



AMERICAN
BANKRUPTCY
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2018 Annual Spring Meeting

Demystification of Executory Contracts in Bankruptcy

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CONCURRENT SESSION

2018

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Citation:

Jay Lawrence Westbrook; Kelsi Stayart White, The
Demystification of Contracts in Bankruptcy, 91 Am.
Bankr. L.J. 481 (2017)

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Tue Feb 27 13:41:45 2018

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The Demystification of Contracts in Bankruptcy

by

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ABSTRACT

A company's ability to retain favorable contracts while escaping unprofitable ones is central to a successful reorganization in Chapter 11 cases. Yet a strange and elusive doctrine often leads the courts to impose unpredictable and perverse results in contract cases. The doctrine requires that a contract have a quality of "executoriness," or it must leave the precincts of the Bankruptcy Code for an anarchic limbo where the courts fashion surprising and often unexplained relief. The American Bankruptcy Institute Review Commission ignored the unanimous recommendation of its committee of contract experts, preferring to retain this outdated doctrine with an explanation as unclear as many of the cases attempting to apply it. Based on a reading of all contemporary executoriness cases, this article examines executoriness in each of the major categories of contracts where it imposes confusion and loss in reorganization practice and demonstrates the correct solutions to each. It does so by tying them to the fundamental economic and social policies underlying bankruptcy law.

I. INTRODUCTION

The "executoriness" of a contract is a strange idea that plays an important role in bankruptcy reorganizations, not unlike the role truthiness plays in a Stephen Colbert anecdote.¹ It sounds attractive but produces ugly results, apparently clarifying while actually obfuscating. It cannot easily be analyzed because no one knows what it is. The justly famous name of a bankruptcy law giant, Professor Vern Countryman of Harvard, has too long protected it from a well-deserved demise, after becoming a monster that its creator, were

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**Class of 2015, The University of Texas School of Law. I am thankful to Professor Westbrook for introducing me to the fascinating world of bankruptcy law and for the opportunity to write this article with him.

¹See Ben Zimmer, *Truthiness*, N.Y. MAG., Oct 13, 2010, at MM22 (discussing the episode in which Stephen Colbert coined "truthiness").

he alive today, would not recognize.² It is especially troublesome applied to modern contracts like options, intellectual property licenses, and LLC operating agreements.

Recently, an inexplicable endorsement of the concept by the ABI Commission³ threatens to extend its baroque confusion to the next generation of troubled companies and their creditors. We propose an end to zombie contracts and the obsolete notions that keep them upright by abolishing the “material breach” rule that embodies executoriness as a prerequisite to application of section 365 of the Bankruptcy Code. Our goal is to offer the definitive discussion of executoriness and lay it to rest. We are greatly encouraged by the fact that the Bankruptcy Appellate Panel of the First Circuit has recently joined the Seventh Circuit in hastening its abolition.⁴

The American Bankruptcy Institute appointed the Commission to Study the Reform of Chapter 11 in 2012. Its recent report has helpfully stirred debate on many important aspects of the United States Bankruptcy Code (the “Code”), including the proper application of section 365 of the Code, which governs contracts in bankruptcy.⁵ That provision permits a trustee in bankruptcy to assume or breach the debtor’s pre-petition contracts. The material breach test, a traditional case law test, has defined a quality of “executoriness” in a contract that must be found before permitting application of section 365. That limitation on section 365’s application creates results that are both unfair and inefficient.

The Commission endorsed retaining the executoriness requirement and the material breach test as a gateway to section 365. It thereby rejected virtually every serious academic and professional recommendation made on the subject for the last thirty-five years.⁶ Those recommendations were al-

²See *infra* note 11. Professor Countryman defined an executory contract as one in which both sides still owe obligations under the contract such that failure to perform those obligations constituted a material breach and relieved the other party of its performance.

³FINAL RECOMMENDATION AND REPORT, AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11 REPORT at 2 (2014) (the “Commission Report”). The twenty-three members of the Commission were all distinguished experts in bankruptcy practice (although not all were lawyers), but just one academic. Thus its focus could have been expected to be quite practical and realistic. The members included no judges and only one former judge. See *Commission Members*, AMERICAN BANKRUPTCY INSTITUTE, <http://commission.abi.org/commission-members> (last visited Apr. 26, 2017).

⁴*In re Tempnology LLC*, 559 B.R. 809 (B.A.P. 1st Cir. 2016). The case is discussed *infra* note 238-46.

⁵Commission Report, *supra* note 3, at 2. While the report focuses on Chapter 11 of the Code, with regard to contracts any reform would almost certainly be applied to liquidations under Chapter 7 as well.

⁶See, e.g., ADVISORY COMMITTEE ON EXECUTORY CONTRACTS AND LEASES, ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11: EXECUTIVE SUMMARY REGARDING SECTION 365 ISSUES (hereinafter “ABI Advisory Committee”) (“The Advisory Committee recommends eliminating the term “executory” in favor of adopting the Functional Test which allows the trustee or debtor in possession . . . to keep beneficial contracts and reject burdensome ones based solely upon benefit/harm to the estate.”) (copy on file with the author); NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY483

most unanimous in rejecting the material breach test to determine executory-ness. The Commission not only refused to recommend eliminating the concept, but also proposed that it be codified for the first time.⁷ That puzzling decision and our proposed way forward are the subjects of this article.

From Twinkies⁸ to airplanes⁹ to adult night clubs,¹⁰ the central importance of contracts to the wealth of a modern business make section 365 an important center of bankruptcy policy.¹¹ In reorganization, the capacity to retain profitable contracts and restructure unprofitable ones may be essential to a company's survival. Section 365 is especially powerful in its effect on commercial relationships because it may compel a counterparty to remain yoked to a reorganized debtor against its will. Moreover, the difference between an assumed and a rejected contract may be the difference between full payment to a creditor and a claim worth only pennies on the dollar.

Section 365 has long exerted an intellectual fascination, because it seems to permit a sort of legal legerdemain. In an earlier article, *Functional Analysis of Executory Contracts* ["FA"],¹² one of us described bankruptcy as "that volume of the law that might have been written by Lewis Carroll, every conventional legal principle refracted through the prism of insolvency" and section 365 as the chapter of that volume that is the most "psychedelic."¹³ Where else, for example, can breaching contracts not only be a legal duty but

TWENTY YEARS, Recommendation 2.4.4 (1997) ("contracts subject to Section 365; Eliminating the 'Executory' Requirement").

⁷Commission Report, *supra* note 3, at 112.

⁸*See In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014) discussed *infra* note 135 and accompanying text.

⁹*In re Hawker Beechcraft, Inc.*, 486 B.R. 264 (Bankr. S.D.N.Y. 2013).

¹⁰*In re S.A. Holdings, Inc.*, 357 B.R. 51 (Bankr. D.N.J. 2006).

¹¹*See, e.g., Ken Ayotte, Leases and Executory Contracts in Chapter 11*, 12 J. EMPIRICAL LEGAL STUD. 637, 659 (2015) (empirical study of effect on reorganizations of changes in section 365). While this article will touch on important section 365 problems involving natural persons, that section has most of its effect in business rather than consumer cases and that will be our focus as well. Additionally, we will focus on executory contracts, specifically, rather than leases, which also fall under the purview of section 365. This emphasis arises from the way the material breach test has been used in the case law and Professor Countryman's own development of the test. *See Vern Countryman, Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 439 (1973) (explaining that his material breach test focuses on executory contracts, rather than leases). Professor Countryman used cases on leases only when it was helpful to explain how the material breach test worked for other executory contracts. *See id.*

¹²Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 228 (1989). In that article, Westbrook proposed abolition of the "Countryman rule." As a relatively new scholar, he awaited with some trepidation the reaction of the best-known scholar in the field, Professor Countryman. A few weeks later he received a copy of a letter from Countryman to the dean of the Harvard Law School urging him to invite Westbrook to visit at Harvard, as he subsequently did. What a mark of the perfect scholar, reacting in that way to a critique of the scholar's best-known work. And he was as fine a man as he was a scholar.

¹³*Id.*

highly profitable too, while rights to specific performance and other equitable remedies are often lost in the dark pool of insolvency?

One point that gives section 365 much of its apparent magic is the requirement that a contract pass a threshold test of “executoriness” before it is subject to section 365. We attempt, as *FA*¹⁴ did before, to strip from section 365 the sorcery that executoriness creates. In its stead, we propose a simple, virtually fool-proof approach to the analysis of contracts subject to the powerful tool kit of section 365, based upon that section’s statutory language¹⁵ and its policy underpinnings.¹⁶

The term “executory contract” is best understood in its ordinary common law sense—a contract in which at least some of the obligations are not yet performed¹⁷—rather than as a special limitation on the application of section 365 to contracts in bankruptcy. Professor Countryman’s limiting definition

¹⁴*Id.* at 230–31.

¹⁵“Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. § 365(a) (2012).

¹⁶We have abandoned the term “Functional Analysis” that appeared in the earlier article, because it led courts to assume that Functional Analysis meant that benefit to the estate was somehow the key to a finding the contract was executory. We now prefer the term “Modern Contract Analysis.” Functional Analysis was not an approach to determining executoriness, but a proposal to abandon executoriness all together as a threshold test. Now as before, the approach we suggest does not propose to use “benefit to the estate” to determine if a contract is “executory” and therefore subject to section 365. We think all contracts are subject to section 365, just as the Bankruptcy Code says. Thus, our approach does not exclude contracts from section 365 based on a threshold inquiry into “executoriness,” but rather brings all contracts within its scope. We stress this because the “Functional Approach” employed by some courts has been used to *determine executoriness*, as a replacement for the material breach test. *See, e.g., In re Jolly*, 574 F.2d 349 (6th Cir. 1978); *In re Bayou Shores SNF, LLC*, 525 B.R. 160, 168 (Bankr. M.D. Fla. 2014) (using the “functional approach” to answer the question of “executoriness”); *In re Seven Counties Services, Inc.*, 511 B.R. 431, 478 (Bankr. W.D. Ky. 2014) (using *Jolly* as a rough guide to the Functional Approach and focusing on whether or not the contract benefits the debtor to determine “executoriness”), *aff’d in part, rev’d in part*, 550 B.R. 741 (W.D. Ky. 2016); *In re Curtis*, 500 B.R. 122, 126 (Bankr. N.D. Ala. 2013) (applying the “FA” to determine whether or not a land installment contract was a secured transaction or an executory contract based on which characterization was most beneficial to the estate); *In re Soderstrom*, 484 B.R. 874, 880 (M.D. Fla. 2013) (using the “functional approach” to determine threshold “executoriness”); *Route 21 Associates of Belleville Inc. v. MCH Inc.*, 486 B.R. 75 (S.D.N.Y. 2012) (same), *aff’d*, *Route 21 Associates of Belleville, LLC v. Millennium Custodial Trust*, 542 F. App’x 41 (2d Cir 2013); *In re RoomStore, Inc.*, 473 B.R. 107, 113 (Bankr. E.D. Va. 2012) (same). This is not the approach we recommend here. We did locate one case using an approach similar to the one we offer in this article. *See First Sec. Bank of Utah, N.A. v. Gillman*, 158 B.R. 498, 503–04 (D. Utah 1993) (recognizing that all contracts must be either rejected or assumed and there can be no such thing as a non-executory contract). *See also In re Ortiz*, 400 B.R. 755 (C.D. Cal. 2009); *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012).

¹⁷SAMUEL WILLISTON & RICHARD A. LORD, WILLISTON ON CONTRACTS § 1:19 (4th ed. 2015). Williston remarks that any contract that has been fully executed on both sides is not even a contract at all. That proposition leaves everything else under the label “executory.” This is the understanding we advocate conceptually: if every obligation has not been already performed, the contract can be dealt with by section 365. We understand the concern that might arise about the possible negative practical consequences of applying section 365 to contracts in which only the debtor owes a duty to pay money, but we

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY485

served an essential purpose during a time when some check was needed on the exercise of section 365 powers by the trustee in bankruptcy.¹⁸ Now that the Code requires court approval of the trustee's decisions under section 365, the limitation imposed by the material breach test only frustrates many of the Code's underlying policies, including the fresh start policy.¹⁹ In this article, we hope to show that common sense can clear away the smoke and mirrors of the case law analyzing section 365.

A closely related aspect of bankruptcy contracts that lends apparent magic to section 365 is that the conclusion about whether to assume or reject any executory contract differs depending on the debtor's position in that contract. For example, there could be two identical contracts for the sale of goods: in one, the debtor is the seller, and in the other, the debtor is the buyer. Our approach would likely recommend different outcomes for each contract. This asymmetrical result does not flow from any analysis of executoriness, but instead is a practical consequence of the powers granted by section 365.²⁰ The debtor as seller can pay off rejected contracts in devalued Bankruptcy Dollars ("BD\$"), if it breaches a contract to sell goods; yet the debtor as a buyer can force counterparties to perform fully by supplying goods at the original contract price through assumption of the contract.²¹ This asymmetric quality exacerbates the confusion created by executoriness.

We present later a detailed analysis of the major cases to demonstrate the efficacy of our Modern Contract Analysis, but our fundamental conclusions are these:

Because bankruptcy necessarily accelerates all claims,²² the effect of section 365 is to divide all the debtor's contracts into partial-payment claims for breach (after rejection) or

stress there is no conceptual difficulty with doing so. It is almost never a problem, so we are happy to say it is not necessary to treat such situations as executory contracts. *See infra* Part V.C.1.

¹⁸In a Chapter 11 reorganization, most of the powers and duties of a trustee are in the hands of the debtor in possession (DIP). 11 U.S.C. § 1107 (2012). We will sometimes refer to the "trustee," as we do here, but more often to the DIP, because reorganization was the central focus of the Commission. We will, however, discuss Chapter 7 and 13 cases involving executory contracts as well as those under Chapter 11.

¹⁹*See infra* Part VI.B.1.

²⁰*See* FA, *supra* note 12, at 263–70.

²¹*Id.*

²²*See infra* Part VI.B.2. Bankruptcy also assembles absolutely all of the debtor's assets—contingent or remote—with the broadest possible definition under section 541. *See* Chao v. Hosp. Staffing Serv. Inc., 270 F.3d 374, 382 (6th Cir. 2001), cited in *In re Robinson*, 764 F.3d 554, 559 (6th Cir. 2014) *cert. denied sub nom. Robinson v. United States*, 135 S.Ct. 2372 (2015). *See also In re Cuyahoga Equipment Corp.*, 980 F.2d 110, 117 (2d Cir. 1992) ("the strong bankruptcy code policy . . . favors centralized and efficient administration of all claims in the bankruptcy court . . ."). We discuss assembly of claims in the text because it is a more complex subject, but the reach of bankruptcy is and must be equally broad as to assets. *See infra* Part VI.B.2.

full-payment claims for performance (after assumption).²³ The purpose of section 365 is to enable the trustee in bankruptcy to maximize the estate by choosing between those results for each contract, subject to the stated statutory constraints²⁴ and to court approval.²⁵

Because section 365 imposes burdens on counterparties, courts are constantly tempted to find a method to protect the counterparty despite the statute. Occasionally, they also wield executoryness to help a trustee in bankruptcy or debtor-in-possession avoid an inequitable result.²⁶ That flexibility may be what the Commission wanted. A determination that a contract is not executory (lacks “executoryness”) means it can neither be assumed nor rejected (performed or breached), leaving it in legal limbo outside of section 365’s command. That eerie state is a convenient place where a difficulty can be fixed with little constraint from rules.²⁷ Yet in every case the device is illegitimate, even where the result is right.²⁸

The concern about counterparties is understandable. The differences in result between state-law outcomes and the application of section 365 often highlight detriments to counterparties in bankruptcy. The balance of fairness between debtor and counterparty under state law is undone by the equality principle, leaving the counterparty to share the pain with everyone else.²⁹

The debate about reforming section 365 in this regard could refocus. It could address whether to include in section 365 a measure of discretion so the court can avoid what it perceives as a seriously inequitable outcome, while discarding the wild card of executoryness. The added discretion would be one way to satisfy the apparent desire for a safety valve. It may well be

²³A reorganization must also cover future and contingent claims to the maximum extent possible. See *infra* Part VI.B.2.

²⁴See *infra* Part II. According to Professor Countryman, the equivalent section has always been “Executory Contracts” since its first adoption in the 1930s in section 77 and was just common law before that. See Countryman, *supra* note 11, at 440–49.

²⁵It is no accident that the first subsection of section 365 authorizes this very choice, with no qualification or exception. Specific exceptions are set forth in the following subsections.

²⁶See *infra* notes 107–08 and 118–19 and accompanying text.

²⁷It would appear this wild-card function was the decisive argument for the ABI Commission: “[The Commissioners] also perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case.” Commission Report, *supra* note 3, at 114–15.

²⁸Of course, we do not suggest obfuscation, but only that a venerable doctrine that seems to solve the problem may nonetheless misdirect judicial analysis from a difficult underlying question—often one of state law. See *infra* Part VI.C.

²⁹Assumption also requires the counterparty to perform for the benefit of the DIP despite a frequent and understandable desire to stop doing business with a bankrupt, because that counterparty detriment is inherent in the idea of permitting assumption in order to maximize estate value. Protection of the counterparty rests on administrative priority and the cure of any defaults. 11 U.S.C. §§ 365(b), 507(a)(2) (2012).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY487

that the Commission unconsciously chose codification of the current ambiguous and unprincipled doctrine in order to retain the covert discretion the doctrine disguises. If so, it did that at the sacrifice of logic and, more importantly, predictable commercial results. Worse still, it recommended codification of confusion while claiming, “[t]he contours of this definition are well developed under the case law and reflect an appropriate balance between the rights of a trustee to assume or reject contracts unilaterally under the Bankruptcy Code and the non-debtor’s obligations and rights in those circumstances.”³⁰ We will examine that claim rigorously.

The next section provides a summary analysis by way of further introduction. Part III covers the background of the executoriness issue, and part IV addresses the Commission Report with its puzzling recommendation. Part V goes through a few key examples of the existing difficulties with the executoriness approach. Part VI sets forth the policy framework for section 365(a) and the key steps in a coherent analysis. Part VII works through exemplary cases that illustrate the principle problems that are currently proving intractable under the traditional test. Part VII concludes with a prayer for clarity. An appendix provides a summary analysis of key decisions based on a reading of ALL of the executoriness cases that have been decided since 1989, when *FA* was published.

II. SUMMARY ANALYSIS

In this section, we will offer a brief summary of the analytical process we suggest for any case involving a difficult contract issue under section 365. Subsequent sections will go through the background, theory, and key cases in detail. But we start with the fundamentals.

The foundational principle is easily formulated: Subject to the stated constraints of section 365, any contract that can be breached can be assumed or rejected. And must be.³¹

In section 365, as in most parts of the Code dealing with property of the estate,³² analysis must start with the state law³³ that governs the creation, interpretation, and enforcement of the contract. Many of the really difficult contract issues in bankruptcy are state-law contract conundrums, often

³⁰Commission Report, *supra* note 3, at 112.

³¹In this article, we fudge a bit as to contracts with performance on one side only. See *infra* Part V.C. We do that to simplify (and placate), although the principle can be shown to work for all contracts.

³²Contracts become property of the estate under 11 U.S.C. § 541(a) (2012).

³³Technically, it must start with applicable non-bankruptcy law, which can include other federal law, but in almost all the cases that means state law. See *Butner v. United States*, 440 U.S. 48 (1979). In an appropriate case, applicable non-bankruptcy law might be a foreign law, although not necessarily the law chosen by the parties because bankruptcy implicates nonparty rights. See, e.g., Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457 (1991).

masked by elaborate discussions of executoriness.³⁴ The first step is to answer two key questions as they would arise *outside of bankruptcy*:

- What would be the net benefit to the estate, if any, from full performance of the contract by both parties?
- What relief could the counterparty to the contract get in case of the debtor's breach of contract?

Only after those state-law issues are resolved can federal law and policy be appropriately applied.

The four federal policies that then come into play are:

1. With specified exceptions, the debtor must receive an all-embracing discharge from pre-bankruptcy claims.³⁵
2. Unsecured creditors should share pro rata (*pari passu*) in the proceeds of the estate.³⁶
3. The value of the bankruptcy estate must be maximized.³⁷
4. All claims, including all contract claims, must be fully resolved by the bankruptcy.

In the exceptional case, other federal policies, in bankruptcy law or elsewhere in federal law, might come into play, but these four are the ones present in every case that is found in a bankruptcy tome under the rubric "executory contracts."

The synthesis of these and other federal policies with the state law of contracts creates a second level of difficulty and confusion. One example is a contract containing contingent obligations under state law. The trustee or the court must determine the value of the contingency either to approve a decision to assume the contract or to estimate the claim for breach (rejection).³⁸ To do so, the relevant state law construing the nature and effect of the contingency must be determined. The state law on that point may be scarce or nonexistent because the issue rarely arises outside of bankruptcy. So, the bankruptcy court may have to wear the mantle of a creative state judge to discover the content of the contingency. That task cannot be

³⁴See, e.g., *In re Knowles*, No. 6:11-BK-11717-KSJ, 2013 WL 152434, at *1-3 (Bankr. M.D. Fla. Jan. 15, 2013) (discussing only the executoriness of LLC agreement when the key question is effect of breach under applicable state law).

³⁵Note that the discharge is equally important to reorganized companies as it is to natural persons, because it gives lenders and suppliers confidence that all of a company's obligations are completely accounted for in its plan of reorganization, with no post-bankruptcy surprises. Much of the controversy about the liability of the new General Motors for the safety defects of the old General Motors turns on this point. See *infra* note 172; see, e.g., Hillary Stout & Danielle Ivory, *Bankruptcy Judge's Ruling Shields G.M. From Ignition Suits*, N.Y. TIMES, Apr. 16, 2015, at B1.

³⁶The technical statement is that creditors of each legal class should share pro rata, but that point can be ignored here for ease of exposition.

³⁷See *infra* Part V.B.1.

³⁸One example is a warranty for goods purchased by the debtor pre-bankruptcy where part of the purchase price was not paid before bankruptcy was filed. See *infra* Part V.C.1.a.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY489

avoided, because it is required by the federal policy of defining “claim” very broadly³⁹ to ensure resolution of all pre-bankruptcy claims in the bankruptcy.⁴⁰

As a guide to what follows, we offer a short summary of the necessary steps in resolving the choice between assumption and rejection of a pre-bankruptcy contract:⁴¹

1. Under state contract law, determine if the contract contains some obligations that remain to be performed⁴² and therefore is executory under the common law definition. If not, it is not a contract at all, just a bit of historical residue.
2. If there is nothing remaining under the contract except obligations owed by the debtor, almost always this is what we think of as a “mere claim” against the estate—that is, the only performance obligation left is the estate’s payment of money in Bankruptcy Dollars (BD\$), typically worth only a fraction of full U.S. dollars.⁴³ These “mere claims” do not require treatment under section 365 because there is nothing left to do except payment and discharge through the bankruptcy process, so here section 502 is the relevant provision.⁴⁴
3. If some obligations remain other than those described in number two, will the net benefit to the estate from performance by both parties (assumption) exceed the net benefit from the estate’s breach of the contract and payment of the breach (rejection) claim in fractional amounts (BD\$)?⁴⁵
4. The trustee should choose and the court should approve the course

³⁹11 U.S.C. § 101(4) (2012) (definition of “claim”).

⁴⁰The policy of resolving all claims is closely related to discharge and *pari passu* distribution to creditors. See *infra* Part VI.B.2.

⁴¹See *infra* Part VI for a full discussion of these concepts.

⁴²The legislative history of the 1978 Code does not require material obligations on both sides of the bargain. It does describe contracts subject to section 365 as those “on which performance remains due to some extent on both sides.” H.R. REP. NO. 95-595, at 347 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6303-04.

⁴³See *infra* Part VI.C.1.

⁴⁴These “mere claims” against the estate that should be treated with section 502 rather than section 365 appear in the case law usually in a discussion that these contracts that are “non-executory.” See *In re Curry*, 526 B.R. 276 (Bankr. C.D. Ill. 2015) (a student loan); *In re Wagoner*, 225 B.R. 603 (Bankr. D.S.C. 1997) (contract for purchase of rights to a sales territory). It would be equally plausible as a logical matter to say that these debtor-only contracts are executory but almost always should be rejected. There would be no negative effect except where a trustee assumes a contract that gives the estate no benefit and results in the counterparty getting paid as an administrative expense. That is a bad practical result but is not problematic for our analysis. Similarly, a trustee trying to “reject” a debtor-only contract would change nothing under section 502 because the effect of rejection would simply be breach and payment in BD\$, which is what will happen even if the contract is not treated under section 365 but is instead treated under section 502. But we know that lawyers worry about inadvertent assumption, see *infra* note 184, and are willing to state the principle in paragraph 2 above as a concession to that concern.

⁴⁵Once more, we emphasize that this finding of net benefit has nothing to do with finding the contract

of action producing net benefit to the estate, unless some other specific provision in section 365 requires a different conclusion.⁴⁶

There are some wrinkles and twists in certain cases. For example, if state law will permit the counterparty to obtain specific performance, one of two questions is usually raised:

- Did the contract in effect transfer to the counterparty a property right that must be recognized in bankruptcy, unless the property right is subject to the avoiding powers?⁴⁷
- Does state law give the other party the sort of equitable rights that cannot be satisfied by payment, and therefore do not fit the definition of “claim,” and must be enforced (e.g., possible nondischargeability of a covenant against competition)?⁴⁸

The discharge of a non-competition covenant illustrates the role of federal bankruptcy policy. In this example, the policy of discharge and fresh start may or may not trump state rules requiring injunctive relief.⁴⁹ Similar questions may arise as to other strong bankruptcy policies. The key difference between our approach and the current material breach test for executory contracts is this focus on the intersection of state-law-created contract rights and federal bankruptcy policy that section 365 embodies. We take a direct path to this intersection, where the proper answers will be found, rather than detouring off into an overgrown thicket of executory contracts at the threshold.⁵⁰ While

to be executory, but rather is simply the exercise of the trustee's judgment about values. See *infra* Part VI.B–C.

⁴⁶An example of an exception is the set of problems under the anti-assumption provision of section 365(c)(1). They present different issues from those discussed here. They are more matters of policy than legal conundrums.

⁴⁷11 U.S.C. §§ 544–551 (2012). An example of a case where a property right was involved and only a fraudulent conveyance action should have been able to terminate the non-debtor party's rights is *Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985), a much discussed case. See FA, *supra* note 12, at 305–15. Another example is *In re Laudenslager*, No. 3:12-bk-2186-PMG, 2014 WL 6544285 (Bankr. M.D. Fla. 2014), in which the court held that the rejection of an executory contract for the sale of residential real estate resulted solely in a damages claim without looking to see if state law considered that contract as creating a property right for the third party. Finally, even interests in LLC agreements, a tricky area we will fully discuss later, may be considered property rights at state law that cannot be eliminated except through the use of an avoiding power. See *In re IT Grp., Inc.*, 302 B.R. 483, 489 (D. Del. 2003).

⁴⁸An example of such a case is *In re Spooner*, No. 11-31525, 2012 WL 909515 (Bankr. N.D. Ohio Mar. 16, 2012), in which the court decided that rejection could not disturb the state law equitable non-monetary rights under a non-compete covenant so the contract was not executory. This was actually a question of discharge, but the court considered it a question of executory contracts—another example of executory contracts clouding the hard issues. See *infra* notes 249–51 and accompanying text.

⁴⁹See, e.g., *In re Ortiz*, 400 B.R. 755 (C.D. Cal. 2009).

⁵⁰The courts desire a more direct approach: “The present case would offer a wonderful opportunity for this Court to codify all of the thoughts on what is and what is not an executory contract and to resolve the problem once and for all, if the intellectual force and requisite time were available, but neither is at

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY491

finding answers at the end of our path can be challenging, there is a lot less underbrush to clear on your way there.

We will detail the efficacy and efficiency of our Modern Contract Analysis in parts VI and VII.

III. BACKGROUND⁵¹

Section 365 of the Bankruptcy Code governs “Executory Contracts and Unexpired Leases.”⁵² It is the only provision dealing extensively with the treatment of contracts in bankruptcy, and no other section purports to deal with the applicability of section 365 as such. The part of the section most directly relevant to this article is subsection (a):

Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.

This section has its origins in judicial doctrines of abandonment, which allowed the assignee of the debtor’s property to abandon contracts that were not profitable, including leases.⁵³ The abandonment doctrine required some affirmative act for acceptance of the contract; otherwise it was rejected. In time, the doctrine expanded, and equity receivers⁵⁴ also had the option to accept or reject contracts.⁵⁵ Problems arose regarding rejected leases because the then-existing provability⁵⁶ requirement interacted with lease rejection in an odd way, leaving counterparties to leases with “non-provable” claims. However, the happy result of this problem was that landlords persuaded Congress to fix the statute in a way that solved many problems arising from rejection of contracts and leases. In the Chandler Act revisions of 1938, Congress added section 63a to ensure that rejected contracts resulted in a provable claim by providing that rejection gives rise to a pre-petition claim for breach. It also drafted section 70b, authorizing trustees to assume or reject an executory contract, including an unexpired lease, within a certain

hand. A more direct approach to this dispute must be and will be taken.” *In re Don & Lin Trucking Co., Inc.*, 110 B.R. 562, 566 (Bankr. N.D. Ala. 1990).

⁵¹See generally WARREN, WESTBROOK, PORTER, AND POTTOW, *THE LAW OF DEBTORS AND CREDITORS* (7th ed. 2014) [hereinafter “DEBTORS AND CREDITORS”].

⁵²See *supra* note 11 regarding our focus in this article on other kinds of executory contracts besides unexpired leases.

⁵³Countryman, *supra* note 11, at 444–45.

⁵⁴Equity receiverships evolved during the late 19th and early 20th centuries and foreshadowed the development of reorganization bankruptcy. See generally COLLIER ON BANKRUPTCY ¶ 21.04 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2017).

⁵⁵Countryman, *supra* note 11, at 444.

⁵⁶The provability requirement prevented contingent or unliquidated claims from being presented and discharged in a bankruptcy proceeding. See *infra* notes 71–75 and accompanying text.

time period after which it would be deemed rejected.⁵⁷

These origins are important because they reveal that Congress intended the statutory predecessor to section 365 to ensure that counterparties holding rejected contracts, including leases, would be paid and discharged. It was trying to prevent the provability requirement from removing contract counterparties and their potential claims from the bankruptcy case. Unfortunately, the “executoriness” requirement now creates the opposite of the intended result—we are back where we started. Rather than discussing “non-provable” claims, courts are now finding that counterparties hold “non-executory” contracts that cannot be rejected, paid, and discharged.⁵⁸ Conversely, the counterparty resides in a state of limbo holding its “non-executory” contract, analogous to its predecessors holding non-provable claims from rejected leases. To see how we got back here, we have a bit more history to cover.

From its first appearance in the Chandler Act revisions up to today, the word “executory” has never been defined.⁵⁹ Over the decades, case law emerged surrounding the word “executory,” using a variety of conceptual approaches to determine “executoriness.”⁶⁰ This was common for bankruptcy law in the early and middle 20th century, which was a “thin statutory skeleton surrounded by an enormous corpus of case law.”⁶¹ Enter Professor Countryman, a towering figure in the history of American bankruptcy law, who was the pioneer in organizing and analyzing the cases on “executoriness” and many other areas of bankruptcy law in a rational, practical way.⁶²

Professor Countryman’s material breach test was a much-needed lifeline for courts struggling with executory contracts problems and was widely adopted over time.⁶³ Its premise was that a contract was executory only if

⁵⁷Countryman, *supra* note 11, at 448.

⁵⁸*See, e.g., In re Superior Air Parts, Inc.*, 486 B.R. 728, 738 (Bankr. N.D. Tex. 2012) (“when a contract is non-executory, the debtor remains bound to its obligations under that contract after the bankruptcy filing”), *aff’d sub nom*, *Lycoming Engines v. Superior Air Parts, Inc.*, No. 3:13-CV-1162-L, 2014 WL 1976757 (N.D. Tex. May 15, 2014).

⁵⁹Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding “Rejection,”* 59 U. COLO. L. REV. 845, 845 (1988).

⁶⁰The three approaches are detailed in FA, *supra* note 12, at 234–35. To briefly explain them here, the first was the traditional “property of the estate” approach, which viewed contracts like any other property of the estate and did not treat them with a special analysis. The second was the implied anticipatory repudiation theory, which analyzed bankruptcy as an anticipatory breach of the contract that assumption “cured.” The third was the “new entity” approach, which understood the estate as a new entity that was not a party to the contract and thus was free to assume or reject it.

⁶¹FA, *supra* note 12, at 234.

⁶²*See, e.g., VERN COUNTRYMAN, CASES AND MATERIALS ON DEBTOR AND CREDITOR* (1964); Vern Countryman, *The Use of State Law in Bankruptcy Cases* (pts. 1 & 2), 47 N.Y.U. L. REV. 407, 631 (1972).

⁶³There is a circuit split to some extent, with circuits diverging on whether to use material breach, FA, or both. Six circuits have explicitly adopted the material breach test: the Third, Fourth, Fifth, Eighth, Ninth and Tenth. *See In re Columbia Gas System*, 50 F.3d 33 (3d Cir. 1995); *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *Matter of Murexco Petrolinc*, 15 F.3d 60 (5th Cir. 1994); *In re Knutson*, 563

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY493

both sides still owed obligations under the contract such that the failure to perform those obligations constituted a material breach and relieved the other party of its performance.⁶⁴

This test greatly clarified the issues in three ways.⁶⁵ First, it ensured there was no assumption unless the counterparty still owed the debtor material performance; this aspect is important because it prevented the trustee from assuming contracts that were unlikely to benefit the estate at a time when court review and approval of assumption or rejection was not required.⁶⁶ Second, it forced courts to look to state law. In our view, that is where most of the answers are to be found. Last, the material breach test often indirectly identified contracts where the counterparty had a property interest that the estate could not reclaim via rejection. Because the material breach test put most courts on the same page and looking in the right direction, it created more coherent results than had existed before.

The 1978 Bankruptcy Code, which was based largely on the recommendations of the Commission on the Bankruptcy Laws of the United States,⁶⁷ was the first comprehensive reform of bankruptcy law since the Chandler Act revisions in the late 1930s.⁶⁸ The Code made changes such as merging all the reorganization chapters into Chapter 11.⁶⁹ The most important change in the 1978 Code relating to executory contracts was the adoption of a requirement of court approval of the decision by the trustee or DIP to assume or reject a contract.⁷⁰ This requirement obviated the most important benefit of the executory contract test, which was the prevention of careless or inadvertent assumptions. Now the assume or reject decision often required affirmative presentation to the court, forcing an advertence to the contract and its impact.

F.2d 916 (8th Cir. 1977); *In re Interstate Bakeries Corp.*, 751 F.3d 955 (9th Cir. 2014); *In re Baird*, 567 F.3d 1207 (10th Cir. 2009). The First and Second Circuits have not explicitly adopted either the material breach test or the Functional Approach, discussed *infra* at notes 84–85 and accompanying text. See *In re La Electronica Inc.*, 995 F.2d 320, 322 n.3 (1st Cir. 1993); *In re WorldCom, Inc.*, 343 B.R. 486, 493–94 (Bankr. S.D.N.Y. 2006) (analyzing Second Circuit case law). The Sixth and Eleventh Circuits find the material breach test somewhat helpful but lean towards applying the functional approach. See *In re Jolly*, 574 F.2d 349 (6th Cir. 1978); *In re Gen. Dev. Corp.*, 84 F.3d 1364 (11th Cir. 1996).

⁶⁴Countryman, *supra* note 11, at 457–58.

⁶⁵We briefly summarize the three reasons that the material breach test got courts on the right track that are more fully explained in FA, *supra* note 12, at 237–38.

⁶⁶The requirement for court approval was added in the Code in 1978. 11 U.S.C. § 365(a) (2012).

⁶⁷The Commission on the Bankruptcy Laws of the United States was established in 1970. It issued a report of recommendations on revisions of the bankruptcy laws to Congress in 1973. Professor Countryman was a consultant for the Commission. See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137 (1973).

⁶⁸Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 32 (1995).

⁶⁹*Id.* at 34.

⁷⁰Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 365(a), 92 Stat. 2549, 2574–75 (1978).

In another important change for our purposes, the Code eliminated the concept of "provability."⁷¹ Provability, as discussed earlier, limited which claims could be discharged in a bankruptcy proceeding to those that were not contingent or unliquidated.⁷² Among other difficulties, the provability requirement had created intractable problems in bankruptcy cases where a company had committed a mass tort.⁷³ Congress addressed this problem in section 502, making the definition of claims as broad as possible to include contingent and unliquidated claims.⁷⁴ This change reflected recognition that modern bankruptcy law required that a bankruptcy procedure "permit a complete settlement of the affairs of a bankrupt debtor, and a complete discharge and fresh start."⁷⁵

Although Congress eliminated provability's incursions on the fresh start policy in the Code, there was another enemy of that policy lurking in section 365: executoryness. The term "executory" remained undefined in the new section 365. The legislative history's only reference to the meaning of the word "executory" in the section was to say "though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides."⁷⁶ While this language appears to borrow from the material breach test, it falls short of explicitly adopting the test and does not even mention the necessity of "material" obligations, despite the fact that Professor Countryman was a consultant to the Commission and no doubt interested in this point.⁷⁷

Nonetheless, courts continued to expand the application of the material breach test to more and more kinds of contracts, and as they did, troubles arose. The material breach test was not well-suited for some kinds of contracts (for example, options), and has become even more problematic for new kinds of contracts, like intellectual property licensing and LLC operating agreements. The test that had solved the problems courts faced at the time of its creation had revealed an entirely new set of problems that it was unable to solve.

Then, in the late 1980s, Professors Andrew⁷⁸ and Westbrook⁷⁹ entered

⁷¹See COLLIER ON BANKRUPTCY, *supra* note 54, at C-4d.

⁷²*Id.*; David Kauffman, *Procedures for Estimating Contingent or Unliquidated Claims in Bankruptcy*, 35 STAN. L. REV. 153, 156 (1982).

⁷³Margaret I. Lyle, *Mass Tort Claims and the Corporate Tortfeasor: Bankruptcy Reorganization and Legislative Compensation Versus the Common-Law Tort System*, 61 TEX. L. REV. 1297 (1983).

⁷⁴Kauffman, *supra* note 72, at 157-58.

⁷⁵See COLLIER ON BANKRUPTCY, *supra* note 54, at C-4d.

⁷⁶H.R. REP. NO. 95-595, at 347 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6303-04.

⁷⁷See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137 (1973).

⁷⁸Andrew, *supra* note 59.

⁷⁹See FA, *supra* note 12.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY495

the fray, trying to continue the legacy of Professor Countryman by clarifying what had become a mass of confusing precedent. Courts began using both of their approaches in conjunction with the material breach test, usually when the material breach test seemed to give the wrong result.⁸⁰

Professor Andrew's article, published shortly before Professor Westbrook's, suggested what has been called the "Exclusionary Approach."⁸¹ Andrew reasoned that the debtor's contract obligations do not automatically enter the estate (they are "excluded") and must be assumed to become a part of the estate. In his view, "rejection" is the estate's decision not to assume the debtor's contract obligations, rather than synonymous with breach of the contract. Andrew then proposed that executoryness was only relevant where a trustee sought to assume a contract, not reject it. The rationale for this distinction was that under the statute rejection gives the counterparty a prepetition claim, relegating it to the same status as any other general unsecured creditor. Andrews reasoned rejection can therefore never harm the estate.⁸² Assumption, on the other hand, can harm the estate because it elevates the counterparty's claim to an administrative expense. Thus, Andrew reasoned that the "executory" requirement is necessary to ensure assumption will actually benefit the estate. His definition of "executory" was a contract where each party has unperformed obligations, such that if the debtor failed to perform, the counterparty did not have to perform. Andrew also focused heavily on explaining that the effect of rejection was not an avoidance power, a very important point.⁸³

Professor Westbrook advanced the "Functional Approach," which attempted to return to first principles to determine the meaning of "executory" and the effect of rejection.⁸⁴ Reasoning from the fundamental policies of bankruptcy law, Professor Westbrook argued that there does not need to be a threshold inquiry into executoryness other than satisfying the common law definition of the word: a contract that remains unperformed to some extent. Under the Functional Approach, any contract with some remaining obligations needs to be assumed or rejected under section 365. The decision to assume or reject should be based on which course of action will benefit the estate. The effect of rejection is a breach of the contract, for which state law

⁸⁰See *In re Majestic Capital*, 463 B.R. 289, 300 (Bankr. S.D.N.Y. 2012) (using *FA*); *Route 21 Assocs. of Belleville v. MHC, Inc.*, 468 B.R. 75, 82–83 (S.D.N.Y. 2012) (using *FA*); *In re Family Snacks, Inc.*, 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001) (using Andrew's approach).

⁸¹Andrew, *supra* note 59.

⁸²In fact, rejection can harm the estate, notably where a profitable contract is inadvertently lost. See *In re DeVries*, No. 12-04015-DML, 2014 WL 4294540 (Bankr. N.D. Tex. Aug. 27, 2014) (a trustee attempted to argue an LLC operating agreement that the trustee wanted to assume was not executory to avoid automatic rejection from the failure to assume within sixty days).

⁸³For Westbrook's critique of Andrew's approach, see *FA*, *supra* note 12, at 325–32.

⁸⁴*FA*, *supra* note 12, at 243–44.

will provide the remedy unless a bankruptcy policy overrides. Assumption simply means the counterparty will receive full payment or performance and that the counterparty will remain fully obligated on the contract. Most of the difficult questions would depend on state contract and remedies law.⁸⁵

In 1997, the National Bankruptcy Review Commission issued its report to Congress making recommendations for legislative action with respect to the Bankruptcy Code.⁸⁶ The Commission recommended multiple changes to section 365, including that the words “rejection” and “assumption” be replaced with “election to breach” and “election to perform.” Additionally, it recommended removing the word “executory” from the statute entirely to eliminate the perceived “executoriness” requirement. Lastly, it advised that the statute’s text should be revised to clarify that rejection was not an avoidance power. As with a number of other recommendations, these proposals were not incorporated into the Bankruptcy Code.

We now enter the labyrinth (one of us re-enters) to try to clear up confusion about the “Functional Approach,” set out a straightforward approach to contracts in bankruptcy, and lay “executoriness” to rest once and for all.

IV. COMMISSION REPORT

The ABI Commission was established in 2011. Its goal was to “study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders.”⁸⁷ It appointed a highly qualified Reporter⁸⁸ and advisory committees for each major area of study. The Commission made a long and detailed report of its recommendations.⁸⁹

One of the advisory committees was devoted to executory contracts. Its very first recommendation was unanimous: the adoption of the Functional Analysis approach and elimination of the “executoriness” requirement.⁹⁰

The Commission flatly rejected the advisory committee’s unanimous recommendation. The issue apparently split the commissioners, but no report was made of the weight of opinion on each side.⁹¹ After noting the argu-

⁸⁵FA, *supra* note 12, at 285.

⁸⁶NATIONAL BANKRUPTCY REVIEW COMMISSION, REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 453–54 (1997).

⁸⁷Commission Report, *supra* note 3, at 2.

⁸⁸Professor Michele Harner of the University of Maryland Law School.

⁸⁹Commission Report, *supra* note 3.

⁹⁰ABI Advisory Committee, *see supra* note 6. Westbrook was a member of that committee.

⁹¹Commission Report, *supra* note 3, at 114 (“The Commissioners debated at length the potential utility to [abolishing the executoriness doctrine].”).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY497

ments against the executoriness requirement, the report suggested the opposite reform, codification of the material breach test:

[The Commissioners] noted the common law origins of the executoriness requirement of section 365 and they also perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executoriness concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.⁹²

The report contained no serious discussion of the impact of the reform on the prospects of reorganization or any examples of troubling outcomes that would be avoided by the application of the recommended material breach test. Apparently, the issue was important enough to command its own section in the report—in preference to many other controversial legal questions in Chapter 11 practice—yet there was no thorough explanation of the majority recommendation or how it addresses the courts' frustration with executoriness analysis and their divergent conclusions.

V. THE DIFFICULTIES ILLUSTRATED

The judges, lawyers, and academics who have puzzled over the executoriness cases for decades must have been as bemused as we were at the Commission's conclusion that "[the executoriness] case law is a valuable resource that would guide the implementation of the codified standard."⁹³ Indeed, one of us who had done a great deal of recent case research in this area commented, "I cannot really find any examples of 'well-settled' rules."⁹⁴ In keeping with our promise to offer a brief overview before plunging into the depths of executoriness, we start with a few examples of that case law, examples that we will flesh out and supplement in the pages that follow. We want to make it clear from the start that we are quite sympathetic to the challenges of resolving these cases, many of which are difficult even under the best analysis. We are especially sympathetic to judges who feel bound by precedent to apply the material breach rule, even where it leads into darkness. We also

⁹²*Id.* at 114–15.

⁹³*Id.* at 112.

⁹⁴In fact, the Commission itself unleashed a gigantic footnote of almost 500 words beginning "[s]ome courts have struggled with the application of the material breach definition . . ." and went on to describe court after court lost on a sea of confusion and inconsistency. *Id.* at 113 n.416.

mention below some cases in which the courts have shown great insight into the executory contract questions, cutting through the clutter to achieve the right answer for the right reasons.⁹⁵

The discussion of the exemplary cases in this section is merely summary; the more detailed discussion follows in a later section.

A. EXAMPLES OF THE “WELL-SETTLED RULES”

The material breach test has been used now for decades in the courts to determine executoriness.⁹⁶ As we have explained above, it advanced the ball significantly by focusing the courts on benefit to the estate and on state contract law, unlike the traditional theories that came before it. However, over those decades, confusion has continued to reign. Courts applying the material breach test have to deal with a mass of inconsistent and unwieldy precedent. However, one rule that could be considered “well-settled” is that once a contract has been determined to be “non-executory,” there are no rules.⁹⁷

1. *Non-executory Limbo*

Although Professor Countryman’s test was not intended to exclude “non-executory” contracts from the bankruptcy estate or immunize them from the reach of the Bankruptcy Code,⁹⁸ that has been the unfortunate result of the case law applying the material breach test. Some courts have held that contracts that are “non-executory” simply “ride through.”⁹⁹ As one court put it, they “survive the bankruptcy case unaffected.”¹⁰⁰ This concept of “ride through” contracts directly cuts against almost every fundamental policy of

⁹⁵See *infra* notes 109–11 and accompanying text.

⁹⁶See *supra* note 63.

⁹⁷We point out that when courts find that a contract is executory, or do not have to decide the issue because the parties concede it is executory, they typically apply section 365 with no problem and reach the right result under the Code. See *e.g.*, *In re Magness*, 972 F.2d 689, 696 (6th Cir. 1992); *In re Ellipsat, Inc.*, 480 B.R. 1, 9 (Bankr. D.D.C. 2012); *In re LeRoux*, 167 B.R. 318 (Bankr. D. Mass. 1994), *aff’d sub nom*, *Summit Inv. & Dev. Corp. v. LeRoux*, No. 94-11251-DPW, 1995 WL 447800 (D. Mass. Oct. 20, 1994), *aff’d*, 69 F.3d 608 (1st Cir. 1995); *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001); *Texaco Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992). Accordingly, executoriness functions only as a saboteur.

⁹⁸See *infra* Part VI.B.2.

⁹⁹See, *e.g.*, *In re Superior Air Parts, Inc.*, 486 B.R. 728, 738 (Bankr. N.D. Tex. 2012) (“when a contract is non-executory, the debtor remains bound to its obligations under that contract after the bankruptcy filing”); *In re Alder*, No. 10-829-JS, 2016 WL 5947220 at *2 n.3 (Bankr. D. Md. Oct. 13, 2016) (recognizing the validity of ride-through in Chapter 11 reorganizations, but not Chapter 7); *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 41 (Bankr. D. Del. 1999); *In re Airwest Int’l, Inc.*, No. 86-00145, 1988 WL 113101 (Bankr. D. Haw. Oct. 12, 1988); *In re Reasor*, No. 13-12494, 2014 WL 1647142 (Bankr. D. Kan. Apr. 23, 2014); *In re Beeter*, 173 B.R. 108 (Bankr. W.D. Tex. 1994); *In re Raymond*, 129 B.R. 354, 357 (Bankr. S.D.N.Y. 1991) (“If a contract is not executory, it cannot be rejected and the parties remain obligated notwithstanding the intervention of bankruptcy.”).

¹⁰⁰*In re Access Beyond Technologies, Inc.*, 237 B.R. at 41.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY499

the Code.¹⁰¹ It hinders the fresh start, equal treatment of creditors, and fair notice to all parties. Despite its irreconcilability with the policies underlying the Code and its lack of statutory authorization, ride through has been popular in the courts, perhaps because courts are unsure what else to do with a contract that fails the material breach test and is thus non-executory.¹⁰²

If all courts agreed that so-called “non-executory” contracts simply ride through, we would disagree with them, but we could at least recognize that they have come to a “well-settled rule.” However, that is not the case.

Some courts have reasoned that a “non-executory” contract cannot be rejected, the uncanny result of which is that the contract is then implicitly *assumed*. Implicit assumption is problematic because it involves an assumption of the entire contract, including its attendant obligations, although courts rarely discuss it as such. For example, *In re Drake* involved a Chapter 7 debtor-employee, Drake, who had an employment separation agreement with monthly payments given in exchange for his covenant not to compete for five years.¹⁰³ The trustee wanted to sell the debtor’s interest in this contract to a third party. To do so, the trustee argued either that it was not executory so could not be rejected or that it was executory and could be assumed and assigned. The court agreed with the trustee’s first argument, found that the non-competition covenant was not executory and could not be rejected.¹⁰⁴ The court then *granted* the trustee’s motion to sell the interest, which necessarily implied that the contract was assumed because assignment under section 365(e) requires assumption.¹⁰⁵ This assumption of the contract means that the estate had assumed Mr. Drake’s non-competition obligations—wait, that cannot be right. This case is not atypical.¹⁰⁶ Because the

¹⁰¹See *infra* Part VIB.3.

¹⁰²See *In re Airwest Int’l, Inc.*, 1988 WL 113101 at *3 (“This Court has already ruled that the Settlement Agreement is not executory, and therefore the Debtor could not reject it. Likewise, since it is not an executory contract, the Debtor cannot assume it.”).

¹⁰³136 B.R. 325 (Bankr. D. Mass. 1992).

¹⁰⁴The court also discussed the “functional approach,” distinct from the approach we offer here, from *In re Jolly*, 574 F.2d 349 (6th Cir. 1978), but determined that “[r]ejection of the contract would arguably relieve the Agency of its payment obligation and the Debtor of his covenant not to compete, but rejection would be prejudicial to the creditors of the bankruptcy estate.” *In re Drake* 136 B.R. at 328. This demonstrates another area where courts are frequently unclear: the effect of rejection. In this case, rejection would not necessarily have relieved the debtor of the covenant not to compete, which would turn on state law and whether such covenants can be compensated in damages and thus turned into a claim. Whether rejection benefitted the estate would depend on the cost of assumption, i.e., the cost of such performance as would in turn require the debtor to perform his non-competition covenant. The court never analyzed the cost issue.

¹⁰⁵See, e.g., *In re Mirant Corp.*, 440 F.3d 238, 253 (5th Cir. 2006) (“According to § 365(f)(2)(A), assumption must precede assignment.”) (citations omitted); *Cinicola v. Scharffenberger*, 248 F.3d 110, 120 (3d Cir. 2001) (“Before an executory contract may be assigned, the trustee first must assume the contract.”).

¹⁰⁶Another example is *In re Schneeweiss*, 233 B.R. 28 (Bankr. N.D.N.Y. 1998), in which the debtor

theoretical question of executoriness is untethered to any conception of practical consequences, the effects of a court's executoriness analysis are too often almost inconceivable.

While *In re Drake* might seem as disorienting as it can get, there is still another path in the maze of "non-executoriness"—to wit, the opposite result. Other courts conclude that the real effect of being "non-executory" is that these contracts *cannot* be assumed—the opposite of "ride-through." A good example is *In re Exide Technologies*,¹⁰⁷ where the court used "executoriness" to save the debtor-employer from broad drafting in its reorganization plan that could have been read to have assumed an employee's generous retirement agreement. The employee argued that the plan had assumed the agreement, providing him ten annual payments of \$75,000. There were no obligations on his part. The reorganization plan's broad drafting appeared to assume most retirement plans as "executory contracts" unless they were specifically rejected or fit in one of the express exclusions. The employee's retirement agreement appeared to fit into the broad assumption provision. The court found that the agreement was not executory in order to remove it from possible assumption under this provision. "Executoriness" appeared to have saved the day for the debtor and perhaps for someone's malpractice insurer.¹⁰⁸

We recognize that sometimes a court descends into the depths of the material breach test, but happily finds the contract "executory," and therefore subject to section 365.¹⁰⁹ Other times, the court may end up in "non-executory" limbo, but is somehow able to navigate the depths enough to still get to

argued that a non-compete covenant was an executory personal services contract that could not be assumed. The court decided the non-compete covenant was not an executory contract, yet appeared to allow it to be assumed because the payments under the contract became property of the estate. *See also In re Minton*, No. 14-91293, 2017 WL 354319 (Bankr. C.D. Ill. Jan. 23, 2017) (slip copy) (finding that LLC operating agreement was not executory and could not be assumed or rejected, but that trustee was bound by right of first refusal in agreement, which would require implicit assumption); *In re A'Hearn*, No. BR 11-00615, 2011 WL 4704235 (Bankr. N.D. Iowa Oct. 4, 2011) (non-compete agreement implicitly assumed because not executory, resulting in the estate receiving payments under the non-compete).

¹⁰⁷378 B.R. 762 (Bankr. D. Del. 2007).

¹⁰⁸For a solution to this case, see the Appendix. *See also In re Bluman*, 125 B.R. 359 (Bankr. E.D.N.Y. 1991) (a finding of non-executoriness saved the trustee from its accidental rejection of a contract by failing to timely assume it); *In re Hawaiian Telcom Commc'ns, Inc.*, No. 08-02005, 2012 WL 273614 (Bankr. D. Haw. Jan. 30, 2012) (non-executoriness saves the estate from accidental assumption of employment agreements).

¹⁰⁹*See, e.g., In re Cardinal Indus., Inc.*, 146 B.R. 720 (Bankr. S.D. Ohio 1992); *In re Waste Sys., Int'l, Inc.*, 280 B.R. 824 (Bankr. D. Del. 2002); *In re Ideal Mortgage Bankers, Ltd.*, No. 10-79280-LAS, 2015 WL 5996293 (Bankr. E.D.N.Y. Oct. 14, 2015); *In re Future Graphics, Inc.*, No. 09-09272-8-JRL, 2010 WL 1965893 (Bankr. E.D.N.C. May 17, 2010); *In re Oseen*, 133 B.R. 527 (Bankr. D. Idaho 1991); *In re Kmart Corp.*, 290 B.R. 614 (Bankr. N.D. Ill. 2003); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 309 (Bankr. D. Del. 2001); *In re Novon Int'l, Inc.*, No. 96-BK-15463B, 2000 WL 432848 (W.D.N.Y. Mar. 31, 2000); *In re Buildnet, Inc.*, No. 01-82293, 2002 WL 31103235 (Bankr. M.D.N.C. Sept. 20, 2002); *In re Sparks*, 206 B.R. 481 (Bankr. N.D. Ill. 1997).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY501

the right result.¹¹⁰ Our issue with these cases is that the material breach test provides little clarity about the hard questions and provides many traps for the unwary.¹¹¹

A good example is *In re Spectrum Information Technologies*,¹¹² in which the court found that employee separation agreements were not executory, so the Chapter 11 debtor-employer could not reject them. The agreements required the debtor-employer to make periodic payments to the various employees, who had obligations about confidentiality, non-interference, and in one of the contracts, non-competition. The court reasoned that these obligations did not pass the material breach test, so could not be rejected. However, the court then explained that even though they could not be rejected, the practical result is the same as if they had been rejected because the employees claiming under those employee separation agreements would have general unsecured claims anyway. As some courts have said, “the time expended searching for executoriness can be spent more fruitfully doing almost anything else.”¹¹³

The *Spectrum* court properly understood the result of rejection (a prepetition general unsecured claim), but the inquiry into executoriness added little value to the hard questions in the case, one of which is whether the employee counterparties still had to perform their confidentiality and non-interference obligations under the contracts that had technically not been “rejected” by the debtor. This is a situation where rejection is actually needed: it gives notice to the counterparties that the debtor will not be per-

¹¹⁰See, e.g., *In re Spectrum Info. Techs.*, 190 B.R. 741 (Bankr. E.D.N.Y. 1996); *In re Provider Meds, LLC*, NO. 13-30678, 2017 WL 213814 (Bankr. N.D. Tex. Jan. 18, 2017) (extensively analyzing a license agreement under the material breach test, finding it executory, and concluding it had been deemed rejected because the trustee failed to assume within the sixty-day window).

¹¹¹Occasionally the hard questions are not just about state law, but also bankruptcy policy. See *Ulrich v. Schian Walker PLC (In re Boates)*, 551 B.R. 428 (B.A.P. 9th Cir. 2016). In *Boates*, the debtor paid his attorney a \$60,000 retainer to handle dischargeability litigation with a bank in connection with his Chapter 7 bankruptcy proceeding. The Chapter 7 trustee sued the attorney, claiming that the retainer agreement with the attorney was an executory contract and could be rejected. This allowed the trustee to demand a refund of the unearned portion of the retainer. Under our approach, the agreement is clearly executory and whether the trustee can obtain a refund would depend on the provisions of the retainer agreement and applicable state law. The executoriness analysis in the opinion clouds the real issue in the case—a divergence of interests between the Chapter 7 trustee and the debtor. All that was left under the retainer agreement was for the attorney to defend the debtor in the dischargeability litigation, so the debtor would have benefitted from assumption. The trustee, however, chose to reject and obtain the unearned retainer for the benefit of the creditors. Our approach better equips courts to clearly identify and analyze the real question in this case—the divergence of interests between the debtor and Chapter 7 trustee—rather than some amorphous concept of executoriness.

¹¹²190 B.R. 741.

¹¹³*In re Hawker Beechcraft, Inc.*, 486 B.R. 264, 276–77 (Bankr. S.D.N.Y. 2013) (citing *In re Riodizio, Inc.*, 204 B.R. 417 (Bankr. S.D.N.Y. 1997)).

forming the contract, and state contract law will guide the counterparty on whether its obligations are now also relieved.

2. *Treatment of Option Contracts*

The problems with “executoriness” have been even more pernicious with option contracts, where courts perform mental gymnastics to obtain the result the case seems to require. Over the years, courts have gotten no closer to a consensus on whether an option contract is or is not an “executory contract” under the material breach test.¹¹⁴ This confusion is not because each option contract’s provisions are so unique that they defy general categorization as “executory” or “non-executory.” Rather, it is because although the material breach test was a leap beyond its predecessors, it is unworkable for unilateral contracts like option contracts.

Application of the material breach test to an option contract often results in a contention that the contract on hand is “non-executory.”¹¹⁵ This is usually because one party, either the DIP or a counterparty, is trying to avoid the reach of section 365.¹¹⁶ While we contend that “executory” has to be understood as broadly as possible to ensure that all the debtor’s assets and liabilities are handled in the bankruptcy, it is easy to see how courts applying material breach find options “non-executory”—unilateral contracts like options inevitably fail the material breach test. This results in the court finding itself yet again in “non-executory” limbo.

An example of this all-too-common situation is *In re National Financial Realty Trust*.¹¹⁷ In that case, the court found that a real estate option contract was “non-executory” in order to conclude that the option had not been rejected, had survived the bankruptcy, and had been legitimately sold to an innocent third party after the bankruptcy. That is, it received the same treatment as a contract that has been assumed and assigned under section 365(e). Moving out into “non-executory” limbo allowed the court to achieve what it perceived as equity from the viewpoint of the innocent third party, but at the expense of the express provisions of the Bankruptcy Code and possibly equity from the viewpoint of the optionor.

Another example of “executoriness” allowing courts to dodge express provisions of the Bankruptcy Code is *BNY, Capital Funding LLC v. US Air-*

¹¹⁴Compare *In re G-N Partners*, 48 B.R. 462, 465–66 (Bankr. D. Minn. 1985), with *In re Continental Properties*, 15 B.R. 732, 736 (Bankr. D.Haw. 1981), and *In re A.J. Lane & Co.*, 107 B.R. 435 (Bankr. D. Mass. 1989), with *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999).

¹¹⁵*In re Nat’l Financial Realty Trust*, 226 B.R. 586 (Bankr. W.D. Ky. 1998); *BNY, Capital Funding LLC v. US Airways, Inc.*, 345 B.R. 549 (E.D. Va. 2006); *In re Plascencia*, 354 B.R. 774, 779 (Bankr. E.D. Va. 2006).

¹¹⁶*In re Nat’l Financial Realty Trust*, 226 B.R. at 588; *BNY, Capital Funding*, 345 B.R. at 552.

¹¹⁷266 B.R. 586.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY503

*ways, Inc.*¹¹⁸ In that lease-financing case, the court found an option contract was not executory so that section 365(c)(2) did not prevent its assumption as a contract for financial accommodations. While the court tried to give due respect to section 365(c)(2) by explaining that the debtor was not seeking to assume the option in the bankruptcy, the option was implicitly assumed because the court reasoned that it “remain[ed] an asset of US Airways.”¹¹⁹

Some courts find themselves faced with option contracts that they believe should be retained for the good of the estate and thus declare them to be “executory,” even though getting an option contract to pass the material breach test requires a lot of creativity. Sometimes that involves just a declaration that the option contract on hand is executory, with only a short foray into the material breach test, as demonstrated by *In re Kellstrom Industries, Inc.*¹²⁰ In *Kellstrom*, a counterparty with a right of first refusal to purchase property from the estate claimed its contract was not executory and thus could not be rejected. The court was faced with contradictory precedents and simply declared that the contract was executory, subject to rejection, in line with what it perceived as the majority result.¹²¹ While the court got the “executoriness” question right by finding that the option was executory, the lack of any remaining debtor obligation means the result was not and cannot reasonably be achieved by a true application of the material breach test. Furthermore, the question of “executoriness” does not help with the harder question in these kinds of cases: what is the effect of rejection of a counterparty’s option to purchase real property? That is a question that our approach attacks directly.¹²²

B. EXAMPLES OF INTRACTABLE NEWER PROBLEMS FOR THE MATERIAL BREACH TEST

1. LLC Operating Agreements

LLC operating agreements present a newer kind of contract for which our approach is aptly suited because the complicated issues here all reside at the intersection of state law and federal bankruptcy policy. For this reason,

¹¹⁸345 B.R. 549. This case involved the financing agreement for a lease, but not the lease itself.

¹¹⁹*Id.* at 555–56.

¹²⁰286 B.R. 833 (Bankr. D. Del. 2002).

¹²¹*Id.* at 834–35. While the court here seemed to think there was a “majority,” for years there has been considerable divide over the issue of whether option contracts are executory. The disagreement between courts is highlighted in *In re Robert L. Helms Constr. & Dev. Co., Inc.*, 139 F.3d 702, 705 (9th Cir. 1998). Courts continue to diverge on the issue. See *supra* notes 114–15.

¹²²See also *In re A.J. Lane & Co.*, 107 B.R. 435, 436 (Bankr. D. Mass. 1989) (finding option contract for repurchase of land was executory and could be rejected, although going astray on the effect of rejection) (discussed *infra* at notes 162–64 and accompanying text); *In re Fleishman*, 138 B.R. 641, 648 (Bankr. D. Mass. 1992) (finding the right of first refusal to purchase land executory and encountering problem of specific performance versus deemed rejection of option but not fully analyzing it).

the material breach test rarely arrives at the right question because the analysis gets lost on the “executoriness” detour. An LLC is a business entity that has characteristics of both a corporation and a partnership: the limited liability of a corporation, the pass-through taxation of a partnership, and the ability to choose among management structures.¹²³ An LLC agreement is the contract governing the management of the LLC; it usually includes provisions creating members’ interests, the transferability of those interests, and members’ responsibilities to one another and the LLC.¹²⁴ By all accounts, it is easy to get lost trying to determine whether LLC agreements meet the material breach test for executoriness; courts are currently wrestling with that question.¹²⁵ However, under our approach this entire debate can be sidestepped because it is clear that any LLC agreement has at least some remaining obligations rendering it “executory” under the common law definition of the word. Thus, one can proceed directly to the pertinent, yet difficult question: how does state LLC law operate within federal bankruptcy law?

Courts that decide to venture down the “executoriness” path with an LLC agreement have little guidance from the irreconcilable precedents on the issue.¹²⁶ Some courts have found unperformed obligations satisfying the material breach test solely on the existence of supermajority voting requirements that apply only if certain contingencies occur like sale of a piece of property.¹²⁷ Those fairly contingent obligations of LLC members have passed the material breach test, while more concrete obligations might fail it. For example, LLC agreements that have detailed notice obligations and appraisal procedures for members’ purchases of other members’ interests have

¹²³Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, at *2 (1995).

¹²⁴*Id.* at *10.

¹²⁵See *In re Strata Title, LLC*, No. 12-24242, 2013 WL 1773619 (D. Ariz. 2013); *In re Jundanian*, No. 10-21513-TJC, 2012 WL 1098544 (Bankr. D. Md. Mar. 30, 2012); *In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006); *In re Ichiban*, No. 06-10316-RGM, 2014 WL 2937088 (Bankr. E.D. Va. 2014). There has been extensive discussion and debate of this issue in the scholarship as well over the last two decades. See, e.g., James M. Jorissen, *Member Bankruptcy Under the New Minnesota Limited Liability Company Act: An Executory Contract Analysis*, 77 MINN. L. REV. 953 (1993); Michelle Morgan Harner, Carl E. Black & Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187 (2005); Alan J. Brody & Ari Newman, *Consequences of the Rejection of LLC Operating Agreements and Sale of LLC Membership Interests*, 32 AM. BANKR. INST. J. 42 (2013).

¹²⁶*In re Strata Title*, 2013 WL 1773619; *In re Capital Acquisitions*, 341 B.R. 632. See *In re Ichiban*, 2014 WL 2937088 (finding that LLC agreement was executory and so the right of first refusal within it had been rejected because trustee failed to assume, but stating in dicta that if it had been non-executory then it could not have been rejected and the right of first refusal would be enforceable in bankruptcy despite the fact that it had an *ipso facto* clause). See also *In re Soderstrom*, 484 B.R. 874 (M.D. Fla. 2013) (finding that under the “functional approach” the LLC operating agreement was executory because its rejection ultimately benefitted the estate.).

¹²⁷*In re Strata Title*, 2013 WL 1773619 at *2.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY505

been found both “non-executory” and “executory.”¹²⁸

Some courts have tried to avoid the “executoriness” inquiry altogether by finding an LLC agreement to be an altogether different kind of animal from an executory contract. Sometimes it is a “business formation and governance document” that enters the estate via section 541 as “property of the estate.”¹²⁹ Other times courts simply decide that because LLC agreements are not executory contracts, section 541 operates on them rather than section 365.¹³⁰

A common fact situation where a court analyzes the “executoriness” of an LLC operating agreement is when a non-debtor member is trying to exercise a right of first refusal to purchase the debtor’s membership interest in the LLC.¹³¹ A good example of this situation is *In re Capital Acquisitions & Management Corporation*.¹³² The Chapter 11 debtor was an LLC, Camco, who had a 20% membership interest in another LLC, Rainbow. A receiver had been appointed, and wanted to sell Camco’s interest in Rainbow to a third party, Welland. Rainbow objected, claiming that the interest could not be sold to Welland until its other LLC members had a chance to exercise their rights of first refusal. Rainbow argued that the LLC agreement was not executory and thus could not be rejected, so its members’ rights of first refusal were enforceable in the bankruptcy proceeding.

The court found that the LLC operating agreement was not executory and so could not be assumed or rejected. The court agreed with Rainbow that non-executoriness meant the LLC agreement, including the right of first

¹²⁸Compare *In re Capital Acquisitions*, 341 B.R. at 634–36 (ignoring the notice and appraisal procedures of the agreement and finding that the agreement was not executory only after discussing indemnification obligations), with *In re Ichiban*, 2014 WL 2937088 at *2 (finding similar notice and appraisal procedures as sufficient for an executory contract).

¹²⁹*In re Denman*, 513 B.R. 720, 725–27 (Bankr. W.D. Tenn. 2014) (LLC Agreement is not an executory contract but instead a business formation and governance document subject to section 541).

¹³⁰See also *In re Warner*, 480 B.R. 641, 654 (Bankr. N.D.W. Va. 2012) (the court rejects the LLC agreement as executory and then analyzes the LLC interests’ entry into the estate via section 541); *In re Ehmann*, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005) (LLC agreement was not an executory contract, but the transfer restrictions on sale of membership interests were kicked out by section 541).

¹³¹See *In re Capital Acquisitions*, 341 B.R. 632; *In re Knowles*, No. 6:11-bk-11717-KSJ, 2013 WL 152434 (Bankr. M.D. Fla. 2013). For a different situation, see *In re Tsiaoushis*, 383 B.R. 616, 620 (Bankr. E.D. Va. 2007) *aff’d*, No. 1:07 CV 436, 2007 WL 2156162 (E.D. Va. July 19, 2007), where the Chapter 11 trustee wanted to use an *ipso facto* clause in the LLC agreement providing for dissolution on bankruptcy of a member to dissolve the LLC because the trustee believed that would provide more value for the estate. The managing member of the LLC objected, saying the agreement was an executory contract and thus subject to section 365(e)(1), which invalidated the *ipso facto* dissolution provision. In this case, the court found the LLC agreement was not an executory contract in order to avoid the invalidation of the *ipso facto* dissolution provision and allow the trustee to use that provision to dissolve the LLC. Thus, even though these disputes have mostly involved non-debtor members attempting to use “executoriness” to protect themselves, the lack of clarity in the law means that “executoriness” can be turned against them very easily.

¹³²341 B.R. 632, 633 (Bankr. N.D. Ill. 2006).

refusal, was enforceable in the bankruptcy. The court conceived of a right of first refusal as a limitation on an individual's "property" interest in an LLC, yet failed to consider the Code's provisions governing limitations on sale of a contract.¹³³ It took this idea from other executory contracts precedent, rather than determining the parties' rights under state law, including the distinction between property rights and contract rights. Protection of Rainbow's members and of the estate's creditors represent important state and federal policies respectively. In the end, Rainbow's members were entitled to their right of first refusal and the creditors lost Welland's higher offer, without any serious consideration of the policies and requirements of either state or federal law.

2. Intellectual Property ("IP") Licensing Agreements

In no area of bankruptcy and reorganization is a proper understanding of the applicability of section 365 more important than in IP. IP licensing agreements appear to some courts to be plain old contracts, but the intellectual property at the heart of them is as important to companies as real property is. Section 365(n) of the Code was a quick fix for an infamous case,¹³⁴ but leaves many questions unanswered, of which trademark issues (omitted from the section 365(n) "fix") are only one segment. This is an area of the law where the material breach test frequently eliminates contracts from the application of section 365 because they are not "executory" under the limiting definition, when in fact these contracts require treatment under section 365. The wrong results from application of the material breach test are compounded by the fact that courts are manipulating executoryness to purposefully avoid dealing with the effect of rejection of IP licensing agreements, an issue still creating confusion.

A case that demonstrates the confusion in this area is *In re Interstate Bakeries*.¹³⁵ Interstate Bakeries had been involved in an antitrust dispute after it had acquired another company holding famous trademarks and labels. To resolve that antitrust dispute, a court had ordered Interstate Bakeries to enter into a licensing scheme for some of its trademarks and brands, including Wonder, Sunbeam, and Twinkies. When Interstate Bakeries later declared bankruptcy, it wanted to reject the licensing agreement.¹³⁶ The parties dis-

¹³³In particular, it never reached sections 541(c)(1)(A) or 365(a), (c)(1), or (e)(1). For the solution to this case, see *infra* Part VII.B.1.

¹³⁴See *Lubrizol Enters. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). For extensive analysis of this case, see *FA*, *supra* note 12, at 305-09 and see Andrew, *supra* note 59, at 916-18. Section 365(n) applies to patent licenses and other intellectual property, but not trademarks. 11 U.S.C. § 101(35A) (2012). Under section 365(n), a licensee can elect to retain its rights to licensed intellectual property despite rejection, but must continue to pay royalties under the licensing agreement.

¹³⁵751 F.3d 955 (8th Cir. 2014).

¹³⁶At first, Interstate Bakeries wanted to assume the licensing agreement with the licensee, Lewis

2017) DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY 507

puted whether it was executory and could be rejected.

Under the court's application of the material breach test, the licensing agreement was determined not to be executory because it had already been "substantially performed," despite its remaining obligations of notice and forbearance of suit, maintenance of the trademarks, and other infringement-related obligations. Thus, the licensing agreement could not be assumed or rejected. The court specifically noted that because the contract was not executory, it did not have to reach the question of the effect of rejection. In fact, the opinion grinds to a halt in the "non-executoriness" limbo and never addresses the effect of its holding at all.

The confusion is similar when the debtor is the licensee, rather than the licensor. Gencor was a licensee of patent rights under an agreement it had entered into with CMI, the owner of the patent.¹³⁷ Gencor later entered involuntary Chapter 11 bankruptcy, and CMI did not file any sort of claim or participate in the bankruptcy. Months after the reorganization plan had been confirmed without any mention of the CMI licensing agreement, CMI sued Gencor for patent infringement, claiming that the licensing agreement was executory and had been rejected because Gencor had failed to assume it.¹³⁸ On that basis, CMI argued that the rejection had terminated Gencor's permission to use the patent under the licensing agreement, allowing CMI to sue for infringement. The court reasoned that the licensing agreement was not executory, despite the remaining reciprocal royalty payment and covenant not to sue obligations, which are the essence of every licensing agreement. Because the agreement was not executory, in the court's view it could not have been assumed or rejected and simply remained enforceable after the bankruptcy.¹³⁹ The effect was assumption, despite the debtor's failure to assume.

At first glance, a strict application of the material breach test seems to require finding licensing agreements "executory" because under applicable IP licensing law the obligations to make royalty payments and the covenant not to sue are material obligations—they are the entire heart of a licensing agree-

Brothers Bakeries. Lewis Brothers asked the bankruptcy court to find that the licensing agreement was not executory and could not be rejected or assumed. It is unclear why Lewis Brothers thought a finding of "non-executoriness" would benefit it more than if Interstate Bakeries assumed the licensing agreement, which would have allowed Lewis Brothers to continue using the trademarks and brands under the terms of the agreement. However, Interstate Bakeries shortly thereafter changed its position to seeking rejection.

¹³⁷*In re Gencor Indus., Inc.*, 298 B.R. 902, 913 (Bankr. M.D. Fla. 2003).

¹³⁸11 U.S.C. § 365(d)(2) (2012).

¹³⁹Even courts who properly find that licensing agreements are executory still contend that non-executory licensing agreements are not subject to the bankruptcy and survive it unaffected. See *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999) (licensing agreement is executory because covenant not to sue is the whole reason license is entered into so is a material obligation under material breach test).

ment, as Professor Countryman said himself.¹⁴⁰ Yet the courts still debate whether licensing agreements are executory or not.¹⁴¹ The squishiness of “executoriness” allows courts to escape the harder issue of IP licensing in bankruptcy, i.e. the effect of rejection, by finding the licenses “non-executory” and thus outside all the relevant provisions of the Code.

C. REMAINING DUTIES ON ONE SIDE OF CONTRACT ONLY

The Commission majority felt it would be “irrelevant” to be concerned with any contract in bankruptcy unless it had remaining performance due on both sides. To be complete, our review of that assertion should start with a contract under which there is no remaining performance by either party. We would agree that is just the corpse of a contract, along with its history and its lingering effects. But the Commission’s majority opined that even a contract with some performance remaining on one side is not an executory contract and not subject to section 365.¹⁴² With this assertion, we cannot fully agree.

1. Debtor’s Duty Only

a. Only Payment Remaining

Where only the debtor owes performance (“debtor-only” contracts) this kind of contract is generally just a claim to be paid in BD\$.¹⁴³ It would be a very rare case where assumption, i.e. full payment and performance, by the debtor would be a good choice for the trustee when no benefit flows from the counterparty with or without that performance.¹⁴⁴

¹⁴⁰Vern Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479, 501-02 (1974).

¹⁴¹Compare *In re Fieldstone Mortg. Co.*, 427 B.R. 364 (Bankr. D. Md. 2010) (licensing agreement is executory); *In re Kmart Corp.*, 290 B.R. 614, 619 (Bankr. N.D. Ill. 2003) (same); *In re Sunterra Corp.*, 361 F.3d 257, 264 (4th Cir. 2004) (same); *In re Biopolymers, Inc.*, 136 B.R. 28, 29 (Bankr. D. Conn. 1992) (same), with *In re Interstate Bakeries, Inc.*, 751 F.3d 955 (8th Cir. 2014) (licensing agreement not executory); *In re Exide Techs.*, 607 F.3d 957, 964 (3d Cir. 2010), as amended (June 24, 2010) (same); *In re SuperMedia, Inc.*, No. 13-10545(KG), 2013 WL 5567838 (Bankr. D. Del. Oct. 9, 2013) (same); *In re Gencor Indus.*, 298 B.R. 902 (Bankr. M.D. Fla. 2003) (same). The reason for the conflict may be that the courts remain unsure about the effects of rejection under section 365(n). Our review of the case law reveals that when courts treat IP licensing agreements as “executory” and apply section 365(n), the analysis and result of the case is correct (with the exception of trademarks, which can create some difficulties). The major cause for courts getting the analysis confused in IP licensing agreement cases is a finding of “non-executoriness.” Again, executoriness is, at best, a saboteur.

¹⁴²Of course, according to the Commission, a contract that fails the executoriness test is not subject to section 365, so for example an IP license that is found non-executory is not within section 365(n), which protects the counterparty. Where does that leave the court and the parties in such a case?

¹⁴³As noted in FA, every executory contract problem will often have a different result depending on the position of the debtor—buyer or seller, licensor or licensee, and so on. See FA, *supra* note 12, at 263-70. The reason is that section 365 is meant to benefit the debtor-estate for the benefit of creditors who are entitled to equal treatment with the counterparty. See *supra* notes 20-21, 29 and accompanying text.

¹⁴⁴One can imagine a rare exception where nonpayment/performance would cause greatly excessive damage to the counterparty, damage so great that rejection would produce a net loss to the estate—but

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY509

However, a failure to examine “irrelevant contracts”¹⁴⁵ carefully may cause a trustee to miss a contract where there is non-obvious performance due from a counterparty, especially contingent performance like a valuable warranty from a seller that would be lost by rejection. That hypothetical contract might look like the following: \$100,000 in materials purchased pre-bankruptcy from a supplier, with \$20,000 still owed at the time of bankruptcy. There is a nontrivial risk that the materials will fail in some way during the five-year warranty period. Under the Chapter 11 plan, the debtor-buyer pays 50% of the supplier’s unsecured claims like this one. Assume these “irrelevant” contracts are not treated by section 365, because the debtor now only owes the payment of money, and they are deemed “non-executory.”¹⁴⁶

After plan confirmation and discharge,¹⁴⁷ one of two possible developments occur. In case A, \$50,000 of materials remain unsold but can be sold to a third party for \$40,000 with the assignable warranty from the seller but will bring only \$5,000 without it. However, the partial payment and discharge is obviously the product of a deemed rejection, and it is likely that under applicable contract law the breach (rejection)¹⁴⁸ will excuse the supplier’s performance of the warranty, making it valueless. If the debtor had assumed, it would have paid the full \$20,000 and had the post-bankruptcy benefit of the warranty, so it would have gained \$25,000 after sale of the material for \$40,000.¹⁴⁹ Next case: same situation in case B, but post-bankruptcy the materials are used to construct a product sold to X and then those materials fail, producing \$50,000 of damage for which the reorganized debtor is liable. The failure would be covered by the warranty, but it is not enforceable because of the rejection, and so the post-bankruptcy debtor suffers the

that seems a case so rare we can afford to ignore it. See *FA*, *supra* note 12, at 264. Other hypotheticals may occur to the twisted mind of a law professor, but they too are likely to be so uncommon as to be ignorable.

¹⁴⁵Commission Report, *supra* note 3, at 115.

¹⁴⁶A nice illustration is found in *Hipcricket Inc. v. mGage LLC*, unreported in A.3d, No. 11135-CB, 2016 WL 3910837 (Del. Ch. July 15, 2016), in which the debtor’s plan chose the default of rejection for all contracts not specifically treated under section 365. The result was that an ex-employee was left free to ignore a non-compete clause in his rejected employment contract. A fair number of lawyers who cling to the material breach test seem to feel that it somehow protects them from a “default setting” error—whether the default setting is assumption or rejection—but the truth is that there is danger either way in failing to have a client carefully review all contracts for these sorts of issues. The court did not extensively discuss executoryness, but did decide that certain obligations were material and breach by one party would excuse the other’s performance. See *id.* at * 12.

¹⁴⁷11 U.S.C. § 1141 (2012).

¹⁴⁸11 U.S.C. § 365(g) (2012).

¹⁴⁹Calculation: \$40,000 - 5,000 = \$35,000 higher price with warranty—\$10,000 more paid (\$20,000 owed, 50% or \$10,000 already payable under plan), leaving \$25,000 profit (ignoring the time value of money).

full \$50,000 loss.¹⁵⁰ It could have avoided the loss if it had paid \$20,000 to assume, thus saving \$30,000. In either case, the DIP will wish it had assumed.

Yet, whether the contract should be assumed would have been a difficult economic question at the time when the plan was designed, especially as to case B. The decision to assume or reject will have turned on the loss the estate would suffer by virtue of full payment of the purchase price (as required by assumption) versus the value of the warranty. That value is the dollar size of the risk discounted by its improbability, a value not always easy to measure as of the date of filing. From the perspective of a legal scholar, the important point is that the decision is one of business judgment,¹⁵¹ not usefully resolvable by the contract-law abstractions defining "a material breach excusing the other party from performance." In that land of delightful abstractions in which we dwell in the contracts course, one could speculate whether a court would or would not say a failure to pay in full would void the warranty under all the circumstances, but no sensible person would substitute that speculation for the realities of the economic judgment.¹⁵² And indeed the courts rarely explore contract law in applying the executory test; they just announce whether or not the test is satisfied.¹⁵³

The current material breach test requires a DIP to delve into whether a contract still requires "material performance," rather than whether or not it would be profitable to keep performing or breach the contract. Management would not find much in the case law to help them accurately predict a court's treatment of their maybe-executory-maybe-not contract. This leaves them with few answers about whether they *can* assume or reject the contract, before they can get to the complex economic question of which course they should pursue.

The Commission's majority had a special concern about protecting the counterparty. In our hypothetical, that should be easy. The partial payment and discharge under the plan means the contract has been breached by rejection, and it is easy to argue that breach excuses the counterparty from the

¹⁵⁰We assume a post-petition warranty given to the buyer from the debtor and therefore a full U.S. dollar obligation to the buyer upon failure of the material.

¹⁵¹Note nonetheless that both consumers and business people make rough judgments about the value of buying expanded or extended warranties all the time.

¹⁵²See, e.g., Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 1 (1991) (characterizing the case law on the material breach test as "hopelessly convoluted"); *In re Cardinal Indus., Inc.*, 146 B.R. 720, 725 (Bankr. S.D. Ohio 1992) (explaining that the cases applying the material breach test are in confusion); See generally Olin McGill & Hon. Francis G. Conrad, *Exorcising Executory: Functionalist Arguments and Incantations to Avoid Meeting the Devil in the Woods*, 1995 ANN. SURV. OF BANKR. LAW 4 (1995).

¹⁵³See, e.g., *In re Kellstrom Indus., Inc.*, 286 B.R. 833 (Bankr. D. Del. 2002); *In re Exide Techs.*, 378 B.R. 762 (Bankr. D. Del. 2007).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY511

warranty. On the other hand, a court that desires to protect the trustee and the estate's lawyers from obloquy or worse for having missed the significance of the warranty can invoke the wild card and decide the contract is not executory. Because there is no settled rule about the effect of a contract-that-is-not-a-contract in bankruptcy,¹⁵⁴ the court can say the counterparty is bound by its warranty and must pay for the post-petition damage because a "non-executory" contract *cannot* be rejected.¹⁵⁵ The court can also find ample authority for the opposite conclusion about the impact of a "non-executory" contract, i.e. it *cannot* be assumed.¹⁵⁶ The problem with wild cards is that chance—sometimes found under the mask of equity—can favor either player. The only players consistently benefitted are the lawyers who litigate these issues at the expense of the parties.

The lesson is that the Report is almost right to the extent it says "executoriness" is irrelevant to a contract where only the debtor has a remaining duty, but an understanding of the right analysis would lead a lawyer to give a client a checklist to search out "mere claims" where assumption should at least be considered.

b. Debtor as Optionor

Another kind of contract that should be considered executory despite only having performance obligations on one side is an option contract in which the debtor is the optionor, the grantor of the option. Like any contract with unperformed obligations, these contracts need to be handled in the bankruptcy process. They must either be breached through rejection or performed through assumption. In the most frequent scenario in which these option contracts arise, the estate will more likely be benefitted through rejection, rather than performance, i.e. assumption.¹⁵⁷ This is the result because option contracts in which the debtor is the optionor have little potential value for the estate. The option has already been paid for and now all that remains is that the debtor may have to expend resources performing the option if it is exercised. Thus, in most cases, an option contract like this should be rejected. In order to be rejected, however, these option contracts must be treated by section 365; that process is thwarted when an option contract inevitably fails the material breach test and is deemed "non-executory."¹⁵⁸

The current treatment by courts of option contracts in which the debtor is the optionor varies widely.¹⁵⁹ Frequently, option contracts in which the

¹⁵⁴See *supra* notes 96–104 and accompanying text; see also *FA*, *supra* note 12, at 243–44.

¹⁵⁵See, e.g., *In re Drake*, 136 B.R. 325 (Bankr. D. Mass. 1992).

¹⁵⁶See, e.g., *In re Exide Techs.*, 378 B.R. 762.

¹⁵⁷See, e.g., *In re A.J. Lane & Co., Inc.*, 107 B.R. 435 (Bankr. D. Mass. 1989); *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999); *In re Plascencia*, 354 B.R. 774 (Bankr. E.D. Va. 2006).

¹⁵⁸See *In re Bergt*, 241 B.R. at 20; *In re Plascencia*, 354 B.R. at 779–80.

¹⁵⁹See *supra* notes 114–21 and accompanying text.

debtor is the optionor, just like those in which the debtor is the optionholder, fail the material breach test and are deemed by courts to be "non-executory."¹⁶⁰ This determination removes them from the powers and procedural protections of section 365, which is the exact Code provision designed by Congress to treat these kinds of contracts. We contend that almost all contracts in which the debtor is the optionor should be rejected under section 365, unless some particular aspect of the option contract means that performance of the option would result in more value to the estate. This is likely a rare occurrence. Regardless of the outcome for any particular option contract in which the debtor is the optionor, every single one of these option contracts must be rejected or assumed under section 365. Court approval provides a mechanism by which we can ensure that the trustee disposes of these contracts properly.

Rejection of contracts in which the debtor is the grantor of the option can present difficult questions about the effect of rejection because often these option contracts involve real estate.¹⁶¹ Our approach focuses on the question by directing the analysis towards state law: how would state law remedy the debtor's nonperformance of the option obligations? Even when courts hold that this kind of option contract is executory, the material breach test does not guide them to the correct result on the effect of rejection. *In re A.J. Lane* provides a good example.¹⁶² In *A.J. Lane*, the Chapter 11 debtor sought to reject an option contract in which the original seller of real property to the debtor had a right to repurchase it. Under the material breach test, the court held that the repurchase option was executory, which took considerable creativity. The court then held that rejection of the option terminated the repurchase right, allowing the debtor to sell the real property free of the repurchase right. The court in this case recognized that state law provides the answer to rejection because it discussed whether the option was a property right in favor of the optionholder. The court decided it was not a property right, but rather a contract enforced by specific performance. Under our approach, that is exactly the kind of state-law right that could not be "terminated" through rejection unless damages could be substituted for specific performance.¹⁶³ If state law granted injunctive relief, that relief cannot be reduced to a claim for payment and discharged.¹⁶⁴ Thus, although the court avoided the traps of the material breach test to reach the correct question (property right or not), the material breach test offers no guidance for how to use state law in the rejection analysis. In option contracts where the

¹⁶⁰See *supra* note 115.

¹⁶¹See *supra* notes 117-18.

¹⁶²107 B.R. 435.

¹⁶³A "claim" does not include injunctive relief. See 11 U.S.C. § 1141; see *infra* Part VI.C.2.

¹⁶⁴See *infra* Part VI.C.2.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY513

debtor is the optionor, the state-law questions are the most difficult. Our approach focuses directly on them.

2. Counterparty's Duty Only

While the Commission Report is partially correct as to debtor-only contracts, it is inexplicably wrong as to contracts where only the counterparty has a duty ("counterparty-only" contracts). We have introduced the classic example, discussed in detail below: the option contract where the debtor has purchased an option, but has no remaining duties unless it exercises the option.¹⁶⁵ Although courts have twisted themselves into pretzels to find performance due on the debtor's side, the options are obviously counterparty-only contracts. If the debtor *chooses* to exercise the option, the counterparty must perform. The counterparty has a contingent obligation under the contract at the time of filing. If it announced at that time it would never honor the exercise of the option, it would be guilty of anticipatory breach and subject to either damages or specific performance. Assuming that the conveyance of land or other counterparty performance under the option was a net benefit to the estate, the debtor should assume and exercise, to the benefit of creditors and the reorganized company.

As with the debtor-only contract, the role of "executoriness" can only be as a spoiler. If the court concludes for some reason (likely equity) that the debtor should not be able to exercise the section 365 choice, it can find that the debtor/optionee has no material *duty* to perform, declare the contract "non-executory" and non-assumable, and sacrifice a valuable asset from the estate. Perhaps some would describe this result as "some type of gating feature"¹⁶⁶ to protect counterparties. As we discuss below,¹⁶⁷ there may be a good reason—an equity—for refusing to enforce the option contract. It is the task of the lawyers and the court to dig down into the legal problem (state contract law or bankruptcy policy) to determine if it is legally legitimate to protect that alleged equity. Playing the executoriness wild card is the wrong solution because it is unprincipled and renders this part of the law incoherent.

VI. THE POLICY FRAMEWORK FOR MODERN CONTRACT ANALYSIS

A. CONTRACTS IN BANKRUPTCY: THE BASICS

At the heart of our analysis is the simple idea that every pre-bankruptcy contract is potentially an asset that enters the estate under section 541 and a

¹⁶⁵See *infra* Part VIIA.

¹⁶⁶Commission Report, *supra* note 3, at 114–15.

¹⁶⁷See *infra* Part VIIA.

liability that is potentially a claim under section 502.¹⁶⁸ Most often a contract is both an asset and a liability. Every aspect of a contract must be swept into a bankruptcy estate in order to satisfy the policies of discharge of the debtor and equal treatment of creditors.

As explained at some length in *FA*, section 365(a) does no more than authorize the trustee to perform or breach every bankruptcy contract. Assumption is merely the decision to assume, and by assuming to give the counterparty the right to full payment¹⁶⁹ as an expense of administration, because the contract becomes a post-bankruptcy contract of the estate itself. Rejection is defined in section 365 as a breach of contract that is treated as a pre-petition breach of the contract regardless of when it actually occurs during the bankruptcy process.¹⁷⁰

By giving the trustee this option, the Code merely recognizes the choice every contract party possesses: to perform or breach.¹⁷¹ The great difference in bankruptcy is that the breach decision is much cheaper than it is outside of bankruptcy. Because the counterparty after breach is an unsecured creditor, and unsecured creditors are likely to be paid pennies on the dollar, the difference between performance and breach is far greater than outside of bankruptcy. Absent bankruptcy, at least in theory, the counterparty would have received full market recompense for its breach damages paid in full U.S. dollars.

In bankruptcy, the breach damage claim will be calculated in the same way under state law, but the payment will be in BD\$. Some pre-bankruptcy contracts will be good bargains the estate should assume, while others will be bad bargains the estate should reject and pay off in BD\$. The choice is one that arises more generally from the trustee's duty to maximize the value of the estate.

Section 365 seems to counterparties to be loaded in favor of the estate, and so it is. The purpose is to retain a valuable asset (the net value of the contract) for the pro rata benefit of all creditors and to dump unprofitable assets. A lot of the perceived inequity of rejection comes from the fact that the counterparty loses the value of full performance. However, all creditors

¹⁶⁸*FA*, *supra* note 12, at 247; Andrew, *supra* note 59, at 854.

¹⁶⁹11 U.S.C. § 503. It is true that some estates are "administratively insolvent," so that even top priority claimants receive only pro rata payments, but it is likely in most cases where executory contracts are at issue assumption means full payment.

¹⁷⁰11 U.S.C. § 365(g) ("the rejection of an executory contract or unexpired lease of the debtor constitutes a breach . . .").

¹⁷¹*FA*, *supra* note 12, at 250 & n.111 (citing RICHARD POSNER, *ECONOMIC ANALYSIS OF THE LAW* 106 (3d. ed. 1986)); O. HOLMES, *THE COMMON LAW* 301 (1923); O. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). The authorization in section 365 is in that sense not strictly necessary, except to require court approval of the trustee's choice within the prevailing business judgment rule and perhaps to remove any moral taint of promise breaking in this context. See *FA*, *supra* note 12, at 250-51.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY515

share in the lost value of full performance in a bankruptcy proceeding, and rejection simply puts the counterparty in the same position as every other unsecured creditor. Assumption on the other hand elevates the counterparty above the other unsecured creditors, and thus should be permitted only if the estate, i.e. all the other creditors, will receive a net benefit.

From all this, we can see that Section 365(a) has three primary purposes: to provide the trustee with the choice of performance or breach, to require the trustee to get court approval, and to require the trustee to give clear notification to the counterparty of the status of its contract. Its principal effect is to turn pre-bankruptcy contracts into claims against the estate for breach (rejection) or claims for full payment or other performance (assumption). It is essential that it achieve these purposes while serving basic bankruptcy policies, to which we now turn.

B. POLICIES AFFECTING CONTRACTS IN BANKRUPTCY

1. *The Four Basic Policies: Discharge, Equality, Value, and Finality*

The structure of the treatment of bankruptcy contracts rests on four interrelated policies fundamental to American bankruptcy law: discharge, equal treatment of similarly situated creditors, maximization of value, and resolution of all claims.

The discharge, the “fresh start,” is perhaps the most basic notion in our bankruptcy law. Often it is examined solely in the context of the bankruptcy of a natural person, but it is equally important in reorganization under Chapter 11. Only a sweeping release of all pre-bankruptcy obligations, permitting a restatement of the emerging debtor’s obligation in one encompassing plan of payment and performance, can permit effective reorganization practice. Such a sweeping discharge means all the stakeholders of a business—shareholders, lenders, suppliers, customers, and employees—can be confident that there are no concealed financial surprises in the debtor’s future. Each stakeholder can price its dealings with the debtor on the basis of that considerable comfort.¹⁷² At the least, each will know that in case of a later liquidation it will not be sharing with unknown pre-bankruptcy creditors.

Just as relevant is the policy of equal treatment of creditors and the related idea of finality. The 1978 Code went much farther than any previous American bankruptcy law—likely farther than any other insolvency law in the world—by eliminating the idea of “provability” as a limit on the nature of

¹⁷²At the outer edges, not surprisingly, the process can be attenuated or even impossible. *In re Fairchild Aircraft Corp.*, 184 B.R. 910 (Bankr. W.D. Tex. 1995), *vacated* 220 B.R. 909 (Bankr. W.D. Tex. 1988) (impossible to eliminate certain contingent and future liabilities). *Cf. In re Motors Liquidation Co.*, 829 F.3d 135 (2d Cir. 2016), *cert. denied*, No. 16-764, 2017 WL 1427591 (Apr. 24, 2017) (denying liability of new General Motors for pre-petition ignition defect claims, but allowing potential liability for independent claims possibly arising from post-sale failure to disclose).

eligible claims so that virtually all claimants would share in the debtor's assets or, in reorganization, in its future business prospects.¹⁷³ The requirement of "provability" had eliminated some creditors from the reorganization proceeding, which could result in much better or much worse treatment for those creditors' claims, depending on whether the business succeeded.¹⁷⁴ The abolition of "provability" reflects a Congressional policy of handling *all* claims against the debtor in one bankruptcy proceeding to ensure that all creditors of like priority share equally in the proceeds of sale of the debtor's assets or in its reorganization values.

The maximization of value for creditors¹⁷⁵ is a fundamental duty of a trustee, although oddly it is not stated explicitly in the statute.¹⁷⁶ Section 365 epitomizes the maximization of value by skewing a number of provisions in the direction of the estate, rather than toward the counterparties to prepetition contracts.¹⁷⁷ One of several important consequences of this asymmetrical, estate-favoring structure is that the analysis of every executory contract case may turn on the bankrupt's position as the buyer or the seller.¹⁷⁸

Finality requires that all pre-existing claims against a bankrupt debtor must be resolved in its bankruptcy. If some performance under a contract that is incomplete at the time of filing, including contingent performance on either side, is not liquidated or reorganized in the bankruptcy, then two bad results would follow. Either all claims cannot be discharged because those excluded from the bankruptcy proceeding are not discharged, or the discharge of all claims will leave the creditors excluded from the proceeding and out in the cold. That was precisely the problem created by the traditional requirement of provability, where claims that were not provable could not be paid pro rata in the proceeding and could not be discharged. Thus, the provability requirement crippled both the discharge and the equal treatment of creditors. The material breach test was invented when provability was still a requirement, so that when Professor Countryman created his test he could not have

¹⁷³Provability was a test applied to a claim to determine if it could be asserted in a pending bankruptcy. For example, most tort claims were not provable and many contingent claims were not as well. See 4 COLLIER ON BANKRUPTCY ¶ 502.LH. (explaining the history of section 502 and how provability works).

¹⁷⁴See, e.g., Lyle, *supra* note 73; Kauffman, *supra* note 72, at 155-58.

¹⁷⁵Modern bankruptcy law contemplates a number of stakeholders—such as employees—that are not creditors or that have interests beyond that of creditors per se; but it is often easier to speak only of creditors. See Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 789-90 (1987).

¹⁷⁶There is an oblique reference in section 704, "Duties of Trustee," to the best interests of stakeholders. See Elizabeth H. McCullough, *Bankruptcy Trustee Liability: Is There A Method in the Madness?*, 15 LEWIS & CLARK L. REV. 153, 161 & n.51 (2011) (explaining trustee's duties and to whom they owe them and collecting cases).

¹⁷⁷The reason is that the Code is serving the larger policy of equality by reducing the counterparty to the same level as the other creditors that are similarly situated.

¹⁷⁸See notes 20-21 and accompanying text.

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY517

contemplated the presence of many sorts of contingent and future claims that are asserted today under the Code's revised rules.

From these four policies follow the central propositions that govern bankruptcy contracts.

2. *The Policies at Work*

a. Gathering of All Contractual Rights

Everything starts with the passage of all the debtor's assets into the estate by operation of law under section 541(a).¹⁷⁹ It is inimical to bankruptcy policy that creditors should be denied the proceeds of the debtor's assets, whether generated by sale or by receipt of the reorganization value of those assets in a plan.¹⁸⁰ Those assets include all of the debtor's contract rights. If there is a net value in any pre-petition contract, it must be shared by creditors, subject to the constraints of section 365 and the priority rules. Returning all assets to the debtor free and clear of all prior claims, a key result of plan confirmation,¹⁸¹ would have exactly those unjust effects, unless all assets were "dealt with" under the plan.¹⁸² If any contractual assets are removed from the effect of the rules that govern the bankruptcy proceeding—a common result of a finding that a contract is "non-executory"—the consequence is that the counterparty gets to enjoy the full benefits of its contract after the bankruptcy is over and never has to share any of the pain with the other unsecured creditors.

b. Every Contract Must Be Resolved: Acceleration

From these requirements, it follows that every bankruptcy contract, as asset and as liability, must be resolved in the course of a bankruptcy proceeding. As discussed below, that means there can be no "ride-through" contracts, which some courts have permitted to pass through the bankruptcy unaffected.¹⁸³ The policies of the fresh start and equal treatment of creditors require that every contract must be treated in a bankruptcy proceeding, whether a Chapter 7 liquidation or Chapter 11 plan. Most Chapter 11 plans serve this requirement by containing a default provision for contracts that the trustee may have missed. Some plans—perhaps most, although no one has done the study—provide that any contract not rejected is assumed;

¹⁷⁹11 U.S.C. § 541(a). We ignore the exemptions for individual debtors, which are of marginal importance in this discussion.

¹⁸⁰For example, the distribution of these values might be in the form of stock in the reorganized company.

¹⁸¹11 U.S.C. § 1141(b)-(c).

¹⁸²*Id.*

¹⁸³See 3 COLLIER ON BANKRUPTCY ¶ 365.02[2][d] (15th ed. 1999); see e.g., *In re Hernandez*, 287 B.R. 795, 800 (Bankr. D. Ariz. 2002) (explaining why ride-through is incompatible with section 365).

others prefer to default to rejecting unmentioned contracts.¹⁸⁴ Presumably, the required court approval¹⁸⁵ of either result is derived from the approval of its plan as a whole.

c. Notice to Counterparties

Given that claims must be accelerated and contracts must be resolved in a bankruptcy, it is simple fairness to ensure that counterparties understand what treatment is proposed for their contracts. A great example of this important but often unacknowledged policy is the case *In re National Financial Realty Trust*,¹⁸⁶ discussed in Part V.A.2 above, where an option to purchase real estate was sold to a third party post-petition, despite not having been explicitly assumed in the debtor's Plan of Liquidation. The grantor of the option, i.e. the counterparty, had been in discussions with the debtor about whether the option was being assumed or rejected, but was never notified of the result. The grantor of the option concluded that it had been rejected. The counterparty had no idea the option had been assigned to a third party until two years later when the third party attempted to exercise it. The court ended up finding that the option was valid because its "non-executori-ness" allowed it to ride-through the bankruptcy. Thus, the counterparty was unexpectedly still on the hook for the contract years later.

3. "Non-executory" Contracts Violate These Basic Bankruptcy Principles

No pre-bankruptcy contract should be resolved by the "ride-through" doctrine because it violates these principles. A declaration of "ride-through" means the debtor does not receive its discharge and fresh start because it is not relieved of its obligations under these "non-executory" contracts. The counterparty can receive full performance after the bankruptcy proceeding, while the rest of the creditors received BD\$. On the other hand, if the contract is "vaporized" by being declared "non-executory,"¹⁸⁷ any liability of the reorganized company will have been discharged, and its assets will stand free and clear of the counterparty's contract claims. It will be effectively unenforceable by either party. The result will disappoint either the counterparty or the debtor, depending on whether the contract would have been a good bargain for the debtor when the issue arose. Any result of ride through—be

¹⁸⁴A number of informal comments opposing our approach have rested on a concern that contracts might be overlooked. In effect, practitioners are understandably concerned for a fudge factor in case a contract is missed. But to yield to that concern, given the substantial costs in more litigation and disrupted business planning that would arise from that concession, would be to run the bankruptcy hospital for the benefit of the staff, not the patients.

¹⁸⁵11 U.S.C. § 365(a).

¹⁸⁶226 B.R. 586.

¹⁸⁷*Sunbeam Prods, Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY519

it survival of the contract or vaporization—runs completely counter to the policies of the Code.

Professor Countryman's limitation on executory contracts did not require or even presume that contracts falling outside of his material breach definition would end up in contract limbo.¹⁸⁸ His explanations of why debtor-only and counterparty-only contracts were not executory reveals that he believed they would enter the estate through, or be dealt with by, other provisions in the Bankruptcy Act.

Professor Countryman explained that contracts where only the debtor owes an obligation should not be "executory" because allowing them to be assumed by the trustee would "convert the claim" to a priority claim; implicit in this statement is the idea that they would be paid as regular claims if not treated by the predecessor to section 365. (They would effectively be rejected, that is breached, under section 365(g).) His test was simply designed to limit the trustee's ability to favor a contract creditor by administrative priority in a way that would not benefit the estate. His explanation reveals that "non-executory" contracts were already claims against the estate to be dealt with by other provisions.¹⁸⁹ So, it is not the case that he believed these "non-executory" debtor-only contracts were supposed to be excluded from the estate. He thought the executory contracts provision was unnecessary to deal with them and including them under the predecessor to section 365 would only create an unnecessary risk of a trustee's assumption, a risk that is alleviated by court approval today.

Similarly, his discussion of contracts where only the counterparty owed obligations implicitly rested on the expectation that these "non-executory" contracts would be dealt with under other provisions of the Bankruptcy Act, not excluded from the bankruptcy case. He explained that the estate's claim against a counterparty under such a contract "obviously is an asset which in most instances will pass to the trustee under section 70a (5) or (6)."¹⁹⁰ Again, here, his definition excludes this kind of contract from the definition of "executory" because he essentially saw no purpose in including it, leaving it to be dealt with under other provisions. He pointed out that assumption of a counterparty-only contract does nothing to benefit the estate and that rejection (breach) does not make sense when the debtor has already performed. So, he was removing these kinds of contracts because he believed that they do not *need* the predecessor to section 365. This reasoning leads to the ines-

¹⁸⁸Countryman, *supra* note 11, at 450-59.

¹⁸⁹*Id.* at 457 (explaining that a contract where the counterparty has fully performed should not be treated as "executory" because that would only create the possibility of the trustee turning a "claim" into a first priority administrative expense, indicating that the counterparty already holds a "claim").

¹⁹⁰*Id.* at 458.

capable conclusion that he thought they would be handled under other provisions in the Act, not that they remained *outside* of the bankruptcy.

C. THE UNDERLYING ANALYSIS OF EVERY EXECUTORY CONTRACT:
STATE CONTRACT LAW FOUNDATION WITH BANKRUPTCY
LAW OVERRIDE

Our approach builds from the policies outlined above. First, the word “executory” should be understood in its common law definition per Williston: “a contract, the obligation of which relates to the future, or a contract under which the parties have bound themselves to future activity that is not yet completed or performed.”¹⁹¹ This ensures *all* the debtor’s contracts with some remaining performance are pulled into the bankruptcy estate to be either rejected or assumed.¹⁹² If the trustee wishes to assume, application of other provisions of section 365 may prevent this, such as the prohibition on assumption of contracts for financial accommodations.¹⁹³ Otherwise, if assumption benefits the estate, the trustee should assume. Similarly, if the trustee wants to reject, state law will determine the effect of the breach, either specific performance, damages, or both. Federal bankruptcy policy may override state-law policies providing for specific performance. This juncture is where the action concerning protecting the third parties’ interests should happen—in deciding the conflict between state law’s granting of certain rights to third parties and the policies of the Bankruptcy Code—rather than in the shadow of “executoriness.” Now we look at the steps in more detail.

Generally, state contract law is the foundation of an executory contract analysis. It should be used to determine whether there is an enforceable contract, the terms of that contract, and most importantly what remedy is available for breach (i.e., rejection). Analyzing contracts in bankruptcy should follow state law on all those questions to the extent possible, except where bankruptcy policy demands a different result. In almost all cases, the treatment of contracts in bankruptcy differs from treatment under state law in only four ways:

1. *Damages are calculated under state contract law, but are paid in BD\$ as an unsecured claim against the estate.*

Courts should look to state contract law to determine the remedy for breach of a contract through rejection. State contract law will govern what the damages are and how to calculate them. The difference in the bankruptcy context is that the damage claim will be paid in BD\$. This is the only

¹⁹¹SAMUEL WILLISTON & RICHARD A. LORD, WILLISTON ON CONTRACTS § 1:19 (4th ed.).

¹⁹²As one court put it, “the need to find executoriness under the present version of § 365 involves the court in unnecessary legal quandaries.” *In re Seymour*, 144 B.R. 524, 529 (Bankr. D. Kan. 1992).

¹⁹³11 U.S.C. § 365(c)(2).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY521

“power” contained in section 365. Courts have confused the effect of rejection as some kind of “avoiding power,” which terminates the counterparty’s rights under the contract, including property rights.¹⁹⁴ Luckily, the issue prompted legislative action in the area of most intellectual property rights through section 365(n). However, for other types of rejected contracts, the result should be the same—a rejection of a contract is simply a breach of the contract, giving rise to a claim calculated under state law.

2. *Specific performance is not usually permitted against the trustee in bankruptcy unless the contract created a property interest under state law that cannot be taken back except through the use of an avoiding power.*

When courts turn to state law to determine the effect of breach, another overriding bankruptcy policy may come into play. If state law grants the counterparty a specific performance right under the contract, that right may be taken away in bankruptcy unless the contract creates a property interest under state law. In that case, only an avoiding power can be used to terminate the property interest. An example of this would be contracts for the sale of land, or options to purchase land, where state law provides that the remedy for breach of such a contract is specific performance and that right is understood as “equitable title” to the land.¹⁹⁵ Specific performance is not otherwise permitted against the trustee in most cases.¹⁹⁶

Another area where the issue of specific performance against the estate arises is in LLC operating agreements containing rights of first refusal to purchase other members’ rights. Some courts conceive of these rights of first refusal as a “property right” that provides for specific performance against the estate.¹⁹⁷ Proper analysis of this issue would require a court to decide whether the state LLC law allowed specific performance of a right of first refusal in a breach of that provision of the LLC operating agreement *outside* of bankruptcy. If it does, and the right amounts to a right in property, then

¹⁹⁴See, e.g., *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4th Cir. 1985).

¹⁹⁵See *In re Laudenslager*, No. 3:12-BK-2186-PMG, 2014 WL 6544285, at *5 (Bankr. M.D. Fla. Nov. 19, 2014) (finding that rejection of an executory contract for the sale of residential real estate resulted in solely a damages claim without looking to state law). We put to one side for this article the problem of a state law granting what looks like a property right, but permits the party entitled to specific performance the right to sue for damages instead. That presents a nice question with limited case law answers. Cf. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972) (property rights protected by different sorts of relief than other sorts of rights).

¹⁹⁶See, e.g., *In re Plascencia*, 354 B.R. at 780; see also *FA*, *supra* note 12, at 255–60.

¹⁹⁷See *In re IT Grp., Inc.*, 302 B.R. 483, 489 (D. Del. 2003) (finding that a right of first refusal to purchase an LLC was a “property right” that could be enforced with specific performance).

only an avoiding power could be used to terminate that right.¹⁹⁸

3. *Ipso facto* clauses may be voided.

The third federal trump of state law is the voiding of “*ipso facto*” clauses. *Ipso facto* clauses seek to limit a party’s rights or restrict access to assets once a party initiates bankruptcy. Some state law can function in a similar way. Such clauses are invalidated under various provisions of the Code, including section 541(c)(1) and section 365(e)(1). This issue often arises in the LLC operating agreement cases because state LLC acts and the LLC operating agreements themselves may purport to relegate a member to assignee status with very limited rights if the member declares bankruptcy.¹⁹⁹ The proper analysis of these cases is discussed below in Part VII.B. That analysis will focus on whether federal bankruptcy law preempts these state LLC acts’ attempts to restrict the member’s rights upon filing for bankruptcy. These statutes in essence function as state law *ipso facto* provisions; the policy behind them is that LLC members should not be required to include in their company a trustee or an assignee of the debtor’s interest against their will.²⁰⁰

While such a state-law provision cannot prevent the LLC interest from becoming property of the estate because of section 541(c)(1), assumption or assignment may be barred by section 365(c)(1)(A), which prevents the trustee from assuming any executory contract or unexpired lease where applicable law excuses the other party from accepting performance from or rendering performance to a substitute party.

Application of that same provision could protect the non-debtor members of the LLC in the same way that the state LLC acts attempt to do so by preventing the trustee from assuming the LLC agreement, even if the state law *ipso facto* provisions are properly invalidated,²⁰¹ as long as the result is not limited to bankruptcy.

The above analysis demonstrates that section 365 already contains provisions capable of dealing with the problems presented by LLC operating

¹⁹⁸In *FA*, it was speculated that such an avoiding power might have been the right way to avoid the license in the famous *Lubrizol* case. See *FA*, *supra* note 12, at 310. That situation is the classic example of getting past executoryness to discover the actual wrong—a possible fraudulent conveyance—and the proper remedy—avoidance. See *supra* note 47.

¹⁹⁹See generally, e.g., *In re Ichiban*, No. 06-10316-RGM, 2014 WL 2937088 (Bankr. E.D. Va. June 30, 2014); *In re Denman*, 513 B.R. 720 (Bankr. W.D. Tenn. 2014).

²⁰⁰See VIRGINIA LIMITED LIABILITY COMPANY ACT §§ 13.1-1040.1-13.1-1040.2 (“Events causing member’s dissociation” includes the member becoming a debtor in bankruptcy and dissociation means that the member has the rights of an assignee); *In re IT Grp., Inc.*, 302 B.R. at 489; *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 749-62 (2004); see also Carter G. Bishop, *Desiderata: The Single Member Limited Liability Company Olmstead Charging Order Statutory Lacuna*, 16 STAN. J.L. BUS. & FIN. 222, 244-51 (2011).

²⁰¹For a scholarly article discussing the frequency with which this is already happening, see Michele Morgan Harner, Carl E. Black, Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187 (2005).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY523

agreements. Section 365(c)(1)(A) is one such provision where Congress has created protection for a counterparty. The problem is that the material breach test takes provisions like section 365(c)(1)(A) out of play if and when an LLC operating agreement is deemed “non-executory.”²⁰²

4. *Occasionally bankruptcy policy may simply override state law.*

The last area where bankruptcy treatment of contracts differs from state-law rules is that sometimes the strong policy favoring discharge of the debtor's obligations will override state-law specific performance rights. This situation is illustrated by covenants not to compete.²⁰³ Imagine a situation where the debtor was subject to a covenant not to compete agreement and rejects it in a Chapter 13 proceeding. The issue is not whether the agreement *can* be rejected, which is where many courts get hung up, because it absolutely can be rejected. Any contract that can be breached can be rejected. The issue is the effect of that rejection. If state law provides that the only remedy for breach of this kind of covenant is an injunction against competition, then we have a clear conflict between the remedy provided at state law (specific performance) and the policy of the discharge (freeing the debtor from burdensome obligations).²⁰⁴ The important point here is that while this is a tough question, it is a tough question about *discharge*, not about whether or not the contract is executory and can be rejected.²⁰⁵

²⁰²See *supra* notes 123–30 and accompanying text.

²⁰³*In re Spooner*, No. 11-31525, 2012 WL 909515 at *3 (Bankr. N.D. Ohio Mar. 16, 2012).

²⁰⁴See DEBTORS AND CREDITORS, *supra* note 51, at 593 (PS 26.4). Cases about oil and gas leases provide an example of this nuance. See generally *In re WRT Energy Corp.*, 202 B.R. 579 (Bankr. W.D.La. 1996); *Emery Res. Holdings, LLC v. Coastal Plains Energy, Inc.*, No. 2:08-CV-907, 2010 WL 1257761, at *6 (D. Utah Mar. 26, 2010). The issue in these cases is not whether an oil and gas lease can be rejected, but instead what the rights of the counterparty are under state law once the debtor has breached, i.e. rejected, that oil and gas lease. Similar examples are found in cases exploring “rejection” of settlement agreements, which hinge on the remedies to a counterparty under state law when the debtor breaches a settlement agreement. See *In re Level Propane Gases, Inc.*, 297 B.R. 503, 509 (Bankr. N.D. Ohio 2003), *aff’d* No. 02-16172, 2007 WL 1821723 (N.D. Ohio June 22, 2007); *In re Spoverlook*, No. 15-13018 t11, 2016 WL 5874830 (Bankr. D.N.M. Oct. 7, 2016) (reaching the correct state-law question after having already determined the settlement agreement was executory). The solutions to oil and gas leases and settlement agreements are presented in the Appendix.

²⁰⁵See *In re Giordano*, 446 B.R. 744 (Bankr. E.D. Va. 2010) (focusing on executoriness when the operative issue in the case is about possible discharge of a specific performance order); *In re Acevedo*, 441 B.R. 428 (Bankr. S.D.N.Y. 2010) (first discussing executoriness of a contract that was the subject of a state court specific performance order when the dispositive issue is whether that order can be reduced to a claim and discharged). But see *In re Lawson*, 14 F.3d 595 (4th Cir. 1993) (properly identifying the issue as one of dischargeability, rather than executoriness). Perhaps this process of balancing the interests of state and federal bankruptcy policy is related to the “gating” function for which the Commission majority was searching under the cloud of executoriness.

VII. ANALYSIS OF CASES: THE MODERN CONTRACT ANALYSIS IN PRACTICE

To demonstrate our approach in practice, we present here our analysis applied to the kinds of contracts presented in the case examples in Part IV: option contracts, LLCs, and IP licensing agreements. We also add in an example of the proper analysis of non-compete covenants because so often the question of dischargeability of injunctive relief is hidden behind fruitless questions of executoriness. These examples provide guidance on how these types of problematic executory contracts can be analyzed in a straightforward manner focusing on state contract law and keeping in mind the bankruptcy policy overrides. In our appendix, we offer many other examples of how our approach can simplify the struggles with “executoriness” courts have experienced over the past twenty-five years.

A. OPTION CONTRACTS

For our first example of Modern Contract Analysis, we will use the option contract at issue in *In re National Financial Realty Trust*. Recall that in *National Financial Realty Trust*,²⁰⁶ discussed in Part V.A.2, the debtor held a real estate option contract. Nothing was done on the option contract until five years into the bankruptcy, when the debtor began exchanging communications with the grantor of the option (the counterparty) about whether the option would be assumed or rejected. When the counterparty asked for evidence that the option had been assumed, it never received an answer. The debtor then sold the option to an innocent third party. Two years later, the counterparty heard from the third party that had purchased the option and was attempting to exercise it.

Under our approach, option contracts are clearly executory because at least one side still has performance obligations due. Every option contract should be dealt with under section 365. If the debtor owns the option, it follows that assumption will probably benefit the estate, but the particular facts of each case would control. Thus, the option in *National Financial Realty Trust* should have likely been assumed, but the parties’ understanding was that the Chapter 11 plan failed to provide for assumption.²⁰⁷ Thus, under section 365(d), the option contract was deemed rejected under section 365(d)(2) upon confirmation of the plan, long before the debtor tried to sell it five years later. Because the option was rejected, it follows that it could not have later been validly sold to the third party.²⁰⁸

²⁰⁶226 B.R. 586 (Bankr. W.D. Ky. 1998).

²⁰⁷Whether the plan assumed the contract is not discussed in the opinion, but the opinion then proceeds on the apparent assumption that the plan did not.

²⁰⁸See 3 COLLIER ON BANKRUPTCY ¶ 365.09 (explaining that in order to assign a contract it must first be assumed under section 365(f)).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY525

The court in *National Financial Realty Trust* was able to use “non-executoriness” to save the debtor from its carelessness in failing to assume, thereby protecting the purchasing party from harm. However, this result came at the expense of leaving the counterparty unaware about the status of the valid option for about five years after the bankruptcy filing. Thus, the equity perceived from the perspective of the innocent purchaser looks quite different from the perspective of the counterparty. Executoriness allowed the court to shift the loss from the purchaser to the counterparty, but it did so in unintentional contravention of the Bankruptcy Code’s requirement that the option be treated as rejected. Perhaps this case is an example of what some may feel is a need for “wiggle-room” in section 365 to cover equities now achieved behind the veil of “executoriness.”²⁰⁹ One advantage to replacing “executoriness” with authorization of judicial discretion would be that the court would have to explicitly balance the harm between the third party and the counterparty and explain why the former had the greater equity in keeping the option than the counterparty would have had in reselling the property at a greater profit following the debtor’s breach.

A similar analysis would apply in *BNY Capital Funding v. US Airways, Inc.*²¹⁰ Here, the debtor, US Airways, was the option-holder on a “letter of intent” for a lease financing arrangement for the purchase of airplanes. The court found after an extensive analysis that this was *not* an executory contract and thus not subject to section 365(c)(2), which would have prevented the assumption of option contract for financing. US Airways wanted to keep the letter of intent, planning to exercise it at a later time after its reorganization to finance its purchase of airplanes. The court gave US Airways exactly what it wanted, explaining that this non-executory contract for financial accommodations not only entered the estate, but also apparently survived the bankruptcy unaffected.²¹¹

Under our analysis, the option is clearly executory because some performance is still due. Thus, section 365(c)(2) does apply. Because this contract is one for financial accommodations, it cannot be assumed. It must be rejected and any damages will be paid in BD\$.²¹² This case is one of many that demonstrate that if the “executoriness” inquiry is omitted, most of these cases can generally be solved simply by applying the provisions in section 365.

²⁰⁹See Commission Report, *supra* note 3, at 114–15.

²¹⁰345 B.R. 549 (E.D. Va. 2006).

²¹¹“As an unexercised option, the LOI was property of US Airways’ bankruptcy estate and re-vested in the re-organized US Airways on the effective date.” *BNY Capital Funding*, 345 B.R. at 556.

²¹²Given that the lender did not want to finance the debtor any more, it is quite likely damages would be zero or merely incidental.

B. REJECTING RIGHTS IN LLC OPERATING AGREEMENTS

LLC operating agreements present challenging questions about the interplay between state LLC law and federal bankruptcy law. Our approach proceeds directly to those challenging questions.

State LLC acts define an interest in an LLC as personal property.²¹³ It is important to recognize that under state law and within the contracts among the parties there are three separate assets potentially entering the bankruptcy estate when an LLC member files a bankruptcy petition: the debtor's economic interest in the LLC, her membership interest in the LLC, and the LLC operating agreement.²¹⁴ The economic interest is the right to receive a distribution from the LLC when distributions are made.²¹⁵ The membership interest is the right to participate in management and control of the LLC.²¹⁶ The LLC operating agreement is a contract among the members that provides their rights and obligations vis-à-vis one another; these usually include a right of first refusal to purchase other members' shares.²¹⁷ Most courts hold that the first two of these interests enter the bankruptcy estate through section 541.²¹⁸ The LLC operating agreement is a separate asset that can be treated through section 365, although many courts conclude differently due to the difficulty of applying the material breach test to an LLC operating agreement.²¹⁹

State LLC statutes provide that the right to manage (i.e. the membership interest) is a personal property right, but neither the statutes nor the relevant literature characterizes the other two interests as either a property right or a contract right. We know that property and contract rights are different, but that difference must await another article or perhaps a book.²²⁰ We want to focus on state-law remedies and avoid the more abstract questions if we can.

It is potentially important to our analysis to consider whether the three interests are interdependent such that performance by the member under one of them determines rights under one of the others. The cases so far suggest that the LLC operating agreement is a separate asset from the other two

²¹³WILLIAM CALLISON & MAUREEN A. SULLIVAN, LTD. LIABILITY CO.: A STATE-BY-STATE GUIDE TO LAW & PRACTICE § 4:1 (2015).

²¹⁴Paul R. Hage & Patrick R. Mohan, *What Your LLC Operating Agreement Can Do for You*, AM. BANKR. INST. J., July 2012, at 24; see also Bishop, *supra* note 200, at 245.

²¹⁵Hage & Mohan, *supra* note 214, at 24.

²¹⁶*Id.*

²¹⁷See Bishop, *supra* note 200, at 245-49; see *infra* Part VII.B.1.

²¹⁸See, e.g., *In re Warner*, 480 B.R. 641, 653, 655 (Bankr. N.D.W. Va. 2012); see also Bishop, *supra* note 200, at 246.

²¹⁹*Compare In re DeVries*, No. 12-04015-DML, 2014 WL 4294540 (Bankr. N.D. Tex. Aug. 27, 2014), with *In re Strata Title, LLC*, No. 12-24242, 2013 WL 1773619, at *2 (Bankr. D. Ariz. Apr. 25, 2013).

²²⁰See FA, *supra* note 12, at 259-61.

2017) DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY 527

interests with its own obligations, so it appears that it can be assumed or rejected separately from the other two.

1. *Generally*

Courts usually struggle through the material breach test for LLC operating agreements because a non-debtor LLC member is attempting to exercise a right of first refusal contained in an agreement. It is common for LLC operating agreements to contain provisions that create a right of first refusal to purchase another member's interest upon a triggering event, sometimes any proposed sale or sometimes bankruptcy. The other LLC members want to enforce their right of first refusal to buy the debtor-member's interest, while the debtor or trustee seeks to sell the interest free and clear. This is the fact scenario of the cases we will examine next.

In *Capital Acquisitions*,²²¹ the court determined that an LLC operating agreement was not executory, and that the right of first refusal to purchase the debtor-member's interest triggered by any sale of the interest was enforceable in the bankruptcy. We presented a full explanation of the facts and reasoning of the case in Part V.B.1.

Under our approach, a court encountering an LLC operating agreement containing a right of first refusal first asks if any party has outstanding obligations that meet the common law definition of "executory." In any LLC agreement, this test will be met as it will invariably contain notice and appraisal procedures for exercising rights of first refusal or other voting obligations. Then, the court would have evaluated whether the right of first refusal survived section 365(e)(1), which invalidates *ipso facto* provisions. The right of first refusal in this case remained valid because it was not triggered by bankruptcy, but rather by *any* sale.

In *Capital Acquisitions*, LLC members were attempting to enforce a right of first refusal to stop the trustee from selling the debtor-member's interest to a third party, Welland, for a higher price. From the trustee's desire to sell the interest to Welland, we can infer that the trustee believed the estate would benefit most from a sale to Welland rather than to the other LLC members. Thus, it seems that the trustee wanted to reject the LLC operating agreement, i.e. breach it, and sell the debtor's economic and membership interest in the LLC (property of the estate) in violation of the right of first refusal. The court would then have to look to state law to determine the effect of the trustee's rejection of the LLC agreement and breach of its right of first refusal provision.²²²

²²¹*In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006).

²²²A similar recent case is *In re Minton*, No. 14-91293, 2016 WL 354319 (Bankr. C.D. Ill. Jan. 23, 2017) (slip copy). In *Minton*, the other LLC members tried to argue the operating agreement was executory and that the trustee's failure to timely assume it within the sixty-day period meant it had been

If state LLC law had granted the other members a specific performance right rather than a right to damages, then the right of first refusal might be a property right that the estate will have to perform. If, on the other hand, state law awarded the other LLC members damages, then the trustee would pay those damages in BD\$ and the trustee could sell the property free and clear.²²³ In *Capital Acquisitions*, the court did analyze whether the right of first refusal was a right protected by specific performance, but looked to other federal law rather than state law. In a proper application of our approach, the court would have looked to Illinois law rather than a federal district court case from Delaware.

*In re Knowles*²²⁴ demonstrates that the material breach test often does not lead courts to the right questions or the right results. In *Knowles*, the husband and wife Chapter 7 debtors owned interests in an LLC, which were subject to a right of first refusal in favor of the other LLC members as provided in the LLC operating agreement. The trustee wanted to reject the LLC operating agreement in order to sell the interests free of the right of first refusal in a competitive bidding process. The court found the LLC operating agreement non-executory despite management and supervision obligations on all members, fiduciary obligations to contribute capital if needed, and quarterly and annual member meetings (none of which had been held). The court characterized these obligations as too remote to make the agreement executory. Because the contract was not executory, the court said that the LLC operating agreement could not be rejected. Instead, the rights of first refusal were enforced, apparently through implicit assumption of the LLC operating agreement.

Under our approach, the LLC operating agreement is executory. The trustee wants to reject it and the right of first refusals within it. The question then is what is the effect of rejection under state law? The court would need to look to applicable state LLC law to determine the effect of a member's breach of an LLC operating agreement by refusing to honor another member's right of first refusal. The answer to that question may not be

rejected. *See id.* The other LLC members argued this rejection meant the debtor lost his membership interest in the LLC. *See id.* The court correctly concluded the interest in the LLC was separate and distinct from any rights or obligations under the operating agreement. *See id.* The court then determined that the operating agreement was not executory and so could not be rejected or assumed, but then held that the trustee was bound by the rights of first refusal in it. *See id.* This analysis leads to the conclusion the operating agreement was implicitly assumed, because the trustee would certainly have been able to breach it and disregard the right of first refusal, just as the debtor would have been under state law. State LLC law or general commercial law would determine the remedy for that breach.

²²³As noted earlier in Part VI.D.2, the trustee will sell at the market price and pay damages for the estate's profits, but the damages are in BD\$, so the estate profits by the difference. The counterparty is left in the same pennies-on-the-dollar position as all the other unsecured creditors.

²²⁴No. 6:11-BK-11717-KSJ, 2013 WL 152434, at *1 (Bankr. M.D. Fla. Jan. 15, 2013).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY529

spelled out under state law, and the bankruptcy court may have to do some creative thinking, akin to a federal court making an “*Erie* guess” in a diversity suit.²²⁵ However, our approach always will lead to that same question. Any differences in the results will be due to differences in facts or applicable state law, rather than differences in the executoriness approach to bankruptcy contracts we see currently. In *Knowles*, if state LLC law gave other members the right to seek an injunction or other specific performance remedy to enforce their right of first refusal, then the result there is correct despite the roundabout analysis. If, however, state LLC law gives a damage remedy, this result in *Knowles* is wrong—the right of first refusal would have been breached, and the members would have been paid damages in BD\$.

2. *Ipso Facto* Triggers in LLC Operating Agreements

There is another aspect of LLC agreements that creates difficulty at the intersection of state law and federal bankruptcy law. As discussed above, LLC operating agreements frequently provide a right of first refusal in favor of other members if one member declares bankruptcy. In the case of the bankruptcy of a debtor who is a member of an LLC where the trustee seeks to assign and sell the debtor’s interest, an opposing party may claim the contract is not executory and is therefore not subject to assumption and assignment. The claim is often based on a provision that terminates the debtor’s membership interest upon bankruptcy and relegates the interest to an “assignee” interest.

If that provision is found only in the LLC agreement, it will fail, because it is an *ipso facto* clause overcome by sections 541(c)(1) and 365(e)-(f). On the other hand, in some cases state law itself contains such a provision. That state law seeking to limit the debtor’s interest upon bankruptcy will also be disregarded under section 541(c)(1), which states that the debtor’s interests become property of the estate notwithstanding “applicable nonbankruptcy law” that seeks to restrict the transfer of the debtor’s interests to the estate.²²⁶ However, even though these clauses are invalidated by sections 541(c)(1) and 365(e)-(f), the contract arguably still cannot be assumed and assigned because of section 365(c)(1) which bars assumption of a contract unassignable under nonbankruptcy law.

²²⁵See *Howe ex rel. Howe v. Scottsdale Ins. Co.*, 204 F.3d 624, 627 (5th Cir. 2000) (explaining when a federal court makes an “*Erie* guess”).

²²⁶See *In re Daugherty Constr., Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995) (the first case addressing the issue); *In re Ellis*, No. 10-16998-AJM-7A, 2011 WL 5147551, at *2 (Bankr. S.D. Ind. Oct. 27, 2011); *In re LaHood*, 437 B.R. 330, 336 (C.D. Ill. 2010); *In re Klingerman*, 388 B.R. 677, 679 (Bankr. E.D.N.C. 2008). There are cases going the other way, i.e. holding that the Code does not invalidate these state laws that appear to function as *ipso facto* clauses. *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708 (Bankr. E.D. Va. 2000); *Nw. Wholesale, Inc. v. PAC Organic Fruit, LLC*, 334 P.3d 63, 77 (Wash. Ct. App. 2014), *aff’d*, 357 P.3d 650 (Wash. 2015).

Courts that survive the executoriness analysis usually find that *ipso facto* clauses are invalidated by applicable sections of the Code.²²⁷ The problem arises when courts find that an LLC agreement is not executory, and therefore do not apply section 365. They may still find that any *ipso facto* clauses are eliminated under section 541, instead of section 365,²²⁸ but they never reach section 365(c), which restricts the trustee's ability to assume contracts even when *ipso facto* clauses are off the table.²²⁹ Section 365(c) is important because it is the provision of the Code designed to protect counterparties from being forced to deal with the trustee, or a third party if a contract is sold in bankruptcy. If applicable nonbankruptcy law allows them to refuse dealing with a party other than the debtor—unrelated to any bankruptcy or insolvency—then arguably the Code protects them from having to accept performance from the trustee or another party.

A good example of a case focusing on section 365(c) is *In re Soderstrom*.²³⁰ In that case, the court correctly decided that the LLC operating agreement was executory and subject to section 365. The agreement did not contain any *ipso facto* provisions, but the court still held that it could not be assumed because under section 365(c)(1) state law granted the other members the right to refuse substitute performance from someone other than the debtor. This analysis demonstrates the way the Code intends to protect the other LLC members. A finding that a contract is not executory means that section 365(c) is out of play. In such a case, the court's resolution of the case may or may not reach the correct outcome, but the analysis will be detached from the Code when the Code in fact contains a specific provision to handle these situations.

While we do look to state law to create the property rights that enter the bankruptcy estate, state law cannot attempt to remove those rights on the basis of insolvency.²³¹ It is within the Bankruptcy Code where the protections for counterparties exists, not from state law, even though the Code may look to state law as it does in section 365(c). Thus, it is even more important with LLC interests and LLC operating agreements that courts ask the correct question in analyzing an executory contract question—how does state law interact with federal bankruptcy law—because it is only then that

²²⁷See, e.g., *In re Strata Title LLC*, No. 12-24242, 2013 WL 1773619, at *2 (Bankr. D. Ariz. Apr. 25, 2013); *In re DeVries*, No. 12-04015-DML, 2014 WL 4294540 (Bankr. N.D. Tex. Aug. 27, 2014); *In re IT Grp. Inc.*, 302 B.R. 483 (D. Del. 2003).

²²⁸*In re Denman*, 513 B.R. 720 (Bankr. W.D. Tenn. 2014).

²²⁹*In re Ehmman*, 319 B.R. 200 (Bankr. D. Ariz. 2005).

²³⁰484 B.R. 874 (M.D. Fla. 2013).

²³¹This policy is reflected in the numerous provisions of the Bankruptcy Code that invalidate state *ipso facto* clauses, such as section 541(c)(1)(B) and section 365(e)(1).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY531

the courts can identify and work through these other conflicts between state law and federal law that LLC operating agreements present.

C. IP LICENSING AGREEMENTS

We save the best for last. IP licensing agreements have proven difficult under the material breach test, but as these examples will show, our Modern Contract Analysis guides the court directly to the pertinent questions.

In the *Interstate Bakeries* case,²³² the court found that a trademark licensing agreement was *not* executory because obligations to make royalty payments and covenants not to sue were deemed nonmaterial. Thus, the court held that the “non-executory” licensing agreement could not be rejected by the debtor licensor and denied its motion to reject. The court noted that finding the contract “non-executory” allowed it to avoid discussing the effect of rejection on the licensing agreement, an issue that has divided the courts.²³³ While the court did not explain what would happen to the licensing agreement now, it would seem that the only option for this “non-executory” contract, oddly enough, would be implicit assumption, since the contract would be enforceable after bankruptcy.²³⁴

Under our approach, things are simplified. The license would clearly be executory because there is some performance due. A trademark licensing agreement such as this one contains obligations on both sides including quality control and maintenance of the trademark. Thus, the trustee or DIP would reject this licensing agreement if it were unprofitable or assume it if it were profitable. The DIP’s motion to reject in this case indicates that it believed the contract was unprofitable.

The court would have had to address squarely the effect of rejection of a licensing agreement. This is not as scary as it seems, because the answer is in applicable nonbankruptcy law.²³⁵ First, the court would likely find that under federal trademark and intellectual property law a licensor’s breach of a licensing agreement does not entitle the licensor to unilaterally revoke the licensee’s rights under that agreement. Instead, the licensee will probably be allowed to continue using the trademark while paying royalties for its use

²³²*In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014).

²³³See *Lubrizol Enters. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985) (“Under 11 U.S.C. § 365(g), Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract.”); *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012) (disagreeing with *Lubrizol*).

²³⁴As with so many of these cases, the exact effect of the court’s ruling is not fully explained and the analyst is forced to infer what must have happened. We contend ride-through is impossible, but most important is the effect of the decision, which is identical to assumption. The debtor was forced to assume, something nowhere authorized under the Code.

²³⁵Because this was a trademark licensing agreement, section 365(n) does not squarely apply.

and receiving damages for the licensor's breach of its remaining obligations under the agreement. So, the effect of breach does not take back the licensee's rights,²³⁶ and the court would now have to determine what remedies the licensee has against the licensor to determine whether the debtor can discharge the ancillary obligations under the contract via rejection. This step is essential because rejection simply turns the breach of contract into a prepetition claim—if this type of contract warrants specific performance, then ordinarily the debtor cannot discharge its obligation through payment of a claim in bankruptcy.²³⁷

A recent decision by the Bankruptcy Appellate Panel for the First Circuit, *In re Tempnology LLC*, supports the reasoning behind our approach.²³⁸ The debtor had a distribution, licensing, and marketing agreement with a counterparty, Mission.²³⁹ The agreement granted Mission licenses to the debtor's IP, trademarks, logos, and gave Mission exclusive distribution rights in defined areas.²⁴⁰ The debtor-licensor rejected the licensing agreement.²⁴¹ The parties argued about whether section 365(n) protected all, or only some, of Mission's rights under the licensing agreement because not all of them clearly fell under the definition of "intellectual property" under section 101(35A).

The bankruptcy court held that section 365(n) did not protect Mission's rights to use the debtor's trademarks or logos because they fell outside of "intellectual property," and the result of this conclusion was that Mission did not retain rights to the trademarks and logos post-rejection.²⁴² The Bankruptcy Appellate Panel concluded that while trademarks and logos could not be retained as intellectual property under section 365(n) of the Code, the bankruptcy court erred in concluding that Mission had no rights in the trademarks and logos after rejection.²⁴³ Rejection did not vaporize these rights that were not addressed by section 365(n).²⁴⁴ Instead, "[w]hatever post-rejection rights Mission retained in the Debtor's trademark and logo are governed by the terms of the Agreement and non-bankruptcy law."²⁴⁵ As we might put it, breach of contract (rejection's effect under section 365(g)) would not somehow entitle the debtor to void its original grant of rights

²³⁶See *FA*, *supra* note 12, at 305-11.

²³⁷As with real estate, the converse would likely not be true under trademark law, where a licensee debtor (i.e., a grantee) could just breach by rejection and pay damages.

²³⁸559 B.R. 809 (B.A.P. 1st Cir. 2016).

²³⁹See *id.* at 811-13.

²⁴⁰See *id.*

²⁴¹See *id.* at 814.

²⁴²See *id.* at 814-15.

²⁴³See *id.* at 822.

²⁴⁴See *id.* at 822-23.

²⁴⁵See *id.*

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY533

under nonbankruptcy law, although it did permit the avoidance of various ongoing obligations.²⁴⁶

To sum up the general rules, if under applicable nonbankruptcy law a party is entitled to damages after a breach, then rejection will result in payment of that party's claim in BD\$ and discharge of the obligations.²⁴⁷ If instead a party is entitled to specific performance protecting its use of the license under applicable nonbankruptcy law, then the breach claim cannot be discharged under the language of the statute, because those obligations cannot be reduced to a "claim" for money against the estate. As to the remaining obligations (like defending the trademark), if federal trademark law provides that the licensee cannot force the licensor to perform the obligations (that is, they are what we would call "ancillary"²⁴⁸), then the licensor will pay the licensee its damages (in BD\$) for the licensor's breach of the trademark maintenance obligations, for example, and will be discharged from those obligations. By contrast, if federal trademark law provides that the covenant not to sue the licensee in a trademark licensing agreement does entitle a party to specific performance, then that covenant will not be discharged by the debtor's rejection of the licensing agreement, although it will likely be conditioned on payment of the agreed royalties, if any.

A similar analysis applies to any intellectual property licensing agreement, subject to the special exceptions of section 365(n) of the Code.

D. COVENANTS NOT TO COMPETE

First, we will review a relatively straightforward non-competition agreement case, *In re Spooner*.²⁴⁹ In *Spooner*, the Chapter 13 debtor had a non-compete agreement with a previous employer, which a state court had already adjudged was not void. The debtor wanted to reject the non-compete agreement in his bankruptcy. The court held that the contract was not executory under the material breach test or the functional approach applied by the Sixth Circuit²⁵⁰ because rejection would not achieve any benefits for the estate. It reasoned that rejection could not eliminate the employer's equitable non-monetary rights in the non-compete agreement and so there was no benefit in rejection, which meant the agreement was not executory under the functional approach.

Non-compete covenants almost always raise tough questions about dis-

²⁴⁶Note that section 365(n) produces similar, although not identical, results for intellectual property like patents.

²⁴⁷*Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 376-77 (7th Cir. 2012). Judge Easterbrook commendably holds that the effect of rejection is whatever would be the result under state law after breach and that rejection cannot be used as an avoiding power.

²⁴⁸See *FA*, *supra* note 12, at 287-94.

²⁴⁹No. 11-31525, 2012 WL 909515 (N.D. Ohio, Mar. 16, 2012).

²⁵⁰*In re Jolly*, 574 F.2d 349 (6th Cir. 1978).

charge, rather than executoryness,²⁵¹ because state law grants a right that directly bumps up against the fresh start policy. Under our approach, there is no executoryness analysis because this obligation clearly fits within the common law definition of the word “executory.” It is also equally clear that the debtor wants to reject this non-competition agreement. So, the only question in this case is what the effect of that rejection would be. The answer to that question would, as always, depend on whether state law gives the employer a specific performance remedy, just damages, or both. If under state law the employer is given solely equitable remedies that cannot be reduced to a “claim,” i.e. payment of money, then the obligations under that contract are not dischargeable. Thus, the contract could theoretically be rejected, but the obligations under it may not be discharged because they cannot be reduced to a claim. The court would have to balance the state-law rights the employer is asserting with the federal policy of the fresh start. This balancing would likely depend on the facts of the specific case and how likely it was that the nondischargeability of these obligations would impact the debtor’s fresh start.²⁵²

*In re Ortiz*²⁵³ is a good example of the analysis we suggest. In *Ortiz*, a boxer had rejected a promotional agreement with a boxing promoter because it had not been timely assumed under section 365(d)(1). The parties did not dispute whether the contract was executory, so the court was saved from wading through any material breach analysis. Instead, the court focused on how the rejection, i.e. breach, affected the substantive rights and obligations of the boxer and the promoter. To determine that question, the court remanded to the trial court with instructions to look to state law to see what remedies the promoter would have if the contract had been breached outside of bankruptcy, and whether those remedies were equitable or could be reduced to a claim for damages.

VIII. CONCLUSION

The appendix lays out further examples of these kinds of contracts, including among others, oil and gas lease contracts and publishing agreements.

We propose a return to the fundamental considerations that prompted Professor Countryman to create the material breach test. The test has drifted away from its principled moorings. The way forward is to return to those moorings, rather than to cling to the lost-at-sea material breach test.

²⁵¹See, e.g., *In re Jarvis*, No. 04-01097-JMD, 2005 WL 758805, at *5 (Bankr. D.N.H. Mar. 28, 2005) (focusing on executoryness of a non-compete agreement when the real question was dischargeability of injunctive remedies) and *supra* notes 203–05 and accompanying text.

²⁵²For a case demonstrating analysis of the discharge issue as we suggest, see *In re Hughes*, 166 B.R. 103 (Bankr. S.D. Ohio 1994).

²⁵³400 B.R. 755 (Bankr. C.D. Cal. 2009).

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY535

Professor Countryman explained that section 365 exists to benefit the estate and should not be exercised where it would prejudice creditors of the estate.²⁵⁴ The material breach test has been warped into a mechanism that does exactly that. It often removes valuable assets from the estate because they are a part of a “non-executory” contract. Just as often, the test leads to outcomes that favor one creditor at the expense of all the rest, because it forces *de facto* assumption of a bad bargain. Above all, the results under the material breach test are wildly unpredictable. This unpredictability harms all commercial parties who cannot with any semblance of confidence predict what might happen to their contracts once a counterparty declares bankruptcy.

By contrast, Modern Contract Analysis furthers the objectives of Chapter 11 and the Bankruptcy Code as a whole. By starting with state or other federal contract and property law, Modern Contract Analysis ensures that pre-bankruptcy bargains and entitlements will be changed in Chapter 11 only insofar as bankruptcy policies, like equality of treatment and rehabilitation of debtors, require alteration. Properly understood, the very process of acceptance or rejection is simply the trustee’s exercise of the opportunity every contract party has to perform or breach with whatever consequences non-bankruptcy law proscribes. Only when nonbankruptcy law is well understood will bankruptcy law apply to reduce damage claims to BD\$ (the equality principle) and to discharge almost all former obligations of the reorganized debtor (the fresh start/rehabilitation principle).

The central role of contracts as valuable assets in the modern corporation may explain a desire to preserve executoryness as a legal wildcard the courts can play when it seems necessary and just to do so. If such a card is wanted, far better it should be clear and explicit. Congress or the courts should replace a baffling case law concept with authorization to use equitable discretion in applying section 365.²⁵⁵ In permitting such a discretion or in exercising it, the courts would be required to confront directly the benefits of equity and its costs, especially the cost of unpredictability (and therefore a likely increase in price) in many millions of contracts that might never be touched by bankruptcy. With or without that safety valve, the end of executoryness would eliminate a major flaw in the law of reorganization by rationalizing the treatment of contracts in the rehabilitation process.

²⁵⁴Countryman, *supra* note 11, at 450–51.

²⁵⁵Bankruptcy courts are given such discretion in a variety of circumstances. For example, section 552(b)(1) of the Code permits the court to limit a secured creditor’s interest in proceeds of its security interest “based on the equities of the case.” 11 U.S.C. § 552(b)(1) (2012).

APPENDIX OF EXAMPLE CASES AND SOLUTIONS

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
OIL AND GAS LEASES/INTERESTS IN REAL PROPERTY	
<p>In re Foothills Texas, Inc., 476 B.R. 143 (Bankr. D. Del. 2012). The debtors had executed an overriding royalty interest (ORI) to a third party years before bankruptcy. In bankruptcy, a plan was confirmed that purported to “reject” the ORI as an “executory contract.” The debtors interpreted this plan to mean that all their obligations under the ORI were rejected, including paying taxes, accounting for royalties, covering costs and expenses. The third party argued that the contract was not “executory” and could not be rejected. The court agreed, applying the material breach test, and held that because the contract was not executory, it could not be rejected under the plan. Thus, it had survived the bankruptcy and was still enforceable.</p>	<p>First, there is no inquiry into executory-ness. The debtor owes some obligations under the ORI so section 365 applies. The debtor attempted to reject this ORI, so the issue is what is the effect of that “breach.” A court would look to applicable state law to answer that question. Because the ORI is essentially a conveyance of an interest in land and was recorded, state law likely conceives of it as a property right that is enforced with specific performance. Thus, unless an avoidance power can terminate this property interest, the ORI obligation survives because it cannot be made into a “claim” and discharged. If state law provides that the breach of an ORI contract can be remedied with damages, then the debtors can refuse to perform the ORI agreement and pay damages. The point is that state law decides whether “rejection” results in a damages claim or a specific performance claim. The latter cannot be simply paid as a claim and discharged in the bankruptcy.</p>
<p>In re Alpha Natural Resources, Inc., No. 15-33896-KRH, 2016 WL 427236 (Bankr. E.D. Va. Aug. 11, 2016). The debtor was bound by an agreement which required it to pay two individuals an amount calculated based on a percentage of coal mined and sold from three separate areas. It sought to reject this agreement in its bankruptcy proceeding. Successors in interest to the two individuals objected that the payment obligation could not be rejected because it was an interest in real property. The court did not engage in</p>	<p>This case is a good example of the proper analysis of interests created under contracts that relate to mineral interests. Such contracts are executory, but the relevant question is the effect of breach of different provisions. State law will determine whether the breach of a certain provision gives rise to damages or a specific performance remedy. In either case, the oil and gas contract can be rejected—the rejection may not have a practical effect on the counterparty’s interest, however, if state law considers it to be a right that can be</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY537

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>an extensive analysis about why the agreement was executory. Instead, it went straight to analyzing applicable state law to determine whether the payment obligation was a contractual one that could be breached and paid with damages or was a transfer of a property interest.</p>	<p>remedied with specific performance.</p>
CONTRACTS FOR SALE OF GOODS	
<p>In re Hawker Beechcraft, Inc., 486 B.R. 264 (Bankr. S.D.N.Y. 2013). The Chapter 11 debtor, an aircraft manufacturer and seller, was attempting to reject Aircraft Purchase and Support Plus Agreements it had with buyers that included scheduled maintenance and warranty obligations. The buyers argued that the contracts were not executory and thus were not subject to rejection under section 365. Before turning to the question of executoryness, the court had an insightful discussion about the fruitlessness of an executoryness analysis because every contract will either be paid as a claim (rejected) or assumed. The court recognized that there can be no such thing as a nonexecutory contract that avoids the ambit of section 365 because those contracts that are deemed nonexecutory still result in a claim against the estate. After this discussion, the court found that the Agreements were executory after an extensive executoryness analysis that hinged on indemnification provisions, the buyer's maintenance obligations, and a provision that said any breach was material and justified a suit for specific performance. The court's earlier discussion of rejection indicates that the result of this rejection was appropriately a pre-petition claim for damages.</p>	<p>Under our approach, the court's inquiry into executoryness would have been reduced to one sentence-the debtor clearly has obligations remaining to service and maintain the aircraft so the agreements are executory in our Williston-understanding of the word. The court would then look to state law to determine whether the remedy for the rejection (i.e. breach) was specific performance or damages. The court here gave the buyers a pre-petition claim without analyzing what the state law remedy for breach would be. If the court had looked at state law, that law might have required looking to the contract itself to determine the remedy for breach, which stated that any breach allowed for specific performance. A court would then have to look yet again to state contract law to determine whether or not this specific performance provision would be enforceable in a typical breach of contract dispute. If it would be, then the Chapter 11 debtor would have to perform the contracts rather than pay damages unless it could use an avoiding power to limit the buyers' rights. If not, the result would be what the court came to here: the buyers are left with a pre-petition claim.</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>In re Arts Dairy LLC, 417 B.R. 495 (Bankr. N.D. Ohio 2009). The “executory contract” at issue was one between the debtor and a creditor who had delivered corn silage that the debtor had yet to pay for. The creditor was arguing that the contract was executory because in exchange for the delivery of corn silage the debtor had executed another agreement promising to deliver manure. The court held that these two agreements were separate, and that the corn silage contract was not executory because the only duty was the payment of money by the debtor. Thus, the court held the creditor could not compel the debtor to assume or reject the corn silage contract. The court does not directly state what the practical effect of this ruling is, but the opinion indicates that the court reasoned the creditor already had a claim against the estate for payment of money for the corn silage.</p>	<p>This case is a good example of a debtor-duty-only contract. The court grappled with executoryness and decided the contract was not executory, which in the court’s understanding relegated it to simply an unsecured pre-petition claim. However, this is the same result that would have happened if the contract had been found to be executory but was rejected (as it should have been since there was no benefit to the debtor justifying assumption). Thus, the debtor-duty-only contracts can be thought of as not subject to section 365 because they are already “mere claims” that are treated by section 502 (this was essentially the court’s analysis). However, there is no conceptual harm in treating them as executory contracts that are subject to rejection. In either case the creditor has an unsecured prepetition claim so the inquiry into executoryness added nothing.</p>
OPTION CONTRACTS	
<p>In re A.J. Lane & Co., 107 B.R. 435 (Bankr. D. Mass. 1989). The Chapter 11 debtor sought to reject a repurchase option in real property he owned in favor of the original grantor. The debtor was hoping to sell the property free of the option. The original grantor had conveyed its interest, and the successor objected to the rejection. The court found that the option was executory under the “material breach” test. The court found that because it was executory, the option could be rejected. The successor attempted to argue that the option was a property interest, contained in a recorded deed. The court understood the result of rejection to be “termination,” and held that the option</p>	<p>The option is executory because all unperformed option contracts are executory under our approach. Thus, the question is really what is the effect of the rejection of that option to purchase real property? A court would have to look to the state law to determine whether a breach of an option is remedied with damages or specific performance. If it’s damages, then the option obligation can be rejected, paid as a claim, and discharged. However, if the option is remedied with specific performance because it is thought of as a “property interest,” then rejection will not affect it. The estate may have to perform unless an avoiding power can be used. It also cannot be discharged in that case because it</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY539

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
was terminated because it was not a property right, but rather a contract right whose remedy was typically specific performance. Thus, the court allowed the debtor to sell the real property free of the repurchase option.	cannot be reduced to a "claim" for money damages unless the court decides that the federal discharge policy overrides the state law rule.
In re Bergt, 241 B.R. 17 (Bankr. D. Alaska 1999). In this case, the Chapter 11 debtor wanted to sell property that was subject to a right of first refusal in favor of other lot owners in the subdivision. The debtor was attempting to reject the right of first refusal. The court found that under 9th Circuit precedent applying the material breach test, the right of first refusal was not executory and so could not be rejected. However, it also goes on to conclude that even if it could be rejected, the effect of that would simply be a breach, and could not terminate the right of first refusal, which was a property interest in the court's view.	The court's analysis is almost in step with our proposed approach. A few changes: First, the entire analysis of executoryness would be eliminated because an unperformed option contract is executory. This would eliminate the court's actual holding that the contract was not executory and could not be rejected. The court would have found that the right of first refusal was executory and then would have to determine the effect of the resulting breach by rejection. The court is right that the right of first refusal cannot be terminated through breach (i.e. rejection) in as much as that is the result under state law, which the court never looks to. Thus, under our view the court would have to look to state law governing rights of first refusal to determine whether or not it was a "property right" that cannot be reduced to a damages claim and paid in BD\$.
In re Plascencia, 354 B.R. 774 (Bankr. E.D. Va. 2006). The Chapter 13 debtor's home was subject to an option in favor of Habitat for Humanity to purchase the debtor's home at the original price plus a modest increase for appreciation. This amount was much lower than fair market value. The trustee objected to confirmation of the plan because this decrease in valuation of the home would result in creditors receiving less than they would in a Chapter 7. The trustee did not make any specific	The court's analysis reveals how little help the material breach test provides for option contracts. The court was able to come to the right question, but only by its own determination and not because the material breach test led it there. Under our approach, the option is executory, as are all unperformed option contracts. Then, the question is the effect of rejection of that option (which the trustee was hypothetically requesting through its objection to the payout under the plan) under state law. The

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>arguments about how the house could be sold at fair market value in violation of the option, but the court independently reviewed applicable law, including section 365, to determine if it was possible. The court found that the option was not executory and so could not be rejected or assumed. However, in the court's view, that did not answer the ultimate question and it then turned to whether or not the trustee was still bound by the option despite its non-executoriness. The court reasoned that the option was a property right under Virginia law, and so the trustee was bound by it anyway.</p>	<p>court ended up getting to this question itself: it looked to Virginia law and determined that under that law the option was a property right. Thus, even under our analysis where the executory option can be rejected, the property right remains unless an avoidance power can be used.</p>
<p>In re C.B. Holding Corp., 448 B.R. 684 (Bankr. D. Del. 2011). The Chapter 11 debtor rejected a restaurant lease, which contained a right of first refusal in favor of the lessor to purchase the restaurant's liquor license when the lease terminated. The debtor first argued that the right of first refusal was not even properly triggered because rejection didn't terminate the lease, and termination was required for the right to repurchase. The court found this in favor of the debtor, but the lessor then argued that the right of first refusal was not executory and could not be rejected, even if the lease could be. The court disagreed and found it was executory and could be rejected. The lessor then used <i>In re The Ground Round</i>, discussed below in the Licensing Agreements section, to argue that a liquor license is something akin to a property right that can be enforced by specific performance against the debtor. In that case, the court allowed the lessor to get the liquor license back from the debtor.</p>	<p>The court here was on track until it encountered <i>In re The Ground Round</i>, discussed below in this appendix. The right of first refusal for the liquor license is executory and can be rejected. However, to determine the result of rejection the court needed to look to applicable state law to decide whether or not the right of first refusal to a liquor license is enforced with specific performance because it is considered a "property right." The court in <i>Ground Round</i> asked this question under applicable law in that case, and while we may not agree with its answer to the question - it was the right question. However, this court should not look to <i>Ground Round</i> to determine whether or not a liquor license is a property right, it should be looking to applicable state law in this case, which is likely Delaware law. So, the court was right in not following the conclusion of <i>Ground Round</i>, but should have followed its lead to state law. Our analysis then provides that if this was a proper-</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY541

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>The court in this case found <i>Ground Round</i> unpersuasive and cited contrary cases for the proposition that rejection precludes specific performance and allows the counterparty to have only a damages remedy. Thus, the landlord had to pay the higher auction price to get the liquor license rather than the lower price provided in its right of first refusal.</p>	<p>ty right under applicable state law, an avoiding power would have to be used to avoid the specific performance property right. However, importantly in this case, the right of first refusal had not even been triggered since the lease had not “terminated.” Thus, even if no avoidance power applied, because the right of first refusal had not even been actually triggered in this case, the debtor likely could have sold the liquor license free of the right of first refusal.</p>
LICENSING AGREEMENTS	
<p><i>In re The Ground Round, Inc.</i>, 482 F.3d 15 (1st Cir. 2007). In this case, the lessee of restaurant premises declared bankruptcy, rejecting a lease that provided for the transfer of a liquor license to the lessor when the lease was terminated. The lessor started an adversary proceeding to obtain the liquor license back because it was considering the lease “terminated.” The court looked to state law (Pennsylvania law) to see if the result of a breach of this kind of license was a specific performance remedy to get the liquor license back and determined that specific performance was a remedy, as were damages. Thus, even though the lease wasn’t really terminated by rejection, the court found that the debtor’s breach was sufficient under state law to allow the lessor to get the license back. The court understood the license under Pennsylvania law to be something akin to a property right that survives bankruptcy unless another part of the Code makes it unenforceable. The debtor then tried to argue that section 544(a)(1) terminates the property right by invoking state law’s treatment of a hypothetical</p>	<p>The court’s analysis comes close to aligning with our approach. The court makes no inquiry into “executoriness,” and goes straight to the question of what the effect of breach is under state law. The court first has to deal with the fact that the lease is not terminated by rejection. The court’s analysis on whether or not the right to the license was something akin to a property right under state law is not completely clear. When the court found that Pennsylvania law would provide specific performance or damages, however, that conclusion indicates that this wasn’t a property right only enforceable by specific performance. Yet, in parts of the opinion the court says that under Pennsylvania law liquor licenses are understood as “property.” We recommend that if damages are a remedy under state law, then the contract can be rejected with the damages paid in BD\$. This is a situation where more remedies given at state law can then end up narrowing a creditor’s remedies in bankruptcy because he will be forced to take the damages remedy over the possibly better options given by state law. Thus,</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>judicial lien creditor. The court found that the result would differ based on the current state law governing lien creditors attaching liquor licenses versus the law as it existed when the license was transferred. The court decided to apply the law that existed at the time, which would not have allowed a lien creditor to attach the liquor license, thus protecting it from section 544's state law avoidance power.</p>	<p>we would reason that the obligation to return the license may be rejected and not enforced with specific performance, with the debtor only paying damages. However, there may have been specifics of the state law that indicated to the court that despite the damages remedy Pennsylvania law considered this a property right, which would mean the court had the right result (the license had to be returned despite rejection). Most importantly, the court asked all the right questions, even if we would disagree on some of the answers.</p>
<p>In re Gencor Industries, 298 B.R. 902 (Bankr. M.D. Fla. 2003). Prior to bankruptcy, the Chapter 11 debtor had been involved with previous patent litigation with a third party and had entered into a licensing agreement as a settlement that allowed the debtor to use the third party's intellectual property. Almost six months after the Chapter 11 debtor's plan was confirmed, the third party sued the debtor for infringement, claiming that the licensing agreement had not been assumed in the plan, which apparently terminated the debtor's rights to use the intellectual property. The court found that the licensing agreement was not executory because the only unperformed obligations were those that are inherent in every licensing agreement and so were apparently not "material." Because the agreement was not executory, the court reasoned that it could not be assumed or rejected in the bankruptcy and remained in effect after the plan. Thus, there was a valid licensing agreement and no infringement.</p>	<p>The court protected the debtor from what it thought were the negative consequences of rejection - termination of the licensing agreement rights. However, rejection itself does not terminate interests that are deemed property rights enforceable by specific performance under applicable law, here federal IP law. The court should have found this agreement executory because there were still unperformed obligations. The debtor may have accidentally rejected this agreement by failing to assume it. However, that rejection would only be a "breach," and the court would have to look to federal IP law to determine what happens to a licensee's rights when it breaches the IP agreement. Likely, the licensee has to pay damages caused by its breach, but it may not lose its property rights in this "irrevocable" license. Federal IP law would determine that, but the court's implicit assumption that the debtor's apparent accidental failure to assume automatically terminates its license rights is mistaken.</p>
<p>In re SuperMedia Inc., No. 13-</p>	<p>There is no extended inquiry into exec-</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY543

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>10545(KG), 2013 WL 5567838 (Bankr. D. Del. Oct. 9, 2013). The Chapter 11 debtor had a license to use photographic images of a third party, YPPI. That contract had numerous transfer restrictions on the debtor's use of the license. The debtor's plan had a clause assuming all executory contracts that were not specifically rejected. After bankruptcy, the debtor sold this license to its contractor, who then sold it to another party allegedly. YPPI sued claiming that because the license was executory and had been assumed, the debtor was bound by all the license's obligations, including the restriction on transfer that prohibited assignment without YPPI's consent. The debtor argued it was not an executory contract and so the debtor did not have to get YPPI's consent or comply with section 365 in selling the contract. The court agreed with the debtor, and found the contract was not executory. This meant that the debtor could sell the interest in violation of the agreement despite that it was implicitly assumed in the bankruptcy in order for it to be sold in the first place.</p>	<p>utoriness. Because there are still some obligations remaining - for example to obligation not to transfer - the contract is executory and can be treated by section 365. This contract was assumed under the plan by the text of plan itself. Thus, the debtor had agreed to take on the obligations in the contract in exchange for the contract's benefits. The debtor breached those obligations when it sold the interest in violation of the licensing agreement. This results in an administrative claim for the debtor's breach of the assumed contract. The court specifically denied YPPI an administrative claim by finding that the contract was not executory. YPPI had also made a separate motion for an administrative claim for these breaches, but the court abstained from ruling on that claim in order to let related state court proceedings play out. Under our analysis, the separate administrative claim issue is moot because the breach of the assumed executory contract results in an administrative claim for YPPI's damages.</p>
<p>In re Stein and Day Inc., 81 B.R. 263 (Bankr. S.D.N.Y. 1988). The Chapter 11 debtor was a book publishing company who had a license from an author for the copyright in the author's book. The author was paid royalties based on the number of books sold. The author moved to require the debtor to assume or reject the copyright license agreement, arguing that it was executory. The court applied the material breach test and found the agreement was not executory because the author</p>	<p>The contract is executory because there are at least some obligations outstanding. The contract can either be rejected or assumed. The DIP sought to reject and the court then should look to state law to determine the effect of the resulting breach. State law will then govern whether the author can remedy that breach with damages or specific performance. If damages, the author will have his royalties paid in BD\$ and the debtor's obligations are discharged. If for some reason state law provides for</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>had no outstanding material obligations under the court's view. The court reasoned that there was no benefit to assuming the agreement and that rejection was not beneficial either because the debtor could not reject the author's right to royalties.</p>	<p>specific performance of licensing contracts like these, then the analysis may get more complicated. The "specific performance" here is still the payment of money—however, perhaps rather than breaching the contract, paying BD\$ for the author's claim for royalties, and discharging further obligations in the bankruptcy, the publishing company may have to perform the contract for its entire duration, which would require assumption and mean the author gets paid in full rather than as a pre-petition general unsecured creditor.</p>
<p><i>In re Learning Publications</i>, 94 B.R. 763 (M.D. Fla. 1988). The Chapter 11 debtor was a publishing company. An author who had a publishing contract with it made a motion to compel the debtor to reject or assume the contract. The court found that the contract was not executory because the author's copyright interest had already been transferred and the only remaining obligation was the publisher's payment of royalties per sale. The court said because the agreement was not executory, the debtor could not be compelled to assume or reject. The court remarked at the end of the opinion that it was not commenting on the amount or validity of the author's claim against the publishing company.</p>	<p>This case is a good example of why debtor-only contracts can still be considered executory as a matter of theory, putting aside practical concerns. The core obligation under this contract that remained was the publisher-debtor's payment of royalties. Rejection of this contract results in the same thing the author currently has: an unsecured claim against the debtor for money owed. The practical concern is the chance that the debtor might mistakenly assume this contract when it will likely derive no benefit from paying the author in full as an administrative claim. However, this would all depend on how federal copyright law treats copyright licensees that breach their agreements. Maybe federal copyright law provides that licensees still have their rights but have to pay damages, but it could provide that the licensee loses its rights if it breaches the agreement. If the licensee's breach of the copyright agreement results in the licensee losing the ability to use the copyright, then the debtor will have to consider whether losing the copyright rights will be harmful to the</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY545

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
	estate. For more discussion on this, see Part V, where we discuss the possible negative consequences of not thinking about debtor-only contracts as executory.
NON-COMPETE COVENANT	
In re Drake , 136 B.R. 325 (Bankr. D. Mass 1992). This case was addressed in the article. To recap, the Chapter 7 debtor had a non-competition agreement with his previous employer under which he received monthly payments after his termination and promised not to compete with his previous employer for 60 months. The trustee wanted to sell the interest in the payments to a bank. The employer argued that the contract had been rejected as a matter of law because the trustee had failed to assume within 60 days. The trustee and bank argued the non-compete contract was not executory, so not subject to section 365's limitations. The court agreed with the trustee and bank, finding the contract was not executory and then granting the trustee's motion to sell the interest, which required implicit assumption of the contract. However, the obligations under that contract were personal to the debtor (non-competition obligations) and cannot even be performed by the estate.	The proper analysis under this case is that the agreement is executory and has been rejected under section 365(d)(1) because of the trustee's delay. The debtor will be considered in breach of the non-competition covenant. The court would have to look to applicable state law to decide what damages or possible specific performance the debtor owed the employer. If the only relief for the employer at state law is damages, those will be discharged in the bankruptcy. If specific performance is granted (i.e. the employer can get an injunction to prevent the employee from competing), the court has a tricky discharge problem because of competing policies under state law and federal bankruptcy policy. Either way, the estate lost its ability to sell the right to payments when the trustee failed to assume this executory contract within 60 days. The court should not be able to use "non-executoriness" to avoid the clear command of the Code on these facts.
EMPLOYEE SEVERANCE CONTRACTS	
In re Exide Technologies , 378 B.R. 762 (Bankr. D. Del. 2007). The Chapter 11 debtors had a special retirement agreement with an executive vice-president that provided for periodic payments of money for ten years. The Chapter 11 plan had very broad lan-	This case demonstrates the purpose that the Commission apparently desires executoriness to serve: a gating function. The court was able to prevent harm to the estate through a finding of non-executoriness. This is also a demonstration of the possible negative effects

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>guage that appeared to include the executive's retirement plan as one that had been assumed. This would have turned the executive's retirement pay into an administrative claim. The court decided that the agreement was not executory since all that remained was the debtor's payment of money to the executive. The executive had no obligations in return, not even a non-competition obligation. Thus, the court was able to use non-executoriness to save the debtor from its overly broad drafting that would have assumed these obligations to pay the executive's periodic retirement payments.</p>	<p>of including debtor-only obligations as "executory." We recognize this fear and thus limit our practical definition of executoriness to exclude contracts that have been reduced to "mere claims" as the executive's had in this case. A "mere claim" is when the debtor owes money to another party but there is no other obligations that must be fulfilled by either party. It is what the legislative history refers to when it says that executory contracts should not include accounts receivable or notes. The executive's right to money is the equivalent of an account receivable, and thus should not be considered an executory contract. The court here got the right result under the material breach test, but we stress that there should be a careful consideration when a debtor-only contract exists. Those contracts are usually just "mere claims," i.e. accounts receivable or something similar, but the trustee and court should examine those contracts to make sure rather than removing them all from section 365 as a categorical rule.</p>
<p>In re Spectrum Information Tech., 190 B.R. 741 (Bankr. E.D.N.Y. 1996). Chapter 11 debtor-employers wanted to reject certain employment and separation agreements, in which there were obligations for termination payments and some consulting obligations for the ex-employees. The court found that these obligations were not sufficient to make the contracts executory under the material breach test and held that they could not be rejected. However, at the end of the opinion the court noted that the result was the same as if the contracts had been reject-</p>	<p>These contracts can be considered executory and the debtor should be allowed to reject them, giving the ex-employees an unsecured claim for prepetition breach under 365(a). Treating them as executory contracts would allow the Chapter 11 debtor and trustee to fully consider what will happen to the ex-employees' obligations when they breach the contract through rejection. Will that breach relieve the ex-employees of their consulting obligations? If that's the case, is that best for the estate or does the estate want those obligations to be performed for some</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY547

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
ed because the ex-employees' had unsecured claims against the estate.	reason? Here the Chapter 11 debtor had sought rejection indicating it was better for the estate to reject the obligations even if that meant the ex-employees' obligations would also be relieved. These considerations however could have resulted in the Chapter 11 debtor wanting to assume these contracts because that benefitted the estate. The court would not have allowed that here since it found these were non-executory. Thus, even though the practical result in this case is the same under the material breach test as it would be under our analysis - the ex-employees have unsecured claims - the result would have been different if the Chapter 11 debtor was trying to assume the contracts because that would have benefitted the estate. The court would not have allowed that under its analysis.
CONTRACTS REGARDING LAND	
Butler v. Resident Care Innovation Corp. , 241 B.R. 37 (D. R.I. 1999). The Chapter 11 trustee sought to reject a land sale contract with a third party, RCI, so that the lot in question could be sold to a different party along with all the debtor's other assets to fund the reorganization plan. RCI argued the contract was not executory and could not be rejected. The bankruptcy court had found that the contract was not executory and that equitable principles weighed in favor of granting RCI specific performance. On appeal to the district court, the trustee again argued that the agreement was executory and could be rejected. The district court conducted an extensive analysis to determine whether or not the agreement was executory and	There would be no extensive analysis of executoryness because this contract is clearly executory. The parties still have to exchange payment and title to the lot. Then, the court would have to decide the effect of the rejection. The court touched on this issue when analyzing RCI's specific performance argument, but did not fully engage it. The court thought it was only relevant if RCI had obtained a specific performance remedy under state law. Instead, it is important what remedy state law would award RCI, not what RCI actually went and obtained. It is clear that specific performance was a remedy under state law, but if damages were also a remedy then the result here may be correct that RCI gets a dischargeable damages claim. The court did not fully

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>which test to use. The court eventually settled on applying the material breach test and found the land sale contract was not executory. RCI then argued that because it was entitled to specific performance under applicable Vermont law, rejection could not prevent it from obtaining specific performance. The district court reasoned that the court only needed to inquire about specific performance rights if RCI had obtained a specific performance order from a state court, which it had not. The district court did not think it needed to consider the hypothetical specific performance right that RCI had. It then decided that rejection was in best interests of the estate, and it appears RCI was left with a damages claim.</p>	<p>inquire into whether or not specific performance was the only remedy at state law for this breach or is accompanied by damages. It essentially disregarded state law as relevant on these facts, but in fact it was.</p>
<p>In re Laudenslager, No. 3:12-bk-2186-PMG, 2014 WL 6544285 (Bankr. M.D. Fla. 2014). In this case, the Chapter 7 debtor, Laudenslager, had a contract to sell residential real estate with a party named Saia. The sale did not go through on time, and Saia filed a breach of contract action in state court against Laudenslager. Then, Laudenslager declared Chapter 7 bankruptcy, and Saia did not make an appearance in the bankruptcy proceeding. The contract was listed on the debtor's schedule of assets and liabilities, but not in the executory contract schedule. After the debtor received his discharge, he filed a complaint in his bankruptcy proceeding for a determination that any debt arising out of the real estate sale contract was discharged. The court decided that the contract was executory based on case law that generally has held that contracts for sale of real estate</p>	<p>Under our approach, the analysis would have focused on whether or not the rejection, i.e. breach, of the contract prompted a damages claim or specific performance under state law. The residential real estate contract was clearly executory, but the court needed to spend more time looking to state law to determine whether these kinds of contracts can be enforced with specific performance. The court does not analyze whether or not Saia's breach of contract claim against the estate would have awarded her damages or specific performance under state law. Generally, contracts to sell real property are among the kinds of contracts that are enforced with specific performance. If this were the case under applicable state law, the court could not have found the breach of contract claim discharged because the estate would have had to specifically perform the contract</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY549

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>are executory when the land has not yet been conveyed. Then, the court decided that because the contract was not explicitly assumed within the 60-day period it had been rejected. The court stated that the effect of rejection as a breach of contract claim, citing <i>In re Lavigne</i>, 114 F.3d 379, 387 (2d Cir. 1997). The court then decided that this breach of contract claim would have been discharged in the Chapter 7 proceeding.</p>	<p>unless another avoiding power applied. If state law gave Saia the option of damages or specific performance, then her damages can be reduced to a "claim" for the payment of money and discharged through the estate. This is an example of how state law can incidentally limit a creditor's remedies in bankruptcy if it gives options of remedies under state law. If it can be reduced to a claim for the payment of money, then it is subject to discharge in a bankruptcy.</p>
<p><i>In re Guerrero</i>, No. 15-26746-BEH, 2015 WL 5162272 (Bankr. E.D. Wis. Sept. 1, 2015). In this case, the debtor was a party to a land sale contract with a party named Bierman. The contract was essentially an installment contract, where the debtor paid off the purchase price of the land in installments and a balloon payment after a certain amount of time. The contract prohibited the debtor from subjecting the property to any liens without Bierman's consent, and after the purchase price was paid, Bierman had to convey the property to the debtor. The debtor failed to make the final payment before declaring bankruptcy. In the bankruptcy proceeding, Bierman was trying to move from relief from the stay to foreclose. Before dealing with that issue, the court first addressed whether the land sales contract was a secured credit arrangement or an executory contract under section 365. It decided it was not an executory contract under the material breach test, and was instead a security device. It then proceeded to address the merits of the motion for relief from the stay.</p>	<p>This case is an example of how the inclusive definition of executory contract does no conceptual harm to our analysis. It is also an example of why Professor Countryman originally analyzed contracts falling outside of his material breach test as not subject to section 365 because they fell under another section, Section 502. In this case, a contract existed that still had remaining obligations. It was "executory" in the common law sense of the word, but the only obligation remaining is the debtor's payment obligation and promise not to encumber the property, and Bierman's obligation to turn over the deed. If this executory contract were rejected, and the court properly looked to state law to determine the effect of breach, it might find that under state law Bierman had an enforceable property right in the land because of the property lien. Accordingly, under state law, breach of the land sales contract does not affect the enforceability of the lien. So, this contract does not need to be dealt with through section 365 because it can be dealt with as a claim against the estate under Section 502. As long as the anal-</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
	<p>ysis of “rejection” always focuses on state law, a “rejected” counterparty to a contract will always be in the same situation as a “creditor” bringing a claim that arises from the contract.</p>
LLC/PARTNERSHIP OPERATING AGREEMENTS	
<p>In re DeVries, No. 12-04015-DML, 2014 WL 4294540 (Bankr. N.D. Tex. Aug. 27, 2014). The debtor had an interest in an LLC, the Devries Family Farm. The other members of the LLC filed an adversary saying that the LLC agreement was an executory contract that had been deemed rejected by the Chapter 7 trustee’s failure to assume. They also argued the filing of bankruptcy dissociated the debtor as a member and made him an assignee (only had an economic interest). The trustee responded the LLC agreement was not executory, so had not been rejected, and the trustee was entitled to the full membership interest. The court conducted an extensive obligation-by-obligation analysis of the LLC agreement to determine if it was executory under the material breach test, and eventually decided that it was. The ipso facto clause that dissociated the debtor was invalidated, but the court then reasoned that the debtor was still dissociated based on his rejection, i.e. breach, because the LLC agreement provided that a breach of that agreement relegated a member to an assignee.</p>	<p>This case is an example of the court getting the right result despite the material breach test. The court’s analysis is almost exactly what we recommend, excepting the material breach test inquiry. The inquiry into executoryness was unnecessary, but once the court decided the LLC agreement was executory it looked to the LLC agreement itself to determine the effect of the breach through rejection. It did not mention state law, but state law likely enforces parties’ LLC agreements and so state law would have directed the court to the exact issue the court focused on. The step the court skipped - looking to state law - is important, however. If for some reason state law did not enforce these kinds of LLC agreement provisions then the court would have had to look to state law, not the agreement, to determine the effect of the breach. So, state law determines whether the LLC agreement’s provision is enforceable or not, and ideally should have been reviewed to ensure it was enforceable before applying it to find that rejection made the debtor an assignee.</p>
<p>In re Strata Title LLC, No. 12-24242, 2013 WL 1773619 (Bankr. D. Ariz. Apr. 25, 2013). The debtor is an LLC that owned a 45% interest in another LLC, Santerra. When the debtor entered bankruptcy, the other</p>	<p>We do think LLC agreements should be considered executory contracts as they have unperformed obligations. Thus, the court came to the right answer, but the material breach test does not always result in LLC agreements being</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY551

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>members in Santerra sent the debtor a letter that the bankruptcy was an event of withdrawal under the Santerra operating agreement and that they were giving notice of their intent to exercise the purchase option of the debtor's interest under the Santerra operating agreement. The Santerra members argued that the operating agreement was not executory, could not be rejected, and that the purchase option was enforceable in the bankruptcy. The court held otherwise, conducting a material breach analysis to decide that the debtor's responsibilities under the operating agreement were substantial enough that it was executory. It looked to existence of supermajority voting requirements that apply only if contingencies occur like sale of a piece of property to find material obligations. The court also found that the purchase option was unenforceable because it was triggered by bankruptcy and thus was an ipso facto clause. The court concluded that the debtor needed to file a reorganization plan by a certain date that either assumed or rejected the operating agreement; thus, the court did not analyze what the effect of rejection or assumption would be.</p>	<p>considered executory as other case examples will show. The court also properly applied section 365(d)(1) to eliminate the ipso facto purchase option. That means that the debtor can sell its interests (which entered the estate through 541) without violating the LLC agreement itself. It also can seek to then reject the LLC operating agreement, which would constitute a breach of that agreement. The consequence of the breach of the LLC agreement would be decided under applicable state LLC law.</p>
<p><i>In re Ichiban</i>, No. 06-10316-RGM, 2014 WL 2937088 (Bankr. W.D. Va. June 30, 2014). The Chapter 7 Debtor had a 16.333% interest in an LLC, and another member was attempting to exercise the right of first refusal in the LLC agreement to purchase the debtor's interest. The right of first refusal provision stated that at the end of an auction, the LLC first and then the other members had a right to purchase the</p>	<p>Under our analysis, the LLC agreement is executory and the debtor clearly wants to reject it. Section 365(d)(1) takes care of the rejection because the debtor or trustee never assumed the LLC agreement. The question is what the effect of this rejection is on the right of first refusal. That question is answered by state law - what is the effect of the debtor's breach of the LLC agreement on his interest? What does</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>membership at the amount of the highest bid. The court explained “if [the LLC agreement] was executory, it was rejected. If it is a non-executory contract, it may not be rejected and, unless it expired on its own terms, remains enforceable.” The right of first refusal did contain an ipso facto provision, triggering the right upon bankruptcy. The court held it was executory through application of the material breach test. It relied on provisions in the LLC agreement that created notice obligations before the exercise of first refusal rights. The court then found that the entire LLC agreement and right of first refusal had been rejected because it had not been assumed within 60 days as required by section 365(d)(1). The court alternatively found the right of first refusal would have expired on its own before that, but it never addressed the ipso facto provision.</p>	<p>the debtor’s breach allow the other LLC members to do? Do they have a claim for damages if the debtor breaches or do they have a right to specific performance or equitable relief? That answer will determine whether the Chapter 7 debtor can discharge his obligations under the LLC agreement in the bankruptcy.</p>
<p><i>In re IT Group Inc.</i>, 302 B.R. 483 (D. Del. 2003). The court treated the LLC agreement at issue here and the repurchase option within it as subject to section 365, without any extensive executory analysis. It had to determine whether a default provision was an ipso facto provision invalidated by section 365(e)(1). The default provision provided that whenever a member defaulted, (by declaring bankruptcy for example), its economic interest was capped at the value of its contributions to the LLC. The other members could buy out the defaulting member at that price. The court said this was an invalid ipso facto clause which meant the debtor’s economic could be sold at its full value and the buy-out right was elimi-</p>	<p>We would analyze the default provision the same as the court since the court properly treated the LLC agreement under section 365 to invalidate the default provision. As for the enforceability of the right of first refusal, the court was on the right track in trying to determine whether or not it was a “property interest,” but the court looked to other federal cases interpreting rights of first refusal rather than applicable state law. Thus, applicable state law may have allowed damages as a remedy for the right of first refusal which would have meant that the debtor could sell the interest in violation of the right of first refusal and pay damages in BD\$. The court decided that this was the kind of right enforceable with specific</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY553

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>nated. The court then held that a right of refusal provision for any sale of a member's interest was enforceable in the bankruptcy because it was not an ipso facto clause. The court thought it was enforceable in the bankruptcy because it said that it was in the nature of a "cognizable" property interest.</p>	<p>performance, but it did so without looking to the right law: state law.</p>
<p>In re Soderstrom, 484 B.R. 874 (M.D. Fla. 2013). The Chapter 7 debtor had a management interest in an LLC that the trustee wanted to sell to one of the estate creditors, Horizon. The LLC claimed that the debtor's full management interest did not pass through to the estate because its operating agreement was not an executory contract that could be assumed under section 365(c)(1) because LLC law allowed the other members to refuse substitute performance. Thus, the debtor only had an economic interest to sell to Horizon. Horizon however wanted to purchase the full management interest, not just the economic interest. The bankruptcy court found that the operating agreement was executory, but that it could not be assumed under section 365(c)(1) because the other members did not consent and state law gave them the right to not accept performance from someone else. Horizon appealed arguing that it was not an executory contract and so was not subject to section 365(c)(1), the provision preventing the LLC agreement from being assumed and the interest sold. The district court agreed that the operating agreement was executory, "under either the test" [material breach or Functional Approach]. Thus, the district court agreed with the bankruptcy court that</p>	<p>The court's analysis of section 365 is similar to what we would suggest, although there would not have to be any inquiry into executory contracts. The other members of the LLC claim that section 365(c)(1) applied to prevent the trustee from assuming the LLC agreement because applicable state law allowed other members to prohibit a new member unless they all consented to the new member. This case demonstrates that the inquiry into executory contracts adds little in cases involving LLC agreements, because the tough questions are how state law interacts with section 365, rather than whether or not section 365 should be applied based on some abstract inquiry into "executory contracts."</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
the contract could not be assumed under section 365(c)(1) because state LLC law required the LLC partners consent to a new managing member.	
<p>In re Roomstore Inc., 473 B.R. 107 (Bankr. E.D. Va. 2012). The Chapter 11 debtor had an interest in an LLC called MDG. The LLC operating agreement provided for a right of first refusal for the debtor's interest. The court's entire analysis is focused on whether or not the LLC agreement is executory. Then when the court decides it is executory, it held without full explanation that rejection terminated the right of first refusal allowing the debtor to sell the interest free of it.</p>	<p>The real question in this case is whether or not rejection terminates the right of first refusal, a question the court answered but did not fully analyze because it was focused on whether the LLC agreement was executory or not. The right of first refusal is executory and subject to rejection, but the court needs to look to the state LLC law to determine what remedy other members have when a member violates a right of first refusal in the LLC operating agreement. The court's result would only be correct if the state LLC act gave damages as a remedy. If state law allowed other members to prevent the sale without their right of first refusal (an equitable remedy), then the right of first refusal would be enforceable as akin to a property interest that cannot be eliminated, unless another avoiding power could be used.</p>
<p>In re Wilson, No. 11-50396-rlj-7, 2014 WL 3700634 (Bankr. N.D. Tex. 2014). The Chapter 7 trustee wanted to sell the debtor's 200 membership units in an LLC, Texas Star Refreshments, to a creditor of the debtor's. The debtor opposed the sale saying that the LLC agreement restricted the transfer and that the units were exempt property. Another member also opposed to sale because of a right of first refusal in the LLC agreement. The trustee and the creditor favoring the sale argued among other things that the LLC agreement was executory and thus had been rejected, which they apparent-</p>	<p>The LLC agreement should have been treated under section 365. If the trustee wanted to try to sell without the right of first refusal, it needed to reject the LLC agreement. Depending on how state law treated that breach, the right of first refusal could be paid in damages or would have to be respected absent an avoiding power. The court would have to look to state law to make that determination rather than just considering equities and what decision best maximized the value of the estate as it appeared to do in the opinion.</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY555

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>ly understood as terminating the right of first refusal in favor of the other members. The court did not extensively analyze executoriness but decided the LLC agreement was not executory. The court went on to decide that the other members could only buy the interest by participating in a competitive bidding process with the creditor and any other interested parties.</p>	
<p>In re Ehmman, 319 B.R. 200 (Bankr. D. Ariz. 2005). The debtor had an interest in an LLC, Fiesta Investments. The Chapter 7 trustee sought a declaration that the trustee has the status of a member in Fiesta, the assets of Fiesta were being wasted, and an order for dissolution and liquidation of Fiesta or the appointment of a receiver for Fiesta. The other members of Fiesta argued that under Arizona LLC law and the operating agreement the only interest the trustee had was an economic interest in Fiesta, and section 365(e)(2) allowed the provisions relegating the trustee to an economic interest to be enforced. The court reasoned that there were in fact property rights in the LLC and contract rights under the LLC agreement when a debtor has an interest in the LLC. The court determined that the LLC agreement in this case was not controlled by section 365 because the trustee was not asserting any rights that had to do with material unperformed obligations. The court instead applied section 541 to the debtor's interest in the LLC, and decided that the state law and operating agreement restrictions on the trustee's interests were unenforceable under section 541(c)(1). The trustee had all the</p>	<p>The court is correct that some of the debtor's interests in an LLC such as the economic interest enter the estate through section 541. But the LLC agreement itself must be treated through section 365 because it is a contract that involves assets and liabilities. Section 365 ensures that the other members of the LLC know whether the debtor will be breaching (rejection of the contract) or performing (assumption). Under section 365, the trustee's attempted assumption in this case may be complicated by section 365(c), which prohibits assumption if state law would excuse the counterparty from accepting performance from a substitute. Many state LLC acts appear to intend to prevent the other LLC members from having to accept into the membership an assignee of one member's rights unless the LLC members consent. A bankruptcy court would have to evaluate whether federal bankruptcy law overrides these state LLC act provisions, or whether state law has created a right for the other LLC members to refuse substitute performance, which would require the trustee to reject the LLC agreement. The hard questions in this case are about the intersection of state LLC acts and federal bankruptcy law,</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
rights and duties that the debtor had - in essence the court allowed the trustee to replace the debtor as a member of the LLC. It appears that the LLC operating agreement was implicitly assumed.	but the court never gets there because it did not treat the LLC agreement under section 365.
<p>In re Tshiaoushis, 383 B.R. 616 (Bankr. E.D. Va. 2007). The Chapter 11 trustee wanted to enforce the LLC operating agreement of an LLC in which a debtor owned an interest because the agreement had a provision providing that LLC would be dissolved upon the bankruptcy of a member and that, upon dissolution, members would proceed to sell or liquidate LLC's property. The trustee thought this would best benefit the estate. The LLC's manager opposed the dissolution, asserting that the operating agreement was an executory contract and that the provision for automatic dissolution was an unenforceable ipso facto clause. The court spends the analysis deciding whether or not the LLC agreement is executory and decides that it is not. This meant that the trustee could dissolve the LLC in accordance with the ipso facto provision because the court said that section 365(e)(1) did not apply.</p>	<p>This case demonstrates a variation on the typical fact scenario because the trustee is now using the LLC ipso facto provisions against the other LLC members. The court's inquiry into executory results in an ipso facto provision being enforceable against third parties by a trustee. Under our analysis, this agreement is executory and the dissolution provision would be invalidated as an ipso facto clause. The trustee would have to either seek to be bought out, attempt to sell its interest, or utilize another state law procedure to dissolve the LLC.</p>
<p>Sullivan v. Mathew, No. 14 C 6877, 2015 WL 1509794 (N.D. Ill. 2015). The Chapter 7 trustee wanted to dissolve the partnership in which the Chapter 7 debtor had a full management and economic interest. The other partners claimed that the partnership could not be dissolved because (1) one of them had elected to purchase the debtor's interest, which precluded dissolution under the terms of the Partnership Agreement, and (2) the Partner-</p>	<p>Under our approach, the analysis for this case would be similar. The court would find this Partnership Agreement executory without the extensive analysis. Then, the court would find that the Partnership Agreement had been rejected as a matter of law because of the trustee's failure to assume in 60 days. This would mean that the debtor was in breach of the Agreement and state law would determine how that breach affected his rights under the Agreement</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY557

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>ship Agreement was executory and had been rejected under section 365(d)(1) after the expiration of 60 days because it had not been assumed. The partners argued that because the Chapter 7 trustee had allowed the Agreement to be rejected by law, the estate was now in breach of the Agreement and thus could not enforce it against the other partners. The court rejected the partners' argument that there had been an election to purchase the debtor's interest, so dissolution was not precluded under the Partnership Agreement for that reason. However, the court agreed with the partners that the Partnership Agreement was executory and had been rejected by the Chapter 7 Trustee after the expiration of 60 days, so the Chapter 7 trustee could not force the partnership to dissolve as it was in breach of the agreement because of the rejection. However, the court pointed out that the Illinois Uniform Partnership Act provided a mechanism by which the trustee could force the partnership to buy the debtor's interest out from him; thus, there was still a way for the trustee to get value for the estate from the debtor's interest.</p>	<p>and what the other partners' remedy was.</p>
SETTLEMENT AGREEMENTS	
<p>In re S.A. Holding Co., LLC, 357 B.R. 51 (Bankr. D. N.J. 2006). The Chapter 11 debtor had been a party to a settlement agreement between it and a municipality about its continued operation of an adult-oriented night club for a term of years. It filed bankruptcy on the eve before it was supposed to shut down under that settlement agreement, staying the municipality's attempt to close the debtor down. The</p>	<p>This settlement agreement is executory because there were unperformed obligations at the filing of the bankruptcy. This case is really about whether or not the debtor's obligations under that settlement agreement can be discharged in the bankruptcy. Under our approach, the court would solely address that question, rather than "executoriness." The court would have to determine whether under state law the municipal-</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>bankruptcy court had abstained from deciding the validity of the settlement agreement because of extensive state court litigation about the issue. The Chapter 11 debtor then moved to reject the settlement agreement in its bankruptcy proceeding. The court extensively analyzed the issue of executoryness under the material breach test and whether or not the municipality had substantially performed its obligations under the contract. The court decided the contract was not executory and could not be rejected. The opinion does not discuss the practical result of its ruling. The debtor presumably thought that rejection would allow it to not perform its obligations under the settlement agreement, i.e. closing down.</p>	<p>ity could get specific performance of the settlement agreement. It is likely with the municipality's zoning power it could have done so. Thus, the debtor's obligations to close as agreed to could not be reduced to a money claim for damages and discharged in the bankruptcy. Essentially in this case the debtor's rejection would likely have no effect on its obligations under the settlement agreement.</p>
<p>Route 21 Associates of Belleville v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012). This case was about settlement agreements regarding clean-up of environmental contamination on land that Route 21 had bought from MCH, the Chapter 11 debtor, before its bankruptcy. Route 21 sued after discovering the environmental contamination, and the parties reached a settlement agreement under which Route 21 would remediate the Site and MHC had promised to indemnify it for any environmental cleanup liability. Route 21 ended up remediating the contaminations, and entered into later settlement agreements with MHC, allocating costs between the two. Then, MCH declared Chapter 11 bankruptcy and wanted to reject the settlement agreements under which it owed Route 21 money. The court found that the settlement agreements were executory and</p>	<p>The analysis of this case is very close to what we recommend, save the court's inquiry into executoryness. This is probably not executory under our definition of the word because it is now a "mere claim," the only thing remaining is the debtor's obligation to pay money. Thus, this could be considered not an executory contract because it will be treated under section 502 as a "claim." But, in our view, any executory contract not treated by section 365 must then be treated by section 502. There cannot be any contracts left out of the estate. In sum, in our view, this is already a "mere claim" and does not need section 365 treatment. However, as this case demonstrates, there is no conceptual harm in subjecting it to treatment under section 365 because Route 21 still ends up with an unsecured prepetition claim. The court properly found that it was best for the estate for</p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY559

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>had been rejected. The court gestured to the Functional Approach but said that the material breach test was met, so it did not to apply the Functional Approach. The court did then look to whether or not Route 21 could demand specific performance in the face of the debtor's rejection. The court reasoned that if the debtor's obligation was not a "claim" as defined by the Bankruptcy Code as an obligation that "gives rise to payment," then it could not be discharged and Route 21 could obtain specific performance. However, after analyzing applicable environmental law and its remedies, the court decided in the end that Route 21 had a claim that could be monetized and did not have a right to specific performance.</p>	<p>these contracts to be rejected and looked to applicable law to determine whether that breach would be remedied through specific performance or damages.</p>
INSURANCE CONTRACTS	
<p>In re Sudbury, Inc., 153 B.R. 776 (Bankr. N.D. Ohio 1993). The Chapter 11 debtor requested a declaration that its insurance agreements were not executory or that they were executory and could be rejected. The insurer claimed the agreements were executory and that the retrospective premiums owned under them were entitled to an administrative expense because of the agreements' executoryness. This position is not fully explained but it appears that the insurer understood that the insurance agreements either had been assumed or would necessarily be assumed, entitling it to its claims paid as an administrative expense. The opinion does not clearly address the practical consequences of the parties' dispute. Nonetheless, the court decided these insurance agreements were not executory contracts under the material breach</p>	<p>These are executory contracts and need to be assumed or rejected just like all contracts. The insurer still has to pay claims that arose during the covered period and the debtor has cooperation and investigation obligations. It is apparent from the opinion that the debtor wanted to avoid assuming the contract, as it was alternatively seeking to reject the executory contract. This position is understandable as assumption would elevate the insurer's claim to an administrative expense without providing any corresponding benefit to the estate. The court appears to have created the result the debtor desired through a finding of "non-executoriness." Under our Modern Contract Analysis, the court instead would look to see what happens under applicable nonbankruptcy law (state insurance law here) if the debtor breaches the insurance agreement</p>

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>test. It also discussed how neither assumption nor rejection would benefit the debtor. Its analysis of assumption mentions an important aspect of these agreements: default or bankruptcy by the debtor did not relieve the insurer of its obligations. Because of this aspect of the agreements, the court noted assumption of the debtor's responsibilities only wasted assets. Regarding rejection, the court reasoned rejection "would deprive claimants under the Policies of payment in order to increase, however marginally, the dividend to other prepetition creditors." This statement appears to assume the insurer would not have to make payments under the agreements if they were rejected, yet the agreements explicitly stated the insurer would have to perform even if the debtor breached. The practical effect of this decision is unclear. It appears the court thought the insurer would still have to perform but the debtor would not pay the insurer as an administrative claim. Accordingly, this looks like de facto rejection.</p>	<p>through rejection. State law would likely tell us to look to the insurance agreements or would have provisions in the Insurance Code dealing with this situation. If state law says that the debtor's breach through rejection doesn't relieve the insurer of its coverage obligations then it would be best for the estate to reject. This is exactly the case here, as the insurance agreements themselves stated that the insurer would have to perform despite the debtor's default. If on the other hand, the state law on insurance contracts or the contract itself would relieve the insurer of performing because of the debtor's breach, then the debtor should assume if it needs to in order to fund its plan or for some other financial reason it is best for the estate for the insurer to perform. Regardless, the decision needs to be made based on what the insurer's obligations will be after breach under applicable state law, rather than in the shadowy world of "non-executoriness."</p>
LETTERS OF CREDIT	
<p><i>Rafool v. Evans</i>, 497 B.R. 312 (C.D. Ill. 2013); <i>In re Central Illinois Energy LLC</i>, 482 B.R. 772 (Bankr. C.D. Ill. 2012). The two letter of credit cases we located arose out of similar fact situations. The Chapter 11 trustee brought an adversary proceedings against the debtor's former attorneys for failing to draw on a letter of credit under which it was a beneficiary. Implicit in the Chapter 11 trustee's argument was that these letters could no longer be drawn upon. In <i>Rafool v. Evans</i>, the bankruptcy court found that</p>	<p>To properly analyze letters of credit in bankruptcy, one must distinguish between the three parties in a letter of credit transaction: the applicant, the issuer, and the beneficiary. There is often a contract between the applicant and the issuer that can be affected by the applicant's bankruptcy. This contract between applicant and issuer would be subject to section 365. The contract between the applicant and issuer is likely a contract to extend financial accommodations under section 365(c)(2). See John F. Dolan, <i>Insolvency</i></p>

2017)DEMYSTIFICATION OF CONTRACTS IN BANKRUPTCY561

CASE SUMMARY	SOLUTION UNDER MODERN CONTRACT ANALYSIS
<p>the Chapter 11 trustee could still draw on these letters of credit because they were not contracts of the debtor, let alone “executory contracts” of the debtor, and not subject to the prohibition on financial accommodations in section 365(c)(2). Accordingly, the attorneys did not cause any loss to the debtor. The district court affirmed. In <i>Central Illinois Energy</i>, the bankruptcy court conducted a similar analysis.</p>	<p><i>in Letter of Credit Transactions Part III (“Part III”)</i>, 132 Banking L.J. 287 (2015). We will leave the bankruptcy of the issuer untouched as the issuer is often a bank. These two cases present the bankruptcy of the beneficiary. The beneficiary is the party entitled to draw upon the letter of credit, which the issuing bank has promised to pay unconditionally based on the contract it has with the applicant, its customer, if the beneficiary presents appropriate demand together with required documents (e.g., a certificate of completion of a construction project). In <i>Central Illinois Energy</i>, it was in lieu of retainage and was the equivalent of an escrow contract in which the bank is the escrow agent who is to pay over the escrowed amount upon stated conditions. So, because both debtors in these cases are beneficiaries, the letter of credit is just an entitlement to payment upon compliance with its requirements that runs in favor of the beneficiary, essentially similar to an option contract or any other unilateral contract in which the debtor performs (presents the required documents) and gets paid. The debtor should assume, present, and get paid. See John F. Dolan, <i>Insolvency in Letter of Credit Transactions Part I</i>, 132 Banking L.J. 195, 202 (2015); John F. Dolan, <i>Insolvency in Letter of Credit Transactions Part II</i>, 132 Banking L.J. 243 (2015); and Dolan, <i>Part III</i>, 132 Banking L.J. 287.</p>