365(b):

> Waiving the debtor's obligations to cure if the default is not curable by money ignores that many defaults going to the essence of the agreement are not curable by money. The non-debtor party should not be forced to perform where deprived of the full benefit of the bargain.[101]

More specifically, in the case of executory contracts, the Justice Department opposed replacing the common law method of distinguishing minor defaults (entitling only damages) from major defaults (voiding the agreement) with the

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[97] *Bankruptcy Reform Act of 1999 (Part II): Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 2 (1999) (prepared statement of Kenneth Klee, Professor, University of California–Los Angeles School of Law, Los Angeles, CA, on behalf of the National Bankruptcy Conference) *available at* http://judiciary.house.gov/legacy/106-klee.htm.

[98] *Id.*

[99] *See* H.R. REP. NO. 106-123, pt. 1, at 33 (1999) (explaining amendments to section 365 of title 11).

[100] *Id.* at 140–41.

[101] *Id.* at 214.

"wholly novel notion of equities."[102] The Justice Department was concerned that this provision—which leaves to the courts the task of determining "based on the equities" whether a debtor is excused form the requirement to cure—"gives no guidance to the judge or parties as to what factors should be weighed, and will therefore generate confusion and litigation."[103]

In the final version of H.R. 833, the intellectual property language was moved from section 365(b)(1)(A)(i), which pertained to real estate leases, to section 365(b)(1)(A)(ii), which pertained to executory contracts.[104] Under this version, section 365(b) excluded from the requirement to cure, a default that is a breach of a provision relating to—

> (i) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption; or
> (ii) the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an executory contract (excluding executory contracts that transfer a right or interest under a filed or issued patent, copyright, trademark, trade dress, or trade secret), if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption and if the court determines, based on the equities of the case, that this subparagraph should not apply with respect to such default;[105]

When the Senate received H.R. 833, it again struck everything after the enacting clause and replaced it with its own bankruptcy bill, S. 625, which contained no provision amending section 365(b).[106] The bill that passed in the Senate did not amend section 365(b).

But in the next session, a bill that did contain an amendment to section 365(b) was introduced in the Senate.[107] Under S. 3186, section 365(b)(1)(A) was amended to read as follows:

> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such

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[102] *Id*.
[103] *Id*.
[104] *See* H.R. 833, 106th Cong. § 215 (1999) (as engrossed in House, May 5, 1999).
[105] *Id*.
[106] S. 625, 106th Cong. (1999).
[107] S. 3186, 106th Cong. § 328 (2000).

> contract or lease unless, at the time of assumption of such contract or lease, the trustee—
>
> > (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provision of paragraph (b)(1);[108]

Section 365(b)(2)(D) was also amended by striking "penalty rate or provision" and replacing it with "penalty rate or penalty provision."[109]

S. 3186's provision on "Defaults Based on Nonmonetary Obligations" represents a departure from previous bills in several respects. First, it omits the intellectual property language from section 365(b)(1)(A) and from section 365(b)(2)(D). Second, the exception to the requirement to cure only applies to unexpired leases of real property and not to executory contracts or personal property leases. Third, "[d]ebtors are compelled to comply prospectively with all operational terms in nonresidential real property leases."[110] Finally, it specifies that the non-debtor party is still entitled to compensation for actual pecuniary loss associated with the breach pursuant to section 365(b)(1). S. 3186 was approved by the Senate and was approved by the House as H.R. 2415,[111] President Clinton pocket vetoed it on December 19, 2000.

Nevertheless, the language of H.R. 2415 as passed by both houses was eventually adopted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which became Public Law No. 109-8 on April 20, 2005, with one minor exception. On July 25, 2002, the House made a final change to the language

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[108] *Id*.

[109] *Id*.

[110] HON. WILLIAM HOUSTON BROWN & LAWRENCE R. AHERN III, 2005 BANKRUPTCY REFORM LEGISLATION WITH ANALYSIS, 102 (Thomson/West 2005).

[111] *See* 146 CONG. REC. H9826, H9840 (daily ed. Oct. 12, 2000) (House agreeing to H.R. Rep. No. 106-970 (2000)); 146 CONG. REC. D1201, D1201 (daily ed. Dec. 7, 2000) (Senate's agreement to H.R. Rep. No. 106-970 (2000)).

amending section 365(b)(1)(A) by providing that pecuniary losses would be compensated pursuant to the provisions of "this paragraph" rather than to the provisions of "paragraph (b)(1)."[112] Perhaps this was because paragraph (b)(1) is "this" paragraph, as the provision appears in subparagraph (A) of paragraph (b)(1). In any event, the Conference report accompanying the change indicated it was not meant to be a substantive change, and "[p]ecuniary losses resulting from such default must be compensated pursuant to sections 365(b)(1)."[113]

III. WHY ARE WE WHERE WE ARE?

The question of why we are where we are with respect to the bankruptcy law of nonmonetary defaults in unexpired leases and executory contracts can be treated as an "academic question" or a "real-world question." An "academic answer" can allude to the contract/property dichotomy in landlord tenant law[114] and in bankruptcy law[115] or opine as to role of state law in bankruptcy.[116] A "real-world" answer simply points to the impact of special interest lobbying on lawmaking.[117]

While we know we are right in answering this last, "real-world" question, courts may (and, in some instances, we hope will) find our answers to other "real-world questions" "wrong" or decide that we were asking the wrong questions. And, so we borrow the following from the under-appreciated Seattle singer/songwriter Scott Katz[118] as our concluding mea culpa:

> By way of recognition of our incorrect position
> And to gracefully unmention our incorrect contention
> That left us in the position of impressive imprecision
> We were wrong, wrong, wrong, wrong.[119]

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[112] H.R. 333, 107th Cong. § 328 (2d. 2002) (as reported to House, July 26, 2002).

[113] H.R. REP. NO. 107-617, at 224 (2002).

[114] *See* Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L.REV. 405, 410–26 (2002) (describing contract approach taken in landlord tenant law).

[115] *See* Blake Rohrbacher, Note, *More Equal Than Others: Defending Property-Contract Parity in Bankruptcy*, 114 YALE L. J. 1099, 1110–31 (2005) (analyzing overlap and distinctions between property and contract law in bankruptcy).

[116] *See* Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1075–76 (2002) (explaining necessary constitutional limits since Bankruptcy Code is expressly and impliedly reliant on state law).

[117] *See* Melissa B. Jacoby, *The Bankruptcy Code at Twenty-Five and the Next Generation of Lawmaking*, 78 AM. BANKR. L.J. 221, 241 (2004) (discussing lobbyists impact on state bankruptcy legislation which serves as model for federal bankruptcy legislation).

[118] *See generally* http://www.yellowtailrecords.com/katz/katzreview.htm (providing additional information on Scott Katz's record).

[119] SCOTT KATZ, *The Wrong Song*, *on* WRONG (Yellowtail Records 1999).