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IPSO FACTO: THE PATTERN OF ASSUMABLE CONTRACTS IN BANKRUPTCY
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INTRODUCTION

Contracts are often among a business’s most important assets, and this is equally true of financially troubled businesses that are seeking to reorganize themselves under Chapter 11 of the U.S. Bankruptcy Code. When a contract is “executory,” that is, wholly or substantially unperformed on both sides, it constitutes a set of rights and obligations with a business’s suppliers, lenders, joint venturers, key employees, and tenants or lessors, to name only a few potential participants in the business’s prospects for financial rehabilitation. It is easy to see that the stakes involved in enforcing, or not enforcing, executory contracts are high. Accordingly, the law in this area has always been complex and difficult. To decline to enforce an executory contract is often to deny a faltering but potentially viable business a crucial advantage in attempting to reorganize; but to enforce an executory contract is to dragoon the other party to the contract into risking new assets in further dealings with an already insolvent company.

The enforcement or non-enforcement of contracts is, of course, preeminently a state law matter, but the Bankruptcy Code is not very deferential to state law in this area. Indeed, one of the Code’s most interesting provisions concerning executory contracts is its invalidation of a standard and widespread state law tool: the ipso facto clause. At its root, an ipso facto clause is simply a contract provision specifying that if one party to the contract files bankruptcy, the other party is no longer obligated to perform. Ordinary contract principles are quite accommodating of provisions that work in this way: private parties are free to agree that their contract will terminate on whatever terms and conditions they wish. However, the Bankruptcy Code is designed in part to enable bankrupt businesses to reorganize, and in the service of this goal the Code overrides the freedom-to-limit-one’s-contract principle. Ipso facto clauses are invalidated as a matter of federal law, and

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1. See infra note 18.
2. Any substantial business in Chapter 11 will be party to perhaps dozens or hundreds of executory contracts, some of which are headline-grabbing. See, e.g., Mary Williams Walsh & Jonathan Glater, Contracts Now Seen as Being Rewritable, N.Y. Times, Mar. 31, 2009, at B1 (discussing contracts in various notorious bankruptcies including American International Group, the municipality of Vallejo, California, General Motors Corporation, and Chrysler Corporation); see also Stillwater Mining Company to Lose Sales Contract Under General Motors Bankruptcy Petition, July 8, 2009, http://www.reuters.com/article/pressRelease/idUS204078+08-Jul-2009+MW20090708 (discussing a palladium and rhodium supply agreement); Peter Whorisky & Kendra Marr, Chrysler Pulls Out of Hundreds of Franchises, Wash. Post, May 15, 2009, at A1 (“It’s not a good feeling,’ said [the president of a certain Chrysler dealership franchise]. . . . [E]ven some of the dealers’ attorneys concede that the legal odds are stacked against them.

3. See BLACK’s LAW DICTIONARY 905 (9th ed. 2009).
4. Section 365(e)(1), the Code’s principal provision on ipso facto clauses, provides in pertinent part: Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified . . . at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
instead, the bankrupt business (the “debtor”) is given the option of continuing
with the contract ("assuming" it) or of abandoning the contract ("rejecting" it).

However, the debtor’s ability to reorganize can also be impeded by contract
provisions other than ipso facto clauses, either because of the provision’s own state
law effects or the way the provision is treated in bankruptcy. This article focuses on
four such provisions, specifically contracts for the non-debtor to make a loan or
other financial accommodation to the debtor, discussed in Part II.A; contracts im-
posing nonmonetary obligations as to which the debtor has defaulted, discussed in
Part II.B; cross-default clauses, discussed in Part II.C; and contracts that are not
assignable under state law, discussed in Part II.D. The Code does nothing to allevi-
ate (and indeed in some cases itself imposes) the large or even insuperable burden
imposed by these provisions on the debtor’s ability to reorganize, in stark contrast
to Congress’s invalidation of ipso facto clauses. Nonetheless, this article shows, the
courts have responded to each of these provisions with a dense, subtle, but unmis-
takable pattern of judicial decisions. In all four areas the judicial decisions have
protected the debtor’s power to reorganize, despite the congressional silence or
even hostility, in effect counteracting the most severe effects of the clauses as if
they were ipso facto clauses. Evidently accommodating the Code’s pro-reorganiza-
tion policy and also the particular facts of the cases, courts, rather than Congress,
have, in effect, invalidated “de facto ipso facto” clauses. In revealing this pattern,
the article brings a strong conceptual unity to what has otherwise seemed to be a
dense and unmanageable thicket of unrelated rules, and along the way it brings out
some important conclusions about judicial method, categorization, and the limits
of codification.

Part I of the article provides background on the concepts of assumption and
rejection of executory contracts, and on the Code’s associated tactic of invalidating
ipso facto clauses. Along the way, Part I positions the concepts of assumption and
rejection squarely within bankruptcy theory’s dominant framework, under which
the Code’s and the courts’ policy choices are often viewed as falling into one of
two generally opposing “camps.” The first is devoted to goals such as robustly
protecting a debtor’s ability to reorganize and preserving a distressed firm’s going-
cconcern value, while the second is committed to protecting the autonomy of partic-
ular creditors, or other rights holders, and their state law created entitlements.

Part II, the heart of the article, demonstrates that the Code’s invalidation of
ipso facto clauses is at the center of a heretofore unrecognized and untheorized
pattern by which the courts have treated at least four otherwise disparate ques-
tions under the law of executory contracts. The first instance of the pattern is the
courts’ treatment of contracts under which a non-debtor has promised to make a
loan or other “financial accommodation” to the debtor. The Code expressly pro-
hibits a debtor from assuming such contracts, and as a result, the presence of even

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This subsection and most of the other provisions examined in this article refer separately to “an executory
contract or unexpired lease,” but for simplicity of exposition this article will generally speak only of executory
contracts (unless the statute itself draws a substantive distinction, e.g., infra note 13). The article’s substantive
discussion applies equally well to both types of instrument.
a relatively small financial accommodation provision in an otherwise assumable contract might risk making the entire contract unassumable—just as the presence of an ipso facto clause would, in the absence of the Code’s override. With financial accommodations, unlike with ipso facto clauses, the Code does not protect the debtor against the contract being unassumable, but the courts have mitigated this problem by permitting the debtor to assume contracts containing “incidental” financial accommodations. In effect, and on a basis that until now has been wholly ad hoc, the courts have developed their own invalidation of this type of “de facto ipso facto” clause.5

The remaining subjects examined in Part II bring further unity to the law of assumption of executory contracts by amplifying upon the above stated pattern. The Code requires a debtor that seeks to assume a contract to cure all defaults thereunder, but under the so-called “historical facts” doctrine a default in anything other than the payment of money is by nature incurable. As a result, nonmonetary covenants as to which the debtor has defaulted can also act like ipso facto clauses—but true to this article’s pattern, the courts have in effect mitigated the problem by permitting assumption of contracts notwithstanding “immaterial” nonmonetary defaults. Similarly, cross-default clauses may prohibitively raise the debtor’s cost of assuming a contract, because if one contract contains a cross-default clause then the express effect is that the debtor must also cure all defaults in the referred-to contracts in order to assume the first. The resulting burden may be large enough to prevent the debtor from assuming the first, just as conclusively as would an ipso facto clause, again in the absence of the Code’s override. Here, too, courts have in effect mitigated the problem by permitting the debtor to assume the first contract without curing cross-defaults in the others, if those others are not “substantially connected” enough with the first. With both nonmonetary defaults and cross default clauses, just as with financial accommodation contracts, the Code itself fails to protect the debtor, but the courts have, in effect, created closely analogous protections of their own.6

The final central subject7 encompassed by Part II’s framework is the well-known controversy over whether the debtor may assume contracts that are non-assignable under applicable state law—for example, personal services contracts. Under the so-called “hypothetical test” imposed by a majority of the circuits that have spoken on this issue, the debtor is denied the right to assume such a contract, again with obvious negative effects on the debtor’s ability to reorganize. Part II shows the hypothetical test to be vulnerable to criticism on a new basis, namely that it bootstraps the personal services nature of the contract into, in effect, an ipso facto clause against which the Code does not protect the debtor. Moreover, with the hypothetical test, unlike the previous three subjects discussed in Part II, the courts themselves also fail to protect the debtor, except in jurisdictions that reject the hypothetical test in favor of the so-called “actual test.” Regardless of one’s stance toward the two basic policy camps discussed in Part I, the Code’s strong policy stance against ipso facto clauses must be treated as a given, and the courts’ failure

5. See generally infra notes 76–97, 148, and accompanying text (discussing financial accommodations).
6. See generally infra notes 99–115 and accompanying text (discussing nonmonetary defaults); infra notes 116–144 and accompanying text (discussing cross-defaults).
7. Additional examples of the pattern are briefly examined infra note 162.

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to protect against analogous problems emerge as a new ground for criticism that
goes beyond existing policy arguments. Part III concludes with some observations about the judicial method and the
process of categorization—a process which is at the heart of most judicial decision-
making and indeed most law-making of any kind. The courts, by virtue of their
closeness to the facts of a particular case and their knowledge of the Code’s impor-
tant pro-reorganization policy, have carried forward the Code’s invalidation of
ipso facto clauses beyond the black and white boundaries set forth by Congress.
Again, one may agree or disagree with the courts’ decisions, or with Congress, but
my interest is in the method rather than the merits of policymaking. The clearest
examples of ipso facto clauses may very well be defined in large part by statute,
but as particular cases make their way through the courts, the richness of their
facts will slowly reveal other examples that, while not within the language of the
statute, should nonetheless be treated the same way. I do not call for codifying any
of the elements of the judicial pattern identified in this article. On the contrary, I
celebrate the suppleness with which the results have been reached without codifi-
cation. The courts are creating a category of ipso facto clauses just as all human
beings create the categories of daily life: particular by particular, often subcon-
sciously, and in the light of experience.

Two decades ago, Jay Westbrook characterized the topic of executory contracts
as the most “psychedelic” in the entire Lewis Carroll-like body of bankruptcy law, and he noted that courts were responding to it with “cries of confusion and frustra-
tion.” For the branch of executory contract law that concerns the debtor’s power
to assume, this article reveals the striking degree of order that actually underlies
what would otherwise seem to be a chaotic welter of disconnected doctrines. Per-
haps this branch of the law is psychedelic, but it is also kaleidoscopic: it follows a
basic pattern, built up out of intricate facets that are constantly repeated in a set of
orderly variations. The courts have developed this pattern by extrapolating from
the Code’s basic anti–ipso facto rules, piece by piece and without reference to any
overarching whole. Regardless of one’s policy stance toward the Code’s basic rules
or the courts’ extrapolations, the pattern itself has great explanatory power. Not
only does it show the order beneath the chaos, it also demonstrates how steadily
the courts can be guided by their own discretion and interpretive power, even in
the absence of codification.

I. BACKGROUND

For newcomers to bankruptcy law, it is doubly startling that the Bankruptcy
Code empowers debtors unilaterally to reject or assume contracts. It is startling,
for one thing, that the debtor has the power to reject. Under state law, a valid

8. See generally infra notes 145–161 and accompanying text.
(1989).
10. Id. Westbrook also noted that some of the critics’ concerns had been only “awkwardly and inade-
quately” addressed by the 1989 congressional “patchwork.” Id. at 228–29. This congressional pattern has con-
tinued with the executory contracts portion of BAPCPA, the Bankruptcy Abuse Prevention and Consumer
Protection Act of 2005. See, e.g., infra note 110.
11. Technically, the Code gives the power to reject or accept executory contracts to “the trustee,”
rather than the debtor. See 11 U.S.C. § 365(a) (2006). But debtors in possession have all of the relevant powers
contract is of course binding on both parties, meaning that once the contract is formed neither side has the power to walk away without the other party's consent. Yet the Bankruptcy Code overrides this foundational state law principle so that a debtor, by filing bankruptcy and then rejecting the contract, can indeed unilaterally walk away from the obligation. The non-debtor's usual state law remedy, namely compensatory damages for breach, is sharply limited by the Bankruptcy Code's overall policy of paying creditors only their pro rata share of the estate, which may be only pennies on the dollar. As a result, these claims are paid not in regular “100 cent U.S. dollars” but rather in “little tiny Bankruptcy Dollars.”

But it is also startling that the debtor has the power to assume. Under state law, the parties to a contract have the power to limit the scope of their obligations by mutual agreement, so that, for example, one party's obligation to the other may be terminated upon the happening of specified events. (To see the importance and pervasiveness of this power, consider a long-term contract for the supply of Walla Walla onions at $47 per ton. The seller and the buyer are free to agree that the contract will renew automatically every year, except that it will stop renewing if the seller gives advance notice to the buyer, or if the buyer finds a seller with a lower price, and so on.) Yet, when the limitation of one party's obligations takes the form of the other party filing bankruptcy—in essence, an ipso facto clause—the Code overrides the parties' power to take advantage of the limitation. As a result, the debtor, by filing bankruptcy and then assuming the contract, can enforce the non-debtor's obligations despite the agreed-on limitation.

of a trustee, see 11 U.S.C. § 1107(a), and as a practical matter most business bankruptcies under the Code involve a continuation of management by the debtor itself, rather than the appointment of an outsider as trustee. Accordingly, this article will generally speak in terms of the debtor rather than the trustee, except when quoting directly from sources that speak of the trustee.

12. See generally Restatement (Second) of Contracts § 1 (1981) (stating that a contract is a promise for the breach of which the law provides a remedy); id. §§ 273–87 (addressing discharge of one party's contractual duties by assent of the other).

13. See Westbrook, supra note 9, at 253. The pro rata rule generally applies only to pre-petition claims, i.e., those arising before the filing of the bankruptcy petition. Claims arising from the debtor's rejection of an executory contract are not pre-petition, because the decision to accept or reject is generally made only after the bankruptcy petition is filed, during the pendency of the bankruptcy proceeding. The fact that the non-debtor's rejection of the contract claim is nonetheless subject to the pro rata rule is particularly noteworthy. See 11 U.S.C. §§ 365(g), 502(g).

Elizabeth Warren points out that this extension of pre-petition treatment to post-petition rejection claims serves the goal of treating like creditors alike, which is one of the Code's overall objectives. “Were the debtor in bankruptcy unable to abrogate its contracts, some contract creditors might be able to jump the priority queue and extract payments in excess of their unsecured claims by forcing performance [of] economically infeasible obligations. Instead, all contract partners face the same bankruptcy risk.” Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 791 (1987) (footnote omitted). Though Warren does not push her point further, the same rationale holds all the more strongly true in the case of executory contracts the breach of which would, under state law, entitle the non-debtor party to specific performance. Receiving specific performance is the equivalent of the non-debtor being paid in 100-cent dollars rather than little tiny bankruptcy dollars, which of course is a more extreme version of “jump[ing] the priority queue.” Id.

Certain claims arising from rejection of executory contracts are also subject to further caps. See 11 U.S.C. § 502(b)(6) (stating that the claim of a real property lessor is capped at the greater of one year's rent or 15 percent of the rent for the remaining lease term, not to exceed three years, plus any arrearages); id. § 502(b)(7) (stating that the claim of an employee is capped at one year's compensation following the earlier of the petition date or the employment termination date, plus any arrearages). The aim of these caps is to prevent any single claim from dominating the total of unsecured claims so as to consume an unduly large share of the distribution.
The next section of Part I fully details these doctrines, but it is important to see the big picture from the outset: with the unilateral power to reject or assume, the debtor always has power over its non-debtor counterparty. Specifically, regardless of how events have unfolded since the initial making of the contract, the debtor has the power to make strategic decisions for its own benefit (or more accurately, for the benefit of its creditors generally), at the expense of the non-debtor party to the contract. If the contract has become burdensome to the debtor, the debtor will reject it, and if the contract remains advantageous to the debtor, the debtor will assume it. Moreover, heightening the importance of these powers, at any given moment a contract is likely to have complementary sets of benefits and burdens: a contract that is particularly burdensome to the debtor is probably, by the same token, particularly beneficial to the non-debtor, and vice versa, so that the benefit to the overall body of the debtor’s creditors is at the same time a distinct harm to the non-debtor.

Consider, for example, the bankruptcy of a hypothetical chain of electronics retail outlets. During the years before its bankruptcy, the retailer entered into hundreds of real estate leases for its various store locations on terms that were, at the time, roughly at the prevailing market rates, and as a result, both the retailer and the lessors benefitted by the making of the leases. But now the retailer files bankruptcy, and the question is whether the retailer/debtor will reject or assume the lease obligations. The answer to this question is simple and powerful: where the real estate market relevant to a particular lease has become depressed, so that the previously agreed-on lease payments are now undesirably high, the retailer will reject the lease; but where the relevant real estate market has boomed, so that the previously agreed-on lease payments are now attractively low, the retailer will assume,14 notwithstanding the ipso facto clauses that the leases include. In either case, the non-debtor lessor is stuck with, and harmed by, the debtor’s decision.

The Bankruptcy Code awards these powers to the debtor, in flagrant departure from state law, for the purpose of helping the debtor to reorganize or, in the case of a liquidation, for the purpose of maximizing the pro rata payout to the debtor’s creditors in general. The welfare of the non-debtor party to the contract, itself a creditor, is sacrificed for the sake of the debtor’s other creditors in general or the debtor itself. In the case of rejection, this is a relatively simple and remarkably clear instance of the federal bankruptcy policy of requiring the pain of the debtor’s insolvency to be spread among numerous parties rather than leaving the losses

14. In a reorganization proceeding under Chapter 11, pursuant to which the debtor will likely continue its business after the proceeding ends, the assumption of the leases is unsurprising. But assumption of the leases is also understandable even in a liquidation proceeding under Chapter 7, pursuant to which the debtor will terminate rather than continue its business. The reason is that the debtor’s assumption of the leases will likely be accompanied by an assignment of them to a third party. (After all, in the assumption branch of the hypothetical, the leases are a valuable asset, namely the right to occupy the real estate for what are now below-market rates.) For the basic limitations on a debtor’s power to assume, see infra Part I.A.

The rejection branch of this hypothetical is based loosely on the 2008 bankruptcy of the Circuit City electronics chain. See, e.g., Circuit City closes its doors for good, Mar. 8, 2009, http://www.nydailynews.com/money/2009/03/08/2009-03-08_circuit_city_closes_its_doors_for_good-3.html (“In its wake, Richmond-based Circuit City Stores Inc. will leave more than 18 million square feet of vacant space in a faltering real estate market. . . . [T]he company will . . . spend its remaining days tallying money from the sale of its assets, breaking or [in the unusual below-market instance] assigning its leases and paying off its growing list of creditors.”).
where they would otherwise fall.\footnote{To underscore this point, one should note that debtors can reject even collective bargaining agreements, so that the resulting losses are forced on the employees who would otherwise have benefitted from the agreement (provided that a balancing of equities test is also satisfied). \textit{See} 11 U.S.C. \textsection{} 1113. This is permitted despite what Elizabeth Warren calls Congress’s general “solicit[ude] of the peculiarly vulnerable position of employees.” \textit{Warren, supra note} 13, at 793; \textit{see, e.g.,} \\textit{Winston \\& Strawn LLP Restructuring and Insolvency Practice, Municipalities Can Easily Reject Collective Bargaining Agreements Under the Bankruptcy Code} (Apr. 2009), http://www.winston.com/siteFiles/Publications/Bargaining_Agreements_under_the_Bankruptcy_Code.pdf (addressing Vallejo, California’s Chapter 9 proceeding and noting the absence of restrictions under 11 U.S.C. \textsection{} 1113(b) and (c)). \textit{But cf.} Jonathan D. Glater, \textit{A Quick Bankruptcy for GM? Not So Fast}, N.Y. TIMES, Apr. 17, 2009, at B1 (contrasting the Lehman Brothers and General Motors bankruptcies because General Motors’ collective bargaining agreements impose certain restrictions under 11 U.S.C. \textsection{} 1113(b) and (c)).} In the case of assumption, the federal policy is more complex, but it generally also serves the policies of assisting the debtor’s reorganization or of maximizing the proceeds from a liquidation. The non-debtor party to a contract that is being assumed rather than rejected does not necessarily face any loss, but is affirmatively required to contribute additional assets or services to the debtor’s estate, in return for the prospect, but not the certainty, of payment under the terms of the contract.\footnote{\textit{See infra notes} 22–33 (describing the Code’s mechanisms—including the curing of defaults and the providing of adequate assurance of future performance—for providing a reasonable prospect of payment).} The non-debtor’s performance of the assumed contract is generally against its will, whether because of the now-unfavorable terms of the contract, the unsavory situation of doing business with an insolvent, and/or the lack of certainty of eventual payment. Indeed, the non-debtor’s reluctance to do further business with the debtor is clear from the very fact that the contract included an ipso facto clause in the first place. These bankruptcy policies, and their interaction with otherwise prevailing state law entitlements, are further explored below.\footnote{\textit{See infra} Part \textsection{}B.}

A. The Debtor’s Power to Assume Contracts in Bankruptcy

The central ideas behind assumption and rejection of executory contracts have already been set forth. This section looks more closely at the applicable Bankruptcy Code doctrine concerning the debtor’s power to assume the contract, with reference where applicable to the parallels between that doctrine and state law.

To the debtor, any executory contract is generally both a right (i.e., the right to receive performance from the non-debtor) and an obligation (i.e., the obligation to render performance to the non-debtor). In fact, absent this dual nature, the contract would not generally be considered executory.\footnote{\textit{See infra} Part \textsection{}I.B.} This is the reason that execu-
tory contracts are sometimes called “both an asset and a liability” to the debtor. But all aspects of a contract, whether those aspects might on their own be an asset or a liability, must be assumed together, if the contract is assumed at all. This is known as the cum onere (or “with its burdens”) principle: the debtor cannot “cherry-pick” aspects of the contract to assume. A deal is a deal, and the integrity of the pre-petition transaction must be respected.

Turning to assumption, if there have been any defaults under the executory contract, the debtor faces two principal requirements in order to assume it. The first is that the debtor cure those defaults; the second is that the debtor give adequate assurance of future performance under the contract. The cure requirement looks backward, and the adequate assurance requirement looks forward.

The requirement that the debtor cure its defaults has two parallels under state law. First, under basic contract principles, a material default by one party in its own obligations discharges the other party’s obligation to perform. So, for the first


21. In some cases it may, of course, be difficult to determine the boundaries of the pre-petition transaction in question. Depending on the intentions of the parties, several contemporaneous agreements relating to the same subject matter may or may not constitute a single contract that needs to be assumed or rejected as a unit. See, e.g., In re Adelphia Bus. Solutions, Inc., 322 B.R. 51 (Bankr. S.D.N.Y. 2005) (permitting rejection of lease of two floors of building and assumption of closely related lease of building annex). This topic is further discussed, infra Part II.C, in connection with cross-default clauses. By the same token, a single agreement may be viewed as falling into several distinct parts, in which case the cum onere principle applies only to each part that the debtor assumes. E.g., In re Gardinier, Inc., 831 F.2d 974 (11th Cir. 1987); In re Flitt Amusement Co. of Wash., Inc., 233 B.R. 837 (Bankr. C.D. Cal. 1999).

22. The cure requirement appears in clause (A) of § 365(b)(1), which provides:

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of the assumption of such contract or lease, the trustee:

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.


23. The adequate assurance requirement appears in clause (C) of § 365(b)(1).

Clause (B) of the subsection sets out a third requirement in this subsection, that the debtor compensate non-debtor parties for actual pecuniary losses resulting from the default, but for purposes of this discussion the compensation requirement can be assimilated to the discussion of cure. To see the similarity between subsections (b)(1)(A) and (b)(1)(B), consider the bankruptcy of a shopping mall tenant that has failed to pay rent or has allowed its storefront to be dark on business days. In such a case, subsection (b)(1)(A) requires the debtor to pay the arrearage or reopen the store, but see infra notes 101–103 and accompanying text regarding the historical facts doctrine, while subsection (b)(1)(B) requires the debtor to pay the landlord for rent concessions to a different tenant, given by the landlord to induce that different tenant not to go elsewhere because of the debtor’s darkened storefront. See Elizabeth Holmes, Vanessa O’Connell & Kris Hudson, Empty Mall Stores Trigger Rent Cuts, WALL ST. J., July 9, 2009, at B1.
party (analogous to the debtor in an assumption situation) to require the other to perform, the first party must be free of default. \textsuperscript{24} The second state-law parallel is more far-reaching and directly parallel to the Code’s cure requirement: even if the first party has materially defaulted, the first party may still require the other to perform if the first party cures that material default. \textsuperscript{25} In effect, a party who has already breached has the power, by cure, to pull the non-breaching party back into the deal from which the latter would otherwise be excused. For example, if the buyer of widgets under an installment contract misses one or more substantial payments to the seller, then the seller is excused from further deliveries, but the buyer can reinstate the seller’s obligations by making the missed payments after all. This is quite close indeed to the Bankruptcy Code’s cure requirement: if the debtor is the defaulting widget buyer from our hypothetical and the widget deal is an executory contract (perhaps because there are further deliveries and payments required after the petition date), then the debtor cannot pull the non-debtor seller back into the deal unless it cures the previous payment defaults. \textsuperscript{26}

The requirement that the debtor provide adequate assurance of future performance, like the cure requirement, has a strong parallel in state contract law. When two parties make a contract, the object of the transaction is a successful exchange of performances rather than just the conferring of a successful cause of action for breach. \textsuperscript{27} For this reason, if one party has reasonable grounds to believe that the other (analogous to the debtor here) will fail to perform, state contract law generally requires that other party to provide the first with “adequate assurance of due performance.” \textsuperscript{28} If the other party fails to provide this assurance, the first party

\textsuperscript{24} \textit{Restatement (Second) of Contracts} § 237 (1981) (“[I]t is a condition of each party’s remaining duties to render performance to be exchanged under an exchange of promises that there be no uncured material failure by the other party to render any such performance due at an earlier time.”); see generally Ralph Brubaker, \textit{Cure of Nonmonetary Defaults as a Prerequisite to Assumption of Executory Contracts and Unexpired Leases: A Lesson in the Nature and Function of the Cure Requirement}, 24 No. 12 \textit{Bankruptcy Law Letter} 1 (Dec. 2004) [hereinafter Brubaker, \textit{Nonmonetary Defaults}] (pointing out the state law parallel). Indeed, following the first party’s failure to perform, not only is the other party freed from its own obligation to perform; the other party is also under a so-called duty to mitigate its damages, so that if the other party does perform it cannot look to the first party for payment. See Rockingham County v. Luten Bridge Co., 35 F.2d 301, 307–08 (4th Cir. 1929).

\textsuperscript{25} \textit{Restatement (Second) of Contracts} § 237 (1981) (referencing “uncured” material failures to perform); see also U.C.C. § 2-508(1) (2003) (providing that a seller that has previously made a prior nonconforming delivery may cure by making a conforming delivery where the time for performance has not yet expired). All references herein to Article 2 of the Uniform Commercial Code are to the 2003 Official Text, rather than to the 2005 Official Text, because of the latter’s lack of enactments to date.

The Restatement provision requires only the absence of “material” failures of performance, while 11 U.S.C. § 365(b)(1)(A) refers seemingly more broadly to all defaults. See infra Part II.B (addressing this subject).

\textsuperscript{26} Note that the debtor’s filing bankruptcy is not itself a default to which the cure requirement applies. See infra note 58 (discussing § 365(b)(2)). If the contract contains an ipso facto clause, the debtor’s filing bankruptcy is undoubtedly a default under state contract law, but the Code takes care to prevent the § 365(a)(1)(A) cure requirement from applying here, consistent with its overall invalidation of these clauses. The same is true of the subsection (a)(1)(C) adequate assurance requirement, discussed in the text that follows.

\textsuperscript{27} In the words of the Uniform Commercial Code, “A contract for sale imposes an obligation on each party that the other’s expectation of receiving due performance will not be impaired.” U.C.C. § 2-609(1) (2003).

\textsuperscript{28} \textit{Id.} (“When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance. . . .”); see also Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998) (recognizing the right to demand
may treat such failure as a material breach by the other, with the result that the first party's obligations under the contract may be discharged. 29 For example, in one case, 30 the contract provided for the seller to provide five burners for an ammonia plant, capable of operating continuously with heavy fuel oil at 260°C Celsius. Before delivery, the buyer discovered that similar burners installed by the seller for a different buyer had been overheating when operating with heavy fuel oil, and demanded, among other things, that the seller provide a letter of credit backing up its obligation to repay the purchase price if the burners failed to perform satisfactorily. 31 The court held that the buyer's demand for the letter of credit was justified—even though the contract itself had contained no express requirement of the sort—and that the seller's failure to provide it constituted a repudiation of the contract. 32

As with cure, the state law adequate assurance requirement is quite close to the Bankruptcy Code's version; in fact, the Bankruptcy Code's version is adapted directly from that of the Uniform Commercial Code. 33 For example, borrowing from the facts above, suppose that the fuel burner buyer had made no pre-delivery demand for a letter of credit, and that the burners, when installed in the buyer's plant, had malfunctioned. On these facts, the Uniform Commercial Code would generally give the seller the right to cure (e.g., by supplying new properly functioning burners), and indeed the seller would be required to do so in order to avoid a breach under the contract. (Indeed, the Bankruptcy Code requirements as to both cure and adequate assurance can be viewed as simply the making explicit of elements that are already implicit in contracts themselves, properly understood—not as federal or state government impositions on private parties. 34 The cure requirement is simply one facet of the remedies for breach, and as such is a natural, though tacit, outgrowth of the parties' basic agreement on performance. Similarly, the adequate assurance requirement, while cast as an obligation rather than a rem-

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29. U.C.C. § 2-609(1) (2003) (providing that, "until he receives such assurance [he] may if commercially reasonable suspend any performance for which he has not already received the agreed return"); id. § 2-609(4) ("[F]ailure to provide [assurance] within a reasonable time not exceeding thirty days . . . is a repudiation of the contract."); RESTATEMENT (SECOND) OF CONTRACTS § 251(2) (1981).


31. Id. at 46–48.

32. Id. at 50.


34. By contrast, one case does explicitly view the requirements as legislative impositions, albeit wise ones. “[T]he provisions for cure of default and adequate assurance of future performance are a substitute for the right that the non-debtor would otherwise have to terminate the contract.” In re UAL Corp., 293 B.R. 183, 191 (N.D. Ill. 2003). For further discussion of this case see infra notes 87–94 and accompanying text. In other words, the requirements of § 365(b)(1) are balanced by the invalidation of ipso facto clauses under subsection (e)(1), discussed more fully infra Part I.B. The thought seems to go that, as a result of subsection (e)(1), the non-debtor is stuck in its contracts with the debtor, but that Congress has at least kept that position from being too harmful. However, such a thought, in addition to neglecting the reasoning behind the state-law roots of the cure and adequate assurance requirements, also fails to account for the fact that those requirements apply even to the assumption of contracts that contain no ipso facto clause.
edy, arguably imposes no obligation that was not already implicit in the parties’ basic agreement on performance.)

B. The Code’s Invalidation of Ipso Facto Clauses

1. Centrality to Debtor’s Power to Assume Contracts

The Bankruptcy Code takes great care to thoroughly invalidate ipso facto clauses, not only regarding the debtor’s power to assume contracts but also in other contexts. Each of these forms of invalidation is designed to protect the debtor’s overall prospects of reorganization by preventing particular non-debtors from declining to shoulder their share of the harm stemming from the debtor’s insolvency. One creditor—the drafter of the ipso facto clause—is harmed so that the body of creditors as a whole will benefit. In Thomas Jackson’s words, the non-debtor’s rights under an ipso facto clause are “the type of rights that bankruptcy law is justified in ignoring because they may be destructive of the collective weal in bankruptcy.”

“Ipso facto clause” is a non-statutory shorthand label for a category of contractual provisions that, in essence, would provide for the debtor’s rights under the contract to terminate upon the filing of bankruptcy or related events. Specifically, the Code refers to a “provision” in the contract “that is conditioned on” any of the following three criteria: “(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.” And the central operative importance of an ipso facto clause is that: “an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of [such a provision].”

The effect, then, is that a non-debtor cannot undermine in advance the debtor-to-be’s power to assume the contract, simply by utilizing a clause that provides for the debtor’s contract rights to be pulled out from under its feet upon its filing of bankruptcy (or upon the other enumerated conditions).

35. See supra note 27; see also RESTATEMENT (SECOND) OF CONTRACTS § 251 cmt. a (1981) (“This principle is closely related to the duty of good faith and fair dealing in the performance of the contract (§ 205).”).

36. J ACKSON, supra note 19, at 43. Subsection (e)(1)’s terms are not, however, limited to the rights of a debtor during bankruptcy. Instead, they broadly provide that the contract “may not be terminated or modified” solely because of the ipso facto events, even after the termination of the bankruptcy proceeding. 11 U.S.C. § 365(e)(1) (2006).

37. See BLACK’S LAW DICTIONARY, supra note 3, at 905.


39. Id.

40. In providing for the invalidation of ipso facto clauses, the Bankruptcy Code differs markedly from its predecessor, the Bankruptcy Act. Under the older statute, ipso facto clauses were generally enforceable simply because there was no equivalent to today’s § 365(e)(1). On the other hand, and significantly for this article’s major theme of judicial response to statutory shortcomings, the case law did tend to water down this enforceability. “Such clauses had been reluctantly enforced in rehabilitation cases under the Act, although a significant trend away from enforceability had begun, at least in cases in which a public interest might be said to have been present or where termination might have frustrated confirmation of an otherwise feasible plan.” COLLIER ON BANKRUPTCY, supra note 20, ¶ 365.05[4] (footnotes omitted).
Ipso facto clauses of certain kinds may be perfectly enforceable as a matter of state law, but the Code supersedes that enforceability. This superseding represents a matter of strong federal policy, namely, protecting the debtor’s power to assume. As noted above in this section, in a reorganization proceeding the power to assume is integral to preserving the debtor’s going concern value, and in a liquidation proceeding the power to assume helps to maximize the return to the debtor’s creditors in general. A single creditor, the non-debtor, is prevented from exiting its relationship with the debtor, so that the other creditors’ relationship with the debtor can be better rehabilitated. Bankruptcy is a sharing of pain, and the invalidation of ipso facto clauses is a clear mechanism by which the Code mandates that sharing.

One can also see the invalidation of ipso facto clauses as a common-sense limitation both on the *cum onere* principle and on the Code’s baseline respect for non-bankruptcy entitlements. If the federal bankruptcy policy of empowering the debtor to assume is to have any realistic force, then contract drafters must not be permitted to readily render that policy nugatory. This is all the more true in light of the pre-bankruptcy bargaining posture of the debtor-to-be that, as a result of natural bargaining dynamics, has little or no incentive to resist the inclusion of the clause. The Code does not allow a few boilerplate drops of pre-petition ink to disrupt its own important and express goals.

The Code’s blanket invalidation of ipso facto clauses is one of many ways in which the Code is more oriented toward the reorganization rather than liquidation of troubled firms. See generally David A. Skeel, Jr., Debt’s Dominion: A History of Bankruptcy Law in America 181–82 (2001). And perhaps the fact that the clauses were enforceable at least to a degree under the Act—plus the congenital conservatism of contract drafters—is one reason contributing to their continued presence in documents today. See infra note 43.

41. See, e.g., Thomas E. Plank, Bankruptcy and Federalism, 71 Fordham L. Rev. 1063, 1128 (2002) (“If one party to a contract is not a debtor in bankruptcy, the other party is free to exercise ‘ipso facto’ provisions based on the debtor’s financial condition.”).


43. Jackson demonstrates that the ordinary contract-bargaining paradigm, according to which both sides’ interests are represented in negotiations and the resulting contract represents an optimal result, is not operative when it comes to ipso facto clauses. “An aspect of the problem of diverse ownership” exists here, he writes. Jackson, supra note 19, at 42. The debtor will be insolvent if the clause is ever triggered, and as a result,

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\text{the group that is likely to bear the costs of this clause . . . is not the debtor (or its shareholders) but the other creditors. Thus, the debtor may have no particular incentive in negotiating loans to exclude such clauses, and other creditors may have no effective way of forcing the debtor to exclude them.}
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Id. (footnotes omitted). Though Jackson writes in the context of loan agreements, to which this article turns in Part II.A, his overall thought is equally applicable to ipso facto clauses in other types of agreements. See, e.g., Douglas G. Baird, Elements of Bankruptcy 140–41 (4th ed. 2006).

These bargaining dynamics are an important additional reason that ipso facto clauses, despite their ineffectiveness in bankruptcy, are so routinely included as boilerplate in contracts. See supra note 40. And of course the enforceability of the clauses outside bankruptcy is an important further explanation. For examples of ipso facto clauses in a variety of contracts other than loan agreements, see Summit Investment & Development Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995) (partnership agreement), Liberty Mutual Insurance Co. v. Greenwich Insurance Co., 286 F. Supp. 2d 73 (D. Mass. 2003) (surety bond), In re Ruona, 353 B.R. 688 (Bankr. D.N.M. 2006) (motor vehicle financing agreement), and In re Mirant Corp., 303 B.R. 319 (Bankr. N.D. Tex. 2003) (electrical power sales agreement).
2. Pervasiveness of Similar Invalidations Throughout the Bankruptcy Code

Before proceeding to the broader policy and theoretical dimensions of § 365(e)(1), we should note that the Code also contains a number of related provisions that are also devoted to invalidating ipso facto clauses in various contexts other than the termination of contracts. Together, these other provisions help to further establish the importance of the Code’s anti–ipso facto policy.

The first sibling provision enlarges the scope of property of the estate. 44 Section 541(c)(1)(B) invalidates any provision “in an agreement, transfer instrument, or applicable nonbankruptcy law” that (a) is conditioned on the same three events that were enumerated in connection with termination of a contract45 and (b) “effects or gives an option to effect a forfeiture, modification, or termination of the debtor’s interest in property.” 46 As a result, property that would otherwise be excluded from property of the estate is instead included, and this section, like its executory contracts counterpart, burdens a single third party in the service of facilitating the debtor’s reorganization or of maximizing recovery by the debtor’s creditors. For example, suppose that Seller has a contract with Buyer that, in addition to reserving a security interest for Seller, provides that if Buyer files for bankruptcy then Buyer forfeits the purchased equipment or so much of it as has not yet been paid for. Section 541(c)(1)(B) prevents this contracted-for forfeiture from occurring, by invalidating the condition and including the equipment as property of the estate, so that the equipment is available to the debtor/buyer for use in its reorganization, or for distribution to its creditors in a liquidation.47

The second sibling provision protects the debtor’s power to use property during the pendency of the case. Section 363(l) allows a trustee to use, sell, or lease property “notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on” the three typical ipso facto events.48 Continuing with the example above, suppose that Seller’s contract with Buyer provides that if Buyer files for bankruptcy, Buyer must redeliver possession of the equipment to Seller. Section 363(l) protects the debtor/buyer’s use, sale, or lease of the property (as opposed to its ownership) by invalidating this ipso facto clause. Alternatively, suppose that an equipment lease grants the lessee the right to use the equipment unless and until the lessee files for bankruptcy. Because of the statute’s invalidation of this ipso

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44. Property of the estate is, in general, a proxy for the assets that the bankruptcy proceeding has power over, and accordingly serves as a direct or (in a reorganization proceeding) indirect measure of the creditors’ recovery. See 11 U.S.C. § 362(a)(3) (2006) (stating that automatic stay is applicable to “any act to obtain possession of property of the estate . . . or to exercise control over property of the estate”).

45. That is, (1) the financial condition of the debtor, (2) the commencement of a bankruptcy case, and (3) the appointment of a bankruptcy trustee or related events. See supra note 38 and accompanying text. With minor wording differences these same three “ipso facto events” are at the heart of all the sibling provisions.


47. The distribution to creditors would of course be subject to the seller’s rights as a secured party. See LaMonica v. N. of Eng. Protecting & Indem. Ass’n (In re Probulk Inc.), 407 B.R. 56, 61–63 (Bankr. S.D.N.Y. 2009) (invalidating clause in debtor’s insurance policy terminating the policy if debtor’s management resolves to file bankruptcy); see also Jackson, supra note 19, at 103. Jackson observes that these clauses, if enforceable, would create a perverse incentive for commencement of a bankruptcy case, because the winner of the forfeited reversionary interest would gain at the expense of other creditors. Jackson, supra note 19, at 103. This failure of bargaining dynamics is very similar to those discussed above in connection with termination of contracts. See supra note 43.

facto clause, the debtor/lessee may assume the lease in its bankruptcy case and continue to use the equipment to facilitate its reorganization. 49

The third sibling provision protects the debtor against statutory liens. 50 Statutory liens are generally recognized in bankruptcy, but when they arise upon the filing of a bankruptcy case or one of the other typical ipso facto events, § 545(1) provides that they lose their presumptive legitimacy and may be avoided under this section, because they resemble state-created attempts to interfere with the Bankruptcy Code’s own priority provisions. 52 To see the effect of this section, suppose that a state statute gives a seller of raw produce, seeds, or other agricultural inputs a lien on all products resulting therefrom (say, processed versions of the produce), and that the lien becomes effective upon the bankruptcy of the Buyer rather than neutrally upon the carrying out of any credit sale. Section 545(1) invalidates such a lien, and as a result, the processed products may be liquidated and the proceeds distributed to all the debtor’s unsecured creditors (including the raw produce seller who no longer would have any priority to those proceeds). Alternatively, the processed products may be used by the debtor/buyer in its business while it reorganizes, without the necessity of providing adequate protection to the putative lien holder. 53 In either case, here, as with the other sibling provisions, the statute clearly facilitates a reorganization or enhances the recovery by general creditors, in both cases at the expense of a single party’s rights under state law.

We should also take note here of § 365(f), which protects the debtor’s power to assign (as opposed to merely assuming) an executory contract, 54 and prevents the

49. For an important case linking § 363(l) to the overall pattern of this article’s Part II, see infra note 162.
50. The Code defines a statutory lien as a:
- lien arising solely by force of a statute on specified circumstances or conditions . . . but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.
51. In this case the usual list of three ipso facto events is elaborated and somewhat expanded, and because of its concern about lien priority the list is expressed in terms of points in time. The full list is:
(A) when a case under this title concerning the debtor is commenced;
(B) when an insolvency proceeding other than under this title concerning the debtor is commenced;
(C) when a custodian is appointed or authorized to take or takes possession;
(D) when the debtor becomes insolvent;
(E) when the debtor’s financial condition fails to meet a specified standard; or
(F) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien.
52. Charles Tabb describes these problematic liens as being “state-created priority, dressed up to look like a lien.” See CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 462 (1997).
53. See 11 U.S.C. §§ 362(d)(1) (providing that lack of adequate protection is cause for relief from automatic stay), 361 (providing forms in which adequate protection may be provided).
54. 11 U.S.C. § 365(f)(1)–(2) provides in pertinent part:
[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection,
(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—
(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
non-debtor party from terminating the contract because of such an assignment.\footnote{55} This section operates even if the executory contract contains a prohibition on assignment, and even if applicable non-bankruptcy law prohibits assignment. Moreover, the section overrides such anti-assignment clauses or non-bankruptcy law even when they are not tied to the particular ipso facto events. For example, a contract clause that simply provides “Party A may not assign its rights hereunder” is invalidated, even though the clause is not triggered by Party A’s financial condition, bankruptcy filing, or the like. For this reason § 365(f) is not a true sibling anti–ipso facto provision, but perhaps a step-sibling. But even so, it is an important element of the overall pattern because, by protecting the debtor’s power to assign, the section furthers the purpose of enabling the debtor to reorganize, exactly as does § 365(e)(1)’s protection of the debtor’s power to \textit{assume}. In both cases, the debtor is empowered to access the value of the executory contract—under (e)(1) by performing on its own and under (f) by selling to a third party that will do so.\footnote{56}

The last of the sibling provisions returns us squarely to our main topic, the debtor’s power to assume an executory contract despite provisions in the contract to the contrary. Section 365(e)(1) is of course the head of the family here, but a full family portrait must also include § 365(b)(2). We have already examined the Code’s basic requirements for assumption—principally, cure plus adequate assurance of performance\footnote{57}—and subsection (b)(2) is simply an exception to those requirements. It provides that no cure or compensation need be given for the breach of a provision relating to the typical ipso facto events.\footnote{58}

As should be clear from the foregoing, the provisions of § 365(e)(1) are by far the most important of the Code’s ipso facto provisions. They will be the most important for purposes of this article, too. The sibling provisions have received com-

\begin{quote}
(B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.
\end{quote}

\footnote{55. 11 U.S.C. § 365(f)(3) provides:
Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease . . . on account of an assignment of such contract or lease, such contract [or] lease . . . may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee. R

\footnote{56. For an interesting case linking subsection (f) to the overall pattern of this article’s Part II, see infra note 162. R

\footnote{57. \textit{See supra} notes 22–33 and accompanying text (discussing § 365(b)(1)). R

\footnote{58. 11 U.S.C. § 365(b)(2) provides:
Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
\begin{enumerate}
\item[(A)] the insolvency or financial condition of the debtor at any time before the closing of the case;
\item[(B)] the commencement of a case under this title;
\item[(C)] the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
\item[(D)] the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.
\end{enumerate}

Clause (D), relating to nonmonetary defaults, is insignificant for purposes of the present discussion, but in Part II.B it is central to the discussion. \textit{See infra} notes 99–115 and accompanying text.

Related to § 365(b)(2) is Bankruptcy Code, 11 U.S.C. § 1124(2)(A). The Code generally provides that a lender’s claim is impaired under a plan unless the debtor cures all related defaults, but it also provides an exception for “a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured.” 11 U.S.C. § 1124(2)(A). R}
paratively little scholarly attention—a tradition that I propose to continue. But
those sibling provisions do help to highlight the policy-based importance under the
Code of invalidating ipso facto provisions—an idea that Part II will show reaches
much further than its statutory text might suggest.

3. Importance to Overarching Bankruptcy Policy

The debtor’s powers of assumption and rejection and the Code’s associated in-
validation of ipso facto clauses involve a stark interface between state-created con-
tract rights and federally implemented reorganization policy. Accordingly, over the
past couple of decades, they have been good fodder for some of the highest level
theoretical bankruptcy policy debates. In Bankruptcy’s Uncontested Axioms, Pro-
fessor and then Dean Douglas Baird observed that the world of bankruptcy schol-
arship can be divided into “two distinct camps,” one composed of “traditionalists”
and the other composed of “proceduralists.”59 The two camps embrace different
sets of axioms. Simplifying greatly, as one must always do in setting up large-scale
frameworks, the traditionalist camp generally sees bankruptcy law as playing a dis-
tinctive role in the legal system with its own important substantive goals.60 It ac-
cordingly embraces values such as keeping financially distressed firms intact,
adjudicating rights and liabilities primarily in light of the particular facts affecting
the parties, and vesting judges with considerable discretion in order to implement
these goals.61 By contrast, the proceduralist camp sees bankruptcy most impor-
tantly as just one element that should be well integrated into the rest of the na-
tion’s economy and legal system.62 It accordingly embraces values such as the
orderly dissolution of firms when economically sensible, reaching legal results with
an eye to their incentives on economic actors who are not before the court, and
deferring where possible to the choices made by autonomous parties.63 As can be
seen even from this brief sketch, each set of axioms or values is internally coherent
(at least as a general proposition), much as one can theorize “a coherent geo-
metry” either with or without the Euclidean postulate that only one line through a
given point can run parallel to another line.64

The Code’s treatment of ipso facto clauses has obvious resonance in these de-
bates. Some commentators—naturally those of a predominantly proceduralist
stripe—have advocated changing the Bankruptcy Code so that ipso facto clauses
would not be invalidated; as a result, the foresightfully drafting non-debtor party
would be free from its obligation to perform after bankruptcy and would, in effect,

60. Id.
61. See id. at 577–80.
62. See id. at 577–78.
63. See id. at 577–80.
64. Id. at 574. “Neither [of these geometries] is more or less true than the other,” Baird observes. Id. If
required to choose one and only one of these labels for my own outlook, I suppose I would have to choose the
traditionalist one, and this article generally bears that out through its acceptance, at least for the sake of
argument and exploration, of the Code’s invalidation of ipso facto clauses and of the courts’ extension of that
policy choice to new contexts. See infra Part II. However, as made clear in the Introduction, and elsewhere in
this article, my purpose here is by no means to defend any particular policy position, traditionalist or other-
wise. Instead, my interest is in discovering the internal coherence or incoherence of bodies of rules, the role of
the courts in moving beyond express statutory mandates, and the ways in which the courts’ decision-making
process reflects the structure of ordinary human thought. See generally Part III.
be able to opt out of its share of the pain. The main outlines of this discussion emerge in two broad articles that overlap only on the subject of ipso facto clauses.65 In the first, Alan Schwartz proposes that much of the Bankruptcy Code should be relegated to the status of default rules rather than mandatory rules, and that one part of this should be the repeal of § 365(e)(1).66 The invalidation of ipso facto clauses is not economically efficient, Schwartz argues, because (among other reasons) the benefits to the estate from being able to choose which contracts to follow through on are precisely offset by the increased charges levied ex ante and in the aggregate by the debtor’s contracting counterparties.67 Against Schwartz’s assertion, Roy Kreitner argues that factors playing into such a calculation are too remote to be considered by creditors, even sophisticated voluntary ones.68 Kreitner also builds on the idea, referred to above,69 that pre-bankruptcy bargaining dynamics would not cause the debtor to resist ipso facto clauses even when doing so would be efficient; hence, the primary effect of repealing § 365(e)(1) would be merely distributional rather than an increase in efficiency.70 Overall, he writes, “[i]n banning ipso facto clauses, the Code pursues the creation of a framework of cooperation that extends beyond the contracting parties.”71

This article does not seek to engage with the traditionalist versus proceduralist debate on its own terms; its parameters and stakes have been, and are being, well explored in the literature.72 Instead, with that debate serving as a backdrop, this


67. See id. at 1843; see also Yeon-Koo Che & Alan Schwartz, Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance, 15 J.L. ECON. & ORG. 441 (1999).

68. See Roy Kreitner, Frameworks of Cooperation: Competing, Conflicting, and Joined Interests in Contract and Its Surroundings, 6 THEORETICAL INQUIRIES L. 59 (2005). As a result, he writes, “nearly nothing” rides on the enforceability of an ipso facto clause except a “long-shot distributive gamble.” Id. at 106. This argument exemplifies one facet of the traditionalist camp as described by Baird. To members of that camp, Baird writes, “very little of bankruptcy law and procedure affects the decisions of creditors or anyone else to do business with the firm in the first place. The bankruptcy process is self-contained.” Baird, supra note 59, at 578.

69. See supra note 43 and accompanying text.

70. Kreitner, supra note 68, at 106–07 (“Ipso facto clauses could be seen primarily as attempts at rent-seeking from remote third parties. As such, they create externalities that should concern economic analysis, at least when such analysis is not unduly narrow.”).

71. Id. at 108.

72. For treatments of ipso facto clauses in particular in the above context, see Susan Block-Lieb, Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case, 42 Am. U. L. Rev. 337, 388 (1993) (stating that the Code’s anti–ipso facto provisions help to realize going concern value as compared to execution sale); Charles W. Mooney, Jr., A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure, 61 Wash. & Lee L. Rev. 931, 1043 (2004) (overriding of ipso facto clauses serves the goal of maximizing rights holders’ recoveries by preserving valuable assets, but “[i]f not offended, procedure theory is at least annoyed” by sacrifice of non-debtor party’s rights for this purpose); Raymond T. Nimmer, Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain, 54 U. Colo. L. Rev. 507, 541–44 (1983) (describing trade-off of gains within bankruptcy against losses external to bankruptcy among distressed debtors that find contracts less available or more expensive); Plank, supra note 41, at 1092, 1127–28 (invalidating of ipso facto clauses protects the bankruptcy process and does not violate the non-expropriation principle); Warren, supra note 13, at 792 (stating that the Code’s nonrecognition of ipso facto clauses “force[s] the non-debtor] to share in the losses of bankruptcy, in order to give the failing business a chance to survive”).
article focuses more closely than has heretofore been done on the subject of ipso facto clauses, with the goal of demonstrating that the decisions that we make about ipso facto clauses also directly implicate a number of seemingly separate doctrines in the executory contracts field. In other words, this facet of the traditionalist versus proceduralist debate reaches much more broadly than is usually thought. In particular, I should perhaps make clear here that I take no position on the intrinsic desirability of § 365(e)(1); rather, I accept this provision of the Code for the sake of argument and use it as a standpoint from which to examine a kaleidoscope of related issues. My interest is not in the merits of policy decisions or theoretical camps in their own right, but in the coherence of one policy decision with others.

In quantifying the generality or specificity of legal discussions, people frequently use figures of speech relating to height above the ground. Purely theoretical discussions are sometimes said to take place “at 30,000 feet,” while purely doctrinal or case-crunching or empirical discussions are situated “on the ground” or “where the rubber meets the road.” This article occupies a position between those extremes and, to extend the metaphor a little, flies at an intermediate altitude, from which we can study the contours of the landscape, the interlinking of towns by major traffic arteries, and other definite structures that are usually taken for granted. As Part II proceeds to show, those structures are based, consciously or not, on the Code’s invalidation of ipso facto clauses.

II. “DE FACTO IPSO FACTO” CLAUSES: A RECURRENT STRUCTURE

Part I of this article showed that the Code’s invalidation of ipso facto clauses is pervasive as well as central to some of the Code’s most important policy choices. In Part II, I build on that foundation in order to reveal the underlying unity of a variety of judicially developed aspects of the law of executory contracts. The law of assumption of executory contracts is remarkably sprawling and dense—even “psychedelic”—but as I show, the invalidation of ipso facto clauses is, or should be, a unifying theme for much of this body of law. Indeed, at least four substantial doctrines in the complex law of executory contracts can be unified under the umbrella of what might be called “de facto ipso facto” clauses. The four sections of Part II examine those four doctrines.

A. Financial Accommodations and Incidentality

In light of the importance of § 365(e)(1)’s invalidation of ipso facto clauses, it is quite striking to realize that that invalidation is subject to a sweeping exception for one of the most important types of executory contract: a contract to make a loan or other “financial accommodation” to the debtor. Indeed, compounding this fact, contracts for loans or other financial accommodations cannot be assumed by the

73. See Westbrook, supra note 9, at 228.

74. I cannot claim credit for inventing as opposed to capitalizing on the term “de facto ipso facto” clause. See Ralph Brubaker, Cross-Default Provisions in Executory Contracts and Unexpired Leases: Assumption Cum Onere and Unenforceable Ipso Facto Provisions, 26 No. 11 BANKRUPTCY LAW LETTER 1, 9 (Nov. 2006) [hereinafter Brubaker, Cross-Defaults] (calling a cross-default clause a “(de facto) ipso facto default clause”); In re Ernie Haire Ford, Inc., 403 B.R. 750, 759 (Bankr. M.D. Fla. 2009) (stating that the termination-at-will clause cannot be used as “de facto ipso facto provision”). Cross-default and termination-at-will provisions are discussed, infra Part II.C and infra note 162, respectively.
debtor even if the contract does not contain an ipso facto clause. These rules potentially open the door to abuse by non-debtor parties or to other undesirably large interference with the Code’s reorganization and payout goals, but courts have found their way to a solution that safeguards the Code’s basic policy, identified in Part I, of ensuring that each creditor accepts its share of the pain of the debtor’s insolvency.75

Section 365(e)(2)(B) and its chapeau provide:

Paragraph (1) of this subsection [i.e., the Code’s principal invalidation of ipso facto clauses] does not apply to an executory contract or unexpired lease of the debtor . . . , if—

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor,
or to issue a security of the debtor.76

For ease of exposition, this article will refer to the contracts covered by subsection (e)(2)(B) as “financial accommodation contracts.”

The clearest and probably most important example of a financial accommodation contract is a loan agreement.77 Suppose that a lender and a borrower have

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75. See infra note 15 and accompanying text.
77. The term “financial accommodation” is not defined in the Code, but generally refers to agreements for the extension of credit. See, e.g., In re UAL Corp., 293 B.R. 183, 187 (Bankr. N.D. Ill. 2003); see also 124 Cong. Rec. H11,089 (Sept. 28, 1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6447 (statement of Rep. Edwards) (“Characterization of contracts to make a loan, or extend other debt financing or financial accommodations is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made over time.”); 124 Cong. Rec. S17,406 (Oct. 6, 1978), reprinted in 1978 U.S.C.C.A.N. 6505, 6515 (statement of Sen. DeConcini). Thus, ordinary credit sales contracts or similar agreements, in which the non-debtor sells goods (or provides services or permits the occupancy of premises) to the debtor with payment to be made in the future, technically involve a credit element, but are not intended to be treated as financial accommodation contracts.

Whether derivatives contracts such as swaps, repurchase agreements, and forward, securities, and commodities contracts are “financial accommodations” is an interesting question that has been rendered generally moot by the expansion in 2005 and 2006 of so-called financial market safe harbor provisions. Under the safe harbors, most non-debtor parties to any of these derivative contract are protected by an analog to § 365(e)(2)(B).

Virtually every swap agreement, for example, contains explicit ipso facto clauses of the kind otherwise invalidated by § 365(e)(1)(A)–(C). ISDA 2002 Master Agreement § 5(a)(vii) provides that an event of default occurs if, among other things, a party:

(2) becomes insolvent or is unable to pay its debts or fails or admits in writing its inability to pay its debts as they become due; (3) makes a general assignment, arrangement or composition with or for the benefit of its creditors; (4)(A) institutes or has instituted against it . . . a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors’ rights . . .

But, continuing with the example of swaps, § 560 provides in pertinent part:

The exercise of any contractual right of any swap participant or financial participant to cause the . . . termination . . . of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be . . . limited by operation of any provision of this title or by order of a court . . . in any proceeding under this title.

11 U.S.C. § 560; see also Collier on Bankruptcy, supra note 20, ¶ 560.01:

Without special protection, a party to a swap agreement with the debtor would be vulnerable in several respects to loss of, or interference with, its rights and remedies under the swap agreement by reason of the commencement by the debtor of a Bankruptcy Code case. For
agreed that the lender will extend a loan to the borrower at a certain point in the future, subject to the usual terms and conditions. These terms and conditions almost invariably include “material adverse change”—or MAC—clauses, pursuant to which the lender is excused from lending if the borrower’s financial condition changes in specified ways for the worse.\footnote{See Thomas S. Hemmendinger, Hillman on Commercial Loan Documentation 7–8 (5th ed. 2000 & Supps.) (discussing the form of a lending agreement including the non-occurrence of a material adverse change as a condition precedent to advances), id. at 8–24 (defining material adverse change for purposes of the same). In an analogous context, see Robert T. Miller, The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements, 50 Wm. & Mary L. Rev. 2007 (2009).} After all, at least in principle, the lender’s readiness to lend has been premised on a certain amount of investigation of the borrower’s creditworthiness and satisfaction with the results. Now suppose that the borrower files bankruptcy before the date of the loan and then seeks to assume the contract, holding the lender to its overall commitment. The MAC clause in the contract purports to free the lender from any obligation to lend, but that clause is an ipso facto clause (because it is “a provision in such contract . . . conditioned on . . . the financial condition of the debtor”) subject to invalidation under subsection 365(e)(1). However, subsection (e)(2)(B) keeps the clause from being invalidated, and frees the non-debtor lender to walk away from the deal as contractually provided for.

Closely related to subsection (e)(2)(B) is subsection (c)(2), which provides that the debtor may not assume an executory contract if “such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.”\footnote{See Thomas S. Hemmendinger, Hillman on Commercial Loan Documentation 7–8 (5th ed. 2000 & Supps.) (discussing the form of a lending agreement including the non-occurrence of a material adverse change as a condition precedent to advances), id. at 8–24 (defining material adverse change for purposes of the same). In an analogous context, see Robert T. Miller, The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements, 50 Wm. & Mary L. Rev. 2007 (2009).} So closely related are the two sections, in fact, that it can be difficult to discern why Congress enacted them both, but the answer is that they cover slightly different situations. Subsection (e)(2)(B), as seen, is an exception to subsection (e)(1)’s invalidation of ipso facto clauses, but subsection (c)(2) disables the debtor from assuming financial accommodation contracts at all. So on one hand, unlike subsection (e)(2)(B), subsection (c)(2) thus protects a lender even when its contract contains no ipso facto clause.\footnote{With material adverse change clauses or even termination-on-bankruptcy clauses being such standard machinery in loan agreements, this additional breadth of (c)(2) is hard to get excited about—except in admiring the way in which banking interests were able to secure statutory protection against their own prospective inadvertence. See infra note 148 (discussing the nature of (c)(2) as a simple sharpening of subsection (c)(1)). The thorough (or cumbersomely duplicative) nature of this drafting recalls similar aspects of the various sibling anti–ipso facto clauses discussed in Part I.B.2 and, further afield, of aspects of the Bankruptcy Code’s 2005 and 2006 derivatives safe harbor provisions.} And conversely, unlike subsection (c)(2), subsection (e)(2)(B) protects the lender even after the bankruptcy proceeding is terminated. (Suppose that the borrower filed bankruptcy and that only subsection (e)(2) were on the books. On these facts, the borrower/debtor would be unable to assume the contract during the bankruptcy proceeding, but after the reorganization the former debtor would still have an enforceable contract, the ipso facto clause of which would remain invalidated under subsection (e)(1).\footnote{As pointed out, supra note 36, subsection (e)(1)’s terms are not limited to rights of a debtor during bankruptcy. Instead, they broadly provide that the contract “may not be terminated or modified” solely be-}
(c)(2) on the books, the former debtor has no such enforceable post-bankruptcy contract.)

On a superficial level, it is easy to dismiss the importance of these provisions, because the Code has other provisions under which lenders can extend financing to debtors post-petition. Bankruptcy Code § 364—right next door to § 365, in fact—contains helpful provisions for what is known as DIP financing or debtor-in-possession financing, and it is tempting to tell a debtor who is unhappy about § 365(c)(2)(B) or 365(c)(2) to just take recourse in § 364. However, the terms on which the debtor can get DIP financing are generally more onerous (including more expensive) than the terms of the debtor’s pre-petition loan agreement. As a result, much is lost to the debtor or its general body of creditors from the evanescence of the pre-petition loan agreement.

Viewing the same point from the broader standpoint of the Code’s overarching policy goals, subsections (e)(2)(B) and (c)(2) clearly have the effect of impeding the debtor’s reorganization or reducing the amount of recovery by the debtor’s general body of creditors. Such an effect is part and parcel of giving effect to the lender’s self-interested state law contract provisions. The contract has the purpose and effect of allowing the lender to opt out of the pain of the bankruptcy process; and by respecting the lender’s non-bankruptcy entitlement, there are fewer participants in the collective bankruptcy process. One nonparticipant is pain-free, and the remaining participants are left to shoulder a greater pro rata share of the pain.

83. See, e.g., In re United Airlines, Inc., 368 F.3d 720, 723 (7th Cir. 2004) (cost of post-petition substitute for pre-petition agreement “likely would rise” because of higher risk of default).

84. To be sure, the statutory baseline described in the text might be variable by agreement between the debtor and non-debtor, to the extent the non-debtor were permitted to waive its rights to be free from the assumption. In the real world, such a waiver by the non-debtor would only come after negotiations, and in these negotiations the non-debtor would have substantial leverage because of the statutes. All negotiation takes place in the shadow of the law, see David Charny, Nonlegal Sanctions in Commercial Relationships, 104 Harv. L. Rev. 373 (1990), and even if they only make the contract unassumable in the absence of an agreement, subsections (e)(2)(B) and (c)(2) nonetheless hamper the reorganization by enabling the non-debtor to extract a price for its cooperation.

Whether the non-debtor’s agreement can in fact enable a financial accommodation contract to be assumed despite subsections (e)(2)(B) and (c)(2) is neither clear from the statute nor authoritatively determined by the case law. The related neighboring subsections (e)(2)(A) and (c)(1), discussed in Part II.D below, expressly prohibit the debtor from assuming personal services contracts only where the non-debtor “does not consent to such assumption.” 11 U.S.C. § 365(c)(1)(B), (e)(2)(A)(ii). By contrast, subsections (e)(2)(B) and (c)(2) contain no such express language, and from this fact it would be possible to draw a negative inference about the non-debtor’s power to waive. See, e.g., Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089, 1092 (9th Cir. 1991) (“It is unlikely that the absence of an exception for consenting lenders is a mere oversight of the drafters.”). Overall, the question is probably purely academic, because court approval would be necessary of the non-debtor’s agreement, whether it were conceptualized as a waiver plus assumption under § 365(a), or as the incurring of unsecured financing outside the ordinary course of business under § 364(b).

The same leverage analysis, and similar questions about assumability based on the non-debtor’s waiver, present themselves mutatis mutandis in connection with the subjects examined in Part II.B (nonmonetary defaults) and Part II.C (cross-defaults). No such question arises in connection with Part II.D (personal services contracts) because of the express terms of subsections (e)(2)(A) and (c)(1), just referenced.
The Code’s rules for financial accommodation contracts are blatantly at odds with its treatment of other executory contracts.85

However, I submit that certain judicial responses to the rules for financial accommodation contracts are in lovely harmony with the Code’s treatment of other executory contracts. In particular, I submit that the courts, in developing the line of cases discussed below relating to “incidental financial accommodations,” have been animated at least subconsciously by a desire to protect exactly the same policies that underlie the Code’s treatment of executory contracts in general. Under this line of cases, the debtor’s reorganization is facilitated or the payout to the debtor’s body of general creditors is maximized, all at the conceded expense of preventing a foresightful creditor from opting out of the bankruptcy process. The one is dragooned for the benefit of the many. The non-debtor party’s state law freedom to take advantage of its contractual “out” is overridden. Welcome to bankruptcy.

This line of cases begins with the fact that, in the messiness of the real world as opposed to the crystalline clarity of the statute books, many executory contracts are neither purely financial accommodations (and thus non-assumable), nor purely ordinary and assumable. Businesspersons negotiate their transactions primarily with a view to the substantive performances that they want to give and receive in exchange, and often enough, these performances will fall partly into the category of extensions of credit (covered by the category of financial accommodation) and partly into the category of ordinary non-credit exchanges (such as the supplying of goods, the leasing of premises or equipment, or the rendering of services). As a result, courts have recognized the idea that a contract may be “hybrid” for assumability purposes, i.e., that certain of its aspects are financial accommodations and certain other aspects are ordinary commitments to supply widgets or services.86

85. Whether this disparity of treatment is nonetheless defensible as a matter of policy is, again, beyond the scope of this article, which concentrates on structure rather than policy. Regarding the similar effect of the derivatives safe harbor provisions, see supra note 77 and Franklin R. Edwards & Edward R. Morrison, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 YALE J. ON REG. 91 (2005) (arguing that the safe harbors do not reduce systemic risk, as usually argued, but supporting them on the grounds that derivatives contracts do not usually have firm-specific, going-concern surplus).

86. Probably the most interesting example of a court recognizing this point is In re Cole Brothers, Inc., 137 B.R. 647 (Bankr. W.D. Mich. 1992), rev’d on other grounds, 154 B.R. 689 (W.D. Mich. 1992). The debtor was a retailer of agricultural equipment that had a multifaceted relationship with two different John Deere entities. One of the Deere entities had contractually agreed to supply the debtor’s inventory, provide floor plan financing for the inventory, and provide retail financing to the debtor’s customers. When the debtor sought to assume, the bankruptcy court expressly grappled with the issue of whether the various facets of the debtor/Deere relationship should be treated as one contract or as many, and it determined that they should all be treated as one. 137 B.R. at 648–51. The court then ruled that that single contract was assumable, because it was not a financial accommodation; stated otherwise, the financial accommodation elements were “incidental,” as discussed in the text and notes that immediately follow. Id. at 651–52. (On appeal, the district court did not expressly consider the hybrid nature of the contractual commitments, and simply held that the contract as a whole was a financial accommodation. In re Cole Bros., Inc., 154 B.R. at 692–93.) For other cases recognizing this point see In re Ardent, Inc., 275 B.R. 122 (Bankr. D.C. 2001) (finding that merger agreement included financial accommodation in the form of non-debtor’s commitment to issue stock and also other commitments by non-debtor including covenant not to compete) and Huntington Nat’l Bank Co. v. Alix (In re Cardinal Indus., Inc.), 146 B.R. 720, 722–23 (Bankr. S.D. Ohio 1992) (considering commitment to lend plus pooling and servicing agreement).

On the other hand, too many courts fail to expressly consider the hybrid nature of contracts that the debtor is seeking to assume, and these courts simply proceed instead to directly characterize the contracts as a whole as financial accommodations or not. The district court’s decision in In re Cole Brothers, 154 B.R. 689 (W.D.
And when the courts determine that the financial accommodation aspects of a hybrid contract should be neglected, so that the entirety of the contract is assumable (including, and despite, the financial accommodation aspects), they call the financial accommodation aspects “incidental.”

An important example arises from the bankruptcy of United Airlines (United).87 Most of United’s ticket sales revenue is derived from credit card purchases, and, as is usual for businesses that accept credit cards, United handled the credit cards through a processing company under a contract.88 Simplifying slightly, the contract provided that (a) the processing company, National Processing, would credit United’s account with the value of the processed transactions, and (b) in the event a credit card transaction was later reversed, whether consensually90 or not,91 United was liable to repay the amount of the corresponding credits and chargebacks to National Processing, which would forward these sums to the credit card issuers. Also, under the rules governing Visa and MasterCard networks, National Processing was liable to the credit card issuers for the amounts of the credits and chargebacks, even if National Processing could not recover those amounts from United. United moved to assume the contract—the contract obviously being a very important asset if United was to continue operating during the reorganization proceeding, since virtually no one buys airline tickets with cash. National Processing objected that United could not assume the contract, because the guarantee by National Processing of United’s obligations to the credit card issuers made the processing contract a financial accommodation. The bankruptcy court rejected National Processing’s argument on the grounds that the contract’s financial accommodation aspects were “incidental.”91 The District Court and Seventh Circuit affirmed, with the latter noting in an opinion by Judge Easterbrook that “[g]uaranty plays an objectively small role” in the contract because it “comes into play only when the net balance of payments is negative, which has never occurred in [the parties’] experience.”92

For purposes of this article, the heart of the matter is the policy orientation that the courts display in ruling that a financial accommodation is, or is not, incidental. In justifying his incidentality ruling, Bankruptcy Judge Wedoff writes, “requiring termination of United’s credit card processing agreement at the outset of the case would significantly impair the prospects for a successful reorganization.”93 Similarly, Judge Easterbrook writes, “[a]ccepting National Processing’s argument that assumption is impossible when any non-trivial clause of a contract entails a loan or guaranty would go far toward defeating debtors’ entitlement to assume executory

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88. In re UAL Corp., 293 B.R. at 185–86.
89. Suppose, for example, that the passenger canceled a ticket with a refundable fare.
90. Suppose, for example, that United canceled a flight and the passenger did not rebook.
91. In re UAL Corp., 293 B.R. at 189.
92. In re United Airlines, Inc., 368 F.3d at 724. The court of appeals also expressed skepticism that the contract between United and National Processing provided for any guaranty at all. Id. at 725.
contracts.” From these and other instances we can begin to see that in developing the line of cases on incidental financial accommodations, the courts have been serving the same policy goals that underlie the Code’s invalidation of ipso facto clauses.

The Code itself says nothing about contracts being assumable despite the presence of financial accommodations of any size, shape, or description. On the contrary, as we have seen, the Code’s two rules on financial accommodation contracts are flatly anti-assumption. And, faced with the reality of a contract that contains both financial accommodation and other elements (but which must, as the cum onere principle suggests, be assumed or rejected as a whole), the court has two equally logical and defensible possibilities. Perhaps the financial accommodation elements are, in effect, neutralized by the other elements, so that the entire contract is assumable (as in cases like the United Airlines bankruptcy); but perhaps, instead, the financial accommodation elements taint the other elements so that the contract cannot be assumed at all. The entire contract must be placed into one box or the other, even though the contract’s aspects are complex enough to make it plausibly belong to both boxes or neither of them. (It is as if a fabric store clerk were required to group fabrics into either a blue stack or a green stack: how should he or she treat the fabrics that are turquoise or teal or printed with a blue and green plaid?) And the fact that the courts have chosen to move contracts like the one in United Airlines to the assumable box rather than the non-assumable box is clearly purposive in a way that faithfully reflects the same goals as the Code’s basic invalidation of ipso facto clauses. At the heart of the Code’s flatly anti-assumption rules on financial accommodations we find the courts inventing a doctrine that goes in the opposite direction: pro-assumption, pro-reorganization, pro-recovery by creditors in general, and anti-opt out by individual creditors for the sake of

94. In re United Airlines, Inc., 368 F.3d at 724 (italics omitted).
95. For example, in a prior case relied on in the United Airlines proceedings, the Eleventh Circuit had observed, “The Agreement at issue here is typical of credit card merchant agreements between all kinds of merchants and merchant banks. If these agreements may not be assumed by the trustee following a bankruptcy filing, rehabilitation will be virtually impossible for any merchant who relies heavily on credit card sales.” Citizens & S. Nat’l Bank v. Thomas B. Hamilton Co. (In re Thomas B. Hamilton Co.), 969 F.2d 1013, 1020 (11th Cir. 1992) (emphasis added).
96. See supra notes 20–21 and accompanying text.
97. For a further discussion of this and related categorization issues, see infra Part III. The contract law device of divisibility can occasionally alleviate these issues. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 240 (1981) (corresponding pairs of partial performance that are agreed equivalents). But even in such cases it remains true that each divisible slice of the contract must be placed into one box or the other. The contract law device of severability might also be made useful in alleviating these issues, and I hope to explore this idea in a future article.
98. On the other side of the same coin, when courts rule that a financial accommodation is not incidental, it is animated by a policy stance that favors the rights of the non-debtor party to the contract, at the expense of the facilitation of a reorganization or the maximizing of a payout to the creditor body as a whole. The district court opinion in the Cole Brothers case discussed supra note 86 is a good example. In reversing the bankruptcy court’s holding that the financial accommodation was incidental, the district court remarked what an “odd result” it would be to require the non-debtor to extend credit to the debtor “where the terms of the security agreements permit the appellants to cancel the credit of a dealer in default.” John Deere Co. v. Cole Bros. (In re Cole Bros.), 154 B.R. 689, 693 n.3 (Bankr. W.D. Mich. 1992). (Of course results such as these, odd or not, are exactly the purpose of subsection 365(c)(1)’s invalidation of ipso facto clauses for contracts other than financial accommodations.) The court also noted § 365’s “concern with protecting creditors,” id., and though it is true that such a concern underlies the cure and adequate assurance requirements as well as subsection (c)(2)(B), § 365 as a whole is at least as strongly committed to contrary goals.
spreading the pain of insolvency across a wide body of participants. The courts have in effect determined an incidental financial accommodation to be a “de facto ipso facto” clause.

Part I of this article set up the basic doctrine of the invalidation of ipso facto clauses, simply as the baseline for later revelation of a pattern of judicial inventions having motivations and consequences that are similar to that baseline. In this section, the case law on incidental financial accommodations has been shown to be the first instance of that pattern. Financial accommodations are generally exempt from the Code’s basic treatment of ipso facto clauses, which of course violates the pattern rather than adhering to it, but the courts have kept incidental financial accommodations within the fold, and thereby, to that extent, carried forward the pattern after all.

B. Nonmonetary Defaults and (Im)materiality

This section of the article demonstrates a second instance in which courts have protected the debtor’s power to reorganize by imposing limitations on the effectiveness of contract clauses that, by prohibiting the debtor’s right to assume, would otherwise have in effect amounted to an ipso facto clause. Specifically, when the contract imposes on the debtor a nonmonetary obligation on which the debtor has defaulted, the contract would generally not be assumable, but courts have refused to apply this idea when the nonmonetary default is “immaterial.”

As discussed in Part I, the debtor cannot assume an executory contract unless it cures any defaults under that contract.99 As a matter of simple logic, then, if certain defaults by their nature cannot be cured, then the debtor cannot assume the contract. And rightly or wrongly, it is accepted that the Code provides that certain defaults—specifically nonmonetary defaults, in which the debtor has failed to comply with an obligation to do something other than pay money—cannot be cured.100 As a result, once the debtor has defaulted on a nonmonetary obligation, the contract of course cannot be assumed. This idea, that nonmonetary defaults cannot be cured, is grounded on what is known as the “historical facts doctrine”: the debtor’s non-compliance with a nonmonetary obligation is a historical fact that cannot be undone, at least in the absence of a time machine.101


100. See, e.g., In re Greenville Am. Ltd. P’ship, No. Civ. A. 00-00721-W, 2000 WL 33710874 (Bankr. D.S.C. Mar. 24, 2000) (stating that the agreement was conditioned on non-debtor sublessee’s obligations on debtor’s obtaining consent of third party within specified time, and debtor’s failure to do so was “by [the agreement’s] own terms . . . not subject to cure”); In re Lee West Enters., Inc., 179 B.R. 204 (Bankr. C.D. Cal. 1995) (stating that the auto dealer’s suspension of business prevents assumption of dealership franchise agreement); In re Deppe, 110 B.R. 898, 904 (Bankr. D. Minn. 1990) (“The lapse in operations [by debtor/franchisee] took place. The estate simply cannot overcome that historical fact.”).

101. See supra note 100 (citing cases). The historical facts doctrine is by no means self-evidently defensible. To be sure, the non-debtor who has suffered a historical default has a claim against the bankruptcy estate, and under some circumstances such a claim may be difficult to value. But one vital purpose of the Code is to monetize all claims, even the difficult to value ones, for the purpose of resolving them in an orderly proceeding. Indeed, the Code defines “claim” in relevant part as any “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” 11 U.S.C. § 101(5) (emphasis added). Bankruptcy judges have generally been very adept at valuing even claims that are unliquidated, contingent, and the like, so the fact that the debtor’s default under an executory contract is nonmonetary is not compelling on its own terms.
Standing alone, the non-curability of nonmonetary defaults would enable non-debtor parties to protect themselves with what are, in effect, ipso facto clauses that are not overridden by § 365(e)(1). For example, even in a contract primarily obligating the debtor to pay money, the non-debtor party at the drafting stage could arrange for this payment obligation to be coupled with some sort of minor nonpayment obligation—for example, an obligation that the debtor issue a statement each month certifying to the non-debtor that the debtor is in full compliance with the contract. Such a nonpayment obligation would not by its terms fall within any of the three prongs of subsection (e)(1) and would accordingly not be overridden by the Code. Yet just as with the provisions that (e)(1) does address, the debtor’s breach of the nonpayment obligation would prevent the debtor from assuming the contract. The debtor failed to issue the required statement last September; this failure to perform is a historical fact and cannot be cured; and in the absence of cure the debtor cannot assume. The ipso facto-like nature of the nonmonetary obligation is clear, and the Code itself provides no override of such effects.

But the courts have responded to this problem by, in effect, creating their own version of subsection (e)(1) for nonmonetary defaults that are “immaterial.” A recent example is In re Chapin Revenue Cycle Management, L.L.C., in which the debtor, the licensee of software, had committed itself both to pay monthly fees for maintenance of the software, and to refrain from reproducing and distributing copies of the software without the licensor’s advance permission. The licensor had notified the licensee that the licensor’s maintenance of the software would be discontinued, and as a result, the licensee began interviewing alternative candidates to maintain the software, and made copies of it available to those candidates. The licensee required the candidates to sign confidentiality agreements, but did not acquire the licensor’s prior permission, and when the licensee filed bankruptcy and sought to assume the contract, the licensor objected that the unauthorized reproduction was a nonmonetary default that prevented the debtor from assuming. The court overruled this objection on the ground that the nonmonetary default was not material. Many other courts have done the same, in the context of nonmaterial nonmonetary defaults.

Nothing in the Code’s language suggests such an immateriality exception—just as nothing, as seen in Part II.A, suggests an incidentality exception to the prohibition on assumption of a financial accommodation contract. Where, then, has the

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Moreover, even defaults that are monetary rather than nonmonetary are historical facts; the difference is not their historicity but simply their readily measurable nature. See Brubaker, *Nonmonetary Defaults*, supra note 24, at 7–8 (“Indeed, most monetary defaults (e.g., failure to make a payment by a certain date) are also ‘historical facts’ and, thus, could be considered incurable using the ‘historical fact’ theory of an incurable default. Payment defaults, however, are the prototype of a curable default.”) (citations omitted). For convenience, references in this article to historical facts are to nonmonetary defaults only.

102. The debtor’s obligation to issue a monthly statement is not, for example, a “provision” in such contract “that is conditioned on . . . the insolvency or financial condition of the debtor at any time before the closing of the case.” 11 U.S.C. § 365(e)(1).


104. *Id.* at 730.

105. *See id.*

106. *Id.* at 731.

107. See generally Brubaker, *Nonmonetary Defaults*, supra note 24, at 6. Post-BAPCPA, see *In re Empire Equities Capital Corp.*, 405 B.R. 687 (Bankr. S.D.N.Y. 2009) (recognizing that nonmaterial historical defaults can be cured, although holding the default in this case to be material).
courts’ impetus for the immateriality exception come from? I submit that it comes from the Code’s basic policy of promoting reorganizations—the same basic policy that underlies the Code’s explicit invalidation of ipso facto clauses. As the First Circuit explained in a somewhat different context in the well-known case of In re Bankvest Capital Corp.:108

Many non-monetary defaults are “historical facts” that are impossible to cure after the fact—for example, a debtor’s failure to maintain leased property in a certain condition, to use leased equipment only for approved purposes, or to meet certain standards of quality or performance. Requiring a debtor to cure such incurable defaults is tantamount to barring the debtor from assuming any lease or contract in which such a default has occurred—no matter how essential that contract might be to the debtor’s reorganization in bankruptcy. . . . To prevent a debtor from assuming a contract based on historical events that it cannot remedy undermines Congress’s basic purpose in § 365: to promote “the successful rehabilitation of the business for the benefit of both the debtor and all its creditors.”109

Now, Bankvest is not a materiality case; instead, it concerns the proper reading of what, at the time, was an ambiguity in § 365(b)(2)(D), which has always been an exception to the basic cure requirement of § 365(b)(1)(A).110 Notwithstanding the

109. Id. at 299–300 (citations and footnotes omitted).
110. More precisely, all of subsection (b)(2) is an exception to all of subsection (b)(1), see supra notes 17–18, 57–58 and accompanying text, but only the relationship between (b)(2)(D) and (b)(1)(A) is directly at issue here. As in effect at the time of Bankvest and until amended by BAPCPA, 11 U.S.C. § 365(b)(2)(2004) provided, in relevant part: “Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to— . . . (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.” This version of subsection (b)(2)(D) is best understood as a pro-debtor recognition of, and response to, the historical facts doctrine: because subsection (b)(1)(A) required cure, and because nonmonetary defaults could not be cured, (b)(2)(D) provided an exception to the cure requirement. See COLLIER ON BANKRUPTCY, supra note 20, ¶ 365.05; David G. Epstein & Lisa Normand, “Real-World” and “Academic” Questions About “Nonmonetary Obligations” Under the 2005 Version of 365(b), 13 AM. BANKR. INST. L. REV. 617 (2005). But, as has been well-explored in the literature since then and until BAPCPA, the adjective “penalty” appearing in (b)(2)(D) could arguably be read as modifying not only “rate” but also “provision relating to a default,” etc. Under the latter reading, the newly adopted clause provided very little protection to the debtor after all, because it would except from the cure requirement only “penalty provision[s] relating to nonmonetary defaults” (whatever those provisions may be). The Ninth Circuit adopted this relatively unprotective reading of the ambiguity, see Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.), 113 F.3d 1029, 1034 (9th Cir. 1997), and the First Circuit adopted the opposite, more protective reading in Bankvest.

In 2005, as the sad final act of this little drama, Congress amended subsection (b)(2)(D) as part of BAPCPA to enact the unprotective reading. In effect, Congress codified Claremont Acquisition and rejected Bankvest. As amended, subsection (b)(2)(D) reads as above, except that the word “penalty” appears before “provision” as well as before “rate.” BAPCPA also contained an amendment relating only to real property leases in subsection (b)(1)(A) (the cure requirement) that one would have expected to be included instead in subsection (b)(2) (the exceptions to the requirements of cure, compensation, and adequate assurance). Specifically, under this amendment to subsection (b)(1)(A), no requirement is required for nonmonetary defaults in real property leases, except that if the real property is nonresidential, then cure is required in the form of “performance at and after the time of assumption in accordance with such lease.” 11 U.S.C. § 365(b)(1)(A). Because the amendment is an exception to one of subsection (b)(1)(A)”s requirements, it would have functioned more clearly if it had been codified in subsection (b)(2), along with the other exceptions to subsection (b)(1). (The fact that subsection (b)(2) as currently written extends to all three of (b)(1)”s requirements, while the amendment extends only to its cure requirement, is only a drafting inconvenience. Structurally and logically the amendment belongs in subsection (b)(2), even if one believes, as I do, that the amendment can sensibly
difference in the issues, however, the reasoning is the same, because the stakes are the same. If the ambiguity in § 365(b)(2)(D) is resolved against the debtor, virtually no contracts in which there has been a nonmonetary default can be assumed, and the same is true if there is no materiality exception to the historical facts doctrine. Hence, Bankvest stands as a strong substantiation of the pro-reorganization policy orientation that, whether courts attend to it or not, surely animates their development of the immateriality exception.\(^{111}\)

The courts must have developed the immateriality exception for a reason, and I submit that the principal reason is the courts’ gravitation toward the Code’s overall policy orientations of facilitating reorganization or, in a liquidation, maximizing payout to the body of creditors as a whole.\(^{112}\) When the nonmonetary default is not material, then the cost of permitting the debtor to assume is relatively small to the non-debtor party. And to permit the non-debtor party to opt out of the Code’s

\(^{111}\) The Bankvest court also explicitly compares nonmonetary defaults to the explicit ipso facto provisions of § 365(b)(2)(A), (B) and (C), 360 F.3d at 301, though a better reference would probably have been to the nearly identical provisions of subsections (e)(1)(A), (B) and (C).

\(^{112}\) This is not to dispute an alternative justification for the immateriality exception advanced by Ralph Brubaker. As discussed, supra notes 20–22 and accompanying text, Bankruptcy Code § 365(b)(1)(A)’s cure requirement as a whole has direct roots in state contract law, and as part of his discussion of this fact Brubaker points out that the concept of cure is inherently tied only to breaches that are material. Under non-bankruptcy contract law, a material breach by one party (analogous to the debtor in bankruptcy) entitles the other party to treat its own obligations as discharged, unless the first party cures that breach, but a breach that is not material confers no such rights. See Brubaker, Nonmonetary Defaults, supra note 24, at 5–7; Restatement (Second) of Contracts § 237 (1981) (conditioning each party’s duty to perform on there being “no unsecured material failure” by the other party to perform); see also Restatement (Second) of Contracts § 241(d) (listing likelihood of cure among the circumstances that are significant in determining whether a breach is material). Here, as at numerous other points in this article, I embrace the state law roots or parallels with various bankruptcy law doctrines. (Indeed, in harmony with Brubaker we should also note other state law roots of the immateriality exception. See supra note 101 and accompanying text.)

The state law roots of the immateriality exception also help to rebut a possible objection to including nonmonetary defaults in the overall pattern identified by this article. In developing the immateriality exception to the historical facts doctrine, the objection might run, courts have not been truly animated by parallels to the Code’s treatment of ipso facto clauses, because courts at most have excused debtors from the cure requirement under subsection 365(b)(1)(A), while a true parallel with ipso facto clauses would also excuse debtors from the compensation and adequate assurance requirements of subsections (b)(1)(B) and (C), as the Code itself does in subsection (b)(2). However, not all aspects of the Code’s treatment of ipso facto clauses are of equal importance. The prospects of a successful reorganization would generally be far more severely harmed by precluding assumption of a contract because of an incurable historical default than by, say, permitting assumption subject to a requirement that the debtor give compensation for the default. For parallel reasons, state law courts have been able to hold both that, as discussed in the preceding paragraph, a nonmaterial breach by one party does not excuse the other from performing, while at the same time, the breaching party is liable to the other for the damages caused by that breach. The classic example is Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239 (1921) (Cardozo, J.). The Code’s treatment of actual ipso facto clauses carries the all-or-nothing consequences of propositional logic, but as shown in Part III, judges’ accommodation of “de facto ipso facto” clauses is characterized by a much more fluid kind of reasoning, which leaves room for the practical nuances represented by the immateriality exception.
pain-sharing process would be inconsistent with the policy of invalidating ipso facto clauses.

Some might say that the Code’s explicit ipso facto clauses (those enumerated in § 365(e)(1))\textsuperscript{113} are themselves nonmonetary in nature.\textsuperscript{114} So if, counterfactually, such clauses were enforceable, then a non-debtor party that sought to be released from its obligations under the contract because of the insolvency of the debtor (or the like) would probably be acting because of so-called historical facts—the insolvency itself, for example—rather than any particular nonpayment that may or may not have resulted therefrom. But my point in this section is subtler and more or less converse: not that breaches of the explicit ipso facto clauses are nonmonetary defaults (which they may or may not be), but rather that even nonmonetary defaults other than ipso facto clauses are nonetheless similar to ipso facto clauses. In basic terms, I am not saying that A’s are B’s, but that some B’s that are not A’s are nonetheless A-like.

Of course the list of explicit ipso facto clauses is limited;\textsuperscript{115} I should not be misunderstood as arguing here that the list should be expanded, and certainly not to include all nonmonetary defaults. But given the paramount importance of the bankruptcy policies that underlie § 365(e)(1)’s limited list, it is quite noteworthy that the courts are serving those policies on a case-by-case basis, even as to contract clauses that are not quite articulated on the list.

C. Cross-Default Clauses and (Lack of) Substantial Connectedness

Continuing the now-established pattern, this section of the article demonstrates that the courts have, in effect, extended the Code’s invalidation of ipso facto clauses in a third instance as well, by invalidating cross-default clauses that bear an insufficient relationship to the contract that the debtor is seeking to assume.

A cross-default clause is simply a provision in one contract providing that the obligor’s default under another contract will also constitute a default under the first.\textsuperscript{116} If the obligor files bankruptcy and seeks to assume the first contract, § 365(b)(1) of course requires the debtor (obligor) to cure all defaults thereun-

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\textsuperscript{113} See \textit{supra} note 38 and accompanying text.
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\textsuperscript{114} The \textit{Claremont Acquisition} court suggested as much as one ground for its conclusion that subsection (b)(2)(D)’s ambiguity should be read in the manner that is less protective of the debtor. The argument runs that if subsection (b)(2)(D) referred to all nonmonetary defaults, then the explicit ipso facto clauses of subsections (b)(2)(A), (B) and (C) could be seen as superfluous. See \textit{In re Claremont Acquisition Corp.}, 113 F.3d at 1034; see also \textit{Brubaker, Nonmonetary Defaults}, supra note 24, at 3; Lesley A. Truitt, \textit{From the Conflicting Treatment of Nonmonetary Defaults in § 365(b), an Exception for Franchises Emerges}, 17 BANKR. DEV. J. 257, 270 (2000). Bankvest, by contrast, suggests that this is not necessarily true in all cases. \textit{In re Bankvest Capital Corp.}, 360 F.3d at 301 (“For example, a breach of a provision relating to ‘the financial condition of the debtor’ might well be monetary in nature, depending on the underlying contract.”).
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The BAPCPA amendment to (b)(2)(D) has now of course made this question purely academic.

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\textsuperscript{115} \textit{Cf.} Truitt, \textit{supra} note 114, at 269.
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\textsuperscript{116} One lawyer describes the framework as follows:
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\begin{quote}
The clause provides that if A and B have entered into a contract (the AB contract) and B defaults under a separate contract with C (the BC contract), A can call an event of default against B under the AB contract. In effect, therefore, the cross-default clause imports into the AB contract all of the BC contract’s events of default, as they apply to B.
\end{quote}

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\textit{Ebo Coleman, Cross-Default Confusion, 16 INT’L FIN. L. REV., Apr. 1997, at 49; see also 1 SANDRA SCHNITZER STERN, STRUCTURING COMMERCIAL LOAN AGREEMENTS § 7.07 (2d ed. 1990 & Supp. 1997). Alternatively, both contracts might be between A and B, in which case additional interesting considerations are present. See \textit{infra} note 131 and accompanying text.}
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But must the debtor also cure all defaults under the second contract in order to assume the first, on the grounds that the cross-default clause causes defaults under the second to also be defaults under the first? A straightforward reading of subsection (b)(3) and the contract clauses themselves would certainly lead to this conclusion. However, the courts have often protected the debtor’s power to assume, and its right to reorganize, by refusing to require the cure of defaults under the second contract under what is emerging as a “substantial connectedness” requirement.

Cross-default clauses are a sensible and common tool in the drafting of contracts. A foresightful lender, while drafting an agreement with an obligor (analogous to the debtor in bankruptcy), may foresee the possibility of the obligor later having financial troubles that are severe enough to cause defaults on other important agreements even though the obligor remains current on payments under the first. Under these circumstances, the lender wants the right to recover against the obligor immediately, without waiting for payments to be missed under the first agreement, because the obligor’s assets may be depleted by other creditors during the interim. At least under state law, a cross-default clause enables the lender to proceed on this immediate basis. (One might even say that the cross-default clause, by giving the lender immediate access to the bargaining table or the courthouse along with other creditors, has a kinship to the Bankruptcy Code’s broad definition of “claim,” though of course the cross-default clause serves only the interest of the particular lender who has built the clause into its agreement.)

The case law in this area is best approached through a second opinion in the United bankruptcy, United Air Lines, Inc. v. U.S. Bank Trust, N.A. United’s rights to use gates and runways at O’Hare Airport, one of United’s hubs, were governed by an airport use agreement that included provisions conditioning United’s rights under the agreement on United’s making timely payments on over $600 million in revenue bonds that had been issued by the City of Chicago (the City) in order to finance improvements to O’Hare for United’s benefit. After filing bankruptcy, United had ceased making payment on the bonds, and when United sought a declaratory judgment on its right to assume the airport use agreement, the City objected on the grounds that, under the express terms of the agreement, the City objected on the grounds that, under the express terms of the agree-
ment, United’s default on the bonds also constituted an uncured default under the airport use agreement which prevented assumption of the latter under § 365(b)(1). 122

Judge Wedoff rejected the City’s contentions and entered judgment for United. 123 He held that the debtor may assume one contract, notwithstanding un-
cured defaults under a second contract that cross-defaults to the first, unless the two contracts are “substantially connected” or “economically linked,” so that a failure to enforce the clause “would deprive the nondebtor party [under the first contract] of an essential part of its bargain.” 124 In the case at bar, the City had no liability on the bonds, United’s nonpayment on the bonds would not affect the City’s ability to market other bonds, and, though a reduction in United’s flight volume at O’Hare would harm the City, United’s default on the bonds would not necessarily cause such a reduction in volume. 125 Accordingly, the “substantially connected” or “economically linked” standard was not met, and United was free to assume without curing the default on the bonds.

In an important footnote, the court also offered what should almost certainly be understood as its underlying policy rationale for imposing the substantially con-
nected or economically linked standard.

The policy underlying § 365(b)(2) and (e)(1)—“to assist in the debtor’s rehabilitation or liquidation” by allowing assumption of valuable executory contracts and unexpired leases despite ipso facto clauses—could certainly be frustrated if a debtor were required to perform under unrelated con-
tracts as a condition for assumption. For example, a particular supplier of goods to the debtor might provide that its supply contract would terminate upon the debtor’s breach of any similar agreement with other specified sup-
pliers. Such a “pay all” requirement could effectively serve as a proxy for the debtor’s insolvency. . . . However, the cross-default rule addresses this pro-
b lem by preventing a debtor from being required to perform contracts substantially unrelated to the one sought to be assumed. 126

In making this statement, Judge Wedoff seems to squarely recognize one ele-
ment of the overall pattern to which this Part II is devoted. Cross-default clauses, even if not themselves ipso facto clauses and accordingly not invalidated by the

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122. See id. at 461–66.
123. See id. at 472.
124. Id. at 468–69, 470.
125. Id. at 470–71. Professor Brubaker observes that the City’s “only meaningful interest” in United’s making full payment on the bonds was apparently “as a more general indication that United would have the financial wherewithal to make the payments.” Brubaker, Cross-Defaults, supra note 74, at 9.

By contrast, for a good example of facts that would satisfy the standard, see Kopel v. Campanile (In re Kopel), 232 B.R. 57 (Bankr. E.D.N.Y. 1999). In that case, the debtor had purchased a veterinary practice from the non-debtor under one agreement, and had leased the space in which the practice was conducted from the non-debtor under a separate agreement. The lease agreement provided that defaults under the purchase agreement would cross-default to the lease agreement, and the court enforced this provision because of the importance to the non-debtor party of being able to step in quickly and operate the business in the event of default under the purchase agreement. Id. at 60–62, 67–69.

Code’s express provisions, can nonetheless have the effect of ipso facto clauses. As such, if one takes the Code’s pro-reorganization, share-the-pain policies seriously, the clauses should be invalidated by analogy to §§ 365(e)(1) and 365(b)(2).

The United Air Lines opinion synthesizes a number of prior opinions on the subject of cross-defaults as applied to § 365(b)(1)’s requirement that the debtor cure all defaults. The prior opinions had been grounded on several differing rationales, but some of them had already made explicit reference to the Code’s anti-–ipso facto policy. One notable example is In re Plitt Amusement Co. of Washington, Inc., in which Judge Bufford wrote:

Consider a business consisting in 666 retail establishments, each operated on leased property. Suppose that the debtor has purchased the entire business from a third party, who has retained a lessor or sublessor interest in each of the properties. Further suppose that, in consequence of intervening circumstances, many but not all of the leases have turned out to be unprofitable. By artful drafting the seller could try to prevent the debtor from assuming the profitable business locations, and rejecting the unprofitable, and argue that the debtor could only assume or reject the entire 666-store transaction. In the section 365 context, such an argument would make

127. In the text accompanying the above-quoted policy rationale, Judge Wedoff concluded that cross-default clauses are not themselves ipso facto clauses. “Only provisions that directly invoke insolvency, bankruptcy filing, or appointment of a trustee or custodian are invalidated by § 365(b)(2) and (e)(1).” United Air Lines, Inc., 349 B.R. at 471 (citing Yates Dev., Inc. v. Old Kings Interchange, Inc. (In re Yates Dev., Inc.), 256 F.3d 1285, 1289 (11th Cir. 2001)). At its root, the Eleventh Circuit’s decision in Yates takes a rigid approach to determining whether a given contractual provision is invalidated by subsections (b)(2) or (e)(1); the statute is taken as having certain necessary and sufficient criteria, and either the provision meets those statutory criteria and is invalidated, or it does not and is not. Yates Dev., Inc., 256 F.3d at 1290.

Judge Wedoff’s reliance on Yates has been criticized, see Brubaker, Cross-Defaults, supra note 74, at 10, and Brubaker has elsewhere criticized Yates in detail, Ralph Brubaker, Option Agreements, the Bargained-For Exchange, and Unenforceable Ipso Facto Provisions, 21 No. 10 BANKRUPTCY LAW LETTER 1 (Oct. 2001) [hereinafter Brubaker, Option Agreements]. For example, consider a clause that permits the non-debtor party to immediately terminate a contract with the debtor at any time the non-debtor deems itself insecure with respect to the debtor’s continued performance. Cf. Uniform Commercial Code § 2-609 (2003). Such an insecurity termination provision, by its “literal language,” is not one of the termination provisions prohibited by Code § 365(e)(1), but is nonetheless so broad that it necessarily subsumes all of the § 365(e)(1) termination conditions. Consequently, the non-debtor party could easily effect an ipso facto bankruptcy termination in the guise of “insecurity” under the Eleventh Circuit’s construction of § 365(e)(1).

Brubaker, Option Agreements, supra, at 2; see also Stern, supra note 116, at 7–17 (drawing the comparison in the other direction in that a default for inability to pay debts as they become due acts “[a]s an event of default for purposes of a cross-default provision); cf. In re Sambo’s Rests., Inc., 24 B.R. 755 (Bankr. C.D. Cal. 1982) (invalidating cross-default provisions in part because they “operate as financial condition clauses”).

Though Brubaker and I share an interest in substantive outcomes that accord a broad swath to subsections (b)(2) and (e)(1), we differ perhaps here in our approach to categorization. As already indicated, my interest in this article is not about the particular lines that Congress has or has not drawn in § 365. Instead, I am interested in the way that the courts have flexibly applied the Code’s reorganization—facilitating policy poles-
tat as reflected in § 365 (whatever the statute’s contents per se may be). See infra Part III. I am able to live contentedly with cases like Yates, and Judge Wedoff’s reliance thereon, so long as judges are willing to use the other tools of their profession in order to reach sensible results that accord with broadly consistent policies. And this, of course, is exactly the result that is achieved in United Air Lines.

128. See also Brubaker, Cross-Defaults, supra note 74. Professor Brubaker acknowledges that United Air Lines is “a perfect example of how a cross-default clause can function, in effect, as a prohibited default flowing, ipso facto, from the debtor’s insolvency or financial condition.” Id. at 9.
no sense: it would altogether frustrate the ability of the debtor to rehabilitate the business by assuming the profitable portions of the business.\footnote{129}

A closely related policy concern has been that enforcing the cross-default clause would amount, in effect, to paying the parties to the other agreements in full, rather than limiting them to their pro rata share of an eventual payout on all claims.\footnote{130} Such a payment in full would be particularly offensive in cases where the two non-debtor parties are the same, or affiliated with each other: in effect, a lender could prevent assumption of one agreement unless it were paid in full on its other agreements.\footnote{131}

On the other hand, these bankruptcy policies should yield when the two contracts are closely enough connected to each other—but courts have had difficulty articulating or even seeing the need for a connectedness standard. Judge Wedoff's articulation ("substantially connected" or "economically linked," so that a failure to enforce the clause "would deprive the nondebtor party [under the first contract] of...
of an essential part of its bargain”) is a helpful synthesis of what the previous courts had been reaching for, but I submit that Judge Wedoff’s most important contribution here is his identification of the reason that the law should have a connectedness standard in the first place. In his words, there are “two complementary principles” that must be accommodated: first, the debtor must assume the contract as a whole, *cum onere*; and second, the debtor need only perform under the contract that it is assuming, not under other agreements. Contracts that are linked by a cross-default clause fall within the gravitational field of both of these principles. Hence, a connectedness standard is needed in order to determine which principle should prevail over the other in any given case. The connectedness standard “defines the scope” of the contract being assumed. Granted that the two agreements appear on separate pieces of paper; this will not always mean that the transactions are independent. Granted also that one of the agreements incorporates defaults under the other by reference; this will not always mean that the transactions are not independent. The decision must be made by reference to the economic realities of the agreements in question.

In this light, questions about the enforceability of a cross-default clause in a given case are clearly a matter of federal bankruptcy policy (at least in the first instance). However, a number of the earlier decisions had proceeded as if the questions were predominantly ones of state law, and the disarray in this regard has been impressive. With or without substantive care, courts have seemed to invoke

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133. *Id.* at 467–68. One might also note that the first principle is at the heart of the values of the so-called proceduralist camp and that the second is at the heart of those of the so-called traditionalist camp. See supra Part I.B.3.
135. As articulated in an earlier case, “a court should carefully scrutinize the facts and circumstances surrounding the particular transaction to determine whether enforcement of the provision would contravene an overriding federal bankruptcy policy and thus impermissibly hamper the debtor’s reorganization.” *Kopel*, 232 B.R. at 64; see also *Lifemark Hospitals, Inc. v. Liljeberg Enters., Inc.* (*In re Liljeberg Enters., Inc.*), 304 F.3d 410, 445 (5th Cir. 2002) (echoing *Kopel*); *In re Wolflin Oil, L.L.C.*, 318 B.R. at 398–99 (same).

As noted above, in the context of derivatives contracts the Code itself seems to take a blanket position on the scope question. Parties will often have multiple swap or other derivatives contracts outstanding between them at the same time, and these are generally structured as part of a single “Master Agreement.” See, e.g., ISDA 2002 MASTER AGREEMENT; id. § 1(c) (single agreement); id. § 6(a) (stating that the event of default enables non-defaulting party to terminate all transactions). The safe harbor provisions for derivatives contracts, see supra note 77, seem to explicitly provide that these provisions must be respected. For example, with respect to swaps, § 560 provides in pertinent part, “The exercise of any contractual right . . . to cause the . . . termination . . . of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be . . . limited . . . by order of a court . . . in any proceeding under this title.” 11 U.S.C. § 560 (emphasis added). Also see Mr. DeCocini’s statement in 136 CONG. REC. 13,153 (1990):

> [T]he bill makes clear that a master agreement together with all its supplements is considered a single swap agreement and even in situations where a swap participant decides not to terminate, a trustee cannot exercise its powers under section 365 with respect to less than the entire swap master agreement.

Though this bright-line statutory approach is very different from the case-by-case economic realities approach, it probably reaches the same result in most cases, because parties to these multiple contracts do generally enter into them in reliance on their rights to set off obligations under one against rights under another. See 11 U.S.C. § 561 (protecting termination and other rights as between derivative products of different types).
136. Nothing, on the other hand, prevents this federal bankruptcy policy from taking the form of faithfulness to background principles of state law. This, of course, is the heart of the proceduralist stance toward bankruptcy policy. See supra Part I.B.3.
the state-law doctrines of integration, divisibility, and severability, and combinations thereof. The courts have often failed to take care to see that each of these doctrines serves purposes of its own, and that these purposes can be very different from that of balancing the cum onere principle against the power to assume or reject contracts with an eye to a successful reorganization. All three of the state-law doctrines are superficially attractive if only because their labels conjure up basic questions of wholeness versus partness, or one versus many. But such questions appear everywhere in law, and they are by no means answered in the same way in different contexts. With the curing of cross-defaults one simply encounters a new variation on the same pervasive one-versus-many puzzle, and this new variation should be carefully confined to its particular setting. As well stated in Plitt Amusement Co. and another pre-United Air Lines case, the issue is simply and narrowly whether the two agreements should be treated as “a single agreement for the purposes of assumption or rejection.”

137. See, e.g., In re Adelphia Bus. Solutions, Inc., 322 B.R. 51, 60 (Bankr. S.D.N.Y. 2005). Judge Buf- ford’s often-quoted statement in In re Plitt Amusement Co. of Washington, Inc., 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999), that “[i]t is well-settled, that in the bankruptcy context, cross-default provisions do not integrate otherwise separate transactions or leases,” is clearly not a reference to state parol evidence law. See id. at 845 (stating that parol evidence is “a wholly separate issue from whether the various instruments constitute a single agreement for the purposes of assumption or rejection”). Later cases have adopted this statement, though, without making the same distinction. For examples of this in addition to In re Adelphia Business Solutions, Inc., see Shaw Group, Inc. v. Bechtel Jacobs Co. (In re IT Group, Inc.), 350 B.R. 166, 177 (Bankr. D. Del. 2006) and In re Convenience USA, Inc., No. 01-81478 to 01-81489, 2002 Bankr. Lexis 348, at *21 (Bankr. M.D.N.C. Feb. 12, 2002).


140. See In re Plitt Amusement Co., 233 B.R. at 840, 845–46 (discussing how one arguably “indivisible, nonseverable,” and “integrated” transaction may nonetheless be “severable”); In re Wolf Oil, L.L.C., 318 B.R. at 395–98 (discussing severability, divisibility, and a “single, integrated transaction”.

141. See Andrea Coles-Bjerre, Bankruptcy Theory and the Acceptance of Ambiguity, 80 AM. BANKR. L.J. 327 (2006) (exploring ambiguities arising out of several of these part/whole or mass/multiplex questions). As I suggest in Bankruptcy Theory and the Acceptance of Ambiguity, resolutions of one-versus-many questions tend to be motivated, in the sense that the outcome may be partly dependent on the decision maker’s subconscious policy orientation on the related legal rules. See, e.g., id. at 352–53, 356, 358–73. The same would likely be true for the connectedness of agreements that are linked by cross-default clauses. In a future article I hope to examine the mass versus multiplex nature of other issues affecting executory contracts, as treated in cases like Stewart Title Guaranty Co. v. Old Republic National Title Insurance Co., 83 F.3d 735 (5th Cir. 1996), and Byrd v. Gardinier, Inc. (In re Gardinier, Inc.), 831 F.2d 974 (11th Cir. 1987), as well as the severability of incidental financial accommodations.

142. To take one straightforward example, for purposes of diversity of citizenship jurisdiction in the federal courts, the domicile of a corporation’s shareholders does not affect the domicile of the corporation itself, but the domicile of an unincorporated association is partially dependent on the domicile of each of its members. See Coles-Bjerre, supra note 141, at 370–73.

143. In re Plitt Amusement Co., 233 B.R. at 845; In re Wheeling-Pittsburgh Steel Corp., 54 B.R. at 781 (‘[A] package for purposes of assumption or rejection.’). With similar care to keep different legal questions separate from each other, the Restatement (Second) of Contracts entirely avoids using the terms divisible and severable:

as wrongly suggesting that an agreement itself can be characterized as “divisible” or “severable” for all purposes and in any circumstances. A court may conclude that an agreement that is “divisible” or “severable” for one purpose or in some circumstances is not “divisible” or “severable” for another purpose or in other circumstances.
For purposes of this discussion, *United Air Lines* is primarily important in three related ways. First, it is emerging as the leading case on the difficult issue of cross-defaults, bringing order to older cases and being followed in more recent ones. Second, it decides the issue—the third in our now-established pattern under § 365—by reference to the Code’s explicit anti–ipso facto provisions, effectively protecting the debtor’s power to reorganize or maximizing recovery by the creditor body as a whole even in the absence of statutory mandate. And third, it does so in a carefully nuanced way that highlights the economic importance of the particular facts of the case. With the enforcement of cross-default clauses, just as with the assumption of financial accommodation contracts and the cure of nonmonetary defaults, policies themselves cannot decide cases. Instead, the judge can legitimately vindicate a given policy only insofar as the balance of facts at hand will let her.

D. The Hypothetical and Actual Tests for Assumption

The fourth and last instance of our pattern of judicially created extensions of the anti–ipso facto doctrine grows out of the notorious “hypothetical” test for assumption of executory contracts. Under this test, which has emerged from an assertedly plain reading of the applicable statute, a debtor may not assume a contract if applicable non-bankruptcy law prohibits the debtor from assigning the contract. In response, a growing minority of courts have developed the competing “actual” test, in which the assignability of the contract is irrelevant to assumption unless the debtor actually seeks to assign. These courts have done so in a conscious attempt to protect the debtor’s power to reorganize or maximize the payout to the creditor body as a whole, and have sometimes even made explicit reference to the Code’s anti–ipso facto rules.

If federal policy were in fact to defer to background principles of state law when the issue is the cure of defaults under an agreement containing a cross-default clause, there would be interesting questions concerning precisely which background principles should be selected. In a very thoughtful analysis, Professor Brubaker suggests that contracts principles forgiving express conditions under certain circumstances, see *Restatement (Second) of Contracts* § 229 (1981), could often provide an appropriate degree of flexibility, and might even have led to the same result as in the *United case itself*. Brubaker, *Cross-Defaults, supra* note 74, at 7–8.

On the other hand, most cross-default clauses are not just express conditions but also events of default, which trigger remedies such as acceleration of indebtedness and liquidation of collateral beyond discharging the duties of the non-breaching party. See Bistrian v. Easthampton Sand & Gravel Co. (*In re Easthampton Sand & Gravel Co.*), 25 B.R. 193 (Bankr. E.D.N.Y. 1982) (stating that default under note triggers cancellation of lease). And the creditor’s exercise of these remedies pursuant to an express event of default will not often be limited by good faith or similar doctrines. See Citibank, N.A. v. United Subcontractors, Inc., 581 F. Supp. 2d 640 (S.D.N.Y. 2008) (stating that cross-default clause provided that bank could terminate swap agreement upon counterparty’s breach of financial condition covenants in credit agreement, and bank’s exercise of termination was not breach of duty of good faith). If very few state law cases focus on cross-default clauses, this is presumably because obligors in violation of the clauses do not remain outside of bankruptcy for long. Cf. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (“Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of ‘good faith.’”); *Uptown Heights Associates Ltd. P’ship v. SeaFirst Corp.*, 891 P.2d 639 (Or. 1995) (stating that the bank’s foreclosure pursuant to expressly provided remedy does not violate duty of good faith).

Section 365(c)(1) provides in relevant part that the debtor “may not assume or assign” an executory contract if “applicable law” excuses the non-debtor party “from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession,” and if the non-debtor party “does not consent to such assumption or assignment.” Facialiy, this statutory language makes the debtor’s power to assume contingent on the debtor’s power to assign, even if the debtor itself is the party that would be performing after assumption and no actual assignment is proposed. A majority of circuits that have ruled on the question apply the statute in this way, in what has come to be known as the “hypothetical” test because assignability is crucial even though the only assignment is purely hypothetical. Assignability under “applicable law” is the standard, including state or federal statutes or the common law of contracts. As a practical matter, important types of contracts that thereby become non-assumable include those under which the debtor is obligated to perform personal services or act in a fiduciary capacity, those under which the non-debtor is obligated to make a loan to the debtor, and contracts between the debtor and state or federal government.
For example, in *In re West Electronics, Inc.*, leading case under the hypothetical test, the debtor was a military contractor seeking to assume its contract to supply missile launcher components to the U.S. Air Force. The court denied the debtor’s motion to assume, even though no assignment was contemplated.

By contrast, the actual test rejects this wooden application of the statute, and accordingly takes account of the non-assailability of a contract only if the debtor actually proposes to assign it. Under this line of analysis, on the facts of *In re West Electronics, Inc.*, the fact that the debtor would have been unable to assign the missile launcher component contract would not have interfered with the debtor’s own assumption of the contract. As with executory contracts in general, the debtor would have the power to assume the contract and thereby benefit from its mix of rights and obligations in the furtherance of its reorganization.

The merits of the actual test versus the hypothetical test have been abundantly explored in the literature and the cases, and this article will not revisit that well-ploughed ground. My discussion of the issue here, as with the subject of cross-
default clauses above,\(^{156}\) is limited to making clear that the actual test is a further example of judicial invention that extends the principle of invalidating ipso facto clauses so as to protect the debtor's power to reorganize.\(^{157}\)

Also, as with the subject of cross-default clauses, some courts have already made this point. For example, in *In re GP Express Airlines, Inc.*,\(^{158}\) the debtor was a small airline seeking to assume its contracts with Continental Airlines, and in the course of granting the debtor's motion based on the actual test, the court explicitly considered and embraced the Code's pro-reorganization policy.

To bar GP Express from assuming its executory contract with Continental would . . . impair a successful reorganization. . . . If the rigid interpretation of *West Electronics* [discussed in the text above] prevails, bankruptcy reorganizations will be defeated when debtors in possession cannot succeed to their pre-bankruptcy contracts. In terms of the classic example of non-assignable contracts, a bankrupt artist should be permitted to complete the portrait.\(^{159}\)

Indeed, the court then proceeded to draw a direct analogy between the hypothetical test and ipso facto clauses, precisely along the lines of this article's analysis throughout Part II.

Finally, sections 363(l), 365(e), and 541(c), indicate that the Bankruptcy Code will not enforce provisions in private agreements or under nonbankruptcy law which terminate a debtor's interest in property or an executory contract merely because of a bankruptcy filing. . . . Under [the hypothetical test], section 365(c)(1) provides for the termination of a debtor's property interest in a contract merely because of the filing of a bankruptcy petition. This result is directly at odds with the anti-ipso facto provisions of the Code. My conclusion that section 365(c)(1) does not bar assumption of contracts by the debtor in possession is consistent with other provisions of the Bankruptcy Code which decline to enforce forfeiture provisions in private contracts.\(^{160}\)

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\(^{156}\) See supra Part II.C.

\(^{157}\) The hypothetical test is arguably just as much a judicial invention as the actual test, for by leaning so heavily on (c)(1)'s text in a vacuum it constructs a purportedly plain meaning that is actually not so plain at all. See, e.g., *In re Hartec Enters., Inc.*, 117 B.R. at 869–71 (recounting the drafting history and showing the clearly sloppy nature of certain amendments). Nonetheless, the hypothetical test is undeniably closer to the statute itself, and in this light the actual test has the more judicial nature.

On this note one should regret the court's wooden application of the actual test in *Institut Pasteur*, 104 F.3d 489. In that case, the court applied the actual test in a way that permitted assumption of a license agreement even though the debtor had been taken over by a competitor of the non-debtor licensor. See *id.* at 493–95. If free enough to adopt the actual test in principle, the court should also have been free enough to limit it in the circumstances of that case, whether as a matter of contract construction or of bankruptcy policy. Cf. Plank, *supra* note 41, at 1120 (arguing against *Institut Pasteur*'s interference with non-debtor's rights).


\(^{159}\) Id.

\(^{160}\) Id. at 232–33; see also *In re Vitanza*, No. 98-19611DWS, 1998 Bankr. Lexis 1497 (Bankr. E.D. Pa. Nov. 13, 1998); *In re Hartec Enters., Inc.*, 117 B.R. 865; Ralph Brubaker, *Assumption of Nonassignable Executory Contracts: Herein of Ambiguous "Applicable Law," Meaningless Statutory Amendments, and an Absurd View of the Absurd*, 24 No. 10 BANKRUPTCY LAW LETTER 10 (Oct. 2004) (arguing against the hypothetical test in part because Congress chose the opposite approach of generally striking down ipso facto provisions that would confer such a bankruptcy windfall on nondebtor parties”). One should also note that the actual test is also in keeping with state contract law while the hypothetical test conflicts with it. If A and B have a contract,
This passage, and the analogous passage from United Air Lines, noting the relationship of cross-default clauses to the Code’s anti-ipo facto policies, are the only ones in which judges have explicitly noticed parts of the pattern revealed by this article’s Part II. Each passage notices one facet of the pattern; but without noticing at least two facets one cannot realize that it is a pattern at all. The two cases bolster their reasoning on one issue with policy borrowed from the Code’s anti-ipo facto policies; but no other cross-default or hypothetical versus actual test case does so. Nor have any judges done so in connection with a financial accommodation case or a nonmonetary default case, and not even the United Air Lines or GP Express Airlines judges realize how strong the policies are in light of the other elements of the pattern.

III. CONCLUSION: ON JUDGING AND CATEGORIZING

Overall, Part II of this article has shown that the Code’s explicit anti-ipo facto provisions have had an implicit reach that makes them even more powerful than they are on their surfaces. Though § 541(e)(1) and its sibling provisions are lim-
In re American Home Mortgage Holdings, Inc., 402 B.R. 87 (Bankr. D. Del. 2009), which is a sale of assets case and does not involve an executory contract at all. American Home Mortgage Corp. (American Home) and DB Structured Products, Inc. (DBSP) were parties to a Master Loan Purchase and Servicing Agreement providing for DBSP to purchase, and for American Home’s affiliate to service, pools of mortgages that had been originated by American Home. During the Chapter 11 proceeding American Home and its servicing affiliate, both debtors, sought to sell the servicing portion of the Master Agreement. DBSP objected to this sale, arguing that the servicing portion of the Master Agreement. DBSP objected to this sale, arguing that the servicing provisions could not be sold independently of the master agreement’s loan sale provisions. Id. at 90–92. The court overruled DBSP’s objection, holding that the servicing and loan sale provisions were not closely enough interrelated to prevent the former from being sold without the latter, and expressly echoing much of Judge Wedoff’s analysis of the cross-default rule in United Airlines. See id. at 98–100. DBSP had argued that the two sets of provisions were indeed interrelated because the agreement required the servicing affiliate to indemnify DBSP against loss arising from American Home’s failures to perform, but the court held that this indemnity provision was invalid because of 11 U.S.C. § 363(l).

In re American Home Mortgage Holdings, Inc., 402 B.R. at 99 (citation omitted). In sum, the case nicely provides another instance of courts extrapolating beyond the Code’s express anti–ipso facto provisions in order to effectuate the policies of those provisions.

To review, these purposes are to protect the debtor’s access to a valuable asset (the executory contract); to spread the collective shouldering of losses from an insolvency by preventing any particular non-debtor party from opting out of, or insulating itself beforehand from, the burden of those eventual losses; and ultimately to protect the debtor’s potential to reorganize itself as a healthy, rehabilitated business enterprise, or in a liquidation to ensure that the body of creditors as a whole recovers to the greatest extent possible. As shown in Part II, all of these purposes have been implemented when the issue at stake is not an explicit ipso facto clause but, instead, a financial accommodation, a nonmonetary default, a cross-default clause, or a personal services or other non-assignable contract.

163. To review, these purposes are to protect the debtor’s access to a valuable asset (the executory contract); to spread the collective shouldering of losses from an insolvency by preventing any particular non-debtor party from opting out of, or insulating itself beforehand from, the burden of those eventual losses; and ultimately to protect the debtor’s potential to reorganize itself as a healthy, rehabilitated business enterprise, or in a liquidation to ensure that the body of creditors as a whole recovers to the greatest extent possible.
awareness of any facet of the pattern. (In two of Part II’s four topics, the courts have been completely silent about carrying forward the Code’s anti–ipso facto policy, and in the other two topics the courts have shown it only in sharply isolated instances.164 Certainly nowhere has any court, or any commentator for that matter, until now, noted the breadth and power of the pattern identified in Part II as a whole, and how sturdy the linkages are among its various elements.)

Second, given that the fundamental purpose of a judicial opinion is to articulate persuasive reasons for the judge’s decision in order to justify its coercive power, there would be no reason for a court that was conscious of a pattern like Part II’s to remain silent about it. On the contrary, a judicial decision on any one of the topics would gain tremendous additional persuasive power if it expressly rested not only on precedents on the same topic but also on precedents from other deeply analogous topics. Future financial accommodation cases can and should draw additional authority from the nonmonetary default and cross-default cases, and so on,165 and the fact that to date there has been no such cross-fertilization is strong grounds to believe that judges just have not seen the pattern.

Third, the operative terms of the judicial decisions concerning each topic have not been well coordinated with each other. Courts have asked whether a financial accommodation provision is “incidental,”166 whether a nonmonetary default is “immaterial,”167 and whether a contract referred to by a cross-default clause is “substantially connected” or “economically linked” with the first so that a failure to enforce the clause would deprive the non-debtor of an “essential part of its bargain.”168 (Perhaps a similar standard should be developed in actual-test jurisdictions in order to avoid the undesirable results of a wooden application there, too.169) From a bird’s eye view, these standards have been similar enough to reveal Part II’s pattern, but potentially different enough (and for no apparent reason) to help show that no pattern has been consciously contemplated in their development.

Fourth and finally, there is simply too much explanatory power to Part II to deny that the pattern in fact exists. The pattern accounts robustly for a large and complex volume of case law, and elegantly reduces it all to a set of simple and powerful conclusions. This article brings an important degree of conceptual unity to much of § 365’s otherwise sprawling and difficult turf. On its surface, the law of assumption of executory contracts is definitely “psychedelic,” as Professor Westbrook suggests.170 But beneath the surface it is serene and orderly. It’s all about the ipso facto clauses.

164. See supra notes 126, 156–158 and accompanying text.
165. Because of the relatively unsettled status of the current case law under subsection 365(c)(1), it is perhaps particularly worth noting that this article provides a fresh standpoint from which to dispute the appropriateness of the hypothetical test rather than the actual test, amplifying powerfully on the sound but isolated observations of the GP Express Airlines court so many years ago. See supra notes 156–160 and accompanying text.
166. See supra Part II.A.
167. See supra Part II.B.
168. See supra Part II.C.
170. Westbrook, supra note 8, at 228.
That so much judicial order has emerged on an apparently subconscious basis is supported by recent studies of ordinary human categorization. Psychologists, linguists, philosophers, and others have devoted a great deal of study to categorization in recent years, and the field of study is enormous, with great untapped potential as applied to the law.\textsuperscript{171} Three basic and related points should briefly be made here in order to give perspective on the emergence of Part II’s pattern. First, categorization seems to be a process that human beings engage in virtually all the time and usually subconsciously.\textsuperscript{172} Hence it is natural and illuminating to conceive of judging itself (and notably, the determination of whether contracts or contract clauses should be treated as de facto ipso facto clauses) as also being fundamentally based on categorization.\textsuperscript{173} Second, a number of scholars suggest that the way in which we categorize things depends significantly on our own background knowledge and past experience, rather than just on, say, simple and objective check-lists of criteria.\textsuperscript{174} Applying that insight here, the fact that Congress expressly invalidated three, and only three, kinds of contract clauses in the category generally known as ipso facto clauses\textsuperscript{175} is not at all inconsistent with the tendency for courts

\begin{extraction}

\textsuperscript{171.} The pathbreaking and still fullest work is Steve Winter's. See, e.g., STEVEN L. WINTER, A CLEARING IN THE FOREST: LAW, LIFE, AND MIND (2001).

\textsuperscript{172.} George Lakoff writes: 

There is nothing more basic than categorization to our thought, perception, action, and speech. Every time we see something as a \textit{kind} of thing, for example, a tree, we are categorizing. . . . Without the ability to categorize, we could not function at all, either in the physical world or in our social and intellectual lives. . . . Most categorization is automatic and unconscious, and if we become aware of it at all, it is only in problematic cases. In moving about the world, we automatically categorize people, animals, and physical objects, both natural and man-made. . . . We categorize events, actions, emotions, spatial relationships, social relationships, and abstract entities of an enormous range: governments, illnesses, and entities in both scientific and folk theories, like electrons and colds.

\textit{George Lakoff, Women, Fire, and Dangerous Things: What Categories Reveal About the Mind} 5–6 (1987); Catherine Hanson & Stephen José Hanson, \textit{Categorization in Neuroscience: Brain Response to Objects and Events}, in \textit{HANDBOOK OF CATEGORIZATION IN COGNITIVE SCIENCE} 119 (Henri Cohen & Claire Lefebvre eds., 2005) (discussing recent studies of categorization in neuroscience).

\textsuperscript{173.} Martha Minow writes, “Legal analysis, cast in a judicial mode, typically addresses whether a given situation ‘fits’ in a category defined by a legal rule or instead belongs outside of it. Many questions presented to the Supreme Court, for example, take the form, ‘Is this a that?’” Martha Minow, \textit{The Supreme Court}, 1986 Term, \textit{Foreword: Justice Engendered}, 101 HARV. L. REV. 10, 35 (1987). Professor Minow goes on to identify some of the Supreme Court’s pending issues as whether Jews or Arabs are a race, whether a contagious disease is a handicap, and whether a statutory provision for job reinstatement following a maternity leave is gender discrimination. \textit{Id. at} 35 n.117.

\textsuperscript{174.} See, e.g., Edward E. Smith & Steven A. Sloman, \textit{Similarity-Versus Rule-Based Categorization}, 22 MEMORY & COGNITION 377 (1994). Professors Smith and Sloman conclude that background knowledge is particularly important when a person is asked to give a narrative explanation of the way in which he or she has categorized something—and such explanations are of course closely analogous to the reasoned explanations that judges are expected to give in their written opinions. Cf. Emilie L. Lin & Gregory L. Murphy, \textit{Effects of Background Knowledge on Object Categorization and Part Detection}, 23 J. EXPERIMENTAL PSYCH. 1153, 1154 (1997) (showing that subjects’ knowledge of an object’s function influences their judgment of whether a modified version of the object belongs in the same category).

On the inadequacy of checklists, Charles Fillmore’s famous discussions of the category “bachelor” are the starting place. Acknowledging that the standard simple definition of bachelor is an “unmarried adult man,” Fillmore immediately proceeds to point out that “[m]ale participants in long-term unmarried couplings would not ordinarily be described as bachelors; a boy abandoned in the jungle and grown to maturity away from contact with human society would not be called a bachelor; John Paul II is not properly thought of as a bachelor.” Charles Fillmore, \textit{Towards a Descriptive Framework for Spatial Deixis, in Speech, Place and Action} 31, 34 (R.J. Jarvella & W. Klein eds., 1982); see also, Minow, \textit{supra} note 173, at 34 (implicitly criticizing legal analysis that treats categorization as a matter “of discovery rather than of choice”).

\textsuperscript{175.} See \textit{supra} note 38 and accompanying text.

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to find that other groups of contracts or contract clauses fit within that category.\textsuperscript{176} And third, the way in which we categorize things seems to be motivated in substantial part by the purposes at hand or the goals that one consciously or subconsciously seeks to achieve.\textsuperscript{177} A burrito may or may not be categorized as a sandwich, depending on whether one is contrasting the national lineages of popular cuisines or seeking to protect one’s shopping mall food court business against competition.\textsuperscript{178} Similarly, a contract clause may or may not be categorized as being in effect an ipso facto clause, depending on how strongly a judge feels the Code’s related policies should be implemented.

Each of the courts’ four groups of “de facto ipso facto” clauses is a standard rather than a rule, and this observation fits nicely with the relatively fluid and flexible nature of categorization sketched above. To ask whether a financial ac-

\textsuperscript{176} Technically, I would actually suggest that the courts are finding that the Part II contracts or clauses fit within a category closely related to ipso facto clauses, which one might call something like “contracts or clauses that are close enough to an ipso facto clause to be treated as in effect being one.” The awkward and lengthy name for this category is typical of so-called “ad hoc categories,” that is, categories that people develop more or less on the fly for particular purposes. \textit{See generally} Lawrence W. Barsalou, \textit{Ad hoc Categories, 11 Memory & Cognition} 211 (1983). An example of an ad hoc category would be “things I don’t want to forget to pack for next week’s trip.”

Professor Barsalou explains that ordinary categories are characterized by clusters of correlated properties, but that ad hoc categories by contrast “appear to violate the correlational structure of the environment.” \textit{Id.} at 214. For example, “bird” is an ordinary category, and this category’s attribute “has feathers” tends to correlate in the real world with the same category’s other attributes (for example, “flies,” or “builds nests”) than with attributes of other categories (for example, “swims,” or “has gills”). By contrast, “[c]onsider the [ad hoc] category of ‘things to take from one’s home during a fire,’ which contains members as diverse as ‘children,’ ‘dog,’ ‘stereo,’ and ‘blanket.’ This category’s instances do not appear to share correlated properties.” \textit{Id.}

Though Barsalou’s own discussion of this point proceeds in a slightly different direction, \textit{see infra} note 177, the apparently uncorrelated nature of the properties for an ad hoc category fits well with the hypothesis that background knowledge is important in categorization. To see this, notice that a lawyer having no relevant background knowledge would be baffled by a category that consisted of (a) clauses providing for termination of a contract upon bankruptcy; (b) contracts providing for a person to make a loan to a debtor; (c) contracts providing for the debtor to perform acts other than the payment of money; (d) cross-default clauses; and (e) contracts that state law provides cannot be assigned without the other party’s consent. Just as with Barsalou’s ad hoc categories, the properties that constitute the courts’ category of de facto ipso facto clauses do not seem to correlate. But now imagine that the same lawyer does have the relevant background knowledge (relating to the Bankruptcy Code’s goals, to the effects that the specified contracts and clauses can have upon a successful reorganization, etc.), and it is easy to see how tightly coherent the category of de facto ipso facto clauses becomes to him or her.

\textsuperscript{177} \textit{See George Lakoff & Mark Johnson, Metaphors We Live By} 164 (1980) (“What counts as an instance of a category depends on our purpose in using the category,” illustrated by chairs that would or would not be suitable for different events); \textit{Winter, supra} note 171, at 101–05 (observing that application of a rule prohibiting animals on a bus should depend on the rule’s purpose; “meaning requires an understanding of context and purpose”); \textit{cf.} Coles-Bjerre, \textit{supra} note 141, at 340 n.37, 352–53 (discussing motivation as a factor in one’s understanding of expressions containing mass/multiplex ambiguity).

Motivation is perhaps even more important in many ad hoc categories than in other categories. \textit{See generally} Barsalou, \textit{supra} note 176, at 214 (stating that a likely reason that “ad hoc categories cut across the correlational structure of the environment [is that they] are instrumental to achieving goals”); Lawrence W. Barsalou, \textit{Deriving Categories to Achieve Goals, in 27 The Psychology of Learning and Motivation} I. 1 (Gordon H. Bower ed., 1991) (focusing on ad hoc categories that are “derived impromptu to achieve a current and novel goal” but acknowledging other ad hoc categories); Gráinne M. Fitzsimons & James Y. Shah, \textit{Confusing One Instrumental Other for Another, 20 Psychol. Sci.} 1468 (2009) (showing that subjects group the members of a goal-oriented category together, although the goal motivating the category has been only subtly activated).

\textsuperscript{178} \textit{See Marjorie Florestal, Is a Burrito a Sandwich? Exploring Race, Class, and Culture in Contracts, 14 Mich. J. Race & L.} 1 (2008) (exploring a case in which a sandwich seller claimed that the landlord’s leasing of nearby space to a Mexican food seller violated a provision in the sandwich seller’s lease prohibiting competition from other sandwich sellers).
commodation is “incidental,” or a nonmonetary default is “material,” or the contracts linked by a cross-default clause are “substantially connected,” is clearly to impose a standard: a loosely prescribed exercise of discretion based on the fullness of a case’s particular facts, rather than a mechanical task based on bright-line criteria.179 As suggested above, perhaps the same should be true in applying the actual test.180

Just as the courts’ overall recognition of de facto ipso facto clauses has been a categorization decision, so too has each court’s evaluation of particular facts in order to rule that a particular financial accommodation provision is or is not incidental, a particular nonmonetary default is or is not immaterial, etc. The processes are congruent: categorization takes place in similar ways at higher and lower levels of generality, and this is unsurprising in light of its pervasiveness in human life and thought. At both levels, what I celebrate in this article is the courts’ heretofore piecemeal and untheorized pattern of applying the overarching policy behind the bright-line ipso facto provisions beyond the articulated boundaries to other situations where, on the ground of consistency, similar results should apply. Judicial discretion is inevitable in the face of factually complex realities. And judicial discretion is inherently a tool that is exercised in light of both policy judgments and the factual nuances of any particular case. It is a phenomenon worthy of marvel that the courts have been able to think their way through such a dense thicket of issues with such a high degree of consistency.

Indeed, in drawing together these disparate strands of executory contract law, I have consciously avoided suggesting that the judicial developments of Part II be codified. The relevant facts inherently involve shades of gray, to be evaluated on a case by case basis as bankruptcy judges are uniquely well situated to do. Beyond the minimal core provisions that the Code already makes explicit, contract clauses that have an impermissible ipso facto-like effect cannot generally be designated beforehand on a statutorily blanket basis, but must be decided upon in the fullness of their factual contexts.

Any code needs interpreting, and the Bankruptcy Code is no exception. For an interpreter, the fact that so many of the Code’s issues concerning executory contracts turn out to be so intimately interrelated is both a challenge and a gift. A challenge because it brings additional levels of complexity to what is already a dauntingly difficult area. And a gift because it means that that complexity is just an intermediate stage of understanding, and that only a small number of enduring questions lie at the end of the road. The law of assumption of executory contracts is no mere proliferation of unrelated technical puzzles. Much of it, instead, reduces to a single rich dilemma—how to accommodate the non-debtor’s state-law contractual freedom, on the one hand, and the Bankruptcy Code’s independent federal concerns with reorganizing businesses and maximizing payouts to the body of


180. See supra note 169 and accompanying text. By contrast, the Code’s explicit ipso facto clauses are clearly confined to certain bright-line categories: a list of three precisely delineated types of contract provision and no more. See supra note 38 and accompanying text.
creditors as a whole, on the other. And as pointed out earlier,\textsuperscript{181} this is exactly the same dilemma that continues to face most of the rest of bankruptcy theory as a whole.

\textsuperscript{181} See supra Part I.B.3.