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National Bankruptcy Review Commission's Section 365 Recommendations and the Larger Conceptual Issues

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Articles

The National Bankruptcy Review Commission's Section 365 Recommendations and the "Larger Conceptual Issues"*

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I. Introduction

In the chapter of the Report of the National Bankruptcy Commission ("Report") entitled "Business Bankruptcy,"[1] the National Bankruptcy Review Commission ("Review Commission")

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1. Section 365 applies in consumer bankruptcy cases as well as business bankruptcy cases. The Review Commission does not expressly indicate that these recommendations are limited to business cases.

makes four recommendations regarding section 365 of the Bankruptcy Code:

> 2.4.1 Clarifying the Meaning of "Rejection"
> The concept of "rejection" in section 365 should be replaced with "election to breach."
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> Section 365 should provide that a trustee's ability to elect to breach a contract of the debtor is not an avoiding power.
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> Section 502(g) should be amended to provide that a 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.
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> 2.4.2 Clarifying the Option of "Assumption"
>
> "Assumption" should be replaced with "election to perform" in section 365.
>
> 2.4.3 Interim Protection and Obligations of Nondebtor Parties
>
> 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.
>
> 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.

These recommendations and the Report's discussion of the four recommendations address some, but not all, of the larger conceptu-

al issues relating to the bankruptcy treatment of leases and executory contracts.

II. History of Bankruptcy Treatment of Leases and Executory Contracts

A. Congressional Enactments

Congress first dealt with leases and executory contracts sixty years ago. In 1938, the Chandler Act[2] added sections 63c, 70b, 116(1), 216(4), 313, 353, 355(2), and 357(2) to the Bankruptcy Act of 1898.[3]

In the Bankruptcy Reform Act of 1978 and subsequent amendments thereto [the "Bankruptcy Code"],[4] Congress replaced these provisions with sections 365, 502(a)(6), 502(g), 366, 559, 560, 1110, 1113, 1114, 1123(b)(2), 1222(b)(6), and 1322(b)(7).[5] In so legislating, Congress retained the basic concept from the Chandler Act that in a bankruptcy case a debtor can reject or assume or assign its leases and executory contracts.

B. Case Law

The concept of a debtor election to assume or reject leases and executory contracts is not a statutory innovation. More than thirty years before the Chandler Act, the Eighth Circuit stated in *Watson v. Merrill*,[6] "[t]he effect (of bankruptcy) is to transfer to the trustee all of the property of the debtor except his executory contracts and to vest in the trustee the option to assume or renounce these."[7]

Professor Countryman traces the case law doctrine of assumption or rejection of leases and executory contracts to the judicial doctrine of abandonment.[8] Michael Andrew, on the other hand, attributes the doctrine of abandonment to case law on assumption or rejection of leases, an 1818 English case, *Copeland v. Stevens*,[9]

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2. The Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840 (1938) (amending Bankruptcy Act of 1898) (repealed 1978).

3. Ch. 541, 30 Stat. 544 (repealed 1978).

4. 11 U.S.C. §§ 101-1330 (1944) [hereinafter Bankruptcy Code].

5. *See generally* Don Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341 (1980).

6. 136 F.2d 359 (8th Cir. 1905).

7. *Id.* at 363.

8. *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 440-47 (1973) [hereinafter Countryman I].

9. 106 Eng. Rep. 218 (K.B. 1818).

holding that a lease does not become a part of a general bankruptcy assignment unless the assignee accepts (assumes?) the lease.[10] Regardless of which came first—abandonment or assumption and rejection of leases—the "chicken" or the "egg", there was a considerable body of case law prior to 1938 recognizing an assumption or rejection election in bankruptcy with respect to leases and executory contracts.

C. Law Review Commentary

Through the years, law review articles have had a uncommonly strong impact on the development of the bankruptcy treatment of leases and executory contracts. In 1927, Professor MacLachlan recommended that the case law on assumption or rejection of leases and executory contracts be codified.[11] These recommendations shaped the Chandler Act's provisions on leases and executory contracts. Then, in 1973, Professor Countryman published two articles on executory contracts in the Minnesota Law Review.[12] These articles, a product of Professor Countryman's work for the earlier Commission on Bankruptcy Laws of the United States,[13] influenced the work of that Commission on leases and executory contracts. And, Professor Countryman's articles have influenced the work of the courts in determining whether a transaction is an "executory contract."[14]

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10. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 846, 856-59 (1988) [hereinafter Andrew I].

11. *See* James MacLachlan, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583, 605 (1927).

12. *See* Countryman I; Vern Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479 (1974) [hereinafter Countryman II].

13. Congress created the Commission on the Bankruptcy Laws of the United States in 1970 to study and recommend changes in the Bankruptcy Act of 1898, Act of July 24, 1970, Pub. L. No. 9-354, 84 Stat. 468 (1970). This Commission submitted its final report to Congress in 1973 in two parts: the first part reported general findings and recommendations, and the second part was a draft of a bill to implement the recommendations. Report of the Commission on the Bankruptcy Laws of the United States, pts I & II, H.R. DOC. NO. 93-137 (1973). These recommendations, with substantial changes, became the Bankruptcy Reform Act of 1978. *See generally* Eric Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 240 (1997); *see also* Harry D. Dixon, Jr., *Bankruptcy Commissions: Then and Now*, 15 AM. BANKR. INST. J. 3 (1996).

14. *See generally* 3 JUDGE JAMES F QUEENAN, JR. ET AL., CHAPTER 11 THEORY AND PRACTICE, § 17.04 (1994). At a 1988 American Law Institute/American Bar Association conference on bankruptcy, Professor Countryman described his Minnesota Law Review article's definition of "executory contract":

III. Recent Theoretical Evolution

Law review articles have not only influenced what the bankruptcy law of leases and executory contracts now is but also have influenced the debate about what the law should be. Law review articles by Michael Andrew provided much of the impetus for review (and for new views) of the bankruptcy law of leases and executory contracts.[15]

At the time of the publication of the first Andrew law review article,[16] the National Bankruptcy Conference[17] was beginning its review of the Bankruptcy Code. The Andrew article influenced the National Bankruptcy Conference's work on section 365. A Working Group of the National Bankruptcy has drafted a comprehensive revision of section 365;[18] that draft is reproduced at the end of the article.

Articles by Jay Westbrook[19] and others also had a major impact on the work of the National Bankruptcy Conference. More important, Professor Westbrook's writings form the primary basis not only for the Review Commission's four recommendations

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> "All it purported to do was extract from the cases we'd had so far what the courts had viewed as executory contracts. The only thing that I supplied was an explanation, which none of the cases gave, for why there was a requirement that performance be due from both sides. The cases were pretty clear that a performance was due from both sides or it wasn't an executory contract. I really don't see yet why that definition should be changed."

ALI-ABA, Williamsburg Conference on Bankruptcy—Transcript 85 (1989) [hereinafter Williamsburg Conference].

15. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L REV. 845 (1988) [hereinafter Andrew I]; Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991) [hereinafter Andrew II].

16. *See* Williamsburg Conference, *supra* note 15, at 53.

17. The National Bankruptcy Conference is a non-profit voluntary association of about 65 judges, professors, and practicing attorneys from all parts of the United States. The Conference was founded in the middle 1930s to promote the improvement of the bankruptcy laws and their administration. The Conference, which meets twice a year, has been consistently active in the legislative process.

18. The senior author of this article served as Reporter to the National Bankruptcy Conference Working Group on Leases and Executory Contracts.

19. *See, e.g.*, Jay Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989) [hereinafter Westbrook I]; Jay Westbrook, *A Fresh Start for Bankruptcy Contracts*, *in* 64TH ANNUAL MEETING OF THE NATIONAL CONFERENCE OF BANKRUPTCY JUDGES, 2-31 (1990) [hereinafter Westbrook II]. According to Andrew, his conclusions and Professor Westbrook's "ultimate conclusions are all but identical." Andrew II, *supra* note 16, at 2. *But cf.* Westbrook II, *supra*, at 2-32, 2-33.

regarding leases and executory contracts but also the Review Commission's twenty-one pages of discussion of this area.[20]

IV. Five "Larger Conceptual Issues"

The Review Commission's discussion of leases and executory contracts begins with the statement that "instead of undertaking a piecemeal analysis of each subsection of section 365, the Commission reviewed the larger conceptual issues inherent in section 365 to eliminate confusion on a global basis."[21] We question (i) whether the Review Commission reviewed the "larger conceptual issues" inherent in section 365 and (ii) we question whether such a review is necessary.

We understand that the Report may not completely address all of the Review Commission's work on these "larger conceptual issues." More important, we believe that Congress should understand that the Review Commission's recommendations and discussion do not completely address the following five "larger conceptual issues" relating to the bankruptcy treatment of leases and executory contracts:

> (1) What can happen to a section 365 transaction in bankruptcy?;
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> (2) Which transactions should be treated as section 365 transactions?;
>
> (3) Who decides what happens to a section 365 transaction in bankruptcy?;
>
> (4) What are the obligations and rights of a nondebtor party to a section 365 transaction during the course of the case?; and
>
> (5) Which section 365 transactions should be treated different from other section 365 transactions?

A. *What Can Happen to a Section 365 Transaction in Bankruptcy?*

1. Overview of Present Code Provision.—Section 365 provides for the rejection, assumption, or assignment of leases and executory contracts. Understanding rejection, assumption and assignment is the first step to understanding what can happen to a lease or executory contract in bankruptcy.

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20. *See* BNA BANKRUPTCY LAW DAILY, March 13, 1997, at xx. 19.

21. Report of the National Bankruptcy Commission, at 459 [hereinafter Report].

Consider, for example, debtor, D, who at the time of its bankruptcy is a tenant at Blackacre Mall under a ten-year lease. The 1997 lease has a ten year term and provides for rent of $10,000 a month. Prior to filing for bankruptcy, D missed three monthly rent payments to its landlord BM.

In bankruptcy, D can reject the lease. On rejection, D is obligated to surrender the leasehold, and BM has a limited, unsecured claim.[22] Even though the rejection occurs postpetition, BM's claim is treated as a prepetition claim since BM's rights under the lease arose prepetition.[23]

Alternatively, D can assume the lease. On assumption, D retains the leasehold, and BM has an unlimited administrative priority claim for all past, present, and future obligations under the lease.[24]

D's other alternative under section 365 is to assign the lease. Assignment of a lease or executory contract under bankruptcy law is different from the general law of assignment. Under contract law, if X contracts with Y and X later assigns her rights and delegates her contract duties to Z, the assignor X remains legally responsible for the performance of the contract.[25] Under bankruptcy law, if Chapter 11 tenant D assigns her lease to X, D has no further responsibility for future lease obligations.[26]

2. Closer View of Review Commission's Recommendations.—The Review Commission retains but "clarifies" rejection, assumption, and assignment. A part of the clarification is a change of terms—"rejection" is to become "election to breach,"[27] "assumption" is to become "election to perform," and "assignment" is to become "transfer."

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22. *See* Bankruptcy Code § 502(b)(6). *See generally* QUEENAN, JR., ET AL., *supra* note 15, § 18.24.

23. *See* Bankruptcy Code § 502(g).

24. *See, e.g., In re* Norwegian Health Spa, 79 B.R. 507 (Bankr. N.D. Ga. 1987); *In re* Mushroom Transportation Co., 78 B.R. 754 (Bankr. E.D. Pa. 1987); *cf.* Bankruptcy Code § 365(b).

25. *See* E. A. FARNSWORTH, CONTRACTS 830-31 (2d ed. 1990).

26. *See* Bankruptcy Code § 365(k).

27. *See* Report, *supra* note 22, at 460. While "rejection" is a familiar contract law term, only bankruptcy speaks of rejection of contracts. Outside of bankruptcy, an offeree might reject an offer; a buyer can reject goods under a contract of sale. Neither an offeree in common law contract nor a buyer in an Article 2 contract can reject the contract.

a. Assumption.—The Commission does not otherwise "clarify" the present law of assumption of leases and executory contracts. We respectfully suggest that there are important "larger conceptual issues" relating to assumption than whether to retain the term "assumption." The present law of assumption results in a treatment of section 365 transactions that is markedly different from the bankruptcy treatment for all of the debtor's other prepetition transactions. Consider, for example, the effect of the present law of assumption of a lease or an executory contract on a debtor's prepetition and postconfirmation obligations.

i. Effect of Assumption on Prepetition Obligations.—Chapter 11 debtor D wants to assume its lease at Blackacre Mall, and D owes BM $30,000 for rent missed prior to its bankruptcy filing. If D assumes or elects to perform its lease, that $30,000 obligation for back rent will be treated differently from all of D's other prepetition unsecured obligations. Assumption requires D to pay the $30,000 unsecured, prepetition back rent claim of landlord BM regardless of what, if any, distribution is made to other holders of unsecured claims.[28] Why? What is the larger conceptual basis for such a rule?

The National Bankruptcy Conference has suggested a conceptual basis for the rule: parties to leases and executory contracts, unlike holders of other unsecured claims, have continuing performance obligations.[29] Assume, for example, that D's lease with BM provided for higher monthly payments in the early years of the lease. To permit D to assume or perform the lease without making these higher, prepetition payments would be to force BM to continue to provide new value (use of the leasehold) to D on terms different from the terms that it negotiated.

ii. Effect of Assumption on Postconfirmation Obligations.—And, if Chapter 11 debtor D wants to assume its lease at Blackacre Mall, the postconfirmation obligations under the lease will be treated more favorably than any of D's other unsecured or even secured obligations. Assumption or election to perform requires D to make the payments provided for in the lease or

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28. *See* Bankruptcy Code § 365(b).

29. REFORMING THE BANKRUPTCY CODE: NATIONAL BANKRUPTCY CONFERENCE CODE REVIEW PROJECT 137 (rev. ed. 1997).

contract without change. If D's lease with BM requires monthly payments of $10,000, then assumption of that lease in bankruptcy will require D to continue paying the lease rental rate of $10,000 postconfirmation without change.[30]

By contrast, Chapter 11 debtor D can cram down changes in its postconfirmation obligations to holders of other unsecured or even secured claims. If, for example, Chapter 11 debtor D's other store is encumbered by a Large Bank (LB) mortgage providing for ten percent interest and one hundred payments of $10,000 a month, D can retain that store and, through the provisions of its Chapter 11 plan and the cram down provisions of Chapter 11 (which apply to holders of secured claims but not landlords holding unsecured claims), change the interest rate, number of payments, and amount of each payment.[31]

According to the National Bankruptcy Conference report, "it can be argued that it treats the nondebtor to an executory contract more favorably than the Bankruptcy Code anywhere treats secured creditors."[32] With all due (and undue) respect to the National Bankruptcy Conference reporter on executory contracts who wrote that statement, the more favorable treatment is a fact not an argument. What can be argued is that the unsecured, nondebtor party to a lease or executory contract should not be treated more favorably than a secured creditor. Professor Klee has made such an argument:

> "It seems unfair to permit the proponent of a plan to rewrite the covenants in a debt instrument to change the payment periods and the interest rates for a secured creditor but not to permit that to be done to a party with a contractual right under a contract or a true lease."[33]

Why does the bankruptcy law of assumption treat parties to leases and executory contracts more favorably than bankruptcy law treats secured creditors? What is the "larger conceptual" basis for such a rule? The argument that lessor BM is continuing to provide new value and mortgagor LB is not seems somewhat strained here.

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30. *See id.*

31. *See* Bankruptcy Code § 1129(b)(2)(A). *See generally* Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495 (1993).

32. REFORMING THE BANKRUPTCY CODE, *supra* note 30, at 138.

33. Williamsburg Conference, *supra* note 15, at 82. It can also be argued that the National Conference of Commissioners on Uniform State Laws in adopting Article 2A moved toward treating leases more like secured transactions.

b. Assignment.—The present bankruptcy law of assignment of a lease or executory contract also raises "larger conceptual issues" that are not mentioned by the Review Commission. For example, contractual restrictions on assignments of leases and contracts that would be enforceable absent bankruptcy are unenforceable in bankruptcy.[34]

Contractual restrictions on transfers of assets of the debtor other than leases and executory contracts, however, are enforceable in bankruptcy. The bankruptcy estate's interest in other property is no greater than the interest of the debtor.[35] While restrictions on the transfer of a Board of Trade seat will not prevent the seat from becoming property of the estate,[36] the restrictions will prevent a Chapter 11 debtor from transferring that seat to a third party.[37]

The "larger concept" that supports the bankruptcy policy of disregarding restrictions on the assignment of leases and executory contracts has been variously described in commentary and cases as a reallocation of values[38] and as a balance of the contract right of a creditor to receive the benefit of its bargain and the equitable right of the debtor to have a right to reorganize.[39] Neither the commentary, nor cases, nor the Review Commission directly explains why these values, but not others, should be reallocated or why these contract rights but not others should yield to reorganization.[40]

c. Rejection.—The Review Commission's more extended discussion of rejection raises but does not resolve these same

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34. *See* Bankruptcy Code § 365(f).

35. Bankruptcy Code § 541(a)(1) ("interests of the debtor in property").

36. Bankruptcy Code § 541(c).

37. Section 541(c)(1)(A) applies only to the transfer that occurs when a bankruptcy petition is filed, and what was property of the debtor becomes property of the estate. We do not read section 541(c)(1)(A) as affecting a later sale or other transfer of property of third parties. Accordingly, the property remains subject to transfer restrictions. *See also* DOUGLAS BAIRD, THE ELEMENTS OF BANKRUPTCY 97-100 (rev. ed. 1993).

38. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 38.12 115 (1986).

39. *Cf. In re* The Circle K Corporation, 127 F.3d 904, 907 (9th Cir. 1997).

40. *Cf.* Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 546 (1983) ("Section 365(f) arguably is an overbroad intrusion in contractual rights whose potential effect on contracting activity is inadequately justified by a desire to capture value for the estate.").

"larger conceptual issues," but only in the context of rejection.[41] The essence of the Review Commission's clarification of rejection is that rejection is merely a breach and not an avoiding power.

Since 1938, the bankruptcy laws have stated that rejection of a lease or executory contract constitutes a breach as of the date of the bankruptcy petition. And, both the Bankruptcy Act of 1898 as amended and the current Bankruptcy Code provide that a landlord who rejects its lease in bankruptcy is not able to use that rejection like an avoiding power and recover its leasehold.

In at least one circuit court decision, a debtor has been permitted to use section 365 rejection of an executory contract like an avoiding power. In *Lubrizol Enterprises, Inc. v. Richmond Finishers*,[42] a Chapter 11 owner of a patent used rejection to take the patent from its prebankruptcy licensee and transfer an exclusive license to another party at a higher price. Congress subsequently amended the Bankruptcy Code to provide licensees of intellectual property with the same protection from section 365 avoidance as lessees of real property. The Review Commission would make clear that parties to all of a debtor's leases and executory contracts have that same protection. The Review Commission correctly explains "if a debtor were empowered to demand possession of property from a third party, the bankruptcy process would readjust the bargains struck at state law, rather than simply determine a claim for breach."[43]

3. Ride-through.—Neither the Review Commission's recommendations nor its discussion of the recommendations mentions ride-through, but neither the Bankruptcy Code nor the Bankruptcy Act of 1898 mentions ride-through.

Reorganization cases under the Bankruptcy Act use the term "ride through" to describe the situation in which the debtor neither assumes nor rejects the contract or lease. Under the Bankruptcy Act case law, the consequences of the debtor's failure to assume or reject are (i) the nondebtor does not have a claim in the case because there is no breach, (ii) discharge does not affect the

41. *See* Report, *supra* note 22, at 459-65.

42. 756 F.2d 1053 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).

43. Report, *supra* note 22, at 462. The Review Commission does not explain why these bargains struck at state law should be honored in bankruptcy and other bargains—such as nonassignability of a lease or executory contract—should not.

enforceability of the debt, so that (iii) the lease or contract remains an asset and obligation of the reorganized debtor.[44]

There are a few reported cases under the Bankruptcy Code that attribute the same ride through consequences to leases and executory contracts that a Chapter 11 debtor neither assumes nor rejects.[45] We believe these cases are inconsistent with the Bankruptcy Code's expanded definition of claim. A party to a lease or executory contract with a Chapter 11 debtor has a section 101(5) claim even before the lease or contract is assumed or rejected.[46] Any such section 101(5) claim would be extinguished when the Chapter 11 debtor's plan was confirmed and so would not ride through the bankruptcy. Consider the following two examples:

(1) X contracts to sell beans to D. X delivers the beans to D. Before D pays for the beans, D files for Chapter 11 relief. X does not file a proof of claim; D makes no specific provision for X in its plan. D's plan is confirmed, and X receives nothing from the bankruptcy. Under current law, X's rights under its nonexecutory contract would not ride through D's bankruptcy. Rather, D's obligation to pay on X's claim would be extinguished by the discharge.[47]

(2) X contracts to sell beans to D. X delivers some but not all of the beans to D. D files for Chapter 11 relief. D's confirmed Chapter 11 plan neither assumes nor rejects D's executory contract with X. Under sections 101(5) and 1141, X's claim is discharged. Under the ride through caselaw, this executory contract rides through the bankruptcy, unaffected by the bankruptcy.

While we do not support the caselaw on ride through, we do support the practice of ride-through, at least in Chapter 11, and would urge Congress to follow the Review Commission's non-review of this concept. As the National Bankruptcy Conference concluded:

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44. *See, e.g.,* Federal's Inc. v. Edmonton Inv. Co., 555 F.2d 577 (7th Cir. 1977); *In re* Afar Dairy, Inc., 458 F.2d 1258 (5th Cir. 1972); *see generally* Countryman II, *supra* note 13, at 561-63.

45. *See, e.g.,* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 546 n.12 (1984); *In re* Continental Country Club, Inc., 114 B.R. 763, 767 (Bankr. M.D. Fla. 1990).

46. *See* Bankruptcy Code § 101(5)(A) ("right to payment whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured").

47. *See id. §* 1141(d)(1)(A) ("discharges the debtor from any debt that arose before the date of such confirmation").

> [T]here are many cases in which there are thousands of ordinary contracts [i.e., purchase orders, equipment leases, etc.] which normally "ride-through" without being scheduled and without notice being given to the other party. In very large such cases, it would be an administrative headache to schedule and notify all of them. The debtor and the other party expect to perform these contracts without formality. In other words, the debtor's failure to schedule such contracts is not accidental or inadvertent. The present system presently works in those types of cases.[48]

B. Which Transactions Should Be Treated as Section 365 Transactions?

As discussed above, the bankruptcy treatment of section 365 transactions differs significantly from the bankruptcy treatment of a debtor's other unsecured and secured obligations. In particular, the consequences of assumption, or "election to perform," are not duplicated elsewhere in the Bankruptcy Code. Accordingly, the answer to the question which transactions should be treated as section 365 transactions can have meaningful practical consequences.

Section 70b of the Bankruptcy Act of 1898 is limited to leases and executory contracts. The Bankruptcy Act of 1898 does not define either the term "lease" or the phrase "executory contract."

Section 365 is similarly limited. And, the Bankruptcy Reform Act of 1978, like the earlier Chandler Act, does not define either the term "lease" or the phrase "executory contract."[49] The phrase "executory contract" has been variously defined by various courts, and there has been substantial amount of writing by judges as well as law professors on what is an "executory contract."[50]

The Review Commission recommends the elimination of the word "executory" from section 365 and uses more than five pages of its twenty-page discussion of section 365 to advocate this

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48. REFORMING THE BANKRUPTCY CODE, *supra* note 30, at 147.

49. According to legislative history: "Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains past due to some extent on both sides. A note is not usually an executory contract if the only performance that remains is repayment." H.R. REP. NO. 95-595, at 374 (1977). *See also* Williamsburg Conference, *supra* note 15, at 84.

50. QUEENAN, JR., *supra* note 15, § 17.03-.08.

change.[51] Review Commission arguments for elimination of the word "executory" include: (i) "a functional analysis of contracts is analytically superior,"[52] (ii) "persistent inconsistencies and difficulties in identifying an executory contract for bankruptcy purposes,"[53] and (iii) "valuable contracts may be unassumable on account of a strict executory test."[54] According to the Review Commission, court review of the debtor's decision whether to assume or reject would replace the executoriness test:[55] "[T]he Proposal would streamline the analysis of the debtor's contracts and provide a directive to courts to analyze the relevant considerations guiding one's decision to perform, breach of transfer a contract, *just as a contracting party would do outside of bankruptcy*."[56] Outside of bankruptcy, a contracting party might easily decide that there are business advantages in paying outstanding amounts owed to key suppliers. Assume, for example, that D contracted with X for repair work and that X completed her work prior to D's bankruptcy filing. All that remains is an account payable by D to X. While there are other artisans, D has a longstanding and outstanding relationship with X and wants to pay X in full even though other holders of unsecured claims may go unpaid. Under state law, a debtor—even an insolvent debtor—can elect to pay some of its creditors in full and not pay other creditors at all.

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51. *See* Report, *supra* note 22, at 472-78. While most of the "executory contract" controversy and confusion has centered on the word "executory," there can also be disagreement as to whether there is a "contract" for purposes of section 365. Consider, for example, the provider agreement that the Social Security Act requires that a certified health care provider file with the Department of Health and Human Services. If the provider agreement is a section 365 transaction, then a third party buying all of the assets of a health care provider in Chapter 11 cannot acquire the all-important provider agreement unless it satisfies all existing *contractual* obligations under the provider agreement, including any obligation to return prebankruptcy overpayments. If, on the other hand, the provider agreement is merely an administrative document memorializing a provider's participation in a program imposing *statutory* obligations, then section 365 and its requirement of curing all prepetition defaults will not apply. *Compare In re* Heffernan Mem'l Hosp., 192 B.R. 228, 231 (Bankr. S.D. Cal. 1996) (executory contract) *with In re* Kings Terrace Nursing Home, Docket Number *ex.*: No. 91B11478 1995 WL 65531, at *9 (Bankr. S.D.N.Y. Jan. 27, 1995) (statutory and regulatory requirements independent of contract).

52. Report, *supra* note 22, at 476.

53. *Id.*

54. *Id.*

55. *See id.* at 474.

56. *Id.* at 477 (emphasis added).

Under existing bankruptcy law, a Chapter 11 debtor cannot assume or "elect to perform" such a prepetition, nonexecutory contract unless it obtains court approval under the limited necessity of payment exception.[57] We do not understand the Review Commission to be recommending a large conceptual change in the present law barring a Chapter 11 debtor from paying some but not all prepetition contracts (i.e., debts) in full. A debtor's accounts payable should not be section 365 transactions.

Nor should a debtor's accounts receivable be section 365 transactions. Assume, for example, that D performed repair work for X prior to D's bankruptcy filing. All that remains to be done is for X to pay D. Obviously, a debtor who has completely performed its part of the contract prior to bankruptcy wants the other party of the contract to pay. A Chapter 11 debtor should not have to follow a process of filing a motion to assume with notice and an opportunity for hearing in order to obtain payment from an account debtors on a prepetition account receivable.

Because of the unique bankruptcy consequences of section 365 assumption (or "election to perform"), there needs to be a constraint on which contracts are subject to the assumption. The limiting language does not have to include the word "executory." Instead, the concept should be that assumption (or election to perform) is limited to situations in which the debtor would not have any right to the other party's continued performance if the debtor ceased its performance.

C. *Who Decides What Happens to Section 365 Transactions in Bankruptcy?*

The various consequences of rejection, assumption, and assignment can affect not only the debtor and the other party to the lease or contract but all claimants. Accordingly, the decision whether to reject, assume, or assign should not be made by the debtor only. Rather, creditors should be given notice of the debtor's election and an opportunity to object with a bankruptcy court hearing to resolve any such objection.

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57. See MARTIN BIENENSTOCK, BANKRUPTCY REORGANIZATION, 423 (1987). *See generally* J. Ronald Trost & Marshall S. Huebner, *The Doctrine of Necessity* (materials prepared in connection with 1997 NYU School of Law Workshop on Bankruptcy and Reorganization).

Section 365(d) makes the debtor's assumption or rejection of leases or executory contracts "subject to court approval."[58] And, as noted above, the Review Commission makes "court review" an integral part of its recommendations.[59] However, there is no indication in the Bankruptcy Code as to what test a court should employ in approving the assumption or rejection of a lease or executory contract. The Report does not directly address what the standard of review should be, but the Report can be read as advocating "enhancement of the estate"[60] or "benefit to the estate"[61] as the test.

There are cases under the Bankruptcy Act of 1898 limiting the trustee's rejection of contracts to those that were burdensome to the estate.[62] Commentators contended that the connection between the law of abandonment and the law of leases and executory contracts mandated such a test: "The fact that the right of rejection is a part of the right to abandon results in the obvious conclusion that a trustee may not reject or disaffirm a contract or lease unless the contract is burdensome to the debtor."[63]

As indicated earlier, Michael Andrew questions whether the assumption/rejection election evolved from abandonment or vice versa.[64] He also questions any analogy to abandonment in determining the standard a court should apply in reviewing a debtor's election with respect to its leases or executory contracts:

> [I]f a trustee abandons valuable property, the creditors can complain of a breach of the trustee's fiduciary duty to maximize the value of the estate. But in the executory contract or lease context, it is not the creditors who complain when the trustee wishes to reject in favor of a more appropriate or favorable

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58. Bankruptcy Code § 365(d).

59. *See supra* note 16 and accompanying text.

60. Report, *supra* note 22, at 475.

61. *Id.* at 477.

62. *See e.g.*, *In re* Chicago Rapid Transit Co., 129 F.2d 1 (7th Cir. 1942); *In re* New York Investors Mut. Group, 143 F. Supp. 51, 54 (S.D.N.Y. 1956). According to the Review Commission, "under the Bankruptcy Act of 1898, there was no requirement of court approval and notice to creditors for those actions." Report, *supra* note 22, at 474. Section 70b of the Bankruptcy Act of 1898 does not expressly provide for court approval. Provisions in Chapter X, XI, XII, and XIII, however, do require court approval of rejection. *See* Bankruptcy Act §§ 116(1), 313(1), 413(1), 613(1). *See generally* Countryman II, *supra* note 13, at 530-63.

63. John Creedon & Robert Zinman, *Landlord's Bankruptcy: Laissez Les Lesses*, 26 BUS. LAW: 1391, 1395 (1971).

64. *See supra* notes 56-57 and accompanying text.

> investment of the estate's funds. Instead, it is the nondebtor party to the contract or lease, who argues not that the trustee should maximize the value of the estate, but that the trustee should maximize the return to that party at the expense of the estate. That argument stands abandonment doctrine on its head.[65]

Most of the reported cases under the Bankruptcy Act of 1898[66] and most of the reported cases under the present bankruptcy law[67] have used a "business judgment" test in reviewing a rejection or assumption decision. We agree with these cases; we agree with Michael Andrew's comparison of section 365 decisions to other investment decisions made by a Chapter 11 debtor.[68]

Professor Shanker has argued that courts should look at the impact of rejection on the non-debtor party in applying the business judgment standard.[69] Relatively few reported cases under section 365[70] have expressly acknowledged consideration of the impact of rejection on the nondebtor party.[71] While it may seem unfair that a Chapter 11 debtor can realize a relatively insignificant benefit by rejecting a lease or contract that is critical to the other party, it is no more unfair than a Chapter 11 debtor realizing a relatively insignificant benefit by not making a payment that is critical to a small supplier who delivered goods prepetition or to a small contractor who did work prepetition.

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65. Andrew I, *supra* note 11, at 897-98.

66. *See e.g.*, *In re* Jackson Brewing Co., 567 F.2d 618 (5th Cir. 1978); *In re* Tilco, 558 F.2d 1369 (10th Cir. 1977).

67. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984).

68. *See* Andrew I, *supra* note 11, at 895.

69. *See* Morris Shanker, *The Treatment of Executory Contracts and Leases in the 1978 Bankruptcy Code*, PRAC. LAW., Oct. 15, 1979, at 11, 21. *See also* Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 523 (1996) ("[T]he trustee sometimes has an incentive to reject when rejection makes the estate better off but makes the other party worse off by a greater amount—that is, when rejection reduces total value.").

70. Bankruptcy Code § 1113(c)(3) uses a balancing of the equities approach to collective bargaining agreements.

71. *See* Infosystems Tech., Inc. v. Logical Software, Inc., Bankr. L. Rep. (CCH) ¶ 71,899 (D. Mass. 1987); *In re* Petur U.S.A. Instrument Co., Inc., 35 B.R. 561 (Bankr. W.D. Wash. 1983).

D. What Are the Obligations and Rights of the Nondebtor Party to a Section 365 Transaction During the Course of the Case?

The "course" of a Chapter 11 case can be a year or more. Increasingly, the decision of whether a lease or executory contract is assumed, assigned, or rejected is deferred until the plan confirmation hearing.[72] Accordingly, there can be a large time gap between the commencement of a bankruptcy and a final determination of the bankruptcy treatment of the debtor's leases and executory contracts. Additionally, there is a large conceptual gap in the present bankruptcy law as to the obligations and rights of the nondebtor parties to executory contracts during this period.

The Report correctly observes: "Nothing in current bankruptcy law *excuses* the nondebtor party to a contract or lease from its performance obligation under the contract or lease during the *gap period*."[73] The Report could also have correctly observed that there is nothing in current bankruptcy statutory law that *compels* a nondebtor party to a contract to perform during the gap period between the filing of the bankruptcy petition and a court hearing on motion to assume or reject and that there is nothing in current bankruptcy statutory law requiring the debtor to compensate the nondebtor party for such performance.[74] There are no provisions in the Bankruptcy Code relating to the postpetition performance obligations and payment rights of parties to executory contracts; although, there are a few reported cases holding that the nondebtor party is obligated to perform postpetition.[75]

With respect to leases, the automatic stay in essence requires the nondebtor party to continue to perform postpetition. The lessor is barred by the automatic stay from retaking the premises or leased personal property from the debtor.[76] Additionally,

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72. *See* Bankruptcy Code § 365(d); *cf. In re* Gateway Apparel, Inc., 210 B.R. 567 (Bankr. E.D. Mo. 1997) (denying debtor's motion to assume and deferring decision on assumption until confirmation hearing).

73. Report, *supra* note 22, at 467 (emphasis added).

74. The nondebtor can, of course, argue that she has satisfied the requirements of section 503 for an administrative priority claim.

75. *See In re* Computer Communications, Inc., 824 F.2d 725 (9th Cir. 1987); *In re* Whitcomb & Keller Mortgage Co., 715 F.2d 375 (7th Cir. 1983); *In re* Feyline Presents, 81 B.R. 623 (Bankr. D. Colo. 1988). *See generally*, Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197 (1985).

76. *See generally* Note, *Section 365 Versus Section 362: Applying the Automatic Stay to Prevent Unilateral Contract Termination in a Bankruptcy Setting*, 61 FORDHAM L. REV. 935

section 365(d) recognizes a right—in at least certain lessors—for postpetition rental payments.

The Review Commission properly recognizes a need for the Bankruptcy Code to address more directly the obligations and rights of the nondebtor party to a section 365 transaction during the course of the case.[77] The estate's right to assume (or elect to perform) would be meaningless if the other party to the lease or contract could not be ordered to continue its performance after the bankruptcy filing. However, the other party should be able to stop its performance unless its right to compensation for such postpetition performance is recognized.[78]

Review Commission recommendation 2.4.3 authorizes the court to order postpetition performance and to provide "*protection* of the interests of the nondebtor party" during the gap. Although the recommendation uses the word "protection," the Report explains that protection will take the form of a priority claim for compensation measured by contract damages law. The following footnote from the Report is helpful to understanding both the Review Commission's recommendation 2.4.3 and the National Bankruptcy Conference's recommendation paragraph f:

> Although the official recommendation of the National Bankruptcy Conference is different than (sic) the Commission's, the NBC's report contains the following discussion that is consistent with the Commission's recommendation: "An order for temporary performance should also be conditioned on terms which will avoid inequity to the nondebtor. For example, it may be unfair to expect the nondebtor to purchase costly equipment under the contract when the trustee only intends to continue the performance of the contract for a fraction of its full term. If the contract provides for a lump sum payment at the end of the term, an allocation of compensation will have to be made to cover the stated time period on a basis that will equate to a contract rate. These and like problems may direct the trustee to make additional payments, or to reduce the goods

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(1993).

77. An advertisement for a $22.50, 37 page pamphlet entitled, *Rights Under Executory Contracts Prior to Assumption or Rejection*, states: "Executory contracts prior to assumption or rejection is the most complex topic in Chapter 11 cases. Because of this, the topic has been left virtually uncovered—until now." This advertisement appears on the last page of Bankruptcy Court Decisions, Weekly News & Comment, February 3, 1998.

78. *But see* Neil P. Olack, *Executory Contracts and Unexpired Leases: Right to Adequate Protection Prior to Assumption or Rejection*, 4 BANKR. DEV. J. 421 (1987).

> or services to be delivered by the nondebtor or vary the times when they need to be tendered. Such protection of the nondebtor, whatever it may be called, will be analogous to adequate protection under section 361. If no satisfactory arrangement can be devised to properly compensate the nondebtor for being forced into a temporary contract, then the court should not allow it."[79]

We urge Congressional consideration of this recommendation and explanation.[80]

E. Which Section 365 Transactions Should Be Treated Differently from Other Section 365 Transactions?

To date, Congress seems to have avoided any reconsideration of the larger conceptual issues of section 365 by enacting special interest legislation. When the Bankruptcy Code was amended in 1984, 1986, 1988, 1990, 1992, and 1994, section 365 was amended.

Section 365 now contains different rules for different kinds of leases:

> (i) a provision of section 365 applies only to leases of real property in which the debtor is the lessor;[81]

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79. Report, *supra* note 22, at 471 n.1139.

80. A Department of Justice Working Group made a similar recommendation to the Review Commission. *See The Report of the Department of Justice Working Group, in* PRACTICING LAW INSTITUTE, 19TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION, 752 PLI/COMM 11 (April 1997).

> The Commercial Law League of America, however, opposes the proposal because: [I]t may increase litigation surrounding section 365 by giving a significant incentive for all non-debtor parties to file motions to obtain temporary orders, because all non-debtor parties will want to have the ability to recover the damages specified in Proposal 3 (i.e., 'losses reasonably and unavoidably sustained.') Further, the CLLA is concerned that the proposal authorizing the filing of motions seeking temporary performance could be construed to permit debtors to obtain temporary performance orders as a way to modify provisions of their current contracts with a non-debtor party. Further, the reference in Proposal 3 to losses reasonably and unavoidably sustained may be interpreted too broadly to give a non-debtor party a windfall at the expense of other creditors, by recovering losses sustained pursuant to a contract that is burdensome to the non-debtor party. Accordingly, for the above reasons and because current law already permits the allowance of administrative claims for actual, necessary costs and expenses of preserving the estate, the Commercial Law League opposes the recommendation.

See Russell H. Rapoport & Alan R. Gordon, *Recommendations and Comments on Section 365*, 102 COM. L.J. 176, 179-80 (1997).

81. *See* Bankruptcy Code § 365(h).

(ii) other provisions apply to leases of nonresidential real property;[82]

(iii) still other provisions apply to leases of nonresidential real property that are shopping center leases;[83]

(iv) some provisions apply to leases of residential property;[84]

(v) some provisions apply to leases of personal property, other than personal property leased to an individual for personal, family or household purposes;[85] and

(vi) there are provisions that apply to a "lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or an aircraft gate."[86]

Section 365 also creates special rules for various kinds of contracts such as time share plans[87] and licenses of intellectual property.[88] And, still other leases and contracts are treated by other sections of the Bankruptcy Code such as section 1110 which deals in part with leases of aircraft, equipment, or vessels or section 1168 which deals in part with leases of rolling stock leases and section 559 on repurchase agreements or section 560 dealing with swap agreements or section 1113 for collective bargaining agreements.

These special provisions for certain transactions have generated numerous practice questions such as whether a transaction comes within one of the special provisions. Consider, for example, the special provisions for shopping centers. Since the Bankruptcy Code presently provides greater protection for the lessor of a shopping center than for other lessors, debtors regularly argue that the building or buildings in which it is leasing space is not a shopping center.[89]

Debtors also make "expresio unius"[90] arguments with respect to transactions that do not come within a special provision.[91] Since the Bankruptcy Code expressly provides that a lessor of real

82. *See, e.g., id.* § 365(d)(3), (d)(4).
83. *See id.* § 365(b)(3), (h)(1)(C).
84. *See id.* § 365(d)(1), (d)(2).
85. *See id.* § 365(d)(10).
86. Bankruptcy Code § 365(c)(4), (f)(1).
87. *See id.* § 365(h)(2).
88. *See id.* § 365(n).
89. *Cf.* 1 DAVID G. EPSTEIN, ET AL., BANKRUPTCY, §§ 5-20 (1992).
90. *Cf. In re* Rubin, 154 B.R. 897, 901 (Bankr. D. Md. 1992).
91. *Cf. In re* Martin Paint Stores, 199 B.R. 258 (Bankr. S.D.N.Y. 1996).

property who rejects its lease cannot take the property back from the lessee but has no corresponding provision for rejection by lessors of personal property, it can be argued that a lessor of equipment who rejects its lease in bankruptcy can take the property back from the lessee.[92]

The Review Commission acknowledges that enactment of its recommendations without elimination of these various special provisions "may create new difficulties both for the special cases and for the general cases."[93] The Review Commission does not otherwise address the question of which, if any, section 365 transactions should be treated differently from other section 365 transactions.[94] If Congress decides to address the larger conceptual interests inherent in section 365, it should address this question.

V. Conclusion

Congress has not reviewed "the larger conceptual issues inherent in" bankruptcy treatment of leases and executory contracts since the 1930s. We respectfully submit that the Review Commission did not undertake such a review.[95]

A review of the "larger conceptual issues inherent in section 365" was not a part of the Review Commission's mandate. The

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92. Professor Kenneth Klee has made a different argument for treating rejection of real estate leases different from rejection of personal property leases: "I think that there was extensive testimony during the hearings. I particularly remember testimony by Peter Coogan about the lessee's interest in real property being unique from personalty because he had privity of estate as well as privity of contract." Williamsburg Conference, *supra* note 15, at 65.

93. Report, *supra* note 22, at 476; *see also id.* at 463 ("this Proposal might be criticized as being inadequately remedial since it stops short of dismantling the special interest provisions presently in section 365").

94. The National Bankruptcy Conference recommends the elimination of the special provisions relating to shopping centers, aircraft, vessel, and rolling stock leases as "not in the interest of reorganization" and "affecting the debtor's ability to reorganize." NBC, at 143-44 (1997). Any Bankruptcy Code provision that affords protection to the nondebtor party to leases is "not in the interest of reorganization" and is "affecting the debtor's ability to reorganize." We respectfully suggest that any congressional comparison include not only the needs of the debtor and the nondebtor party in this type of transaction but also the needs of the debtor and nondebtor party in this type of transaction as contrasted with the needs of the debtor and nondebtor party in other section 365 transactions.

95. *Cf.* John D. Ayer, *Not Dead on the Gurney*, NORTON BANKR. L. ADVISER (WEST), Oct. 1997, at 1, 3 ("In defense of themselves, there is plenty that the commissioners can say. They didn't have the staff, the support or the hospitable environment of the 1973 commission. And indeed, they never had a mandate for comprehensive reform.").

Congressional Record section-by-section description of the 1994 legislation establishing the Review Commission states:

> [T]he Commission should be aware that Congress is generally satisfied with the basic framework established in the current Bankruptcy Code. Therefore, the work of the Commission should be based upon reviewing, improving, and updating the Code in ways which do not disturb the fundamental tenets of and *balance* of current law.[96]

The "larger conceptual issues inherent in section 365" that the Review Commission did not review are, in essence, questions of "balance." As Judge Robert Jones observed, "[t]he purpose behind section 365 is to balance the state law contract right of the creditor to receive the benefit of his bargain with the federal law equitable right of the debtor to have an opportunity to reorganize."[97] We believe that, with few exceptions, the bankruptcy courts have properly balanced these competing "rights" or policies.

The Review Commission was well-served by the advice of Gerald K. Smith, prominent Phoenix bankruptcy lawyer and Deputy Director of the Commission, on Bankruptcy Laws in the United States in 1972-73, on leases and executory contracts: "Major policy issues were resolved long ago as to the mechanics of assumption and rejection. Section 365 of the Code and the cases dealing therewith are generally satisfactory."[98]

In turn, Congress was well-served by work of the Review Commission on leases and executory contracts and by the work of the National Bankruptcy Conference. Bankruptcy legislation[99] that adopts the section 365 recommendations of the Review Commission as restated in the revised draft of section 365 prepared by the National Bankruptcy Conference would be "improving and updating the Code in ways which do not disturb the fundamental tenets of and balance of current law."

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96. 140 CONG. REC. H10,752-01 (daily ed. October 4, 1994) (emphasis added).

97. Coleman Oil Co. v. Circle K Corp., 190 B.R. 370, 376 (B.A.P. 9th Cir. 1996), *aff'd*, 127 F.3d 904 (9th Cir. 1997).

98. Gerald K. Smith, *Executory Contracts*, in NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 1995-96 721, 722 (1996). This article was one of a series, solicited by Judge Norton from members of the American College of Bankruptcy, as advice to the National Bankruptcy Review Commission on needed changes in the bankruptcy law. *See Norton Annual Survey of Bankruptcy Law* 1995-96, *supra*, at ix.

99. *Cf.* Ayer, *supra* note 97, at 3. "Grant Gilmore pointed out years ago that bankruptcy reform comes in 40-year cycles (1898, 1938, 1978). On this schedule, we aren't due for legislation until 2018." *Id.*