American Bankruptcy Institute Law Review
Volume 5 Number 2 Winter 1997

THE COMMISSION'S RECOMMENDATIONS CONCERNING THE TREATMENT OF BANKRUPTCY CONTRACTS

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In the modern age, wealth arises most frequently from contracts. At any given moment, a large part of extant wealth consists of contract rights. Yet contracts also represent the largest source of debts and other obligations. Being thus the yin and yang of value, it is not surprising that the treatment of contract rights is central to the resolution of the crises created by financial distress.

The United States has by far the most elaborated system in the world for treatment of contract rights in insolvency cases. [1] That system, focused in section 365 of the Bankruptcy Code, is very sophisticated, but it has also grown terribly convoluted and hopelessly complex. Section 365 [2] itself has become so long there is an audible groan from a bankruptcy class when the day comes to open the Code to that section. The section is filled with provisions that respond to perceived mistakes in judicial resolution of bankruptcy−contract issues, [3] along with a host of special−interest provisions that accrete to it each congressional session like barnacles. [4]

The National Bankruptcy Review Commission was therefore faced with a general demand for reform of a portion of bankruptcy law that is both important and seriously flawed. [5] Nonetheless, as it explored these problems through public hearings and otherwise, the commissioners apparently became convinced that the number and complexity of the problems presented by bankruptcy contracts made it impossible to address them all, given the time and resources available to the Commission. [6] They invited suggestions for a high−value approach that would permit them to adopt a small number of important reforms, leaving the multitude of specific issues to Congress and the courts. [7]

Suggestions were made in response to that invitation, [8] and the Commission adopted four specific recommendations going to fundamental conceptual issues in the treatment of contracts in bankruptcy cases. [9] In contrast to other areas where major changes are recommended, these recommendations were apparently unanimous. [10] This article provides a brief summary and explanation of those recommendations.

The Commission's recommendations all relate to pre−bankruptcy contracts (hereafter "bankruptcy contracts") rather than new contracts arising after the petition has been filed. [11] They divide into two subjects: the re−invention of the estate's option to perform or breach pre−bankruptcy contracts; and the creation of an entirely new procedure to deal with interim performance of pre−bankruptcy contracts prior to the estate's decision to perform or to breach those contracts.

I. Performance or Nonperformance of Pre−Bankruptcy Contracts

The Commission has recommended a fundamental change in terminology and in doctrine with respect to the estate's decision to perform or breach a pre−bankruptcy contract under section 365(a). It recommended: [12] that the very term "executory contract" be banished from the Code, replaced by something like "bankruptcy contract;" that Congress eliminate the requirement that a contract be "executory" as a pre−requisite to being "assumed or rejected;" that the terms "assumption" and "rejection" be consigned to the ashcan of history, replaced by "election to perform" and "election to breach " a bankruptcy contract; that the long−standing error of treating "rejection" of a bankruptcy contract as a pseudo−avoiding power be explicitly repudiated in the Code.

II. Abolition of the "Executoriness" Requirement

As noted above, every contract presents two faces: right and obligation, asset and liability, opportunity and risk. A bankruptcy regime that simply abandoned all pre−bankruptcy contracts to which the debtor was a party would often forfeit the largest part of the wealth available to distribute to creditors in a liquidation. [13] Even more certainly, reorganization would rarely be possible without the capacity to enforce and perform the contracts that a business had on hand when it sought bankruptcy protection. [14]

On the other hand, a legal system that permits an estate to assume the benefits of these contracts has to address the rights of the other party to each contract, the "counterparty." [15] The long−standing rule in our system has been that the estate must pay a price for the benefits of a contract. [16] It must make all of the obligations of the contract an expense of administration, giving the counterparty an entitlement to priority ahead of other prepetition creditors for any payments or damages arising under the contract. [17] Furthermore, that priority is given not only to post−bankruptcy obligations under the contract, but also to debts from prepetition performance or default, elevating those prepetition debts to priority status ahead of contemporary debts owed to other prepetition creditors. [18] If the estate chooses instead to breach a bankruptcy contract, the damages arising from its breach will ordinarily be unsecured, prepetition debts. [19] The result of these rules is to make the estate's calculations about performance or breach quite different from that of a nonbankrupt party.

In principle, the trustee's decision that the estate should choose to perform a bankruptcy contract or to breach it is just the same as for any other contract party. [20] Every party to a contract is free to make the same choice to perform or breach. [21] The decision to perform permits a party to enjoy the benefits of the contract net of the costs of the performance necessary to obtain those benefits. [22] The decision to breach, moral questions aside, permits a party to pay damages for nonperformance when those damages would be less than the cost of performance.

The biggest difference in the bankruptcy context is that the estate pays damages for breach in teeny weeny Bankruptcy Dollars, but would have to pay for performance in full, 100−cent U.S. dollars, so that the difference in value between performance and breach may be much greater than for a nonbankrupt party. [23] The consequence is that the estate's decision to perform or not to perform each pre−bankruptcy contract may greatly affect the amount of the return made to creditors, either in direct distribution or through the on−going operations of the business. [24]

These facts make the decision by the estate to perform or breach extremely important. A decision not to perform a contract that turns out to have been a good bargain may represent the loss of the creditors' only chance for a dividend or the only hope of reorganization of the business. A decision to perform a contract that turns out to be a bad bargain may divert the remaining assets to the counterparty, leaving nothing for other creditors, or may generate a heavy weight of administration costs sinking a reorganization.

Until adoption of the 1978 Code, the trustee's decision that the estate perform or breach a bankruptcy contract did not require review or approval by the bankruptcy court. [25] Not only that, but breach (rejection) of a contract often happened by operation of law if the trustee failed to act within a stated period. [26] Given the time pressure and confusion typical of the period following the filing of a bankruptcy petition, as well as possible delays in the appointment of a trustee, [27] it is not surprising that mistakes were fairly often made in the decisions (or "deemed" decisions) about bankruptcy contracts. As a result, there arose an elaborate doctrine that required a finding of what I have called "executoriness" as a pre−requisite to assumption or rejection (election to perform or breach) of a bankruptcy contract. [28]

The doctrine of "executoriness" became remarkably convoluted and arcane. Decisions were confused, impenetrable, and inconsistent, until Professor Vern Countryman published his classic two−part article in the Minnesota Law Review. [29] He proposed the famous "material breach" test as a basis for finding a contract sufficiently "executory" to satisfy the requirement for assumption or rejection. [30] The test stated that a contract would be sufficiently "executory" for performance or breach by the estate if "material" performance remained for both parties to the contract at the time of bankruptcy. [31]

The material−breach test had remarkable explanatory power when applied to the confused mass of case law and it dramatically improved the courts' analyses of these issues. As a result, the test was adopted in several circuits and became the most successful and oft−cited doctrine ever to arise from academic work in the bankruptcy field. [32] It is clear to me that we would never have advanced in our understanding of bankruptcy contracts without the insights that arose from the Countryman articles and the material−breach test.

Thereafter, two developments changed the situation in important ways. Congress in 1978 required for the first time, in section 365(a) of the new Code, that the court approve the decision to perform or breach a bankruptcy contract. [33] In addition, bankruptcy contract doctrine (along with the commercial world it serves) grew far more sophisticated, so that it presented contract problems ever more difficult to solve in the face of the traditional pre−requisite of "executoriness." Both developments created a need and an opportunity to take the next step beyond the material−breach solution to the problem.

The adoption of court review of decisions to perform or breach greatly reduced the need for any threshold requirement of "executoriness" as a filter against ill−advised, or inadvertent, decisions by the trustee or debtor−in−possession ("DIP"). [34] At the same time, the explosion of reorganization cases involving complex contract issues, like covenants−not−to−compete and patent licenses, made the application of that requirement difficult and the results unpredictable. [35] The costs of "executoriness" increased at the same time its benefits had largely disappeared.

Against this background, the Commission chose to address both the underlying conceptual and terminological issues and the most serious specific problem that had arisen from the "executoriness" requirement. [36] By eliminating the "executoriness" requirement, along with the term "executory," the Commission's recommendation would focus the courts on the central point: the trade off in an estate decision to perform or breach a bankruptcy contract. If performance will bring benefits exceeding the cost of performance, the estate should elect to perform. If it is cheaper to pay damages in Bankruptcy Dollars to dump an unprofitable contract, the estate should elect to breach. [37] Except for the sharp limitations that bankruptcy imposes on the remedies available to the counterparty, [38] the calculations should proceed entirely on the basis of applicable nonbankruptcy contract law as applied to the contract in question. There need be nothing more to it than that, so the enormous dead weight of executory−contract doctrine can at last be jettisoned. Never again do we need confront a contract that the estate supposedly can neither perform or breach.

Aside from ridding us of confusing and misleading doctrine, the elimination of the threshold requirement of "executoriness" will provide a number of specific benefits. One example that is cited in the Commission Report is the option contract. [39] A debtor may enter bankruptcy holding a valuable option to purchase land, or stock, or other property at a favorable price. Too often, courts have been mislead into finding that the contract is not executory (lacks "executoriness") because there is no performance left for the breach of which the debtor could be sued. [40] Thus the contract is held to be nonassumable and a valuable asset of the estate is lost. [41] The correct answer is that the estate has the election to exercise the option (and pay the price) or to let it lapse, just like any other contract party under state law. Once the "executoriness" requirement has been cleared away, the correct issue becomes apparent: is the option valuable or not?

There were two principal concerns about the abolition of the "executoriness" requirement. [42] One was that it might upset well−established case law. [43] The report responds that the effect will be to focus attention on the original point of the requirement, benefit to the estate. [44] Besides, the case law is utterly confused and confusing, so there is little to lose in abandoning it.

The other concern was that estates might elect to perform contracts with no benefit remaining for the estate. [45] The worst case would be adoption of an account payable, a contract with nothing remaining except the debtor's prepetition obligation to pay, thus elevating that obligation to a first−priority administration expense. There are really just two possible instances: sheer stupidity on the part of the trustee and the approving court; and the "demanding creditor" problem. The first problem is always with us and, in principle, never entirely correctable, but, happily, it is also rare. The second is the problem of the supplier who demands priority for existing debts as a condition to postpetition supplies or the lender who seeks cross−collateralization (or "cross−prioritization") as the price of DIP financing. [46] Although this is a genuine concern, the courts know the answer: "Just say no." [47] We should not have to have a very costly and confused doctrine of "executoriness" that is the legal equivalent of "Stop me before I assume again."

III. Repudiation of "Rejection" as an Avoiding Power

There has been no more serious consequence of traditional executory−contract doctrine than the use of "rejection" as an avoiding power. [48] The classic example was the Fourth Circuit case, *Lubrizol Enterprises v. Richmond Metal Finishers (In re Richmond Metal Finishers*). [49] In that case, the court held that an inventor that had given a license to another party prior to bankruptcy could use "rejection" of the "executory contract" to erase the license and to give an exclusive license to another party. [50] The effect was to permit the estate to rescind the contract and make a state−law property right disappear. [51] The impact on the world of licensing was immediate and awful, so Congress quickly, but narrowly, "fixed" the problem with an amendment to section 365, adding subsection (n). [52] That fix joined a series of prior fixes also provoked by judicial mistakes arising from using executory−contract doctrine (specifically "rejection") as a sort of pseudo avoiding power. [53]

The proper solution is already contained in the Code's provisions making "rejection" the same as breach of contract, payable as a prepetition claim for damages. [54] Therefore, the remedy for rejection should be determined in the first instance under applicable nonbankruptcy law and will ordinarily be a damage claim calculated according to the usual state−law contract principles. [55] That claim will then be paid in Bankruptcy Dollars. Of course, state law will not give the *breaching party*—the estate rejecting the contract—the right to rescind the contract or take back the consideration it has already given. [56] Nothing in bankruptcy law does that either, [57] so there is no basis for using rejection as an avoiding power.

The Commission recommends that the Code drop the terms assumption and rejection entirely, [58] the concomitant to the dropping of "executory," so as to put behind us the old confusions. Indeed, the term "rejection" no doubt contributed semantically to the confusion that made some courts think a contract could be "vaporized" by an estate. [59] The Commission also suggests that the Code state more explicitly that the consequence of the estate's "election to breach" is a prepetition damage claim. [60]

Beyond terminology, however, the Commission recommends that the statute state, in so many words, that the election to breach is not an avoiding power, [61] so as to be sure to lay to rest forever cases like *Richmond Finishers*. In that connection, it is worth noting that in *Richmond*, as in other, similar cases, there may have been a transfer avoidable under one of the traditional avoiding powers, but the focus on executory−contract doctrine obscured the point. [62]

The Commission Report very helpfully emphasizes the dichotomy in the contract area between substantive rights and remedies. [63] Bankruptcy law for the most part leaves substantive contract law to state law, but it imposes strict limits on the remedies available against the estate. [64] Specific performance is rarely granted against the estate, [65] because such a remedy would give one unsecured, prepetition creditor—the counterparty—one−hundred−percent performance while all others are getting paid in Bankruptcy Dollars. [66]

On the other hand, sometimes specific performance is available against the estate. [67] When that should be true is not clear in the cases [68] and may be controversial as a matter of policy. One analysis applies where it appears that state law has effectively granted a property right by way of specific performance, as where it says that a purchaser of land has "equitable title" once the contract is signed and is entitled to specific performance of that contract. Ordinarily, bankruptcy law does not affect property rights, as opposed to contract rights, except through the avoiding powers. [69] Another analysis permits the problem to be understood through the definition of a "claim," because only a claim can be discharged. [70] On that basis, it can be argued that certain obligations under state law cannot be "claims" because they cannot be reduced to payment. Therefore they cannot be discharged and must be performed despite the discharge. [71]

Where the line is to be drawn in this area between the dominion of state law and that of bankruptcy is not part of the Commission's recommendations, although the report hints that federal law should have the controlling role. [72]

IV. Interim Performance

The second category of recommendation by the Commission with regard to executory contracts has to do with giving greater protection to a counterparty during the interim period while a trustee or DIP is deciding to perform or breach a

contract. [73]

Given that a principal historical function of "executoriness" was to provide a solution where a bad decision to assume or reject had been made, [74] its elimination would make even more important the "election to perform or breach. "The importance and finality of the decision makes it necessary to give the trustee or DIP some breathing room within which to sort through pre−existing contracts and make the correct election as to each. A snap decision may lose a favorable bargain or elevate a losing contract to administration priority.

Traditionally, the counterparty's interests have been given little or no attention in this process. The "business judgment" rule [75] focused the court's attention solely on the interest of the estate and whether it was plausible that the trustee's decision was the best one for the estate. [76]

The focus on the estate only is reasonable as to the final decision because the counterparty is only being required to share the pain with all the other unsecured creditors. [77] With regard to interim performance, on the other hand, it is arguable that counterparties have been unfairly treated, especially in reorganizations. They have found themselves in limbo, required to perform or to prepare to perform during the interlude after filing while the estate ponders whether to elect to perform or to breach. [78] Often, the counterparties have had no reliable assurance that they will receive proper compensation for their performance or their damages if the estate ultimately elects to breach. [79] In particular, there are a number of cases suggesting that the counterparty should be paid only for the "actual benefit" to the estate from interim performance and not full contractual compensation for its performance or its damages for standing ready. [80]

In reorganization cases, where the problem is most serious, the only remedy the Code now gives to the counterparty is to demand that the bankruptcy court establish a deadline for the estate's election. [81] The remedy is of limited value, however, because the courts are quite properly reluctant to force so important a decision too quickly. [82]

The Commission concluded that the prejudice to the counterparty should not be corrected by eliminating the estate's breathing room. [83] Part of the essence of reorganization bankruptcy—heresy though it may be to say it—is delay, within reason. [84] Debtors or trustees need breathing room to get organized and get perspective and information. They must have some time to make decisions as important as the election to perform or to breach major contracts. [85] The Commission therefore decided to establish a new procedure that might offer more realistic interim relief to a counterparty. [86]

The new procedure permits the counterparty to apply to the court for a type of interim relief much easier for the court to grant than the compelling of a quick final decision on the contract. [87] The counterparty may ask for a "temporary performance" order that will specify the terms on which the estate may demand interim performance from a landlord, a supplier, or other counterparty pending the decision to perform or to breach. [88] The order can include payments that the estate must make for such performance. [89] It can also cover the compensation to which the counterparty may be entitled for preparing to perform or for holding itself ready to perform. [90] In each case, damages should be computed under ordinary state−law contract principles, rather than to focus only on benefits or needs of the estate. [91] Most important, the counterparty's temporary−performance−order claims will enjoy administration priority. [92] Of course, the court will not issue the order if it does not believe that the temporary performance is plausibly within the needs of the estate—an interim business judgment rule. [93]

Some concern was expressed that the recommendation as to compensation should speak in terms of the full contract price, but the report explains that some of the damage elements for which the Commission intends to allow compensation could not be measured by a price stated in the contract. [94] For example, damages from preparing oneself for performance may require restitution principles. [95] The recommendation therefore provides for the usual contract principles to apply, assuring the counterparty the same sorts of protection ordinarily available to contract parties to the extent of interim performance. [96] While there will no doubt be litigation arising from the fact that interim performance by definition is not the ordinary performance the parties originally contemplated—and therefore damages will differ from the ordinary contract situation¾ one of the functions of the temporary performance order will be to identify these damages and specify their compensation in advance, as far as possible. [97]

This last point highlights the fact that the Commission does not recommend any change in existing law as to a counterparty that does not apply for a temporary performance order. [98] A party that only later claims great difficulty and damage during the interim will be relegated to existing doctrine, which is ungenerous to counterparties. In this way, the Commission's approach gives much greater protection to counterparties than existing law, but ensures that the trustee or DIP has a reasonable idea of the cost of interim performance and that hindsight does not distort damage claims.

Conclusion

Although many of the Commission's recommendations necessarily invoke controversy between holders of strongly differing views, its proposals for executory contracts should attract the support of all those who prefer order to confusion.

FOOTNOTES:

[*] Benno C. Schmidt Chair of Business Law, The University of Texas School of Law. I am only one of many to acknowledge the contribution that Professor Elizabeth Warren made to the entire field of bankruptcy by her extraordinary service as reporter to the National Bankruptcy Review Commission. One small part of that effort lay in the realm of executory contracts. I am also glad to acknowledge the able research assistance of David Johnson '99, in the preparation of this paper.Back To Text

[1] *See* Richard Broude and Jay L. Westbrook, *Contract Issues In International Insolvencies, in* Insolvency and Finance in the Transportation Industry (London 1993). There is an enormous literature about "executory contracts." *See, e.g.*, Vern Countryman, *Executory Contracts in* Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1973)[hereinafter Countryman, *Part I]*; Vern Countryman, *Executory Contracts in* Bankruptcy: Part II, 58 Minn. L. Rev. 479 (1974) [hereinafter "Countryman, *Part II*"]; Michael Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection*", 59 U. Colo. L. Rev. 845, 883−84 (1988)[hereinafter "Andrew, *Rejection*"]; Jay L. Westbrook, A Functional Analysis of Executory Contracts, 74 Minn. L. Rev. 227 (1989)[hereinafter "Westbrook, *Functional*"]. *See generally*, 3 Collier on Bankruptcy ¶ 365.01 at 16 (Lawrence P. King et al. eds., 15th ed. rev. 1997). Back To Text

[2] *See* 11 U.S.C. § 365 (1994) (dealing with executory contracts and unexpired leases).Back To Text

[3] *See also* infra notes 49−51 and accompanying text (discussing case in detail). Back To Text

[4] *See* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 459 n.1113 (1997) [hereinafter Commission Report] ("The [Judiciary] Committee believes that continued creation of special interest exceptions to section 365 is not desirable, and intends to revisit section 365 so that it is, in Mr. Hahn's words, a 'total cohesive section.'") (quoting H.R. Rep. No. 100−1012, at 3 (1988)). Back To Text

[5] *See* Commission Report, supra note 4, at 459 (noting section 365 is critically important provision and there is need for clear guidance to establish fair and uniform treatment of contracts in bankruptcy).Back To Text

[6] *See* Commission Report, supra note 4, at 310 (stating that one challenging task undertaken by the full Commission was review of chaotic case law involving executory contracts).Back To Text

[7] *See* id.Back To Text

[8] Several presentations were made to the Commission on this subject, notably a comprehensive review by Professor David Epstein in September, 1996. I had the privilege of responding to the invitation described in the text at a session held in February, 1997. The suggestions that I made at that time, which were largely adopted in the final recommendations, drew heavily on proposals made by The Bankruptcy Code Reform Project of the National Bankruptcy Conference. *See* National Bankruptcy Conference, Reforming The Bankruptcy Code 122 (Rev. 1997). Those proposals were drafted for the NBC by a committee chaired by George Hahn of the New York bar; the reporter for that committee was Professor Epstein.Back To Text

[9] *See* Commission Report, supra note 4, at 459−478 (discussing each recommendation in detail); *see also* infra note 12 (stating certain recommendations).Back To Text

[10] *See generally* id. at 459−78 (evidencing no stated objection).Back To Text

[11] *See* id. at 472−73 (noting section 365 currently refers to executory contracts and not to all contracts); *see also* 3 Collier, supra note 1, ¶ 365.02 at 20 (noting section 365 applies only if contract is in existence at commencement of case).Back To Text

[12] The text summarizes the recommendations and emphasizes the key points. The text of the recommendations as to performance and breach is as follows:

> 2.4.4 Contracts Subject to Section 365; Eliminating the "Executory" Requirement
>
> Title 11 should be amended to delete all references to "executory" in section 365 and related provisions, and "executoriness" should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.

Commission Report, supra note 4, at 454.

> 2.4.1 Clarifying the Meaning of "Rejection" The concept of "rejection" in section 365 should be replaced with "election to breach."
>
> Section 365 should provide that a trustee's ability to elect to breach a contract of the debtor is not an avoiding power.
>
> Section 502(g) should be amended to provide that claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition. 2.4.2 Clarifying the option of "Assumption" "Assumption" should be replaced with "election to perform" in section 365.

Commission Report, supra note 4, at 453. Back To Text

[13] *See* Commission Report, supra note 4, at 466 (discussing election to perform contract makes contractual obligations rise to level of administrative expense priority and, thus, significantly affects distribution to all creditors, if converted to chapter 7, it can consume substantial portion of estate's assets).Back To Text

[14] *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) (rejecting contracts that save estate from burdensome obligations that can impede reorganization).Back To Text

[15] It has always been difficult to "tag" the other party to a bankruptcy contract for discussion purposes. In the past, my device was to capitalize the Other Party. See Westbrook, Functional, supra note 1, at 231. In recent years the rise of derivative contracts has given us a much more felicitous solution: the "counterparty." *See, e.g.*, Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a* Regulatory Paradigm, 138 Penn. L. Rev. 333, 348 (1989) (using "counterparty" to refer to parties with opposite interests).Back To Text

[16] *See* Commission Report, supra note 4, at 463 (stating once trustee assumes, estate becomes obligated to perform or assign); *see also* 11 U.S.C. § 365(f)(2) (providing trustee may assign executory contract only if assumed and adequate assurance of future performance is provided). Back To Text

[17] *See* Commission Report, supra note 4, at 463 (discussing failure of estate to perform or assign will result in administrative priority claim for damages that must be paid ahead of all other general creditors).Back To Text

[18] Professor Morris Shanker has made a thoughtful and persuasive attack on this rule. Morris G. Shanker, *Bankruptcy Asset Theory and Its Application to Executory Contracts*, 1992 Ann. Sur. Bankr. L. 97, 130−31. One difficulty with his proposal is that it creates a complex problem of separating pre−petition and postpetition obligations and damages. Back To Text

[19] *See* Commission Report, supra note 4, at 463−64 (stating party to breached contract receives pro rata distribution); 3 Collier, supra note 1, ¶ 365.03 at 22 (noting that after contract is rejected, claim for damages is treated as prepetition claim).Back To Text

[20] *See* Westbrook, Functional, supra note 1, at 231 (discussing trustee's option to assume or reject pre−bankruptcy contract involves determination of estate's most profitable course).Back To Text

[21] *See* id. at 250 (stating "state contract law permits a party to choose between performing or breaching").Back To Text

[22] *See* Commission Report, supra note 4, at 464 (noting that "a net benefit to the estate . . . [results when] the value of the nondebtor party's remaining performance exceeds the estate's costs of taking over the debtor's remaining obligations.").Back To Text

[23] Obviously, the largest difference between the cost to an estate and the cost to a nonbankrupt party arises when the estate will pay only a small percentage of unsecured claims. The closer the anticipated distribution approaches 100%, the smaller the difference between the trustee's calculation of the costs and benefits of performance or breach and the calculations of a nonbankrupt party. *See* Westbrook, Functional, supra note 1, at 253 (stating bankruptcy dollars may be worth only ten cents in U.S. dollars) (citing Herbert & Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in* Chapter 7 Bankruptcy Proceeding Closed During 1984−87, 22 U. Rich. L. Rev. 303, 313−14).Back To Text

[24] The discussion here assumes a business bankruptcy, because most of the interesting and important questions surrounding bankruptcy contracts arise in such cases.Back To Text

[25] *See* Commission Report, supra note 4, at 473 (noting that estate could be obligated to fulfill contracts even though other creditors may be harmed).Back To Text

[26] The equivalent provision today is section 365(d)(1), which provides for "deemed rejection" in a chapter 7 case if the estate has not assumed the contract within 60 days of the filing of the petition. *See* 11 U.S.C. § 365(d)(1) (1994). Back To Text

[27] *See generally* Barry L. Zaretsky, *Trustees and Examiners in* Chapter 11, 44 S. C. L. Rev. 907, 924 (1993) (noting that appointment of trustees might delay bankruptcy filings).Back To Text

[28] *See* Westbrook, Functional, supra note 1, at 230 (noting that courts have required finding of "executoriness" in contracts in order for trustee to have option of performing or breaching)Back To Text

[29] *See* Countryman, *Part I, supra* note 1, at 460 (focusing on problem of characterizing pre−bankruptcy contract as executory).Back To Text

[30] *See* id. Professor Countryman defines an executory contract as one: "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing performance of the other." Id. Back To Text

[31] *See* id.Back To Text

[32] *See* Commission Report, *supra* note 4, at 474 n.1145 (noting that every circuit, except Sixth Circuit, utilizes Countryman's test); *see, e.g.,* In re Bluman, 125 B.R. 359, 361 (Bankr. E.D.N.Y. 1989) (stating majority of

jurisdictions have adopted Countryman's definition). *But see* Chattanooga Mem'l Park v. Still (In re Jolly), 574 F.2d 349, 351 (6th Cir. 1978) (noting Countryman definition is helpful but does not offer resolution). Back To Text

[33] *See* 11 U.S.C. § 365(a) (stating that trustee, subject to court approval, "may assume or reject any executory contract or unexpired lease of debtor").Back To Text

[34] *See* Commission Report, supra note 4, at 474 (stating that purpose of executoriness test is achieved through court review).Back To Text

[35] *Compare* In re Noco, Inc., 76 B.R. 839, 843 (Bankr. N.D. Fla. 1987) (declaring that contract, which included covenant not to compete, was not executory); *with* Burger King Corp. v. Rovine Corp. (In re Rovine Corp.), 5 B.R. 402, 404 (Bankr. W.D. Tenn. 1980) (stating that noncompetition covenant was executory).Back To Text

[36] *See* Commission Report, supra note 4, at 472−78 (discussing problems arising from requirement of executoriness and proposal to eliminate all references to term "executory").Back To Text

[37] In the odd case, damages might be so great, even in Bankruptcy Dollars, that the estate should elect to perform even an unprofitable contract. *See* Westbrook, Functional, supra note 1, at 293.Back To Text

[38] *See* Westbrook, Functional, supra note 1, at 260 (noting that bankruptcy contracts are governed by limitations on counterparty's remedies asserted by equality principle and pro rata rule).Back To Text

[39] *See* Commission Report, supra note 4, at 476 n.1154 (noting that valuable contracts, such as option contracts, may be declared unassumable because of strict executory test).Back To Text

[40] *See, e.g.*, Brown v. Snellen (In re Giesing), 96 B.R. 229, 232 (Bankr. W.D. Mo. 1989) (finding that option contract in this case was not executory); Travelodge Int'l, Inc. v. Continental Properties, Inc. (In re Continential Properties, Inc.), 15 B.R. 732, 736 (Bankr. D. Haw. 1981) (determing that option contract was not executory contract subject to rejection or assumption by debtor).Back To Text

[41] *See* Commission Report, *supra* note 4, at 476 (noting that contracts may be unassumable because of strict executory test).Back To Text

[42] *See id.* at 477. Back To Text

[43] *See* id. (commenting on concerns about effect on case law and estates).Back To Text

[44] *See* id. (stating that effect of eliminating "executory" would force courts to focus on matter of benefit to estate).Back To Text

[45] *See* id. (noting that courts established narrower definition of "executory" to guarantee that contracts would be assumed only if beneficial for estate).Back To Text

[46] *See, e.g.*, Charles J. Tabb, *A Critical Reappraisal of Cross−Collateralization in* Bankruptcy, 60 S. Cal. L. Rev. 109 (1986) (examining issue of postpetition preferences and concluding that this type of preferential treatment is inappropriate); Charles J. Tabb, *Emergency Preferential Orders in* Bankruptcy Reorganizations, 65 Am. Bankr. L.J. 75, 78 (1991) [hereinafter *Preferential*] (discussing that certain parties, such as prepetition lenders and unpaid suppliers, often have leverage against debtor and may receive unusual benefits from debtor). Back To Text

[47] *See* Preferential, supra note 46, at 115 (urging judges to adopt uniform rule that prohibits acceptance of preferential treatment of prepetition claims).Back To Text

[48] This use of rejection was first attacked in a systematic way in an outstanding article by Michael Andrew. *See* Andrew, *Rejection*, *supra* note 1, at 901−02. It was also the subject of attack in an article I published shortly

thereafter. *See* Westbrook, Functional, supra note 1, at 294−95. Andrew and I disagreed on the concepts involved, but agreed on the results with regard to rejection. Back To Text

[49] 756 F.2d 1043 (4th Cir. 1985).Back To Text

[50] *See* id. at 1048.Back To Text

[51] *See* Commission Report, supra note 4, at 460. (recommending the Code "delineate the consequences of electing to breach to correct . . . contrary results reached by some courts;" i.e., *Lubrizol* decision).Back To Text

[52] *See* Intellectual Property Bankruptcy Protection Act of 1988, S. Rep. No. 100−105, at 11 (1988), *reprinted in* 1988 U.S.C.A.A.N. 3205 (changing subsection (n) to allow licensee to elect two sets of consequences upon licensor's bankruptcy and modifying rights of retaining licensee as nondebtor party to content).Back To Text

[53] *See* Commission Report, *supra* note 4, at 461 (stating "rejection does not . . . serve as an avoiding power separate and apart from the express avoiding powers already provided in the Bankruptcy Code.").Back To Text

[54] *See* 11 U.S.C. §§ 365(g), 502(g) (1994).Back To Text

[55] *See* Commission Report, supra note 4, at 461.Back To Text

[56] *See* id. at 462 (limiting elections to breach under section 365 to state law consequences).Back To Text

[57] *See* id. at 462−63 (stating to permit voluntary breach of valid contracts whenever estate might benefit would lead to uncertainty).Back To Text

[58] *See* supra note 12 and accompanying text.Back To Text

[59] *See* Commission Report, supra note 4, at 461.Back To Text

[60] *See* id. at 461.Back To Text

[61] *See* id. at 460−61.Back To Text

[62] *See* Westbrook, Functional, supra note 1, at 270−71.Back To Text

[63] *See generally* Commission Report, supra note 4, at 459−62.Back To Text

[64] *See* id. at 461 (suggesting that granting broad rights to specific performance would unfairly impose preferential treatment).Back To Text

[65] *See* id. (noting choice between damages and specific performance has "powerful distributional consequences").Back To Text

[66] *See, e.g.,* In re TransAmerican Natural Gas Corp., 79 B.R. 663, 665−68 (Bankr. S.D. Tex. 1987) (discussing effects of estimation of claims and bankruptcy court's authority to use whatever method is best suited to circumstances at hand).Back To Text

[67] *See, e.g.,* In re Sokoloff, 200 B.R. 300, 301 (Bankr. E.D. Pa. 1996) (illustrating possibility of specific performance for rejection determined by state law rights).Back To Text

[68] *See, e.g.,* In re Fleishman, 138 B.R. 641, 648 (Bankr. D. Mass 1992) ("Specific performance should not be permitted where the remedy would in effect do what section 365 meant to avoid, that is, impose burdensome contracts on the debtor.") (citing *In re* Waldron, 36 B.R. 633, 439 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936

(11th Cir. 1986)).Back To Text

[69] *See* 11 U.S.C. §§ 548, 544, 547.Back To Text

[70] The analysis is that only debts are discharged and a debt is defined as liability on a claim. *See* id. sections 101(5), 101(12), 727, 1141.Back To Text

[71] *See, e.g.*, Airplane Pilots Ass'n v. Continental Airlines (In re Continental Airlines), 125 F.3d 120, 135 (3d Cir. 1997) (stating that claim for seniority rights is reducible to monetary damages under nonbankruptcy law).Back To Text

[72] *See* Commission Report, supra note 4, at 461−62.Back To Text

[73] *See* id. at 466 (suggesting that "in the first chaotic moments after filing" the DIP or trustee must make important and binding decisions adversely affecting the contract creditor).Back To Text

[74] *See* id.Back To Text

[75] *See* 3 Collier, supra note 1, ¶ 365.03 at 22 (noting most courts have applied "business judgment" test to trustees' decisions).Back To Text

[76] *See* id. at 22−23 (noting courts have applied business judgment test in decisions of trustees to assume or reject contracts or leases).Back To Text

[77] *See* Commission Report, supra note 4, at 477 (discussing proposal's attempt to promote equality of creditors). Back To Text

[78] *See* id. at 466−67, 477 (explaining Code's non−requirement of decision to perform or breach contract and Proposal's response to this).Back To Text

[79] *See* id. at 467−69 (stating Code does not deal with proper compensation and proposing compensation should be measured under ordinary contract principles).Back To Text

[80] *See* Commission Report, supra note 4, at 467 n.1135 (referring to cases where nondebtor did not receive full compensation).Back To Text

[81] *See* 11 U.S.C. § 365(d)(2) (1994) (allowing any party to ask court to specify time period for trustee to assume or reject contract). In chapter 7 cases, the Code does provide a default period of sixty days. *See* id. section 365(d)(1). If it is not extended, rejection (election to breach) is automatic. *See* id.Back To Text

[82] *See* Commission Report, supra note 4, at 466−67 (noting reasons for courts' reluctance). Back To Text

[83] *See* id. (stating courts may or may not order assumption or rejection of contracts in order to prevent premature and detrimental decisions).*Back To Text*

[84] *See* id. at 451 (discussing need for efficiency and speed in bankruptcy reorganization cases).Back To Text

[85] *See* id. at 466−67.Back To Text

[86] The text of the recommendation is:

> A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

> Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract if such nondebtor party was acting in accordance with a court order governing temporary performance.

Commission Report, supra note 4, at 453.Back To Text

[87] *See* id. at 465−66 (laying out proposal and explaining necessity of interim relief). Back To Text

[88] *See* id. at 467−68 (noting court can require temporary performance or preparation of temporary performance of contract and can authorize payments to nondebtor in accordance with contract).Back To Text

[89] *See* id. Back To Text

[90] *See* id.Back To Text

[91] *See* Commission Report, supra note 4 at 468−69 (explaining there is no justification for using special bankruptcy rules for assessing damages in lieu of ordinary contract principles).Back To Text

[92] *See* id.Back To Text

[93] *See, e.g.*, Lubrizol Enters. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046 (finding courts addressing question of whether rejection of executory contract would be advantageous to debtor must start with business judgment rule).Back To Text

[94] *See* Commission Report, supra note 4, at 469−70 (stating various factors, other than just contract price, must be examined when measuring compensation).Back To Text

[95] *See* id. at 469−70 (discussing need to apply restitution concepts in assessing damages in certain cases).Back To Text

[96] *See* id. at 470−71 (explaining and showing examples where ordinary contract principles, such as restitution and duty to mitigate, are necessary to protect nondebtors in cases involving interim compensation).Back To Text

[97] *See* id. at 471−72 (admitting litigation cannot be avoided when measuring contract damages, but proposal, by using ordinary contract principles, provides principled basis and clear factual inquiry when measuring damages).Back To Text

[98] *See* id. *See generally* Commission Report, *supra* note 4, at 465−72 (failing to address situation where nondebtor does not request temporary performance). Back To Text