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LIMITATIONS ON ASSUMPTION AND ASSIGNMENT OF EXECUTORY CONTRACTS BY "APPLICABLE LAW"

THERESA J. PULLEY RADWAN

It is one of a creditor's greatest fears. The company that owes you money—perhaps a substantial amount of money—is going under, and you, along with countless other creditors and shareholders, are about to lose some or all of your investment. With some amount of luck, the company might manage to survive bankruptcy proceedings and emerge relatively unscathed—that is, without actually closing its doors entirely. But even if the company continues to exist, it is practically impossible for anyone to come out whole.

The filing of a petition in bankruptcy necessarily indicates financial difficulty for the debtor. Some event or series of events caused the debtor to be unable to survive, or at least unable to profit, without the assistance of the Bankruptcy Code (Code). Yet among the dismal circumstances of a bankruptcy shine a few opportunities for the Chapter 11 debtor, a chance to start anew or at least amended. One of the brightest of these opportunities lies in the ability of a debtor to choose those obligations under which it wishes to continue to operate while ridding itself of agreements in which it no longer wishes to be involved.

Even if the debtor has not defaulted in its obligations under the contract or the debtor-in-possession can cure any defaults and provide assurance of its ability to operate pursuant to the contract in the future, however, the debtor-in-possession still might not be permitted to assume its contracts under some judicial interpretations of Section 365 of the United States Bankruptcy Code, which governs the treatment of executory contracts in the context of a bankruptcy filing. This article explores the judicial interpretation of that statutory provision and the limits some courts have placed on the ability of debtors to assume contracts entered into before filing for bankruptcy.

The importance to the debtor of being able to choose between contracts is illustrated by the supplier of specialized goods. For example, assume the debtor, an art company, specializes in custom portraits of families, and as of the date of filing for bankruptcy, the debtor has fifty contracts outstanding on half-finished portraits for which the debtor will not be paid until completion. If the debtor can elect to continue to operate under these contracts, the debtor has a guaranteed income stream once those fifty half-finished portraits are completed. Despite the bankruptcy, business can continue as usual. If, however, the debtor must decline the contracts, the debtor cannot collect any income on the fifty half-finished portraits. Income to support the reorganizing business must come from new contracts.

This presents a number of problems for the unfortunate debtor. First, the debtor must convince new clients that, despite its pending bankruptcy, it will indeed complete the portraits commissioned. Not only does this present a challenge in convincing the new customer, but the debtor must also convince its pre-bankruptcy creditors to allow the debtor to take on new endeavors. After all, every dollar used

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to create the new portraits means a dollar less to pay the old creditors. Second, if it is not allowed to complete the contracts, the debtor has essentially lost the costs of producing the half-finished portraits. If allowed to assume the contracts, the debtor would recoup its costs when the portraits are completed. If not, however, the time and supplies are lost forever, as no market exists for half-finished family portraits to outside buyers. Finally, even if the debtor manages to gather new clients, the new portraits are not likely to be completed quickly. The expected commissions from the portraits may not come in time to save the already-struggling business, and thus the reorganization may be doomed by the debtor's inability to continue to operate under contracts already pending at the time of the bankruptcy filing.

Like assumption of contracts, assignment of contracts may be necessary to further the reorganization efforts of the debtor. By assuming and then assigning a contract, the debtor may avoid its responsibilities under the contract (because the contract will be completed by the assignee) while also managing to avoid a claim against it in the bankruptcy (because the non-debtor party to the contract has no cause of action for breach of contract against the debtor). Furthermore, an assignment frequently comes as part of a larger sale of all or part of a debtor's business as part of the reorganization effort. If, for example, our painter found himself in a bankruptcy situation because he took on too many projects to complete them and collect the proceeds, he might wish to sell some of the less profitable contracts to another painter. Such a sale may be vital to the reorganization of the debtor, but it requires the ability to assign the affected contracts.

If the primary goal of bankruptcy reorganization is to permit the debtor to leave the bankruptcy as a new entity armed with the skills it needs to survive in the market, the Code must give the debtor an opportunity to use all available resources in order to succeed. In the current business world, where contracts constitute a large and growing percentage of the assets of a company, the ability to control the disposition of these contracts becomes the ability to control the reorganization itself.

Although the courts also seek to protect non-debtor parties in the bankruptcy process, they tend to favor the goal of reorganization, for without offering the debtor the ability to reorganize, Chapter 11 of the Bankruptcy Code could be abolished altogether in favor of Chapter 7 liquidations. In some cases, a Chapter 7 liquidation remains the debtor's only true option, but when given the opportunity, most debtors and their creditors prefer a reorganization. Under a liquidation, a creditor will receive a percentage of the amount owed to it when the trustee collects and distributes the estate. Under a Chapter 11 reorganization, some creditors will receive a percentage payout while others, whose contracts are assumed, will continue to do business with the debtor as usual and may receive practically the entire payment owed to them under the contract. Rarely will creditors receive a lesser payout under
reorganization than under liquidation. Thus, to the extent feasible, public policy prefers reorganization over liquidation.

In order to know whether a contract to which the debtor is a party falls within the confines of Section 365, one must first determine whether the contract qualifies as "executory." This article first explains how which contracts are considered executory and then delves into the conditions under which an executory contract may be assumed and, particularly, into the exceptions triggered by non-bankruptcy laws restricting assignment of contracts. It concludes that Congress intended to allow contracts that are not assignable either by law or the terms of the contract to be assumed by the debtor, and recommends that Congress amend the current law to make its intent clear.

I. EXECUTORY CONTRACTS

Though many cases have fine-tuned the concept of what contracts constitute the realm of executory contracts, one definition stands apart as the seminal, tried-and-true definition. An executory contract is one "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." In order to determine whether a contract qualifies as executory, one should ask whether, as of the date on which the debtor filed its petition in bankruptcy, the debtor owed a duty to the other party to the contract. In return then, one must inquire as to whether the other party also owed a duty to the debtor as of the filing date. If each of these two questions is answered in the affirmative, an executory contract is present.

It is perhaps easiest to pinpoint what may be included within the realm of executory contracts by considering what may not be included. For example, if the debtor had contracted to purchase a bushel of apples from a local farmer prior to filing a petition in bankruptcy, whether the contract for the purchase of the apples constitutes an executory contract depends upon what has happened between the parties from the contract date until the petition date. If neither party has acted upon the contract, it is executory. The farmer owes a duty to the debtor to harvest the apples and deliver them. The debtor owes a duty to the farmer to pay for and receive

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3. There would be a lower payout when the debtor begins in Chapter 11 reorganization and then transfers to a Chapter 7 liquidation proceeding. The lesser payment to the creditor results from the added expenses, such as trustee and legal fees and employee payroll, incurred by the estate as time passes without a successful reorganization.


5. See Webber v. Credithrift of Am., Inc. No. 6 (In re Webber), 7 B.R. 580, 584 (Bankr. D. Or. 1980).

6. Most notably, the United States Supreme Court defines executory contracts as those under which "performance is due to some extent on both sides." NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984) (citation omitted).


8. Though a debtor in bankruptcy may be an individual, a group, a corporation, or other entity, and thus be referred to as "he," "she," "it," or "they," the majority of cases considering the issues discussed herein deal with corporate filings, each seeking a reorganization of the debtor. Thus, the pronoun "it" will be used throughout this article.
the apples. If, however, the debtor received the apples before the petition date but has not yet tendered payment, the contract is not executory. The debtor still owes a duty to the farmer to pay for the apples, but the farmer owes no corresponding duty to the debtor. The farmer’s only remaining role in the transaction is to receive the benefit of the debtor’s duties.9

Once an executory contract has been identified, the parties must next determine how the executory contract will be treated in the bankruptcy context. Section 365(a) of the Bankruptcy Code provides that, “[e]xcept as provided in sections 76510 and 76611 of this title and in subsections (b),12 (c),13 and (d)14 of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract15 or unexpired lease of the debtor.”16 Though Section 365 describes the actions that may be taken by a trustee in bankruptcy, a debtor-in-possession equals a trustee under the Bankruptcy Code.17

Assumption of a contract merely continues the contractual relationship between the two parties thereto, as if no bankruptcy had ever been filed. Thus, both parties to the contract continue under the terms of the contract, accepting both the terms of the contract and applicable law, until the natural termination of the contract.18 Rejection of a contract serves as a court-approved breach of contract and terminates both parties’ rights to demand further performance under the contract.19 Once the contract is so rejected, each party is relegated to the status of a claimant for damages incurred as a result of the termination of the contract.20 This broad-sweeping provision permits the debtor-in-possession, after identifying those contracts that

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9. Ironically, the farmer’s diligence in providing the apples to the debtor prior to the petition date will actually be harmful to his business interests. Rather than having the possibility that the debtor-in-possession will seek to assume the contract as if no bankruptcy had been filed, the farmer is automatically relegated to the status of a creditor in the bankruptcy. Depending on the status of his claim (in this situation, probably a general unsecured claim), the farmer might be paid only a percentage of the amount that he is owed by the debtor.
11. Id. § 766 (treatment of customer property).
12. Id. § 365(b)(1) (default under executory contract).
13. Id. § 365(c) (assignment of contracts).
14. Id. § 365(d) (regarding Chapter 7).
17. See, e.g., § 1107(a) (excepting the right of a trustee to be compensated and certain duties of the trustee). For cases filed pursuant to Chapter 11 of the Bankruptcy Code, a trustee will not be appointed automatically. In such cases, a debtor will frequently choose to operate the bankruptcy case on its own. The resulting entity is entitled the “debtor-in-possession.” For further discussion of the role of a debtor-in-possession in a pending bankruptcy proceeding, see RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 4.05. For the remainder of this article, references to the debtor-in-possession, debtor, or trustee shall be used interchangeably, as applicable.
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involve the debtor and meet the requirements of an executory contract, to choose whether to continue to operate under the contract or abandon it, forcing the other party to accept the consequences of the debtor's decision. The debtor-in-possession's powers are not unlimited, however. The debtor-in-possession may not assume a contract if the debtor defaulted on the contract prior to filing the bankruptcy petition unless the debtor-in-possession cures the default or provides other assurance that the default will indeed be remedied. In this way, the Code protects a non-debtor party to a contract from being forced into a continuing relationship with a debtor who has a history of nonperformance under the contract. The debtor-in-possession must also compensate the other party for its losses arising from such default. Finally, the debtor-in-possession must provide "adequate assurance" that it will be able to meet its future obligations under the contract in order to provide the non-debtor with confidence that the debtor will not slip back into its pattern of nonperformance. Assumption of a contract is further limited in that it must be approved by the bankruptcy court.

II. LAWS PROHIBITING ASSIGNMENT OF A CONTRACT

Even if the debtor has not defaulted in its obligations under the contract or the debtor-in-possession can cure any defaults and provide assurance of its ability to operate pursuant to the contract in the future, the debtor-in-possession still might not be permitted to assume or to assign the contract. Although the concept of restricting the debtor-in-possession's ability to assume or assign a contract has been widely accepted, the borders of that restriction are widely contested.

Section 365(c) provides that

[t]he trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

21. The ability of a debtor-in-possession to reject an executory contract "is vital to the basic purpose of a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization." Bildisco & Bildisco, 465 U.S. at 528. When a debtor-in-possession rejects the contract, the non-debtor receives a claim against the estate in the Chapter 11 proceeding; the court treats the claim as if it occurred pre-petition, regardless of the actual timing of the claim, under the theory that the non-debtor was required to continue under the terms of the contract until rejection or acceptance by the debtor-in-possession. See Richard F. Broude, Executory Contracts and Unexpired Leases in Bankruptcy, SE 33 ALI-ABA 435 (August 26, 1999).


23. Id. § 365(b)(1)(B).

24. Id. § 365(b)(1)(C). Some exceptions to these requirements exist for defaults linked to the filing itself. § 365(b)(2). In addition, the Code specifies what constitutes "adequate assurance" in cases involving shopping center leases. § 365(b)(3). Adequate assurance of future performance requires that the debtor-in-possession demonstrate a likelihood that it will be able to perform its duties under the contract in the foreseeable future and includes an analysis of "the nature of the parties, their prior dealings, their present circumstances, and the character and feasibility of the debtor's plans for future performance" to determine whether the debtor, based on past performance, has enough resources to continue to perform the contract in the future. 2 HON. WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 39:31 (2d ed. Supp. 1999).

25. The courts typically approve assumption at the request of the trustee or debtor-in-possession, In re The Beare Co., 177 B.R. 879 (Bankr. W.D. Tenn. 1994), unless they deem assumption of the contract not within the "reasonable business judgment" of the estate, meaning either that assumption cannot be in the best interests of the estate or that the decision to assume did not result from the exercise of reasonable business judgment. See id. at 882.
applicable law excuses a party, other than the debtor, to such a contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.\textsuperscript{26}

The language of Section 365(c)(1) speaks of assumption or assignment. Interpretation of this section requires consideration as to whether Congress truly intended to prohibit assumption, thus preventing the debtor from enjoying the benefits of the contract entirely, or whether Congress simply sought to prohibit assumption in an effort to prohibit the subsequent assignment of the contract.

The argument within the courts and among legal commentators evolves from policy. If Congress truly intended that under certain circumstances an executory contract could be neither assumed nor assigned, Congress has placed a fairly severe limitation on the power of the debtor-in-possession to continue under contracts that may be beneficial, or even necessary, to its ability to reorganize. If the debtor-in-possession assumes the contract without assigning it, all parties would be in the same position that they would have been in but for the bankruptcy filing, but because of the filing, the balance between the parties changes since the non-debtor may now avoid a contract that would otherwise oblige it. On the other hand, if Congress intended that the contract may be assumed under Section 365 but not assigned to a third party, Congress has failed to say so clearly in the language of the statute. While this interpretation might arguably better serve the purposes of the assignment prohibition, if such interpretation is correct, Congress has favored the reorganizing debtor to the detriment of the non-debtor party to the contract.

\textbf{A. The Debtor/Debtor-in-Possession Distinction}

In the 1980s, at the inception of arguments concerning the meaning of Section 365(c)(1), courts pointed to a flaw in congressional drafting. The courts focused on the language in Section 365(c)(1) prohibiting assumption or assignment if applicable law\textsuperscript{27} excuses performance given to or received from a third party. Although today the courts focus on the “assumption or assignment” language, the courts at that time focused on the “third party” language.

The seminal, though not the first, case dealing with the “third party” language came out of the Third Circuit.\textsuperscript{28} In \textit{In re West Electronics, Inc.}, the court considered the limitations of assignment of a contract for the production of military equipment.\textsuperscript{29} The non-debtor argued that the debtor-in-possession constituted a different entity from the debtor itself and the court agreed.\textsuperscript{30} By separating the entity


\textsuperscript{27} The term “applicable law” in section (c)(1) has been interpreted routinely by the courts to mean “applicable nonbankruptcy law.” Metropolitan Airports Comm’n v. Northwest Airlines, Inc. (In re Midway Airlines, Inc.), 6 F.3d 492, 494 n.2 (7th Cir. 1993).

\textsuperscript{28} In re West Electronics Inc., 852 F.2d 79 (3d Cir. 1988).

\textsuperscript{29} Id. at 82-84.

\textsuperscript{30} Id. at 83. In practice, few situations exist in the bankruptcy context in which the debtor and debtor-in-possession are deemed to be different entities. \textit{See}, e.g., Cle-Ware Indus., Inc. v. Sokolsky (In re Cle-Ware Indus., Inc.), 493 F.2d 863, 871 (6th Cir. 1974) (“Only in exceptional circumstances, which we do not now foresee, will
of the debtor from that of the debtor-in-possession, assumption could never occur. Any assumption by the debtor would become a de facto assignment to the debtor-in-possession, and thus would not be permitted under Section 365(c)(1).

In contrast to the West decision, other courts and Congress have indicated that a debtor and a debtor-in-possession constitute the same entity for purposes of Section 365. The court in In re American Ship Building Co., Inc. stated that Congress could not have intended to distinguish between a debtor and a debtor-in-possession. To make such a distinction would mean that no contract could truly be assumed when applicable law forbids assignment, for a debtor never exists as its pre-bankruptcy entity after filing a bankruptcy petition. As assumption is a concept created by the Bankruptcy Code, it defies logic to create such a concept, only to have it never be capable of use.

Perhaps the most notable expression of this opinion came from Congress itself in connection with its passage of the 1980 technical Bankruptcy Amendments:

This amendment makes it clear that the prohibition against a trustee’s power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal service nature of the contract.

This clear statement of congressional intent fixed one drafting problem with Section 365(c)(1) by clarifying that a debtor-in-possession may technically assume a contract. It opened a Pandora’s box, however, by creating confusion as to whether Congress intended to prohibit merely the assignment of prohibited contracts or the initial assumption of such contracts as well. In addition, it created further uncertainty regarding precisely when assumption will be prohibited.

[the appointing of separate counsel for debtor and debtor-in-possession] be allowed by this court. The debtor and debtor-in-possession is one and the same person....”

31. Some commentators have abandoned the debtor/debtor-in-possession distinction altogether:

A number of courts in executory contracts cases have puzzled over whether the debtor in possession is a “new entity” as compared to the debtor, in trying to decide whether the debtor in possession is bound by the debtor’s contracts prior to assumption. What is important, however, is that the estate clearly is a new entity. The debtor in possession is the debtor, see Bankruptcy Code section 1101(1), acting in a trust capacity as representative of that estate. The debtor can be displaced at any time by an independent trustee; thus, nothing should turn on whether the debtor and the debtor in possession are the same entity. The important issue is not whether the debtor in possession is bound by the debtor’s contracts, but whether the estate is.


32. This analysis stands true whether Section 365(c)(1) prohibits merely assignment or both assumption and assignment, as any assumption constitutes an assignment as well.


35. Id. at 362.

36. H.R. REP. NO. 96-1195, § 27(b) (1980); see also Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.), 165 F.3d 747, 754 (9th Cir. 1999).

37. Nevertheless, as demonstrated by West, even this congressional statement did not ensure that debtors-in-possession would be treated the same as debtors. See supra part II.D.3 for additional analysis of the legislative history.
B. The Contradiction of Section 365(f)(1)³⁸

The confusion over congressional intent has been further fueled by an apparent inconsistency with the language of Section 365(f)(1), providing that

\[\text{except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection...}^{39}\]

At first glance, section (f)(1) appears to permit assignment regardless of applicable law, contrary to the provisions of section (c)(1). If neither section (c)(1) nor section (f)(1) existed, the debtor-in-possession would always be permitted to assume executory contracts but never permitted to assign if applicable law or the contract itself prohibited the debtor from doing so.⁴⁰ If only section (f)(1) existed, the debtor-in-possession would always be permitted to assume a contract and to assign it, despite a law or contractual provision to the contrary. Finally, if only section (c)(1) existed, the debtor-in-possession would not be able to assume or assign a contract when applicable law prohibited assignment of the contract.⁴¹

By enacting both sections (c)(1) and (f)(1), Congress seems to have indicated a desire to have a result other than those listed above.⁴² The debtor-in-possession cannot be absolutely prohibited from assigning executory contracts, nor can the debtor-in-possession always be permitted to assign executory contracts. Thus, the debtor-in-possession may be either (1) permitted to assume only when the law permits assignment of the contract (or the non-debtor party consents⁴³), and then permitted to assign the contract, if desired; or (2) permitted to assume provided that the debtor-in-possession has no intention to assign the contract, and then permitted to assign the contract at a later date, if desired.

³⁸. For a more extensive analysis of the history of the conflict between sections (c)(1) and (f)(1), see Brett W. King, Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law," 70 AM. BANKR. L.J. 95 (1996).


⁴⁰. This is so because once the debtor-in-possession assumes a contract, all provisions of the contract (and the law governing the contract) are assumed. In re Peninsula Asphalt Corp., 1990 WL 369438, at *5 (W.D. Mich. Sept. 6, 1990) (citing In re Ralston, 401 F.2d 293, 295 (6th Cir. 1968); In re Italian Cook Oil Corp., 190 F.2d 994, 996-97 (3d Cir. 1951); In re Baxter, 104 F.2d 318, 320 (6th Cir. 1939)).

⁴¹. There is a problem with section (c)(1) regardless of whether section (f)(1) exists. In either case, Congress has not made clear whether it intends to prohibit just the ultimate assignment of prohibited contracts or also the initial assumption of them. Because a contract cannot be assigned until it is assumed, In re Schick, 235 B.R. 318, 322 (Bankr. S.D.N.Y. 1999), the assignment would also be restricted as permitted by law. This is a subtle distinction from the first alternative (neither section (c)(1) nor section (f)(1) in existence). In the first scenario, the debtor-in-possession may assume the contract, but not assign it. In the second scenario, the assumption itself may be prohibited, presumably to prevent any subsequent assignment.

⁴². Statutory construction rules require that a statute be construed, if possible, in such a way as to make all provisions of the statute effective. E.g., City of Jamestown, Tennessee v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534, 538 (11th Cir. 1994).

⁴³. Consent need not be given expressly in connection with the bankruptcy. In Metropolitan Airports Comm'n v. Northwest Airlines, Inc. (In re Midway Airlines, Inc.), 6 F.3d 492 (7th Cir. 1993), the court held that a provision in the contract permitting assignment of the contract sufficed as consent to the assignment in the bankruptcy proceeding, even though the non-debtor party to the contract objected to the assignment upon the bankruptcy filing.
For example, assume that a statute prohibited assignment of any contracts with a state agency. Prior to a bankruptcy filing, the non-agency party could not assign such a contract. Once a bankruptcy filing occurs, under the first scenario, the debtor-in-possession still could not assign the contract, but it would also not be permitted to assume the contract and itself render performance within the confines of the contract. This effectively ends the contract solely as a result of the bankruptcy filing. Under the second scenario, the debtor-in-possession would be allowed to assume the contract and to operate under it as if no bankruptcy had been filed. If the debtor-in-possession sought to assign the contract, however, such assignment would be prohibited, just as it would have been prohibited before the bankruptcy filing.

Unfortunately, neither of these interpretations makes much sense. If section (c)(1) is interpreted to prohibit assumption of a contract when assignment of the contract would be prohibited, only those contracts that can be assigned can be assumed. This, as courts have noted, basically renders section (f)(1) meaningless. Because a contract must be assumed before it can be assigned, section (f)(1) does not become effective until after section (c)(1) is applied. Section (f)(1) will only be triggered by a contract that cannot be assigned or assumed under the barrier of section (c)(1). The only instances in which a contract could get past the barrier of section (c)(1) and still be assignable under section (f)(1) are when the law does not prohibit assignment of the contract but the contract itself does, or when the non-debtor party consents to the assumption.

On the other hand, if section (c)(1) is interpreted to prohibit the assumption of a contract only if the debtor-in-possession actually intends to assign the contract, an odd result occurs. When a contract is not to be assigned, it may be assumed. Because the contract is not to be assigned, section (f)(1) becomes irrelevant. When, however, the debtor-in-possession intends to assign the contract, section (c)(1) kicks in to prevent the initial assumption. As a result, section (f)(1) becomes useless because the contract could never be assumed in the first place.

Thus, the two sections work together in only two isolated circumstances: when the non-debtor party agrees to the assignment or when the contract itself creates the lone prohibition on assignment. It seems incredible that Congress would create two broad provisions to cover such unusual and limited situations. Certainly, if Congress intended to create exceptions for these two circumstances, its intent could have been furthered by more narrowly tailored language that would create substantially less confusion.

44. E.g., Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.), 113 F.3d 1029, 1032 (9th Cir. 1997).
46. In such a situation, the provisions of section (c)(1) do not apply due to the addition of the language—"whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties"—located therein. The provisions of section (f)(1) do not apply to contractually based restrictions on assignment.
47. As in the previous situation, if the prohibition on assignment is not by law, but by contract, there is no conflict between sections (c)(1) and (f)(1) because section (c)(1) is inapplicable. Likewise, if the non-debtor party consents, the two provisions are reconcilable.
C. The "Applicable Law" Requirement

One back-door approach that courts have used effectively to hold that a contract could be assumed and/or assigned despite the existence of a law prohibiting the assignment is the requirement that the prohibition on assignment come from an "applicable law." The Bankruptcy Code does not define the phrase "applicable law," and thus it has become the domain of the courts to do so.

It is crucial to note from the outset that the term "applicable law" can be found in other sections of the Bankruptcy Code, most notably Section 365(f)(1). Defining applicable law differently for sections (c)(1) and (f)(1) has provided some courts with a means of avoiding the inherent conflict between the sections. In an effort to reconcile these two provisions, some cases have sought to construe section (c)(1) as an exception to the rule stated in section (f)(1). These courts have defined applicable law in section (f)(1) broadly so that it includes any law that prohibits, restricts, or conditions the assignment of the contract. They have interpreted section (c)(1) narrowly, limiting applicable laws to those that expressly excuse one party from accepting performance from or rendering performance to another party. As an example, the court in In re Grove Rich Realty Corp. reasoned that section (f)(1) applies when a law prohibits either assignment of rights under the contract or delegation of duties. Such a construction does not create any additional clarity of interpretation. A contract primarily includes rights owed to a contracting party and duties owed by a contracting party. Thus, any law prohibiting assignment under any circumstances will prohibit one or both of these categories.

Most courts have focused not on whether assignment and delegation are both prohibited by law, but whether the statute at issue prohibits delegation alone. The interpretation of applicable law is further clouded by the artificial distinction created between non-assignable contracts and non-delegable duties. Non-assignable contracts include those in which the benefits to be received cannot be transferred. A non-delegable contract, on the other hand, concerns those in which the duties to be performed cannot be delegated to another. This is much more common. Almost any personal service contract falls within the realm of non-delegable contracts.

48. For an extensive analysis of the interpretations of "applicable law" under Section 365, see Morris W. Macey & James R. Sacca, Reconciling Sections 365(c)(1) and (f)(1) of the Bankruptcy Code: Should Anti-Assignment Laws Prohibit Assumption of Contracts by a Debtor in Possession?, 100 COMM. U. 117 (1995).
50. E.g., Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.), 165 F.3d 747, 752 (9th Cir. 1999) ("Subsection (c)(1) states a carefully crafted exception to the broad rule [by only excusing a party if the identity of the contracting party is material to the agreement...").
51. See e.g., Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.), 113 F.3d 1029, 1032 (9th Cir. 1997) (rejecting consideration of applicable law requirement because assignment of franchise agreement was prohibited regardless, but discussing the distinction between the two definitions of "applicable law").
52. Perlman, 165 F.3d at 732.
53. Id.
55. Id. at 506.
56. 17 AM. JUR. 2D Contracts, § 5 (1991) (citing Crane Ice Cream Co. v. Terminal Freezing & Heating Co., 128 A. 280 (Md. 1925)).
57. 6 AM. JUR. 2D Assignments § 3 (1999) (citing Barker Development Co. v. Unibank & Trust Co. of Coralville, 314 N.W.2d 175 (Iowa Ct. App. 1981); Matter of Estate of Murphy, 554 N.W.2d 432 (N. D. 1996)).
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Clearly, if the popular “Cirque du Soleil” contracted to perform, the ticket-holders would not be willing to accept Cirque du Soleil assigning their obligation to perform to Barnum & Bailey’s circus performers. Regardless of what anyone thinks of either Cirque du Soleil or Barnum & Bailey, the fans have contracted to pay money to have the opportunity to see a performance by Cirque du Soleil, and they have a reasonable expectation of doing so.

At common law, many courts interpreted “applicable law” under section (c)(1) to apply only to non-delegable, personal service contracts. Thus, even if a law existed that prohibited assignment, that law might not be sufficient to prohibit assumption and assignment under section (c)(1). By limiting the application to personal service contracts, the courts reasoned, this interpretation promoted Congress’s intent to prohibit assignment of those contracts that rely on a special skill or talent.

Ostensibly, the rationale for distinguishing non-delegable, or personal service, contracts from other contracts is that these laws generally give the party receiving or rendering performance the option to refuse an alternate performer, rather than making the refusal automatic. For example, In re Lil’ Things, Inc. involved assumption and assignment of a store lease. Texas law prohibited subleasing property without the consent of the landlord. Though the contract involved assignment of a duty to perform (in this case, to pay rent), this duty did not constitute a personal service. It could easily be performed by anyone with sufficient funds to do so. Money from one tenant would operate as well as money from another tenant. The court held that the Texas law constituted a general prohibition against assignments. The terms of the statute were not sufficiently specific to fall under section (c)(1) because they did not permit a party to refuse acceptance. Rather, the terms of the statute simply prohibited the assignment altogether. Hence, the absence of a personal service contract or sufficiently specific law mandated that section (c)(1) did not prevent the assumption.

In 1984, the First Circuit expanded the definition of applicable law, even as applied to section (c)(1). The court in In re Pioneer Ford Sales, Inc. read Section 365(c)(1) closely and held that it applies to any law that merely allows, not requires, a contracting party to refuse to accept performance from or render performance to another party. Since the mid-1980s, the principle that applicable law includes those laws that prohibit non-assignable contracts as well has been widely accepted.

58. Though both are titled a “circus,” Cirque du Soleil differs widely from Barnum & Bailey’s traditional three-ring circus. Cirque du Soleil contains numerous unusual acrobatic feats, with a focus on artistry. There are no animals and no clowns. The show is described as “a novel show concept that is as original as it is non-traditional: an astonishing theatrical blend of circus arts and street performance, wrapped up in spectacular costumes and fairyland sets and staged to spellbinding music and magical lighting.” Cirque du Soleil, at http://www.cirquedusoleil.com/en/coulisse/index.html (last visited May 4, 2001).


60. Terrace Apts., 107 B.R. at 384.
62. Id. at 591.
Despite this widespread acceptance, courts have at times continued to use the non-assignable/non-delegable distinction in deciding cases. The Eleventh Circuit recently held that a general law prohibiting assumption does not qualify as "applicable law" under section (c)(1). In City of Jamestown, Tennessee v. James Cable Partners, L.P., the city and debtor had entered into a contract for a cable franchise. When the debtor-in-possession sought to assume the executory contract, the city objected, citing a Tennessee statute prohibiting assignment. The court held that the statute’s generality failed to trigger the anti-assumption provisions of section (c)(1):

A general prohibition against assignment does not excuse the City from accepting performance from a third party within the meaning of § 365(c)(1). In order to be excused from accepting performance, the City would need to point to applicable law such as a Tennessee law that renders performance under the cable franchise agreement non-delegable.

As a matter of policy, there exists no reason to distinguish between statutes that absolutely prohibit assignment (or delegation) and those that allow a party to refuse to accept the assignment. It is contrary to common sense to give more protection for a statute that simply permits a party to refuse an assignment than to one that always prohibits assignment. In theory, the legislature drafted statutes that always prohibit assignment because they thought it important enough that these types of contracts never be assigned—even if the other parties to the contracts consent to assignment. But under the Lil' Things construction of section (c)(1), those are the very contracts that are permitted to be assigned! Meanwhile, those contracts that the legislature could conceivably accept assignment of are less likely actually to be assigned. The end result fails to meet the original intentions of the statutes and defies the common logic of contracts.

As is obvious from this line of cases, an inquiry into what constitutes "applicable law" creates an initial point of disagreement. It seems odd that "applicable law" would have two meanings within one statute. Yet, to have the same meaning creates an inconsistency by prohibiting assignment under section (c)(1) when applicable law prohibits it, but permitting the same assignment under section (f)(1). When read together, this discrepancy creates an inherent conflict between the subsections of Section 365. Returning to the state agency example, if the definitions of applicable law are the same, section (c)(1) only allows the debtor-in-possession to assign the contract if applicable law so allows. If a law prohibits assignment, so does section (c)(1). But section (f)(1) would permit the assignment despite the law expressly prohibiting assignment of state government contracts. As will be discussed for the remainder of this article, this confusion in the courts seems minimal when compared with the confusion once an applicable law has been found, but both problems can be solved either by a proper interpretation of Section 365 or, preferably, a change in the law to eliminate these problems.

66. Id. at 538.
D. Assumption Versus Assignment

If a court determines that a law does exist that prohibits assignment, Section 365(c)(1) applies. Then it becomes necessary to focus on the "assumption or assignment" language found therein to determine whether the assumption or merely the subsequent assignment will be prohibited, assuming that the non-debtor party refuses to consent thereto.

1. The Hypothetical Test

One theory of construction of section (c)(1), known as the "hypothetical" construction, focuses on the "plain language" of Section 365(c)(1). The majority of federal courts of appeals considering the issue have adopted this construction. The language of Section 365(c)(1) states that if applicable law prohibits assignment of the contract, then the debtor-in-possession may not assume or assign the contract. If Congress had intended merely to prohibit assignment of the contract, it would not have included the possibility of assumption within section (c)(1). Central to this construction is the well-accepted notion that the language of a statute, if clear, must be followed.

In re West Electronics, Inc. embraced the hypothetical construction at an early stage. The debtor had contracted with the Air Force to provide power supply boxes for AIM-9 missile launchers, but by the Federal Nonassignment Act (Anti-Assignment Act), government contracts are not permitted to be assigned. The West court first dealt with the issue of whether the debtor and debtor-in-possession were different entities such that an assumption of the contract automatically constituted

67. The hypothetical test has been adopted by the Third, Fourth, Fifth, Ninth, and Eleventh Circuits. See Perlman v. Catapult Entertainment, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747 (9th Cir. 1999); City of Jamestown, Tennessee v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994); Catron v. Breeden (In re Catron), 25 F.3d 1038 (4th Cir. 1994); In re West Electronics, 852 F.2d 79 (3rd Cir. 1988); see also Turner v. Avery, 947 F.2d 772, 774 (5th Cir. 1991) ("An executory contract is nonassumable if, under applicable law, any party other than the debtor may decline to accept performance by the trustee.").

68. 11 U.S.C. § 365(c)(1).

69. One court has even indicated that, in order for an assignment to occur, the non-debtor party must provide its consent twice. Breeden v. Catron (In re Catron), 158 B.R. 629, 636 (E.D. Va. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994). The Catron court indicated that the debtor-in-possession cannot assume a contract that cannot be assigned without the consent of the non-debtor party. Once the contract has been assumed, Section 365(c)(1)'s language prohibits assignment of the contract without the non-debtor's permission, which is arguably a second consent. Id. As a matter of practice, the debtor-in-possession will frequently move to assume and assign a contract in one action, thus merging the two inquiries and the two consents into one.

At least one court has argued that the inclusion of both terms in Section 365(c)(1)—assumption and assignment—indicates that there must be some circumstances in which assumption may occur without an assignment (the reverse situation being impossible because a contract cannot be assigned if not assumed). In re Cardinal Indus., Inc., 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990). Thus, the court interpreted the inclusion of both terms as an indication that Congress would permit assumption, even if the applicable law prohibited assignment. Otherwise, the phrase "or assign" is rendered superfluous. Id. at 977.

70. Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'") (citing United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241-42 (1989); Rubia v. United States, 449 U.S. 424, 430 (1981); United States v. Goldenberg, 168 U.S. 95, 102-03 (1897); Oneale v. Thornton, 10 U.S. 53 (1810)).

71. 852 F.2d 79 (3d Cir. 1988).

an assignment. The court went on to explain that resolution of the different-entities issue did not actually affect the outcome of the case because the express language of section (c)(1) clearly prohibited both assumption and assignment by including both terms. "The literal meaning of the words chosen by Congress clearly requires the analysis and conclusion we have just articulated and we are confident that it is what Congress intended." Even if the debtor-in-possession constituted the same entity as the pre-petition debtor, the assumption itself would be prohibited.

The Anti-Assignment statute yielded another case applying the hypothetical test the following year. In United States v. Carolina Parachute Corp., the debtor-in-possession sought to assume a contract to supply parachutes to the government. Following the precedent set by West Electronics, the court held that the language of section (c)(1) clearly precluded assumption of the contract, even if the contract would not be assigned. The Carolina Parachute case demonstrates the fundamental problem inherent in the hypothetical test. The court acknowledged that government contracts were the primary source of income for the debtor and that, without these contracts, the debtor's chances of a successful reorganization were compromised. Despite these admittedly compelling facts, however, the court held that assumption would not be permitted. Even very recently, a Virginia bankruptcy court demonstrated that the hypothetical test is still very much alive when it prohibited the assumption of a telephone system contract for an Army base, citing the Anti-Assignment statute as its authority.

Intellectual property has likewise proved to be fertile ground for Section 365(c)(1) cases. In the 1994 case of In re CFLC, Inc., a California bankruptcy court considered how federal law prohibiting assignment of intellectual property licenses affected a debtor-in-possession. Cadtrak, the non-debtor, had granted to the debtor a license of intellectual property. The debtor-in-possession sought to assume the contract, which would effectively be assigned to Everex Systems, Inc.,

73. West Electronics, 852 F.2d at 82-83; see also supra Part II(A).
74. West Electronics, 852 F.2d at 83.
75. Id.
79. United States v. TechDyn Systems Corp. (In re TechDyn Systems Corp.), 235 B.R. 857 (Bankr. E.D. Va. 1999). The court did note, however, that the policy behind Section 365(c)(1) probably did not support the conclusion that assumption should be prohibited even when there is no intention to assign. Policy notwithstanding, the court could not change the law. Id. at 863-64.
80. The policies promoted by the hypothetical test and general patent law are at direct odds. To follow the hypothetical test limits the contractual freedom in patent law. For further analysis of the contradiction in policies, see Gregory G. Hesse, On the Edge: Ninth Circuit Slams Shut the "Back Door" Access to Patented Technology, 1999 AM. BANKR. INST. J. LEMIS 41 (April 1999).
81. 174 B.R. 119 (N.D. Cal. 1994), aff'd, 89 F.3d 673 (9th Cir. 1996).
82. See id. at 122; see also Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972) (citing Bowers v. Lake Superior Contracting, 149 F. 983 (8th Cir. 1906); Wood Harvester Co. v. Minneapolis Harvester Co., 61 F. 256 (8th Cir. 1894); Lane & Bodley Co. v. Locke, 150 U.S. 193 (1893); Hapgood v. Hewitt, 119 U.S. 226 (1886); Troy Iron & Nail Factory v. Coming, 55 U.S. 193 (1852)).
the entity that purchased the assets of the debtor-in-possession. The court first noted that a California law permitting assignment of intellectual property rights directly conflicted with federal law prohibiting such assignment; thus the California law would be preempted.\textsuperscript{83} As a result, the federal law prohibiting assignment controlled assumption and assignment of the contract.\textsuperscript{84} The court held that, because assignment was legally prohibited, assumption was likewise prohibited, making moot the issue of whether the sale to Everex constituted a de facto assignment or merely an assumption. Interestingly, the court spoke only of assignment, holding that the assumption would be a de facto assignment. Thus it is unclear whether the court intended to use the hypothetical test or the actual test.\textsuperscript{85}

More recently, the Ninth Circuit applied the hypothetical test to prohibit the assumption of a patent license. In\textit{Perlman v. Catapult Entertainment, Inc.},\textsuperscript{86} the debtor-in-possession sought to assume patent licenses as a part of its reorganization efforts. The licensor of the patents objected on the basis of federal law prohibiting the assignment of patents. Although the court recognized the different theories of interpreting section (c)(1), the court felt bound to a hypothetical construction of the statute.\textsuperscript{87} Utilizing a hypothetical analysis, the court agreed with the licensor. The debtor-in-possession could not assume the contract, regardless of whether it intended to assign the contract, because section (c)(1) clearly prohibited the assumption of non-assignable contracts.\textsuperscript{88}

The courts have also adopted the hypothetical test outside of the realms of the Anti-Assignment statute and intellectual property. For example, the Fifth Circuit used the hypothetical test to prohibit assumption of contingency fee contracts for legal services.\textsuperscript{89} Likewise, the Fourth Circuit refused to permit assumption of a partnership agreement regarding a shopping center.\textsuperscript{90} The Eleventh Circuit, following a hypothetical analysis, held that a cable franchise could be assumed, but only because no applicable law prohibited assignment.\textsuperscript{91} At least one bankruptcy

\begin{thebibliography}{99}
\bibitem{83} CFLC, Inc., 174 B.R. at 122. The bankruptcy court expressly overruled the California Supreme Court. The state's highest court had previously reasoned that preemption was not appropriate because federal case law prohibiting assignment of intellectual property rights was not statutory. Because federal common law does not exist per the \textit{Erie} doctrine, this non-statutory law would not preempt state law. \textit{Id.}
\bibitem{84} \textit{Id.}
\bibitem{85} \textit{Id.} The “actual test” will be discussed in Part II.D.2 infra.
\bibitem{86} 165 F.3d 747 (9th Cir. 1999).
\bibitem{87} \textit{Id.} at 750.
\bibitem{88} The court expressly stated that Section 365(c)(1) “links nonassignability under ‘applicable law’ together with a prohibition on assumption in bankruptcy... [A] debtor-in-possession may not assume an executory contract over the non-debtor’s objection if applicable law would bar assignment to a hypothetical third party, even where the debtor-in-possession has no intention of assigning the contract in question to any such third party.” \textit{Id.} (quoting 1 DAVID G. EPSTEIN ET AL., \textit{BANKRUPTCY} § 5-15 (1992)).
\bibitem{89} Turner v. Avery, 947 F.2d 772 (5th Cir. 1991), \textit{aff’d}, 109 F.3d 765 (5th Cir. 1997). The court distinguished between contracts in which the lawyers had performed all duties and were simply awaiting payment and those in which the legal services had not yet been completed. The former are not executory contracts. The latter are executory but fall under Section 365(c)(1). \textit{Id.} at 774 (citing \textit{In re Tonry}, 724 F.2d 467 (5th Cir. 1984)).
\bibitem{90} Breeden v. Catron (\textit{In re Catron}), 158 B.R. 629 (E.D. Va. 1993) (holding that debtor-in-possession may not assume partnership agreement upon filing, despite lack of intention to assign), \textit{aff’d}, 25 F.3d 1038 (4th Cir. 1994).
\bibitem{91} City of Jamestown, Tennessee v. James Cable Partners, L.P. (\textit{In re James Cable Partners, L.P.}), 27 F.3d 534 (11th Cir. 1994).
\end{thebibliography}
court has also followed a hypothetical construction of section (c)(1) in considering assumability of a resale contract.92

The hypothetical test has the dual benefits of simplicity and clarity. Once a court determines that an applicable law restricts assignability of a contract, that contract may not be assumed. There exists no subjective inquiry into the debtor’s state of mind. There exists no inquiry into whether the contract is being assumed or covertly being assigned. There exists simply a prohibition on the debtor doing anything further with the contract. But while these benefits aid judicial construction and consistency by providing a simple rule that should, in theory,93 provide a predictable result, they do not necessarily meet the intent behind the statutes or the Bankruptcy Code in general.

To use a hypothetical construction favors the non-debtor over the debtor. In general, this may well be acceptable. After all, the non-debtor has not filed for protection under the Bankruptcy Code and has become an unwilling participant in the bankruptcy process. Why should the non-debtor suffer as a result of the actions of the debtor? But the general policy of the Bankruptcy Code remains to further the debtor in its efforts to reorganize94 while hopefully protecting some interests of the creditors. The protections given to the non-debtor under this test may exceed what is necessary to protect its interest. Simply prohibiting the assignment, as opposed to the assumption, would allow the non-debtor to continue to do business as it would have had no bankruptcy been filed. To prohibit assumption, even if no assignment is contemplated, allows the non-debtor to back out of a contract on a technicality when the contract would have been performed as if no bankruptcy had occurred, that is, when the non-debtor would receive the full benefit of its bargain. The Code may be willing to protect non-debtors, but bankruptcy should not become a windfall to a non-debtor party seeking to escape the terms of a contract entered into validly.

2. The Actual Test

Although most of the appellate courts have favored the hypothetical interpretation of Section 365(c)(1),95 most trial courts have moved toward an “actual” interpretation.96 Under the “actual” test, the courts look to whether the debtor-in-possession, if permitted to assume the contract, actually intends to assign it. If so, the debtor-in-possession will be prohibited from assuming the contract in the first place. As in the hypothetical test, the actual test focuses on assignment of the contract to ultimately determine the right to assume the contract. The actual test, however, examines what the debtor-in-possession actually intends to do with the

93. The rule provides a predictable result only in theory because, as has been demonstrated above, the courts have many means, even under a hypothetical construction, to avoid the implications of Section 365(c)(1). See supra notes 25-88 and accompanying text.
95. The only federal appellate court to openly embrace the actual test thus far is the First Circuit. See Institut Pasteur & Pasteur Sanoft Diagnostics v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997); Summit Investment & Development Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995).
96. Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.), 165 F.3d 747, 749 n.2 (9th Cir. 1999).
contract rather than what the debtor-in-possession could hypothetically do with the contract.

As noted, most federal appellate courts have refused to utilize the actual test. In *Institut Pasteur & Pasteur Sanofi Diagnostics v. Cambridge Biotech Corp.*, however, the First Circuit bucked the trend. In *Institut Pasteur*, the parties entered into cross-licensing agreements to use patents owned by one another. The debtor-in-possession, Cambridge Biotech Corporation, sought to assume the agreements as part of its reorganization. Institut Pasteur objected. To complicate matters further, Cambridge planned to reorganize via a stock sale to bioMerieux, a competitor of Institut Pasteur. Thus, an assumption by Cambridge, even without an express assignment, would effectively operate as an assignment of the licensing agreements to bioMerieux. Federal law clearly prohibited assignment of patent licensing agreements, but at the trial level, the court held that the sale of stock did not constitute an assignment and thus permitted the assumption.

On appeal, the First Circuit agreed. The court began by citing *In re CFLC, Inc.*, which had used a hypothetical analysis in a federal patent case. Under a hypothetical analysis, the assignment-or-assumption distinction would be irrelevant because assignment in violation of federal law could, hypothetically, occur. But the trial court had distinguished *CFLC* on the basis that that case involved an effectual assignment instead of a sale of stock and was therefore factually different. Obviously this factual difference should not dictate which standard to use because, for the hypothetical test, whether the debtor-in-possession contemplates an assignment is irrelevant. Nonetheless, the court seized upon this difference and utilized an actual construction of Section 365(c)(1). The court focused on whether the non-debtor, Institut Pasteur, would receive the full benefit for which it contracted under the agreement if the contract were assumed by the debtor-in-possession. To this inquiry, the court answered affirmatively, holding that Institut Pasteur would have continued use of Cambridge's technology and methodology. Thus, assumption was proper despite the fact that the debtor could, hypothetically, assign the contract after assumption, contrary to applicable law.

At least one circuit remains undecided on the issue of assumption versus assignment. The Sixth Circuit has specifically declined to decide whether section (c)(1) contemplates the prohibition of assumption entirely or simply assumption in cases of intended assignment.

Although the appellate courts have not overwhelmingly embraced the actual construction test of Section 365(c)(1), the trial courts have accepted it with open

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97. 104 F.3d 489 (1st Cir. 1997) abrogated on other grounds by Hardemon v. City of Boston, 144 F.3d 24 (1st Cir. 1998).
98. 174 B.R. 119 (N.D. Cal. 1994), aff'd, 89 F.3d 673 (9th Cir. 1996).
99. The First Circuit had previously reached a similar result in *Summit Investment & Development Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995), a case involving the transfer of partnership interests. In that case, the First Circuit advocated a "case by case inquiry into the actual consequences—to the non-debtor party—of permitting these executory contracts to be performed by the debtor party." Id. at 612. As in the *Institut Pasteur* case, the court focused on the effect to the non-debtor party.
100. Rieser v. Dayton Country Club Co. (In re Magness), 972 F.2d 689 (6th Cir. 1992) (holding that no assumption was permitted under either of the hypothetical or actual constructions because trustee sought to assume and assign a golf club membership).
In re GP Express Airlines, Inc., the court held that the debtor-in-possession, an airline, could assume its contract with Continental Airlines for, among other things, printing airline tickets. The court distinguished the case before it from other cases by noting that in many other cases, the debtor-in-possession ultimately intended to assign the contract. Cases using a hypothetical construction disregard whether the debtor-in-possession intends an assignment, and thus the intention to assign should not be the basis for the use of one test over another. Nonetheless, the court used this difference to justify application of a different test and held that to bar assumption of the contract simply because it could not be assigned would impair the debtor-in-possession's reorganization efforts.

Furthermore, it would force a potential debtor to make a difficult choice between filing a petition in bankruptcy and maintaining its contracts since filing a bankruptcy petition would automatically invalidate any executory contract that could not be assigned legally.

The Southern District of Ohio, located within the jurisdiction of the undecided Sixth Circuit, permitted a debtor-in-possession partnership to assume executory contracts with the individual partners. The Weaver court focused on a recent amendment to section (c)(1) to clarify that the debtor and debtor-in-possession constituted one entity for purposes of section (c)(1). Thus, the court concluded, an assumption by the debtor-in-possession does not constitute an assignment, and under the actual construction test, if no assignment is actually contemplated, the assumption will be permitted.

Yet another 1994 case permitted assumption of a contract in cases when the debtor-in-possession did not contemplate an assignment. American Ship Building is one of a growing number of cases involving the Anti-Assignment Act in which the court permitted assumption. In American Ship Building, the court focused
primarily on the lack of a distinction between a debtor and a debtor-in-possession. Because the entities are the same, no assignment would occur between them; therefore under an actual construction, assumption must be permitted. In justifying its decision to permit assumption of the ship-building contract, the court spoke of balancing competing interests between the debtor-in-possession’s efforts to reorganize and the non-debtor’s right to enforce the non-assignability of the contract:

In this way, the statute also achieves a balancing of interests. On the one hand, legitimate anti-assignment laws which are designed to protect the non-debtor to the contract are preserved. On the other hand, legislatures are effectively barred from using the statute to pass laws designed to insulate their constituencies from ever having to do business with debtors in bankruptcy. In this way, the Bankruptcy Code achieves the balancing of interests so essential to the successful uniform application of bankruptcy laws nationwide to a wide variety of business enterprises. 110

The policy behind permitting assumption of a contract when the debtor-in-possession does not contemplate assignment is to protect the debtor-in-possession’s reorganization efforts by allowing it to continue to operate under useful contracts. 111 At the same time, it permits the non-debtor party to continue with the same relationship that would have existed but for the bankruptcy filing. This strikes a comfortable balance between the rights of the parties. The non-debtor party remains protected. It does not have to do business with an entity other than the one it contracted with, assuming that the reorganized debtor and the pre-petition debtor are basically the same entity. Meanwhile, the debtor-in-possession can continue with those contracts most likely to facilitate a successful reorganization. As a policy

In general, the purpose of any statute prohibiting assignment will include some or all of these ideals. Thus, the analysis remains the same for most or all such statutes. If an assignment is not intended, assumption will not harm the purpose of the statute prohibiting assignment.

110. American Ship Bldg., 164 B.R. at 363 (citing In re Hartec Enterprises, Inc., 117 B.R. 865, 873 (Bankr. W.D. Tex. 1990)). Of course, both the hypothetical and actual tests seek to balance the competing interests of the debtor-in-possession and the non-debtor. The hypothetical test tips the scales in favor of protecting the non-debtor’s interests in the contract. The actual test favors the reorganization of the debtor-in-possession to the detriment of the non-debtor seeking to escape its contractual obligations.


111. Although the overriding purpose of Chapter 11 is to further the reorganization of the debtor, numerous provisions of the Bankruptcy Code favor a third party, despite the potential ill effects upon the reorganizing debtor. See, e.g., 11 U.S.C. § 547(c) (1994) (listing exceptions for preferential transfer rules); § 1165 (requiring consideration of public interest in connection with other sections); § 507 (permitting priority claims for administrative expenses, wages and salaries, and other categories of claims against the debtor).
matter, the results under the actual test are preferable because of this balance achieved.

3. Legislative History

a. Enactment of and Amendments to Section (c)(1)

Regardless of the merits of policy, it remains the jurisdiction of the legislature to set policy and, more importantly, to create the means to implement it.112 Once the legislature has spoken via statute, the language of the law controls.113 If Congress clearly intended something contrary to what the statute’s language indicates, however, the language may be supplemented as necessary to determine the proper application of the statute.114 In order to determine whether interpretation of section (c)(1) can extend beyond the language of the statute, an analysis of Congress’s intent in creating section (c)(1) is required.

For the most part, Congress provided little legislative history to aid in determining its intent regarding section (c)(1).115 Certainly in passing the original statute in 1978,116 congressional analysis of the section was sparse.117 Amendments

112. In re Law, 37 B.R. 501, 511 (Bankr. S.D. Ohio 1984). ("The most fundamental rule of statutory construction is to give effect to the intention of the legislature.").


114. Perlman, 165 F.3d at 753 (citing City of Auburn v. United States, 154 F.3d 1025, 1029 (9th Cir. 1998)); California v. Montrose Chem., 103 F.3d 1507, 1515 (9th Cir. 1997).

115. Despite the drought of evidence of legislative intent, courts have been able to utilize the small amount available to craft convincing arguments. For a comprehensive analysis of the legislative history surrounding section (c)(1), see In re Cardinal Industries, Inc., 118 B.R. 971, 981 (Bankr. S.D. Ohio 1990).


The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment....

Id.

117. See id. The only legislative history regarding passage of section 365(c) reads as follows:

Subsection (c) prohibits the trustee from assuming or assigning a contract or lease if applicable nonbankruptcy law excuses the other party from performance to someone other than the debtor, unless the other party consents. This prohibition applies only in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract or lease itself.

S. REP. NO. 95-989, at 59 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5845. The language does not provide much analysis of the assignment versus assumption issue. Interestingly, the comments also provide some analysis of the role of section (f)(1):

Subsection (f) partially invalidates restrictions on assignment of contracts or leases by the trustee to a third party. The subsection imposes two restrictions on the trustee: he must first assume the contract or lease, subject to all the restrictions on assumption found in the section, and adequate assurance of future performance must be provided to the other contracting party.

Id. (emphasis added). Unfortunately, as with section (c)(1), the statements of Congress provide little insight into Congress’s intent with regard to the assumption of contracts.
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to sections (c)(1) and (f)(1) were passed in 1984, 118 1986, 119 and 1992, 120 but perhaps the language most revealing of congressional intent came with passage of the 1980 Technical Amendments, which changed none of the actual text of Section 365.

This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition has been filed because of the personal service nature of the contract. 121

Congress designed the amendment to answer the question later posed by the West Electronics court, whether the debtor and debtor-in-possession constituted the same entity for purposes of Section 365(c)(1). As the court in West Electronics pointed out, however, the question becomes moot under a hypothetical construction of section (c)(1). If assumption is prohibited by the very fact that a contract cannot legally be assigned, then a debtor-in-possession can never perform under such a contract. This is true not because the debtor-in-possession is a different entity than the debtor, but because of the nature of the contract itself. Thus, if a hypothetical construction is used, Congress's statement made in connection with the 1980 amendments—Section 365(c)(1) does not apply to a debtor-in-possession rendering the same services as if no bankruptcy petition had been filed—becomes meaningless. 122 Though other amendments have occurred, none provides further insight into Congress's intent with regard to the interpretation of Section 365(c)(1).

b. Proposed Amendments to Section (c)(1)

Recently, a number of amendments to the Bankruptcy Code have been proposed in Congress. 123 At this point, all have failed. Nonetheless, the proposed language

118. In 1984, Congress amended the statute to replace language regarding acceptance or rendering performance from "the trustee or an assignee" to "an entity other than the debtor or the debtor-in-possession or an assignee." Pub. L. No. 98-353, 98 Stat. 361, 362 (1984). This clarifies that the performance may be given to a debtor-in-possession (despite the dicta of the subsequent West Electronics case) without automatically constituting an assignment.

119. Congress again amended the statute in 1986 to strike language permitting performance regarding "an assignee of such contract or lease." Though it appears to be a somewhat significant change, Congress listed the change under the section for "Technical Corrections" to the Bankruptcy Code and provided no analysis of the effect of the change. See Bankruptcy Judges, United States Trustees & Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088, 3117 (Title II, Subtitle C, Miscellaneous Amendments & Technical Corrections).

120. The 1992 amendment added a provision to section (f)(1) that prohibits a trustee from assigning an "unexpired lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event." Pub. L. No. 102-365, 106 Stat. 982, 984 (1992).

121. H.R. REP. No. 96-1195 § 27(b) (1980).

122. Congress has since passed other amendments to the Bankruptcy Code, specifically to section (c)(1). Again, Congress has provided little insight into the interpretation of section (c)(1) by these amendments. See supra notes 113-15.

123. In 1994, Congress established the National Bankruptcy Review Commission (NBRC). Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106. Congress charged the NBRC with the responsibility of reviewing the Bankruptcy Code and reporting its recommendations for changes. The NBRC delivered its final report to Congress on October 20, 1997. The only recommendations made by the NBRC regarding Section 365 were (1) to change the idea of "assumption" of a contract to "election to perform" and the idea of "rejection" of a contract to "election to breach," in order to be more consistent with terminology used in most state contract actions; (2) to drop the requirement that a contract be "executory" to trigger Section 365; and (3) to create a greater distinction
provides some insight into congressional intent, as well as into the future of Section 365(c)(1).

A recently proposed amendment to Section 365(c)(1) maintained the current "assume or assign" language but added language to allow assumption of all executory contracts:

Section 365(c) of title 11, United States Code, is amended to read as follows:

(1) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A)(i) applicable law excuses a party to the contract or lease from accepting performance to an assignee of the contract or lease, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) the party does not consent to the assumption or assignment; or the 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.

(2) Notwithstanding paragraph (1)(A) and applicable nonbankruptcy law, in a case under chapter 11 of this title, a trustee in a case in which a debtor is a corporation, or a debtor in possession, may assume an executory contract or unexpired lease of the debtor, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties. 124

Congress has recognized some problems inherent in section (c)(1) and attempted to amend them. It appears that the proponents of this amendment intend to permit assumption even in cases where assignment is not permitted. Specifically, the amendment's mention of assumption in subsection (2) of the amendment indicates that, despite applicable nonbankruptcy law or contract provisions, the debtor will be able to assume an executory contract. Given that the preceding sections speak of applicable nonbankruptcy law that limits assignability, it appears that subsection (2) would allow assumption despite applicable nonbankruptcy law limiting assignability. This proposed amendment, had it passed, would have provided some direction to the courts as to congressional intent under section (c)(1), though it lacks some of the simplicity and clarity that should be part of statutory construction. 125

between assumption and assignment of contracts. National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years, Final Report §§ 2.4.1, 2.4.2, 2.4.4 (1997).

The NBRC noted that Section 365 has created a vast number of inconsistent court decisions but focused primarily on maintaining state contract principles within the federal bankruptcy system. The most helpful insight provided by the NBRC, for purposes of this article, is the need for a greater distinction between assumption and assignment, indicating that the NBRC may also feel that the debtor-in-possession's ability to assume contracts should not be linked to the contracts' assignability.


125. Section (c)(2) is not, unfortunately, crystal clear. The section can be read in two ways. The final clause may be interpreted to add a reminder that contractually-based restrictions do not affect the assumability or assignability of a contract. It is unclear, however, whether Congress's initial reference to applicable bankruptcy law that prohibits the mere assumption of the contract (which makes little sense given that nonbankruptcy laws rarely, if ever, concern the assumption in a bankruptcy context) or to applicable nonbankruptcy law that prohibits assignment of the contract. If it is the latter, it is not clear why Congress separates the concepts of applicable nonbankruptcy law and applicable contract provisions, when the treatment under either provision—i.e., ignoring the prohibition—is the same.
The additional language of the proposed amendment—particularly section (c)(2)—permits assumption, yet the proposed amendment has flaws. First, when the new language is read with section (f)(1), the debtor-in-possession could both assume and assign a contract despite a law stating otherwise. If this is truly the intent of Congress, the same result may be achieved by eliminating both sections (c)(1) and (f)(1) of the Code. Statutory construction rules instruct us that each word in a statute is important. The proposed amendment flies in the face of such canons by adding two provisions that together promote policies that Congress almost certainly did not intend by the passage of Section 365.

A second problem arises from the apparent internal inconsistency of sections (c)(1) and (c)(2). Section (c)(1) prohibits "assumption and assignment." As with the old statute, this raises a question of whether Congress intended to prohibit the initial assumption, only the assignment, or both. Inclusion of both terms indicates that they are intended to be prohibited, yet section (c)(2) expressly permits assumption. The same friction occurs if Congress intended only to prohibit the assumption despite applicable nonbankruptcy law and contrary to contractual provisions. The only method of avoiding this friction is to interpret section (c)(1) as prohibiting only the assignment itself, in which case the term "assumption" within section (c)(1) becomes superfluous.

III. TOWARD A WORKABLE SOLUTION

Despite some imperfections in the proposed statute, it provides a good indication of Congress’s current thinking with respect to section (c)(1). It also provides a good starting point for creating a workable model for Section 365. Congress apparently intended to follow the structure of the actual test, slightly modified: assumption of any contract would be permitted—perhaps even if the debtor would prefer to assign it—but assignment would not be permitted if applicable law prohibits such assignment and the non-debtor party does not consent. Although congressional intent provides a sufficient basis for judicial decisions, a clear and unambiguous statute is always preferred.

Before considering the variety of combinations of sections (c)(1) and (f)(1) and the implications thereof, it should be noted that the law applicable to a contract must


127. Congress repeatedly demonstrates its ability to react when decisions of the judiciary fail to reflect the actual intent of Congress. Obviously, when Congress noted that courts were distinguishing between "debtors" and "debtors-in-possession," it made a few technical amendments to the Bankruptcy Code in response. Weaver v. Nizny (In re Nizny), 175 B.R. 934 (Bankr. S.D. Ohio 1994); see Rivers v. Roadway Express, Inc., 511 U.S. 298, 305 n.5 (1993) ("Congress frequently 'responds' to judicial decisions construing statutes, and does so for a variety of reasons. According to one commentator, between 1967 and 1990, the Legislature 'overrode' our decisions at an average of 'ten per Congress.'") (citing William N. Eskridge, Jr., Overriding Supreme Court Statutory Interpretation Decisions, 101 Yale L.J. 331, 338 (1991)).

remain applicable once that contract has been assumed. To hold otherwise would allow a debtor with no intention to assign under the actual construction to assume a contract and then to assign it if the debtor later changes its decision. If the debtor's intent always included assignment, however, the contract would not be permitted to be assumed so long as the actual test was applied correctly. But the debtor should not be permitted to use its innocent intent at the time of assumption to later avoid the strictures of law or contract that do not permit assignment.

As indicated previously, if neither section (c)(1) nor (f)(1) existed, the debtor-in-possession would always be permitted to assume executory contracts, but never permitted to assign them if applicable law or the contract itself prohibited the debtor from doing so. The differences between this result and the results intended by Congress are minimal. First, Congress intended to carve out an exception to apply when the non-debtor party consents to the assignment. Second, Congress intended to permit assignment of contracts when the only restriction on assignment exists within the four corners of the contract to be assigned. If these are Congress's only goals with respect to assumption and assignment of contracts in bankruptcy, the end result could be reached by more narrow means.

If Congress's intent is to prevent assignment of executory contracts when applicable law prohibits such assignment, as appears to be the case, this can be accomplished in one of two ways, depending on whether Congress intends to prevent such assignment directly or indirectly.

The first, and probably the most simple, means of achieving Congress's ends is to delete the relevant language from each of sections (c)(1) and (f)(1). In order to allow the non-debtor's consent to the assignment, a new section (f)(1) could state that, notwithstanding applicable state law prohibiting assignment of the contract, the debtor-in-possession may assign if the non-debtor party consents thereto. The same section of (f)(1) could expressly note that prohibitions on assignment located within a contract are not effective to prevent assignment of the contract. Section (c)(1) would then no longer be necessary because the rules regarding assumption of a contract would not be affected.

An alternative to deleting the current language of sections (c)(1) and (f)(1) altogether is modifying the current sections to more clearly reflect Congress's goals.


130. Congress still has not expressly considered situations such as those in the CFLC and Institut Pasteur cases, where the debtor-in-possession or trustee is transferring the assets of the debtor to a third party as part of its reorganization efforts. In such a situation, the "assumption" of a contract may have the same effect as an "assignment" of the contract in that it forces a non-debtor party to conduct business with a party other than the one with which it contracted. Arguably, to permit assumption in this case, and thus an effectual assignment, upsets the balance of the sections as proposed here by forcing the non-debtor to do something that it would otherwise not have to do. If the debtor-in-possession cannot assign the contract to a third party outright, it should not be permitted to get around prohibition of the assignment by assuming the contract and selling its business to the same third party.

131. Section (f)(1) also includes a prohibition on assignment of "nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event." 11 U.S.C. § 365(f)(1) (1994). This provision is not considered herein and thus the continuing existence of this provision is not questioned. It is interesting to note, however, that under the proposed amendments brought in 1999, this phrase is deleted in its entirety. H.R. 833 §305, 106th Cong. (1999) (deleting all text from the semicolon through the end).
In order to do so, section (c)'s introductory phrase could be amended by deleting the prohibition on assumption, with a corresponding deletion of the assumption restriction in section (c)(1)(B). In this way, assumption would be permitted in any situation, but assignment would be prohibited if applicable law forbids assignment and the non-debtor party refused to consent. This leaves the debtor-in-possession with the option to assume but on notice that assignment will not be tolerated. Rather than having a statute that unnecessarily fetters the initial assumption, the debtor-in-possession will self-police by not attempting to assume contracts that it intends to assign when assignment violates the law or a provision in the contract. Section (f)(1) would be necessary only to establish that assignability of a contract shall not be affected by non-assignability provisions in the contract if laws prohibiting such assignment would be rendered superfluous by section (c)(1)'s express requirements that such laws be enforced absent consent of the non-debtor party.

CONCLUSION

It appears that Congress sought to utilize sections (c)(1) and (f)(1) to prevent the assignment of contracts that are non-assignable by law. While this remains a valuable goal, it can be achieved with more narrow legislation that prohibits assignment when forbidden by another law and absent consent of the non-debtor party, but that still protects the debtor's freedom to assume contracts that it fully intends to fulfill itself. Congress has and should continue to focus on Section 365 as one of the sections of the Bankruptcy Code that currently needs amendment. Until Congress creates a Section 365 that adequately and clearly meets its goals, there is justification in sections (c)(1) and (f)(1), congressional intent, and precedent for permitting assumption of a contract in situations where a debtor-in-possession will perform. To fail to use this interpretation of Section 365 would harm the debtor's reorganization efforts and would benefit no one but the lucky creditor for whom the debtor's bankruptcy serves as a technical excuse for abandoning a contract to which he previously consented.

132. Note that the proposed section (c)(2) would be rendered unnecessary by this construction.
133. One question of interest is whether a party should be allowed to consent to an assignment even though it is forbidden by law. The argument goes: had the law actually wished to provide a party with a right to consent, the legislature passing the law certainly could have included such a provision in the text of the statute. Presumably, by its failure to do so, the legislature expressed an intention that the statute not be waivable by affected parties. Consider, however, that in some circumstances, particularly in questions of procedure, an affected party may be permitted to waive technical legal violations. See Chamberlain v. Thames, 509 S.E.2d 443 (N.C. Ct. App. 1998) (allowing party to waive infraction of rules of appellate procedure).