consent. More specifically, Sunterra acknowledges that *§ 365(c)* is drawn in the disjunctive and, by its plain language, prohibits Sunterra from "assuming *or* assigning," rather than from "assuming *and* assigning," the Agreement. And [HN4] as a settled principle, "unless there is some ambiguity in the language of a statute, a court's analysis must end with the statute's plain language ...." *Hillman v. I.R. S., 263 F.3d 338, 342 (4th Cir. 2001)* (citing *Caminetti v. United States, 242 U.S. 470, 485, 61 L. Ed. 442, 37 S. Ct. 192 (1917))* (the "Plain Meaning Rule").

Sunterra maintains that the Plain Meaning Rule has no application here, relying on [HN5] the two narrow exceptions to application of a statute's plain language. The first such exception, premised on absurdity, exists "when literal application of the statutory language at issue results in an outcome that can truly be characterized as absurd, i. e., that is so gross as to shock the general moral or common sense ...." *Id.* (quoting *Sigmon Coal Co. v. Apfel, 226 F.3d 291, 304) (4th Cir. 2000)* [**18] (internal quotation marks omitted), *aff'd sub nom. Barnhart v. Sigmon Coal Co., 534 U.S. 438, 151 L. Ed. 2d 908, 122 S. Ct. 941 (2002)*. The second exception is premised on legislative intent, and it exists only "when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent ...." *Id.* A reviewing court may look beyond the plain language of an unambiguous statute only when one of these exceptions is implicated. *Sigmon Coal, 226 F.3d at 304*. And we have recognized that "the instances in which either of these exceptions to the Plain Meaning Rule apply 'are, and should be, exceptionally rare.'" *Hillman, 263 F.3d at 342* (quoting *Sigmon Coal, 226 F.3d at 304*).

Sunterra maintains that we should affirm because, although the plain language of the Statute precludes its assumption of the Agreement, application of the literal test produces a result that is *both* absurd and demonstrably at odds with clearly expressed legislative intent. Specifically, Sunterra contends that we should reject the plain meaning of the Statute, and read the disjunctive [**19] "or" as the conjunctive "and," for three reasons: (1) the plain meaning of *§ 365(c)* is absurd because it creates internal inconsistencies therein; (2) the plain meaning of *§ 365(c)* is absurd because it is inconsistent with general bankruptcy policy; and (3) the plain meaning of *§ 365(c)* is incompatible with its legislative history. We examine these contentions in turn.

1.

Sunterra maintains that adherence to the Plain Meaning Rule produces an absurd result because it sets *§ 365(c)* at war with itself and its neighboring statutory provisions. Specifically, Sunterra maintains that a literal reading of *§ 365(c)* implicates the absurdity exception because it renders inoperative and superfluous *§ 365(f)(1)*, [14] as well as the phrase "or the debtor in possession" found in *§ 365(c)(1)(A)*. [*266] Sunterra, relying on *Sutherland Statutory Construction*, contends that we should interpret *§ 365(c)* to minimize any discord among the provisions of *§ 365* and, if possible, construe *§ 365(c)* so that none of *§ 365* is inoperative or superfluous. 2A Norman J. Singer, *Sutherland Statutory Construction* § 46.06 (5th ed. 1992) (" A statute should be construed so that effect is given to all its [**20] provisions, [and] so that no part will be inoperative or superfluous ....").

14 Subsection 365(f)(1) of the Bankruptcy Code provides, in pertinent part, as follows:

> Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract ...of the debtor, or in *applicable law*, that prohibits, restricts, or conditions the assignment of such contract ..., the trustee may assign such contract ...under paragraph (2) of this subsection ....

11 U.S.C. § 365(f)(1) (emphasis added).

a.

In support of its inconsistency contention, Sunterra first maintains that it is absurd to read *§ 365(c)(1)* literally because such a reading renders *§ 365(f)(1)* inoperative and superfluous. The asserted inconsistency between *§ 365(c)(1)* and *§ 365(f)(1)* arises from use of the term "applicable law" in each provision. *In re Catapult, 165 F.3d at 751*. Subsection (c)(1) bars assumption (absent consent) when "applicable law" would [**21] bar an assignment. And subsection (f)(1) provides that, *contrary provisions in applicable law notwithstanding*, executory contracts may be assigned. Of course, the assumption of an executory contract is a necessary prerequisite to its assignment under *§ 365. See 11 U.S.C. § 365(f)(2)(A)* (providing that trustee may assign executory contract only if trustee first assumes such contract in accordance with provisions of *§ 365*). A literal reading of *§ 365(c)(1)*, therefore, initially appears to render *§ 365(f)(1)* inoperative or superfluous.

The Sixth Circuit, in its decision in *In re Magness*, squarely addressed the issue of whether the seemingly warring provisions of *§ 365(c)(1)* and *§ 365(f)(1)* are reconcilable. *In re Magness, 972 F.2d 689, 695 (6th Cir. 1992)*. In so doing, the court acknowledged that "*section*

365(c), the recognized exception to 365(f), appears at first to resuscitate in full the very anti-assignment 'applicable law' which 365(f) nullifies." *Id.* As the court observed, however, the conflict between *§ 365(c)(1)* and *§ 365(f)(1)* is illusory, because "each subsection recognizes an 'applicable law' of markedly different [**22] scope." *Id.*; *accord In re James Cable, 27 F.3d at 537-38*; *In re Lil' Things, Inc., 220 B.R. 583, 590-91 (Bankr. N.D. Tex. 1998)*; *In re Antonelli, 148 B.R. 443, 448 (D. Md. 1992), aff'd without op., 4 F.3d 984 (4th Cir. 1993)*. First, [HN6] *§ 365(f)(1)* lays out the broad rule - "a law that, as a general matter, 'prohibits, restricts, or conditions the assignment' of executory contracts is trumped by the provisions of subsection (f)(1)." *In re Catapult, 165 F.3d at 752* (citing *In re James Cable, 27 F.3d at 538*; *In re Magness, 972 F.2d at 695*). *Section 365(c)(1)*, in contrast, creates a carefully crafted exception to the broad rule, under which "applicable law does not merely recite a general ban on assignment, but instead more specifically 'excuses a party ...from accepting performance from or rendering performance to an entity' different from the one with which the party originally contracted ...." *Id.* Therefore, under the broad rule of *§ 365(f)(1)*, the "applicable law" is the law prohibiting or restricting assignments as such; whereas the "applicable law" under *§* [**23] *365(c)(1)* embraces "legal excuses for refusing to render or accept performance, regardless of the contract's status as 'assignable' ...." *In re Magness, 972 F.2d at 699* (Guy, J., concurring).

[HN7] In order to determine whether a law is overridden by *§ 365(f)(1)* under the foregoing interpretation of *§ 365(f)(1)* and *§ 365(c)(1)*, a court must ask *why* "applicable law" prohibits assignment. *In re Catapult, 165 F.3d at 752* (citing *In re Magness, 972 F.2d at 700* (Guy, J., concurring); *In re Antonelli, 148 B.R. at 448*). And only applicable anti-assignment law predicated [*267] on the rationale that the identity of the contracting party is material to the agreement is resuscitated by *§ 365(c)(1)*. *Id.* Premised on this interpretation, we agree with those Circuits that apply *§ 365(c)(1)* literally - the provisions of *§ 365(c)(1)* are not inevitably set at odds with the provisions of *§ 365(f)(1)*. *In re Catapult, 165 F.3d at 752*; *In re James Cable, 27 F.3d at 538*; *In re Magness, 972 F.2d at 695*.

b.

The second pillar of Sunterra's inconsistency contention is that a literal [**24] reading of *§ 365(c)(1)* creates a conflict within itself. Specifically, Sunterra contends that *§ 365(c)(1)* cannot be read literally because, when so read, the phrase "or the debtor in possession" found in *§ 365(c)(1)(A)* is rendered inoperative and superfluous. Certain bankruptcy courts have agreed with Sunterra's contention, observing, for example, that, "[i] f the directive of *Section 365(c)(1)* is to prohibit assumption whenever applicable law excuses performance relative to *any* entity other than the debtor, why add the words 'or debtor in possession?' The [literal] test renders this phrase surplusage." *In re Hartec Enters., Inc., 117 B.R. 865, 871-72 (Bankr. W.D. Tex. 1990)*; *accord In re Fastrax, Inc., 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991)*; *In re Cardinal Indus., Inc., 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990)*. As the Ninth Circuit has recognized, however, this position is untenable because "[a] close reading of *§ 365(c)(1)* ...dispels this notion." *In re Catapult, 165 F.3d at 752*.

[HN8] By its plain language, *§ 365(c)(1)* addresses *both* assumption and assignment. *Id.* An assumption and an assignment [**25] are "two conceptually distinct events," and the nondebtor must consent to each independently. *Id.* Under the plain language of *§ 365(c)(1)*, therefore, *two independent events* must occur before a Chapter 11 debtor in possession is entitled to assign an executory contract. The debtor in possession must first obtain the nondebtor's consent to assume the contract, and it must thereafter obtain the nondebtor's consent to assign the contract. Therefore, "where a nondebtor consents to the *assumption* of an executory contract, *§ 365(c)(1)* will have to be applied a second time if the debtor in possession wishes to *assign* the contract in question." *Id.* And in the second application of *§ 365(c)(1)*, the issue is whether "applicable law excuses a party from accepting performance from or rendering performance to an entity other than *...the debtor in possession.*" *11 U.S.C. § 365(c)(1)(A)* (emphasis added). We agree, therefore, that the phrase "debtor in possession," far from being rendered inoperative or superfluous by a literal reading of subsection (c)(1), dovetails neatly with the disjunctive language therein: "The trustee may not assume *or* assign [**26] ...." *11 U.S.C. § 365(c)* (emphasis added); *see In re Catapult, 165 F.3d at 752*.

In light of the foregoing, Sunterra's inconsistency contention also lacks merit - the Statute may be read literally without creating an irreconcilable conflict within itself or with its neighboring statutory provisions.

2.

Sunterra next maintains that the bankruptcy court and the district court properly declined to read the Statute literally, correctly concluding that to do so would produce a result that is inconsistent with general bankruptcy policy. Those courts declined to adhere to the Plain Meaning Rule because they concluded that a literal reading of the Statute conflicts with general bankruptcy policy, implicating the absurdity [*268] and intent exceptions to the Rule. Indeed, the district court decided that the result produced by the plain language of the Statute was "quite unreasonable." Opinion at 866. We turn

to Sunterra's contention that the intent and absurdity exceptions apply here.

a.

We first assess whether a conflict between the Statute and general bankruptcy policy implicates the absurdity exception to the Plain Meaning Rule. The district court [**27] refused to read *§ 365(c)* literally because it viewed the result produced by such a reading to be "quite unreasonable." [HN9] In assessing whether a plain reading of a statute implicates the absurdity exception, however, the issue is not whether the result would be "unreasonable," or even "quite unreasonable," but whether the result would be *absurd. See Maryland State Dep't of Educ. v. U.S. Dep't of Veterans Affairs, 98 F.3d 165, 169 (4th Cir. 1996).*

Sunterra maintains that reading *§ 365(c)* literally is absurd because such a reading conflicts with the general bankruptcy policy of fostering a successful reorganization and maximizing the value of the debtor's assets. RCI, on the other hand, asserts that reading *§ 365(c)* literally is not absurd because Congress did not sacrifice every right of a nondebtor party to the reorganization process, and that courts should not assume that "sections of the Bankruptcy Code unfavorable to the debtor were enacted in error." RCI observes that the Bankruptcy Code contains many provisions preserving the rights of nondebtor parties from its general debtor-favorable application (the "Nondebtor Provisions"). *See, e. g., 11 U.S.C. §§ 362* [**28] *(b)* (listing exceptions to automatic stay, authorizing nondebtor parties to exercise their nonbankruptcy rights notwithstanding *§ 362(a)*), 555-557, 559, 560 (protecting rights of nondebtor party under securities contracts, commodities contracts, grain storage contracts, repurchase agreements, and swap agreements, from effects of automatic stay, avoidance powers, and provisions of *§ 365*). In response, Sunterra acknowledges that "anyone looking at *§ 365* appreciates that the Bankruptcy Code balances non-debtor rights with those of a debtorin-possession." Sunterra maintains, however, that most of the Nondebtor Provisions address particular grievances of an identifiable constituency, or were enacted in response to particular court decisions. Sunterra contends, therefore, that the mere existence of such provisions does not make it plausible that, in enacting the Statute, Congress intended to preclude Chapter 11 debtors from assuming executory contracts existing prior to the bankruptcy filing.

To the contrary, the existence of the Nondebtor Provisions makes it plausible that Congress meant what it said in the Statute. And as Judge Traxler observed in *Sigmon Coal*, if it is plausible [**29] that Congress intended the result compelled by the Plain Meaning Rule, we must reject an assertion that such an application is absurd. *Sigmon Coal, 226 F.3d at 308* (holding statute not absurd because, although literal application of statute produced somewhat anomalous result, plausible explanation existed). In these circumstances, application of the Plain Meaning Rule does not produce a result so grossly inconsistent with bankruptcy policy as to be absurd.

b.

We turn next to Sunterra's contention on the intent exception. Affirming the bankruptcy court, the district court decided that the actual test, reading the disjunctive "or" as the conjunctive "and," is "far [*269] more harmonious" with bankruptcy policy than the literal test. Opinion at 866. Relying on *United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)*, the court declined to apply the plain meaning of the Statute, declaring that, "although the plain meaning of statutes must generally be enforced, there is a competing principle that statutes should not be interpreted to produce results that are *unreasonable in light of the drafters' intentions." Id.* The court [**30] then ruled that, because the literal test produced a result that conflicted with the goals of Chapter 11, it need not apply the plain meaning of the Statute. *Id.*

In its *Ron Pair* decision, the Supreme Court held that a statute's "plain meaning should be conclusive except in the 'rare cases [in which] the literal application of [the] statute will produce a result *demonstrably at odds* with the intentions of its drafters.'" *489 U.S. at 242* (quoting *Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571, 73 L. Ed. 2d 973, 102 S. Ct. 3245 (1982))* (emphasis added). Under *Ron Pair*, therefore, a court is obliged to apply the Plain Meaning Rule unless the party contending otherwise can *demonstrate* that the result would be contrary to that intended by Congress. Requiring a demonstration that the plain meaning of a statute is at odds with the intentions of its drafters is a more stringent mandate than requiring a showing that the statute's literal application is unreasonable in light of bankruptcy policy.

Some bankruptcy commentators maintain that sound bankruptcy policy supports adoption of the actual test. *See* 3 Lawrence P. King, *Collier on Bankruptcy* [**31] § 365.06[1][d][iii] (15th ed. revised). As the Supreme Court has repeatedly emphasized, however, Congress is the policymaker - not the courts. *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A., 530 U.S. 1, 13, 147 L. Ed. 2d 1, 120 S. Ct. 1942 (2000)*(citing *Kawaauhau v. Geiger, 523 U.S. 57, 64, 140 L. Ed. 2d 90, 118 S. Ct. 974 (1998); United States v. Noland, 517 U.S. 535, 541-42, n. 3, 134 L. Ed. 2d 748, 116 S. Ct. 1524 (1996); Union Bank v. Wolas, 502 U.S. 151, 162, 116 L. Ed. 2d 514, 112 S. Ct. 527 (1991)).* And, put simply, the mod-

ification of a statutory provision to achieve a preferable policy outcome is a task reserved to Congress. *Id.*

As the Ninth Circuit has recognized, application of the actual test "effectively engrafts a narrow exception onto *§ 365(c)(1)* for debtors in possession, providing that, as to them, the statute only prohibits assumption *and* assignment." *Catapult, 165 F.3d at 754.* Under the actual test, the disjunctive "or" of *§ 365(c)* is read as the conjunctive "and," and the term "assume" is effectively read out of the Statute. No matter how appealing such an interpretation may be from a policy standpoint, "we cannot adopt [such [**32] interpretation] as our own without trespassing on a function reserved for the legislative branch ...." *Sigmon Coal, 226 F.3d at 308.*

In these circumstances, any perceived conflict between a literal reading of the Statute and general bankruptcy policy fails to implicate the intent exception to the Plain Meaning Rule. As we observed in *Sigmon Coal*, [HN10] a federal court must "determine the meaning of the statute passed by Congress, not whether wisdom or logic suggests that Congress could have done better ...." *Id.* We conclude, therefore, that the intent exception is not implicated here.

3.

Sunterra next maintains that the district court should be affirmed because a literal application of the Statute produces [*270] an outcome at odds with legislative history. Importantly, *§ 365*, as it now reads, was added to the Bankruptcy Code in 1984 (the "1984 Act"), and there is no relevant legislative history for the *1984 Act. In re Cardinal, 116 B.R. at 978.* Sunterra contends, however, that the 1984 amendments had their genesis in a 1980 House amendment to an earlier Senate technical corrections bill. That amendment "was accompanied by 'a relatively obscure [**33] committee report,'" *In re Catapult, 165 F.3d at 754* (quoting 1 David G. Epstein, *et al., Bankruptcy* § 5-15 (1992)), which states:

> 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 nature of the contract.

1195, 96th Cong., 2d Sess. § 27(b) (1980) (the "1980 Report"). The First Circuit relied on the 1980 Report in its adoption of the actual test. *Summit Invest. & Dev. Corp. v. Leroux, 69 F.3d 608, 613 (1st Cir. 1995).* Sunterra contends that a literal reading of the Statute is at odds with the 1980 Report, and that this contradiction supports its position. However, legislative history suggesting an interpretation contrary to a statute's plain meaning is not necessarily sufficient to override the Plain Meaning Rule. In *Sigmon Coal*, for example, we declined to rely on legislative history to displace the plain meaning of the statute, because the history consisted [**34] merely of a statement made by a single member of *Congress. 226 F.3d at 306.* Although such legislative history was "worthy of consideration, [it was] simply not the sort of conclusive legislative history that would trump contrary language in the statute." *Id.*

For at least three reasons, the 1980 Report is not conclusive on congressional intent concerning the 1984 Act. First, the 1980 Report relates to a 1980 proposal, which was never enacted, rather than to the 1984 Act; and we have held that courts are not free to replace a statute's plain meaning with "unenacted legislative intent." *United States v. Morison, 844 F.2d 1057, 1064 (4th Cir. 1988).* Second, the 1980 Report was prepared several years prior to enactment of the Statute. *In re Catapult, 165 F.3d at 754.* Finally, it reflects the views of only a single House committee. *Id.* For these reasons, we agree with the Ninth Circuit that the 1980 Report is not "the sort of clear indication of contrary intent that would overcome the unambiguous language of subsection (c)(1)." *Id.* We must decline, therefore, to reject the Statute's plain meaning on this basis.

C.

Finally, [**35] we turn to Sunterra's contention that, in any event, RCI consented to Sunterra's assumption of the Agreement. Pursuant to the Statute, a debtor in possession may assume or assign an executory contract if the nondebtor party consents thereto. *11 U.S.C. § 365(c)(1)(B).* Sunterra maintains that RCI had agreed, in section 5.11 of the Agreement, that it would not prohibit Sunterra from transferring the License to a successor in interest if the transfer included substantially all of Sunterra's assets, and that in so doing, RCI consented to its assumption of the License.

The provision of the Agreement at issue provides that the assignment section of the Agreement shall not preclude the transfer of the License to a successor in interest of substantially all of Sunterra's assets if the assignee agrees in writing to be bound by the License (the "Transfer [*271] Provision"). [15] Sunterra maintains

that RCI had consented, in the Transfer Provision, to permit transfer of the License to a successor in interest under certain circumstances. RCI contends that any consent it provided to Sunterra in the Transfer Provision is irrelevant because, under the Statute, the issue is whether [**36] applicable law prohibited the transfer *irrespective of the provisions of the Agreement.* In support of this proposition, RCI observes that the Statute applies "whether or not such contract ...prohibits or restricts assignments of rights ...." *Id. § 365(c)(1)(A).*

15 The Transfer Provision of the Agreement provides:

> The provisions of this section shall not preclude the transfer of this license to a successor in interest of substantially all of [Sunterra's] assets if the assignee agrees in writing to be bound by this License.

Agreement § 5.11.

RCI's reliance on this aspect of the Statute's language is misplaced. The Transfer Provision does not *prohibit* or *restrict* Sunterra from transferring its rights under the Agreement; the Transfer Provision *favors* assignment - it entitles Sunterra to assign the Agreement without RCI's consent so long as the assignment includes substantially all of Sunterra's assets. Rather than being irrelevant, therefore, the issue of contractual [**37] consent in the Transfer Provision could be determinative of whether the Statute barred Sunterra's assumption. *See In re Midway Airlines, Inc., 6 F.3d 492, 497 (7th Cir. 1993)* (finding proassignment contract language determinative of assignment issue under *§ 365(c)*). Accordingly, we must disagree with RCI that the Agreement, in *permitting* Sunterra to transfer the License to a successor in interest, is irrelevant to whether the Statute precluded Sunterra from assuming or assigning the Agreement.

Finally, RCI maintains that, even if it consented to Sunterra's transfer of the License to a successor in interest under certain circumstances, the Transfer Provision applies only to assignments, and not to assumptions. We agree. The Transfer Provision is set forth in the "Assignment" section of the Agreement, and all other provisions of that section apply, by their terms, *exclusively* to assignments. [16]

16 In support of the proposition that RCI, by virtue of the Transfer Provision, consented to assumption of the Agreement, Sunterra relies on the Seventh Circuit decision in *In re Midway Airlines. 6 F.3d 492 (7th Cir. 1993).* The agreement at issue there, however, explicitly contemplated assumption and assignment in the bankruptcy context. The Transfer Provision, on the other hand, contemplates neither an assignment in the bankruptcy context nor an assumption.

Sunterra also relies on a Louisiana bankruptcy court decision *In re Supernatural Foods, 268 B.R. 759 (Bankr. M.D. La. 2001),* to support the proposition that RCI, by the Transfer Provision, consented to assumption of the Agreement. We are unpersuaded by that decision, however, and we decline to follow it.

[**38] In sum, we draw the following conclusions. RCI consented to Sunterra's assignment of the License to a successor in interest under certain circumstances. The Transfer Provision, however, does not apply to an *assumption* of the Agreement by a Chapter 11 debtor in possession. Because the terms assumption and assignment describe "two conceptually distinct events," *In re Catapult, 165 F.3d at 752,* and because the Transfer Provision pertains to an assignment rather than an assumption, RCI did not consent to Sunterra's assumption of the Agreement. Without RCI's consent, Sunterra was precluded from assuming the Agreement. IV. Pursuant to the foregoing, the bankruptcy court erred, and the district court erred [*272] in affirming the bankruptcy court. We therefore reverse, and we remand for such other and further proceedings as may be appropriate.

REVERSED AND REMANDED

Positive
As of: Feb 07, 2012

In re: FOOTSTAR, INC., et al., Debtors.

Chapter 11, Case No. 04 B 22350 (ASH), (Jointly Administered)

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

323 B.R. 566; 2005 Bankr. LEXIS 361; 53 Collier Bankr. Cas. 2d (MB) 1476

February 16, 2005, Decided

DISPOSITION: Objection by Kmart to the debtors' motion to assume executory contracts was overruled.

CASE SUMMARY:

PROCEDURAL POSTURE: Debtor filed for chapter 11 bankruptcy protection and remained a debtor in possession. Debtor moved to assume their executory contracts with non-movant company pursuant to *11 U.S.C.S. § 365(a)* The company filed objections to the motion and asserted, among other things, that assumption was barred as a matter of law under *11 U.S.C.S. § 365(c)(1)*. The bankruptcy court addressed the objection based on *§ 365(c)(1)*.

OVERVIEW: The debtor operated two distinct business segments. One was a discount and family footwear (discount business) and the other was athletic footwear and apparel (athletic business). The debtor largely divested the athletic business through sales of assets and store closings. What remained of the debtor's operations was a reduced, and profitable discount business which did 95 percent of its sales in the company's stores. The debtor sought to assume the agreements between it and the company which was critical to their ability to reorganize. The bankruptcy court found that *§ 365(c)(1)* was not applicable to the debtor because it was a debtor in possession which sought to assume, but not assign, its non-assignable contract. The bankruptcy court adopted the "actual test" and stated that *§ 365(c)(1)* should be construed in accordance with its "plain meaning." Under *§ 365(c)(1)* a debtor in possession could assume because by the statute's own limitations it could have no consequence or effect as to a debtor in possession which is not an entity other than itself.

OUTCOME: The company's objections to assumption was overruled.

LexisNexis(R) Headnotes

Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
Contracts Law > Types of Contracts > Lease Agreements > General Overview
[HN1] *11 U.S.C.S. § 365(a)* provides that the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. The standard to be applied by a court in determining whether an executory contract or unexpired lease should be assumed is the business judgment test, which is premised upon the debtor's business judgment that assumption would be beneficial to its estate.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts

Contracts Law > Types of Contracts > Executory Contracts
[HN2] See *11 U.S.C.S. § 365(c)(1)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN3] With regard to a bankruptcy proceeding and executory contracts, the great majority of lower courts have taken the view that the courts should apply an "actual test" in construing the statutory language so as to permit assumption where the debtor in possession in fact does not intend to assign the contract.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN4] The United States Court of Appeals for the First Circuit rejects the proposed hypothetical test in Leroux, holding instead that *11 U.S.C.S. § 365(c)* and *(e)* contemplate a case-by-case inquiry into whether the nondebtor party actually was being forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted. Where the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity materially distinct from the prepetition debtor with whom the nondebtor party contracted. Rather, sensitive to the rights of the nondebtor party, the bankruptcy court must focus on the performance actually to be rendered by the debtor-in-possession with a view to ensuring that the nondebtor party will receive the full benefit of its bargain.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
[HN5] The United States Bankruptcy Court for the Southern District of New York holds that *11 U.S.C.S. § 365(c)(1)* can and should be construed in accordance with its "plain meaning" to reach a conclusion which is entirely harmonious with both the objective sought to be obtained in *§ 365(c)(1)* and the overall objectives of the Bankruptcy Code, without construing "or" to mean "and."

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Contracts Law > Debtor & Creditor Relations
Governments > Legislation > Interpretation
[HN6] *11 U.S.C.S. § 365(c)(1)* states that the trustee may not assume or assign. The key word is "trustee." The statute does not say that the debtor or debtor in possession may not assume or assign -- the prohibition applies on its face to the "trustee." Nothing in the Bankruptcy Code prohibits the debtors from assuming agreements. To construe "trustee" in *§ 365(c)(1)* to mean "debtors" or "debtors in possession" would defy the "plain meaning" of the statute as written by Congress and could be characterized as judicial legislation.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > General Overview
Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
[HN7] Nowhere does the Bankruptcy Code define "trustee" as synonymous with "debtor" or "debtor in possession." Quite the contrary, when the Bankruptcy Code refers to both "trustee" and "debtor" (or "debtor in possession") in the same statutory provisions, the two terms are invariably invested with quite different meanings. Indeed, such is the case with *11 U.S.C.S. § 365(c)(1)*, *(e)(1)* and *(2)* and *(f)*. Congress has been quite careful in the use of the terms "trustee" and "debtor" or "debtor in possession", as shown (with precise relevance to this dispute) in the 1984 amendment to *§ 365(c)(1)*.

Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Appointment
Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles
Civil Procedure > Parties > Capacity of Parties > Trustees
[HN8] Under the Bankruptcy Code, the debtor remains the debtor in possession unless and until a trustee is appointed by court order under *11 U.S.C.S. § 1104*. When a trustee is appointed, the debtor is no longer a debtor "in possession" -- the trustee succeeds to all the rights and properties of the debtor, which is thereby displaced from its property interests. The appointment of a trustee ef-

fects a statutory transfer or assignment of the debtor's property, including its contractual relationships, from the debtor to the trustee. *11 U.S.C.S. § 323(a)* states that the trustee in a case under this title is the representative of the estate. *11 U.S.C.S. § 323(b)* states that the trustee in a case under this title has capacity to sue and be sued. Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are completely ousted. The Bankruptcy Code places a trustee in the shoes of the bankrupt corporation and affords the trustee standing to assert any claims that the corporation could have instituted prior to filing its petition for bankruptcy. A debtor's appointed trustee has the exclusive right to assert the debtor's claim.

Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles
Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Eligibility & Qualifications
Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Voidable Transfers > Lien Creditor & Purchaser
[HN9] Under *11 U.S.C.S. § 544(a)(1)*, the trustee stands in the shoes of an assignee for the benefit of all creditors. By *11 U.S.C.S. § 323(a)* the trustee is given full authority to represent the estate and to dispose of the debtor's property that makes up the estate. Upon appointment the trustee steps into the shoes of the debtor and the creditor body as a whole in order to exercise their rights to sue on behalf of the estate.

Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > General Overview
Bankruptcy Law > Reorganizations > Debtors in Possession > Duties
Bankruptcy Law > Reorganizations > Debtors in Possession > Powers & Rights
[HN10] See *11 U.S.C.S. § 1107(a)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Bankruptcy Law > Reorganizations > Debtors in Possession > Powers & Rights
Contracts Law > Debtor & Creditor Relations
[HN11] *11 U.S.C.S. §1107(a)* grants to the debtor in possession all the rights and powers of a trustee. Under this grant, the debtor in possession has the right to assume contracts provided in *11 U.S.C.S. § 365(a)*. The trustee's power to assume under *§ 365(a)* is qualified by *§ 365(c)(1)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
[HN12] The particular limitation in *11 U.S.C.S. § 365(c)(1)*, by its terms, as applied to a debtor in possession, does not prohibit assumption without assignment.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Reorganizations > Debtors in Possession > Powers & Rights
Contracts Law > Debtor & Creditor Relations
[HN13] *11 U.S.C.S. § 365(c)(1)* is quite logical and sensible as written if one construes "trustee", in accordance with its plain meaning, to mean trustee, not debtor in possession. The basic objective of the limitation under *§ 365(c)(1)* is vindication of the right under applicable law of a contract counterparty to refuse to accept performance from or render performance to an entity other than the debtor or the debtor in possession.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
Contracts Law > Debtor & Creditor Relations
[HN14] The constraint on assumption without assignment imposed on a trustee under *11 U.S.C.S. § 365(c)(1)* -- by reason of the fact that a trustee is an entity other than the debtor or the debtor in possession -- by its own terms cannot apply to a debtor in possession, which is obviously not an "entity other than" the debtor in possession. A trustee is an entity other than the debtor or the debtor in possession -- the trustee is an entirely different entity, who has succeeded by operation of the Bankruptcy Code to all the debtor's property including contracts. Since this de facto statutory assignment of the contract to the trustee is in derogation of the basic objective of *§ 365(c)(1)*, it makes perfect sense to say that the trustee may not assume the contract, and also that the trustee may not assign it -- hence, may not assume or assign.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts

Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
Contracts Law > Debtor & Creditor Relations
[HN15] The basic objective of *11 U.S.C.S. § 365(c)(1)* -- to protect the contract counterparty from unlawful assignment of the contract -- simply is not implicated when a debtor in possession itself seeks to assume, but not assign, the contract.

Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
Contracts Law > Debtor & Creditor Relations
[HN16] It is sensible to view the debtor-in-possession as the same entity which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have employed absent the bankruptcy filing.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Reorganizations > Debtors in Possession > Powers & Rights
Contracts Law > Debtor & Creditor Relations
[HN17] *11 U.S.C.S. § 365(c)(1)* limits the trustee's power to assume or assign by confirming rights under applicable law of a contract counterparty. Applying this limitation to the trustee, the trustee cannot either assume or assign because in either case the counterparty would be forced to accept performance by an entity other than the debtor or the debtor in possession. Likewise, applying the limitation to the debtor, a debtor in possession cannot assign because the counterparty would be in the same position. However, also applying the limitation of applicable law to the debtor, the debtor in possession can assume because by the limitation's express terms it can have no consequence or effect as to a debtor in possession, which is not an entity other than itself.

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OPINION BY: Adlai S. Hardin, Jr.

OPINION

[*567] DECISION ON MOTION TO ASSUME EXECUTORY CONTRACTS

Before the Court is the debtors' motion to assume their executory contracts with Kmart Corporation ("Kmart") pursuant to *Section 365(a) of the Bankruptcy Code, 11 U.S.C. § 365(a)*. Kmart has opposed the motion, asserting that assumption is barred (i) as a matter of law under *Section 365(c)(1)*, (ii) by the debtors' breaches of contract and (iii) because the debtors cannot provide adequate assurance of future performance. In addition, Kmart has cross-moved for relief from the automatic [*568] stay so that it may terminate the contracts.

This decision concerns only Kmart's legal objection based on *Section 365(c)(1)*. That objection is overruled as a matter of law.

Jurisdiction

This Court has jurisdiction over these proceedings under *28 U.S.C. 1334(a)* and *157(a)* [**3] and the standing order of referral to Bankruptcy Judges signed by Acting Chief Judge Robert J. Ward on July 10, 1984. These are core proceedings under *28 U.S.C. § 157(b)*.

Background

The debtors filed some 2,529 cases in early March 2004 under Chapter 11 of the Bankruptcy Code. The debtors' Chapter 11 cases have been procedurally consolidated under *Rule 1015(b) of the Federal Rules of Bankruptcy Procedure.* A creditors' committee and an equity committee were appointed in March and June of 2004, respectively.

As of the commencement date the debtors operated two distinct business segments, (i) discount and family footwear, referred to as "Meldisco," and (ii) athletic footwear and apparel, or "Athletic." The debtors have largely divested the Athletic segment of the business through sales of assets and store closings. The debtors also report substantial progress in "streamlining" the Meldisco segment to eliminate unprofitable operations by sales of assets, store closings and termination of the debtors' operation of footwear departments in Gordman's stores and in Federated stores.

What remains of the debtors' operations [**4] is a reduced, and profitable, Meldisco division. Some ninety-five percent or more of the debtors' current revenues are generated from sales of discount family footwear at over 1,500 shoe departments located in Kmart stores.

The governing contract is a so-called "Master Agreement" between debtor Footstar, Inc. ("Footstar") and Kmart effective as of July 1, 1995. Pursuant to the Master Agreement, each shoe department in a Kmart store is operated by a separate "Shoemart Corporation" owned fifty-one percent by Footstar and forty-nine percent by Kmart. Each Shoemart Corporation enters into a "Sub-Agreement" with Kmart which provides that the Shoemart Corporation has the exclusive right to operate a footwear department in the particular Kmart store.

It is the Master Agreement and the Sub-Agreements (collectively, the "Agreements") that the debtors seek to assume. Noting that Kmart assumed these Agreements in its own Chapter 11 case in May 2003, the debtors assert that the Agreements have been and currently are highly profitable for Kmart, and for the debtors themselves. Assumption is critical to the debtors' ability to reorganize. The debtors assert that assumption will enable them to [**5] confirm a plan providing for one hundred percent payment to creditors with equity unimpaired. Failure to assume will likely result in liquidation of the debtors and only partial recovery for creditors.

Discussion

I. *Section 365(a)*

[HN1] *Section 365(a)* provides that the trustee, "subject to the Court's approval, may assume or reject any executory contract or unexpired lease of the debtor." As correctly stated by the debtors: "The standard to be applied by a court in determining whether an executory contract or unexpired lease should be assumed is the business judgment' test, which is premised upon the debtor's business judgment that [*569] assumption would be beneficial to its estate." *See* Debtors' Motion P 16 at page 6 and cases cited there and in P 17.

In this case it is clearly in the debtors' interest to assume the Agreements, and Kmart does not argue to the contrary.

II. *Section 365(c)(1)*

Section 365(c)(1) provides, in pertinent part, as follows:

> [HN2] (c) The trustee may not assume or assign any executory contract . . . if --
>
> > (1) (A) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance [**6] from or rendering performance to an entity other than the debtor or the debtor in possession . . .; and
> >
> > (B) such party does not consent to such assumption or assignment. . .
> >
> > .

The parties have addressed two basic issues in their briefs and oral arguments. The second issue is whether "applicable law" excuses Kmart from accepting performance from or rendering performance to an entity other than the debtors -- to oversimplify, whether the Agreements are non-assignable. [1] Since I conclude that *Section 365(c)(1)* is not applicable to a debtor in possession which seeks to assume, but not assign, its non-assignable contract, I do not reach this second issue.

1 Article 16 of the Master Agreement expressly prohibits assignment.

The threshold issue, as addressed by the parties here and a number of courts, is a question of statutory interpretation -- must the word "or" in the statutory language

"assume or assign" be read literally, *i.e.*, as a disjunctive, or should it be construed in context as the [**7] functional equivalent of the conjunction "and." The issue does not arise if a debtor's purpose in assuming is to assign the contract to a third party. But where the "actual" purpose of the debtor in possession is not to assign the contract but to perform it, or rather, to continue performing it, the issue has divided the courts.

One Circuit Court in two separate decisions, *Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir.), cert. denied, 521 U.S. 1120, 138 L. Ed. 2d 1014, 117 S. Ct. 2511 (1997)* and *Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995)*, and [HN3] the great majority of lower courts [2] have taken the view that the courts should apply an "actual test" in construing the statutory language so as to permit assumption where the debtor in possession in fact does not intend to assign the contract. The First Circuit articulated the "actual test" as follows in *Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d at 493* (citations omitted):

> [HN4] We rejected the proposed hypothetical test in *Leroux*, holding instead that subsections *365(c)* and *(e)* contemplate a case-by-case inquiry into whether the nondebtor party . . . [**8] *actually* was being "forced to accept performance under its executory contract from someone other [*570] than the debtor party with whom it originally contracted." Where the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity *materially* distinct from the prepetition debtor with whom the nondebtor party . . . contracted. Rather, "sensitive to the rights of the nondebtor party . . .," the bankruptcy court must focus on the performance actually to be rendered by the debtor-in-possession with a view to ensuring that the nondebtor party . . . will receive the "full benefit of [its] bargain." (emphasis in original)

[**9] The courts applying the "actual test" reject an interpretation based on a "hypothetical" (but not real) intent to assign the contract in contravention of the balance of the statutory provision. These courts emphasize the fact that a literal interpretation of the disjunctive "or" is utterly incongruent with the objectives of the Bankruptcy Code and would lead to the anomalous result that a debtor in possession would be deprived of its valuable but unassignable contract solely by reason of having sought the protection of the Bankruptcy Court, even though it did not intend to assign it.

Three Circuit Courts have interpreted the statutory language in accordance with its "plain meaning," thereby adopting what has been referred to as the "hypothetical test." *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004)*; *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747 (9th Cir. 1999)*; *In re West Elecs., Inc., 852 F.2d 79 (3d Cir. 1988). See also, In re Catron, 158 B.R. 629 (E.D. Va. 1993)*; *aff'd without op., 25 F.3d 1038 (4th Cir. 1994)*. [3] These [**10] courts disdain to construe the "or" to mean "and" in the phrase "assume or assign," and they apply the language "assume or assign" literally as it is written, reasoning that if the statute as written produces results which seem at odds with the basic objectives of the Bankruptcy Code, the remedy lies with Congress, not the courts.

2 *See, e.g., In re Ontario Locomotive & Indus. Ry. Supplies (U.S.), Inc., 126 B.R. 146 (Bankr. W.D.N.Y. 1991)*; *In re Mirant Corp., 303 B.R. 319 (Bankr. N.D. Tex. 2003)*; *In re Cajun Elec. Members Comm. v. Mabey (In re Cajun Elec. Power Co-op, Inc.), 230 B.R. 693 (Bankr. M.D. La. 1999)*; *In re Lil' Things, Inc., 220 B.R. 583 (Bankr. N.D. Tex. 1998)*; *In re GP Express Airlines, Inc., 200 B.R. 222 (Bankr. D. Neb. 1996)*; *In re American Ship Bldg. Co., Inc., 164 B.R. 358 (Bankr. M.D. Fla. 1994)*; *Texaco Inc. v. Louisiana Land & Exploration Co., 136 B.R. 658 (Bankr. M.D. La. 1992)*; *In re Fastrax, Inc., 129 B.R. 274 (Bankr. M.D. Fla. 1991)*; *In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990)*; *In re Hartec Enters., Inc., 117 B.R. 865 (Bankr. W.D. Tex. 1990), vacated on other grounds, 130 B.R. 929 (W.D. Texas 1991).*

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> The parties have cited *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994)*, *rehearing en banc denied, 38 F.3d 575 (11th Cir. 1994)*, as a fourth case adopting the "hypothetical test." While the Court appears to accept the hypothetical test, without analysis, the actual holding of that case was that *Section 365(c)(1)* was not applicable because "applicable law" did *not* excuse the City of Jamestown from accepting performance from an entity other than the debtor.

I agree with the outcome reached by the majority of the courts, which have adopted the "actual test," but I suggest [**11] a somewhat different focus for analysis of *Section 365*. [HN5] The statute can and should be construed in accordance with its "plain meaning" to reach a conclusion which is entirely harmonious with both the objective sought to be obtained in *Section 365(c)(1)* and the overall objectives of the Bankruptcy Code, without construing "or" to mean "and."

[HN6] *Section 365(c)(1)* states that "the *trustee* may not assume or assign . . ." (emphasis supplied). The key word is "trustee." The statute *does not* say that the debtor or debtor in possession may not assume or assign -- the prohibition applies on its face to the "trustee." In this case there is no trustee. Here, it is the debtors who seek to assume the Agreements. Nothing in the Bankruptcy Code prohibits the debtors from assuming the Agreements. To construe "trustee" in *Section 365(c)(1)* to mean "debtors" or "debtors in possession" would defy the "plain meaning" of the statute as written by Congress and could be characterized as the same sort of judicial [*571] legislation as Kmart condemns in the cases that apply the "actual test" to construe "or" as "and."

[HN7] Nowhere does the Bankruptcy Code define "trustee" as synonymous with "debtor" or "debtor [**12] in possession." Quite the contrary, when the Bankruptcy Code refers to both "trustee" and "debtor" (or "debtor in possession") in the same statutory provisions, the two terms are invariably invested with quite different meanings. Indeed, such is the case with *Section 365(c)(1), (e)(1)* and *(2)* and *(f)*. Congress has been quite careful in the use of the terms "trustee" and "debtor" or "debtor in possession", as shown (with precise relevance to this dispute) in the 1984 amendment to *Section 365(c)(1)*, discussed near the end of this decision.

[HN8] Under the Code, the debtor remains the debtor in possession unless and until a trustee is appointed by court order under *Section 1104*. When a trustee is appointed, the debtor is no longer a debtor "in possession" -- the trustee succeeds to all the rights and properties of the debtor, which is thereby displaced from its property interests. The appointment of a trustee effects a statutory transfer or assignment of the debtor's property, including its contractual relationships, from the debtor to the trustee. *See 11 U.S.C. § 323(a)* ("The trustee in a case under this title is the representative of the estate."); *11 U.S.C. § 323(b)* [**13] ("The trustee in a case under this title has capacity to sue and be sued."); *Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352-53, 85 L. Ed. 2d 372, 105 S. Ct. 1986 (1985)* ("Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are completely ousted.'") (quoting H.R. REP. No. 95-595, pp. 220-21 (1977)); *The Mediators, Inc. v. Manney (In re Mediators, Inc.), 105 F.3d 822, 825-26 (2d Cir. 1997)* ("The Bankruptcy Code places a trustee in the shoes of the bankrupt corporation and affords the trustee standing to assert any claims that the corporation could have instituted prior to filing its petition for bankruptcy."); *Honigman v. Comerica Bank (In re Van Dresser Corp.), 128 F.3d 945, 947 (6th Cir. 1997)* ("A debtor's appointed trustee has the *exclusive* right to assert the debtor's claim." (emphasis original)); *Official Comm. of Unsecured Creditors v. Bechtle (In re Labrum & Doak, LLP), 237 B.R. 275, 293 (Bankr. E.D. Pa. 1999)* ([HN9] "Under *11 U.S.C. § 544(a)(1)*, the trustee stands in the shoes of an assignee for the benefit of all creditors."); COLLIER [**14] ON BANKRUPTCY P 323.01 [1] (15th ed. 2004) ("By *section 323(a)* the trustee is given full authority to represent the estate and to dispose of the debtor's property that makes up the estate."); NORTON, BANKRUPTCY LAW AND PRACTICE 2D § 79:14 (1998) ("Upon appointment the trustee steps into the shoes of the debtor and the creditor body as a whole in order to exercise their rights to sue on behalf of the estate.").

In short, the debtor and the trustee in a Chapter 11 case are entirely different parties. It bears repeating that no provision of the Bankruptcy Code states in words or substance that references in the Code to "trustee" are to be construed to mean "debtor" or "debtor in possession." A basic misconception, in this Court's view, underlies the three Circuit Court decisions adopting the "hypothetical" test, in that all three proceed from the premise, expressed or unstated, that "trustee" as used in *Section 365(c)(1)* means "debtor in possession." *See In re Catapult Entm't, Inc., 165 F.3d 747, 750*, where the Court states, without

citation to the Code, "it is well-established that *§ 365(c)*'s use of the term trustee' includes Chapter 11 debtors in possession," [**15] and *In re West Elecs., Inc., 852 F.2d 79, 82*, where the Court quotes *Section 365(c)*, [*572] including in the quote the bracketed language:

> "(c) The trustee [which includes the debtor in possession [ftn. 1]] . . ." (emphasis supplied).

Footnote 1 referred to in this quotation cites to *Section 1107 of the Bankruptcy Code*, which is indeed a relevant section of the Code for this analysis, but which does not provide in words or substance that "trustee" means or includes "debtor in possession."

Section 1107(a) defines the "rights, powers, and duties of debtor in possession." It states:

> [HN10] (a) Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

[HN11] *Section 1107(a)* thus grants to the debtor in possession "all the rights . . . and powers . . . of [**16] a trustee. . . ." Under this grant, the debtor in possession has the right to assume contracts provided in *Section 365(a)*. Since the *trustee's* power to assume under *Section 365(a)* is qualified by *Section 365(c)(1)*, however, the critical language in *Section 1107* for purposes of this dispute is the prefatory clause "subject to any limitations on a trustee. . . ."

Consistent with the prefatory clause in *Section 1107(a)*, many decisions have held that various statutory limitations on the powers of a Chapter 11 trustee apply to debtors in possession. For example: *Harvis Trien & Beck, P.C. v. Federal Home Loan Mortg. Corp. (In re Blackwood Assocs., L.P.), 153 F.3d 61, 67 (2d Cir.* [*573] *1998)* (applying the limitation in *363(c)(2)* to a debtor in possession that cash collateral cannot be used, sold, or leased unless entities with interest consent or the court authorizes it); *Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.), 907 F.2d 1430, 1440-41 (4th Cir. 1990)* (same); *Eagle Ins. Co. v. Bankvest Capital Corp. (In re Bankvest Capital Corp.), 360 F.3d 291, 295 (1st Cir.), cert. denied, 124 S.Ct. 2874, 159 L. Ed. 2d 776 (2004)* [**17] (applying the limitation in *365(b)(1)* to a debtor in possession that a contract cannot be assumed unless the debtor in possession cures the default, compensates for any pecuniary loss resulting from default, and provides adequate protection of future performance); *South St. Seaport Ltd. P'ship v. Burger Boys, Inc. (In re Burger Boys, Inc.), 94 F.3d 755, 761 (2d Cir. 1996)* (same); *Pieco, Inc. v. Atlantic Computer Sys., Inc. (In re Atlantic Computer Sys., Inc.), 173 B.R. 844, 857 (S.D.N.Y. 1994)* (same); *In re United Airlines, Inc., 368 F.3d 720, 722 (7th Cir. 2004)* (applying the limitation in *365(c)(2)* to a debtor in possession that an executory contract or unexpired lease cannot be assumed if it is a contract to make a loan or extend other debt financing); *Tully Constr. Co. v. Cannonsburg Envtl. Assocs., Ltd. (In re Cannonsburg Envtl. Assocs., Ltd.), 72 F.3d 1260, 1265 (6th Cir. 1996)* (same); *TransAmerica Commer. Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089, 1092 (9th Cir. 1991)* (same); *Watts v. Pennsylvania Housing Finance Co. (In re Watts), 876 F.2d 1090, 1095 (3d Cir. 1989)* [**18] (same); *In re Teligent, Inc., 268 B.R. 723, 732-33 (Bankr. S.D.N.Y. 2001)* (same); *BNY Fin. Corp. v. Masterwear Corp. (In re Masterwear Corp.), 229 B.R. 301, 308 (Bankr. S.D.N.Y. 1999)* (same); *Hart Envtl. Mgmt. Corp. v. Sanshoe Worldwide Corp. (In re Sanshoe Worldwide Corp.), 993 F.2d 300, 302 (2d Cir. 1993)* (applying the limitation in *365(c)(3)* to a debtor in possession that a lease of nonresidential real property cannot be assumed if it has been terminated under applicable nonbankruptcy relief prior to the order for relief); *In re 611 Sixth Ave. Corp., 191 B.R. 295, 298 (Bankr. S.D.N.Y. 1996)* (same). In each of these cases, the statutory limitation in question, such as the requirement in *Section 365(b)* to cure defaults and provide adequate assurance of future performance, or the requirement in *Section 363(c)(2)* to not use, sell, or lease cash collateral unless entities with interest consent or the court authorizes it, applies equally to debtors in possession as a matter of simple logic and common sense. In each such case, there is no basis to distinguish between a trustee and a debtor in possession with respect to the particular [**19] statutory limitation.

There is no doubt that the prefatory clause in *Section 1107* applies to the limitation on assumption and assignment prescribed in *Section 365(c)(1)*. However, merely substituting "debtor in possession" for "trustee" in *Section 365(c)(1)* does not illuminate the limitation set forth by Congress in *Section 365(c)(1)*, nor how that limitation should, or even can, be applied to a debtor in possession under *Section 1107*. The question presented is whether the limitation in *Section 365(c)(1)* as *applied to*

the debtor in possession prohibits assumption without assignment. Analysis shows that [HN12] this particular limitation, by its terms, as applied to a debtor in possession, does not prohibit assumption without assignment.

Preliminarily, it should be noted that [HN13] *Section 365(c)(1)* is quite logical and sensible as written if one construes "trustee", in accordance with its plain meaning, to mean trustee, not debtor in possession. The basic objective of the limitation under *Section 365(c)(1)* is vindication of the right under applicable law of a contract counterparty to refuse to accept performance from or render performance to an entity "*other than* the debtor or the debtor [**20] in possession." A trustee *is* an "entity other than the debtor or the debtor in possession" -- the trustee is an entirely different entity, who has succeeded by operation of the Bankruptcy Code to all the debtor's property including contracts. Since this *de facto* statutory assignment of the contract to the trustee is in derogation of the basic objective of *Section 365(c)(1)*, it makes perfect sense to say that the trustee may not assume the contract, and also that the trustee may not assign it -- hence, "may not assume *or* assign." But it makes no sense to read "trustee" to mean "debtor in possession" either in context of the statutory provision or under the plain meaning canon, and nothing in the Bankruptcy Code justifies such a reading. Indeed, where the debtor seeks to assume but not assign a contract, to read the statute to say that "the *debtor in possession* may not assume . . . any contract if . . . applicable law excuses [the counterparty] . . . from accepting performance from or rendering performance to an entity *other than the debtor in possession* . . ." would render the provision a virtual oxymoron, since mere assumption (without assignment) would *not* [**21] compel the counterparty to accept performance from or render it to "an entity other than" the debtor.

The same analysis compels the conclusion that [HN14] the constraint on assumption without assignment imposed on a trustee under *Section 365(c)(1)* -- by reason of the fact that a trustee *is* an "entity other than the debtor or the debtor in possession" -- by its own terms cannot apply to a debtor in possession, which is obviously not an "entity other than" the debtor in possession. [HN15] The basic objective of *Section 365(c)(1)* -- to protect the contract counterparty from unlawful assignment of the contract -- [*574] simply is not implicated when a debtor in possession itself seeks to assume, but not assign, the contract. [4]

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> The Supreme Court has laid to rest the notion that a debtor in possession should be deemed a different entity than the prepetition debtor. *N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 528, 79 L. Ed. 2d 482, 104 S. Ct. 1188 (1984)* (holding that [HN16] "it is sensible to view the debtor-in-possession as the same entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have employed absent the bankruptcy filing").

[**22] This conclusion comports with the "plain meaning" of all of the words employed in *Section 365(c)(1)* and gives full effect to that section and to the provisions and objectives of Chapter 11, which are designed to foster, not frustrate, the reorganization and the economic well-being of debtors in possession. And it avoids the perverse and anomalous consequence of the "hypothetical test" rule under which a debtor may lose the benefit of a non-assignable contract vital to its economic future solely because it filed for bankruptcy.

Finally, there is legislative history supporting the proposition that Congress did not intend *Section 365(c)(1)* to preclude the debtor in possession from assuming its non-assignable contracts. The language of *Section 365(c)(1)(A)*, as originally passed in 1978, read:

> (c) 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* [**23] *of such contract or lease*, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties . . .

Pub. L. No. 95-598 (1978) (emphasis supplied). In 1980, there was a proposed bill to amend the Bankruptcy Code, the Bankruptcy Technical Correction Act of 1980. H.R. REP. No. 1195, 96th Cong., 2d Sess. (1980). The Committee on the Judiciary published a report explaining the reasoning for the suggested changes but concluding that "it is also premature to change a statute that has been in effect for such a short period of time where it is not really known to what extent these concerns are other than transitory." *Id.* That report included a proposed amendment to *Section 365(c)(1)(A)* that would *inter alia* replace "the trustee" with "an entity other than the debtor or the debtor in possession." *Id.* The report explained:

> 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 [**24] of the personal nature of the contract.

Id. § 27(b).

Congress did not pass an amendment modifying *Section 365* until 1984. Pub. L. No. 98-353 (1984). By that amendment Congress adopted the change in language quoted above exactly as proposed in 1980 and replaced "the trustee" with "an entity other than the debtor or the debtor in possession." [5]

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> The language of *Section 365(c)(1)(A)* as it reads today resulted from a *second amendment* in 1986. PUB. L. No. 99-554 (1986). That amendment merely struck the superfluous language "or an assignee of such contract or lease" from *Section 365(c)(1)(A)* and, as such, has no bearing on the current issue.

[*575] Although legislative history alone may not be the touchstone for statutory interpretation, in this Court's view there is no sound reason to ignore this 1980 Judiciary Committee Report. The Report clearly addressed the very amendment adopted in 1984 and just as clearly expressed that Committee's view as to the inapplicability of *Section 365(c)(1)* to [**25] a debtor in possession's assumption. *Cf. In re Sunterra Corp., 361 F.3d at 269-70.*

In any event, this legislative history does no more than confirm the conclusion which is compelled by both the plain meaning of the statute as it is written and its logic and purpose. [HN17] *Section 365(c)(1)* limits the trustee's power to assume or assign by confirming rights under applicable law of a contract counterparty. Applying this limitation to the trustee, the trustee cannot either assume or assign because in either case the counterparty would be forced to accept performance by "an entity other than the debtor or the debtor in possession." Likewise, applying the limitation to the debtor, a debtor in possession cannot assign because the counterparty would be in the same position. However, also applying the limitation of applicable law to the debtor, the debtor in possession *can* assume because by the limitation's express terms it can have no consequence or effect as to a debtor in possession, which is *not* "an entity other than" itself.

Conclusion

For the reasons stated above, Kmart's objection to assumption based on *Section 365(c)(1)* as a matter of law is overruled. [**26] Further proceedings will be scheduled promptly to resolve factual issues relating to the debtors' alleged breaches of contract and issues arising under *Section 365(b)(1)* relating to cure amounts and adequate assurance of future performance. Kmart's cross-motion for relief from the automatic stay will be considered in the context of these further proceedings.

Dated: White Plains, NY

February 16, 2005

Adlai S. Hardin, Jr.

U.S.B.J

SUPPLEMENT TO FEBRUARY 16, 2005 DECISION ON MOTION TO ASSUME EXECUTORY CONTRACTS

Kmart Corporation ("Kmart") has moved for reargument of this Court's decision dated February 16, 2005 (the "February 16 Decision" or "Decision") overruling Kmart's legal objection based on *Section 365(c)(1) of the Bankruptcy Code* to the debtors' motion to assume their executory contracts with Kmart. This constitutes a supplement to the February 16 Decision and will address only the concerns raised by Kmart in its motion for reargument.

Kmart argues that the February 16 Decision "overlooks and contradicts *United States Brass & Copper Co. v. Caplan (In re Century Brass Prods.), 22 F.3d 37 (2d*

Cir. 1994) [**27] " (hereafter *"Century Brass").* The February 16 Decision did not cite *Century Brass,* [1] but it certainly did not overlook or contradict the proposition for which that case stands. The February 16 Decision did cite two Second Circuit opinions and eleven more decisions by other circuit courts and lower courts for the proposition, as stated in the February 16 Decision, that "consistent with the prefatory clause in *Section 1107(a),* many decisions have held that various statutory limitations on the powers of a Chapter 11 trustee apply to debtors in possession." This is precisely the substance of the Court of Appeals' holding in *Century Brass.* It is a holding with which this Court expressly armed in the February 16 Decision, stating:

> There is no doubt that the prefatory clause in *Section 1107* applies to the [*576] limitation on assumption and assignment prescribed in *Section 365(c)(1).*

1 Neither did Kmart in its briefing on the motion.

[**28] Kmart entirely misstates this Court's holding and analysis in the February 16 Decision when it asserts:

> The Decision held that because *section 365(c)(1) of the Bankruptcy Code* provides that "the trustee" may not assume non-assignable executory contracts, it does not prevent a "debtor in possession" from assuming such contracts.

That is not at all what this Court held, and the rationale for the Decision was not "because *section 365(c)(1)* provides that 'the trustee' [as opposed to the debtor] may not assume non-assignable executory contracts." The rationale for the Decision is that the substantive limitation in *Section 365(c)(1)* by its terms becomes operative only *'if'* the non-debtor is excused by applicable law from further contractual relations with an entity *"other than"* the debtor, and assumption by a debtor without assignment does not involve an entity other than the debtor. Applicable law does not excuse a non-debtor from performance with a debtor who assumes but does not assign.

The fundamental defect in Kmart's theory of the case (and that of the three circuit courts that have adopted [**29] the "hypothetical test") is that it focuses solely on the introductory language of *Section 365(c)* "the trustee may not assume or assign," and ignores the fact that the prohibition applies only **'if'** the substantive limitation in subsection (1)(A) excuses performance by the non-debtor. As shown in *Century Brass,* analysis is required to determine whether, and how, the substantive limitation on the trustee may be applied through *Section 1107(a)* to a debtor in possession when there is no trustee.

The February 16 Decision analysis begins with the proposition that, both as a matter of fact and statutory law under the Bankruptcy Code, the "trustee" and the "debtor in possession" are not synonymous. Giving recognition to this unarguable fact and the plain meaning of the statutory provision, *Section 365(c)(1)* on its face does not apply to a debtor in possession. It is only through the prefatory clause in *Section 1107(a)* that the limitations in *Section 365(c)* and other sections become applicable to a debtor in possession. The point was aptly expressed in *Young v. Paramount Communs. (In re Wingspread Corp.), 186 B.R. 803, 805 (S.D.N.Y. 1995)* [**30] where the District Court said that *"Century Brass* is better read as primarily interpreting *§ 1107(a),* and only through it *§ 546(a)(1),*" and that a statutory imitation on the power of a trustee is applicable to a debtor in possession only "through the lens of *§ 1107.*"

The February 16 Decision proceeds to analysis of *Section 1107(a)* and concludes that the prefatory clause in *Section 1107(a)* does apply to the limitation on assumption and assignment prescribed in *Section 365(c)(1),* consistent with the holding of the Court of Appeals for the Second Circuit in *Century Brass,* as well as the two other decisions of the Second Circuit and the eleven additional cases which were cited in the Decision.

But that conclusion does not end the analysis. The February 16 Decision goes on to state: "The question presented is whether the limitation in *Section 365(c)(1) as applied to the debtor in possession* prohibits assumption without assignment."

As the Decision then elucidates, the limitation prescribed in [**31] *Section 365(c)(1)* exists only "if" a counter parry to a contract is excused by applicable law from accepting performance from or rendering performance to "an entity *other than* the debtor or the debtor in possession." Thus, through *Section 1107(a), Section 365(c)(1)* does indeed [*577] apply so as to bar a debtor in possession from assuming in order to assign its contract to another entity. But this limitation cannot by its express terms be construed to bar the right of a debtor in possession to assume without assignment, since without assignment there is no "entity other than the debtor in possession" involved with the contract. To hold otherwise would conflict with both the plain meaning and the intent of the statute as written by Congress.

This Court's analysis is entirely consistent with that of the Second Circuit in *Century Brass*. The question in that cast was whether the two-year limitation in *Section 546(a)(1)* on the power to commence avoidance actions under Chapter 5 applied to debtors in possession. The limitation period, as the statute then read, [2] was "two years after the [**32] appointment of a trustee." The debtor in possession in *Century Brass* argued, based on the "plain meaning" of the statute as then written, that the limitation could not apply because a debtor in possession is not appointed and therefore could not be subject to the limitation which ran from the time of "appointment." The Court of Appeals concluded that by reason of *Section 1107(a)* the two-year limitation applied to the debtor in possession and began to run when the debtor filed its petition.

> 2 *Section 546(a)(1)* has since been amended to provide that the limitation period is two years after the later of the entry of the order for relief or one year after the appointment or election of a trustee if such appointment or election occurs before expiration of the two-year period.

Quoting the reference in *Century Brass* to legislative history indicating that *Section 1107(a)* "places a debtor in possession in the shoes of a trustee *"in* [**33] *every way"* and that *Section 1107* is "all encompassing," Kmart asserts that any limitation on a trustee must apply to a debtor in possession. That indeed is what *Section 1107(a)* states ("subject to any limitations on a trustee"), and both the Circuit Court in *Century Brass* and this Court in the February 16 Decision held that a debtor in possession is subject to all substantive limitations on a trustee. But the Court of Appeals in *Century Brass* also recognized, as did Congress in the Bankruptcy Code, that a trustee is not the same as a debtor in possession in point of fact and law, and consequently that particular statutory provisions will apply differently to each. Hence, the Court of Appeals held that the two-year limitation for a debtor in possession commenced upon the order for relief, as opposed to the statutory commencement of the appointment date for a trustee. In rejecting a literalist approach to *Section 546(a)(1)*, the Second Circuit focused on the *substantive* limitation set forth in the statute *as applied to the debtor in possession* and recognized that the result may vary from the [**34] literal language of the statute because the statute was written in the perspective of the trustee. *"Century Brass* does not foreclose a literal interpretation of *§ 546* where it is directly applicable; it only requires a non-literal interpretation where *§ 546* is applicable through the lens of *§ 1107." In re Wingspread Corporation, 186 B.R. at 805.*

The February 16 Decision follows *Century Brass* in focusing on the substantive limitation in *Section 365(c)(1)*. But in this case no deviation from the literal language of subsection (c)(1) is required to implement the intent of Congress and the plain meaning of the statute. The statute bars assumption or assignment but only "if" the non-debtor would be excused from continuing performance with an entity "other than the debtor or debtor in possession." The Decision applies the language of the substantive [*578] limitation to a debtor in possession and concludes that this particular limitation on the trustee's power to "assume or assign" does not bar a debtor in possession who assumes but does not assign its contract, since [**35] a trustee is an "entity other than" the debtor, but the debtor in possession is not. Nothing in logic, legislative history, the Bankruptcy Code, *Century Brass* or any other decision of the Second Circuit compels or countenances the use of a fiction (that a debtor in possession is "an entity other than the debtor or the debtor in possession") in applying *Section 365(c)(1)* to a debtor in possession which assumes but does not assign its contract.

Accordingly, upon reargument the Court adheres to its prior Decision.

Dated: White Plains, NY

March 31, 2005

/s/ Adlai S. Hardin, Jr.

U.S.B.J.

Caution
As of: Feb 07, 2012

In re: ANDRES HERNANDEZ and DOROTHY HERNANDEZ, Debtors.

Chapter 11, Case No. 99-01192-YUM-EWH

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF ARIZONA

287 B.R. 795*; *2002 Bankr. LEXIS 1692

December 12, 2002, Decided
December 12, 2002, Filed

PRIOR HISTORY: *In re Hernandez, 2002 Bankr. LEXIS 1701 (Bankr. D. Ariz., Sept. 9, 2002)*

DISPOSITION: Memorandum decision; stay lifted.

CASE SUMMARY:

PROCEDURAL POSTURE: Involuntary petitions under Chapter 11 were filed against the debtors. The creditors moved to compel rejection of an executory license agreement pursuant to *11 U.S.C.S. § 365(d)(2)*, and to lift the stay pursuant to *11 U.S.C.S. § 362* to permit them to terminate the agreement. The court previously held that the debtors could not assume the agreement. However, the court deferred ruling on the "ride-through" issue raised by the debtors.

OVERVIEW: If the court determined that the agreement had to be rejected, then the debtors would have forfeited their rights under the agreement simply by consenting to an order for relief after an involuntary bankruptcy case was initiated against them. On the other hand, had the debtors not been forced into bankruptcy, their rights under the agreement could have been terminated only after a material breach. Therefore, the debtors had fewer rights in bankruptcy than outside of bankruptcy. The court found such a result to be inconsistent with the principles of Chapter 11. At the same time, the rights afforded under Chapter 11 to non-debtor parties to executory contracts were entitled to protection. The court found that the ride-through doctrine for executory contracts applied any time a debtor failed to address such a contract, whether that failure was inadvertent or intentional. In addition, the treatment of executory contracts inside of a Chapter 11 plan was optional. Requiring the debtors to reject the agreement would have resulted in significant harm to the debtors and their creditors which outweighed the harm caused to the creditors at issue.

OUTCOME: The debtors were not required to reject the agreement, but instead were permitted to file an amended plan which permitted the agreement to ride through the case. However, the automatic stay was lifted with respect to the agreement.

LexisNexis(R) Headnotes

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Contracts Law > Debtor & Creditor Relations
[HN1] A debtor cannot assume a contract which falls under the provisions of *11 U.S.C.S. § 365(c)(1)* unless it can be demonstrated that the contract could be assigned to a hypothetical third party, even if the debtor has no intention of assigning the contract.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Contracts Law > Types of Contracts > Executory Contracts
Contracts Law > Types of Contracts > Lease Agreements > General Overview
[HN2] See *11 U.S.C.S. § 365(c)(1)*.

Contracts Law > Breach > General Overview
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN3] Rejection of an executory contract constitutes a breach of that contract as of the date immediately preceding the filing.

Bankruptcy Law > Reorganizations > Plans > Contents > Discretionary Provisions
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN4] The treatment of executory contracts by a Chapter 11 debtor is governed by *11 U.S.C.S. §§ 1123* and *365*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Bankruptcy Law > Reorganizations > Plans > Contents > Discretionary Provisions
Contracts Law > Types of Contracts > Executory Contracts
[HN5] See *11 U.S.C.S. § 1123(b)(2)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Contracts Law > Types of Contracts > Executory Contracts
[HN6] See *11 U.S.C.S. § 365(a)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN7] The "ride-through" doctrine is purely a creature of case law; the doctrine is not provided for in *11 U.S.C.S. §§ 1123* or *365*, or anywhere else in the Bankruptcy Code. Simply stated, the ride through doctrine provides that executory contracts that are neither affirmatively assumed or rejected by the debtor under *11 U.S.C.S. § 365*, pass through the bankruptcy unaffected.

Bankruptcy Law > Practice & Proceedings > General Overview
[HN8] Theories developed under the Bankruptcy Act apply to cases decided under the Bankruptcy Code.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Types of Contracts > Executory Contracts
[HN9] Ride-through of executory contracts in a bankruptcy case is a well-recognized and established legal doctrine.

Bankruptcy Law > Reorganizations > Plans > Contents > Discretionary Provisions
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN10] Ride-through of an executory contract in a bankruptcy case is not an option for the treatment of an executory contract under *11 U.S.C.S. § 365*. *Section 365* presents the debtor with two express options--assumption or rejection. Ride-through is not an affirmative choice available to the debtor under *§ 365*. Therefore, if an executory contract is addressed in a Chapter 11 plan pursuant to *11 U.S.C.S. § 1123(b)(2)*, it must be either assumed or rejected. The debtor may not treat an executory contract in a Chapter 11 plan and at the same time, effect a ride-through of that contract--these are inconsistent proposals. In addition, ride-through is not a de facto assumption. A contract that is not assumed is not entitled to the benefits afforded by *11 U.S.C.S. § 365* such as insulation from ipso facto provisions or the right to cure arrearages within a reasonable period of time notwithstanding what the payment terms of the contract may be. Unless and until an executory contract is assumed, the debtor is not afforded any of the rights granted under *§ 365(e)*. The ride-through theory allows the debtor to retain the benefits as well as the burdens of the contract, not the benefits of assumption. Consequently, ride-through is not the equivalent of formal assumption under *§ 365*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Bankruptcy Law > Discharge & Dischargeability > Reorganizations
[HN11] The logical result of a ride-through contract is that claims which arise from the breach of such a contract cannot be discharged through a Chapter 11 plan.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN12] Almost every executory contract to which a debtor is a party is affected by the filing of a bankruptcy case because of the imposition of the *11 U.S.C.S. § 362* automatic stay.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN13] The ride-through doctrine for executory contracts in bankruptcy cases applies any time a debtor fails to address an executory contract, whether that failure is inadvertent or intentional.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
Governments > Legislation > Interpretation
[HN14] When interpreting the Bankruptcy Code, the court must begin with the statutory language. In the context of interpreting the Code, the plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters. In addition, *11 U.S.C.S. § 365(d)(2)* must be interpreted in the context of the broad purposes of the entire Code.

Contracts Law > Types of Contracts > Executory Contracts
Contracts Law > Types of Contracts > Lease Agreements > General Overview
Real Property Law > Landlord & Tenant > Lease Agreements > Residential Leases
[HN15] See *11 U.S.C.S. § 365(d)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN16] *11 U.S.C.S. § 365(d)(2)* provides that a debtor may assume or reject an executory contract. The use of the term may (as opposed to the term shall) indicates the permissive nature of the section. Therefore, according to the plain meaning of *§ 365(d)(2)*, a debtor may or may not assume or reject an executory contract.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
Civil Procedure > Judgments > Relief From Judgment > General Overview
Contracts Law > Types of Contracts > Lease Agreements > General Overview
[HN17] See *11 U.S.C.S. § 365(d)(4)*.

Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
Contracts Law > Types of Contracts > Lease Agreements > General Overview
[HN18] Because *11 U.S.C.S. § 365(d)(4)* provides for the automatic rejection of commercial leases that are not assumed, a debtor is in essence forced to either assume or reject the lease--electing not to address the lease is not an option.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Bankruptcy Law > Reorganizations > Plans > Contents > Discretionary Provisions
Contracts Law > Types of Contracts > Executory Contracts
[HN19] See *11 U.S.C.S. § 1123(b)(2)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts

[HN20] As with *11 U.S.C.S. § 365(d)(2)*, the language of *11 U.S.C.S. § 1123(b)(2)* is permissive in nature, and the debtor may choose not to address an executory contract under a Chapter 11 plan. Thus, the treatment of executory contracts inside of a Chapter 11 plan is optional.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN21] *11 U.S.C.S. § 365(d)(2)* establishes that the court, upon the request of a non-debtor party to the contract, may order the trustee to determine within a specified period of time whether to assume or reject the contract. The operative language of the statute is permissive. According to the statutory language, the court has discretion to determine whether or not to grant the request of the non-debtor party and direct the debtor to act.

Bankruptcy Law > Reorganizations > Plans > Eligible Proponents
Contracts Law > Debtor & Creditor Relations
Contracts Law > Types of Contracts > Executory Contracts
[HN22] The four part test set out in Mauro for determining whether a bankruptcy debtor should be permitted to delay the decision to assume or reject an executory contract serves as a useful guide for analyzing when ride through of an executory contract should be permitted. The four factors are: (1) the damage that the other party to the contracts would suffer, beyond compensation available under the Bankruptcy Code; (2) the importance of the contracts to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusivity period has terminated.

Bankruptcy Law > Reorganizations > Plans > Contents > General Overview
[HN23] Chapter 11 plans which depend for funding on the outcome of litigation may be confirmable under the right circumstances.

COUNSEL: [**1] For ANDRES S. HERNANDEZ, Debtor: JOHN A WEIL, LAW OFFICE OF JOHN A. WEIL, YUMA, AZ.

For Great Northern Equipment Company: Jeffery R. Gilles, Esq., Paul W. Moncrief, Esq., Lombardo & Gilles, PLC, Salinas, CA.

JUDGES: EILEEN W. HOLLOWELL, UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: EILEEN W. HOLLOWELL

OPINION

[*796] **MEMORANDUM DECISION**

In this case, the court must determine whether it must issue an order directing [*797] the Debtors to reject an unassumable executory contract pursuant to *11 U.S.C. § 365(d)(2)* upon the request of the non-debtor party to the contract. For the reasons set forth below, the court holds that: (1) the Debtors are not required to reject the contract, but may instead elect not to address the contract in their Chapter 11 plan; (2) the contract may ride-through the bankruptcy; and (3) the automatic stay is lifted with respect to the contract.

PROCEDURAL HISTORY

On September 9, 2002, the court issued a Memorandum Decision holding that the Debtors, Andres and Dorothy Hernandez could not assume a License Agreement dated January 17, 1997 (the Agreement). The Agreement granted Andres Hernandez, Steve Wolfe and Andrew Smith "exclusive" licenses to use [**2] a patented technology which extends the shelf life of lettuce. [1] The September 9, 2002, decision sets forth, the factual history surrounding the execution of the Agreement and the court will not repeat that history in this decision. However, a brief review of the proceedings in this case is warranted:

> 1 Steven Wolfe and his related entities are collectively referred to as the Monterey Leaf Creditors.

In November of 1999, involuntary petitions under Chapter 11 were filed against the Debtors, Andres and Dorothy Hernandez. Orders for relief in both cases were entered in January of 2000, and the cases were consolidated shortly thereafter. In February of 2001, the Debtors filed a Plan of Reorganization which provided for the assumption of the Agreement. Both the Monterey Leaf Creditors as well as the licensor under the Agreement, Great Northern Equipment Company (Great Northern), opposed confirmation of the Debtors' Plan. [2]

> 2 Great Northern and the Monterey Leaf Creditors are hereinafter collectively referred to in this decision as the Objectors.

[**3] In their Objections to the Debtors' Plan, the Objectors contended that the Ninth Circuit's holding in *In re Catapult Entertainment, Inc., 165 F 3d 747 (9th Cir. 1999)* bars the Debtors from assuming the Agreement. In Catapult, a case involving a non-exclusive software license, the Ninth Circuit held that [HN1] a debtor cannot assume a contract which falls under the provisions of *11 U.S.C. § 365(c)(1)* unless it can be demonstrated that the contract could be assigned to a hypothetical third party, even if the debtor has no intention of assigning the contract. [3] The Objectors further asserted that, if the Agreement could not be assumed, it must be deemed rejected.

3 *11 U.S.C. § 365(c)(1)* provides as follows:

"(c) [HN2] The 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 --

(1)(A) applicable law excuses a party, other than the debtor, to such 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;"

[**4] At the June 14, 2002 hearing on Plan Confirmation, the court requested additional briefing from the parties on the applicability of Catapult to the Agreement, which by its terms purported to grant Hernandez an exclusive license. In their brief, the Debtors presented several arguments in support of their effort to assume the Agreement. The Debtors also raised an alternative argument in support of confirmation of their Plan. According to the [*798] Debtors, even if assumption of the Agreement was not a viable option, they should not automatically be forced to reject the Agreement. The Debtors argued that in addition to the affirmative acts of assumption and rejection, *§ 365* permits a debtor to allow an executory contract to "ride through" a Chapter 11 bankruptcy case.

In its September 9, 2002 Memorandum Decision, the court held that the Debtors could not assume the Agreement. The court found that: (1) even though the license granted to Hernandez was purportedly exclusive rather than non-exclusive, the Agreement nevertheless fell within the provisions of *§ 365(c)(1)* and the requirements for assumption set forth in Catapult; and (2) the terms of the Agreement did not permit assignment [**5] to a hypothetical third party absent the consent of the licensor. Consequently, the court ruled that the Agreement fails the "hypothetical test," and as such, could not be assumed by the Debtors. [4] However, the court deferred ruling on the "ride-through" issue raised by the Debtors until after the parties had an opportunity to submit supplemental briefs on that issue.

4 For an analysis and critique of the problems presented by application of the hypothetical test, See Daniel J. Bussel & Edward A. Friedler, The Limits on Assuming and Assigning Executory Contracts, *74 Am. Bankr. L. J. 321 (Summer 2000)*.

On October 16, 2002, Great Northern filed a Motion to Compel Rejection of the Agreement pursuant to *§ 365(d)(2)*, and a Motion to Lift the Stay pursuant to *11 U.S.C. § 362* to permit it to terminate the Agreement. The Monterey Leaf Creditors joined Great Northern in both of these Motions. The issues raised in the motions to compel rejection and to lift stay are directly [**6] affected by the court's determination of the "ride-through" issue, and as such, those motions are addressed by the court in this Memorandum Decision. Both sides have filed their briefs and the matter is now ready for decision.

JURISDICTION

The court has jurisdiction in this matter pursuant to *28 U.S.C. § 1334(a)* and *28 U.S.C. § 157(a) and (b)*.

DISCUSSION

I. Introduction

The facts of this case create an unusual problem: If the court determines that the Agreement must be rejected, then the Debtors will have forfeited their rights under the Agreement regardless of whether the Debtors actually committed a breach. See *§ 365(g)*(providing that [HN3] rejection of an executory contract constitutes a breach of that contract as of the date immediately preceding the filing). In essence, the Debtors will have forfeited their rights under the Agreement simply by having consented to the entry of an order for relief after an involuntary bankruptcy case was initiated against them. [5] On the other hand, had the Debtors not been forced into bankruptcy, their rights under the Agreement could only be terminated upon a demonstration [**7] of a material breach. This case, therefore, presents the unusual situation where a debtor has fewer rights [*799] *in bankruptcy* than outside of bankruptcy. The court finds such a result to be inconsistent with the reorganization principles of Chapter 11. At the same time, the rights afforded under Chapter 11 to non-debtor parties to executory contracts are entitled to protection. With these con-

cerns in mind, the court now addresses the "ride-through" theory raised by the Debtors.

> 5 On January 14, 2000, the Debtors entered an agreement with the petitioning creditors to allow entry of an order for relief with the understanding that the case would be dismissed 120 days after a settlement was reached. (See Debtors' Answer to Inv. Pet. at Dkt. # 8). At that time, the Objectors were not actively involved in the case. The Monterey Leaf Creditors filed their first pleading in the case, an Objection to Debtors' Disclosure Statement, on March 12, 2001. (See Dkt. # 47). Great Northern filed its first pleading in this case, an Objection to Debtors' Plan, on October 16, 2001. (See Dkt. # 87).

[**8] **I. The Ride-Through Doctrine**

[HN4] The treatment of executory contracts by a Chapter 11 debtor is governed by *11 U.S.C. §§ 1123 and 365. § 1123(b)(2)* provides that a Chapter 11 plan may [HN5] "subject to 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under this section." In turn, *§ 365(a)* provides that the debtor [HN6] "subject to court approval, may assume or reject any executory contract."

[HN7] The "ride-through" doctrine advocated by the Debtors is purely a creature of case law; the doctrine is not provided for in *§§ 1123 or 365*, or anywhere else in the Bankruptcy Code. Simply stated, the ride through doctrine provides that executory contracts that are neither affirmatively assumed or rejected by the debtor under *§ 365*, pass through the bankruptcy unaffected. See e.g., *In re Polystat, Inc., 152 B.R. 886, 890 (Bankr. E.D.Pa. 1993)*("In a chapter 11 case, where a debtor has failed to expressly assume or reject an ... executory contract, that ... contract will be unaffected by the bankruptcy filing"); *In re Day, 208 B.R. 358, 368 (Bankr. E.D.Pa 1997)* [**9] (holding that "it has long been the rule in bankruptcy that an executory contract that is neither assumed or rejected continues in place between the parties, passing through the bankruptcy to the reorganized debtor").

Ride-through finds its origin in the pre-Bankruptcy Code case of *Consolidated Gas, Elec. Light and Power Co. of Baltimore v. United Railways and Elec. Co. of Baltimore, 85 F.2d 799 (4th Cir. 1936)*. In that case, the Fourth Circuit held that an "executory contract ... remains in force ... until it is rejected, and unless rejected, it passes through with the other property of the debtor to the reorganized corporation." *Id. at 805*. [6] Since Consolidated Gas, the ride-through doctrine, which has also been described as the "pass through" or "continuing contract" theory, has been applied by several Circuits Courts of Appeal. See e.g., *In re O'Conner, 258 F.3d 392 (5th Cir. 2001)*; *Boston Post L.P. v. FDIC, 21 F.3d 477, 484 (2d. Cir. 1994)* cert. den. *513 U.S. 1109, 130 L. Ed. 2d 782, 115 S. Ct. 897 (1995)*; *In re Greystone III Joint Venture, 948 F.2d 134, 141 (5th Cir. 1991)*; *In re Public Service Co. of New Hampshire, 884 F.2d 11 (1st Cir. 1989)*. [**10] The doctrine has also been recognized by commentators in law journals, [7] and treatises including Collier: " [*800] If the debtor fails to either assume or reject the contract by separate order or in its plan, it appears that the contract would continue in existence .... if the debtor continues operating, arguably the contract passes through the bankruptcy and remains a liability of the reorganized entity." 3 Collier on Bankruptcy, § 365.02[2][d] (15th Ed. Rev. 1999); see also 7 Collier on Bankruptcy, § 1123.02[2] (15th Ed. Rev. 1999).

> 6 Although Consolidated Gas was a pre-Code case, the legal precepts developed therein remain applicable today because [HN8] theories developed under the *Bankruptcy Act* apply to cases decided under the Code. See *In re Bonner Mall Partnership, 2 F.3d 899, 913 (9th Cir. 1993)* ("Where the text of the Code does not unambiguously abrogate pre-Code practice, courts should presume that Congress intended it to continue unless the legislative history dictates a contrary result"); *In re Polysat, Inc., 152 B.R. 886, 890 (Bankr. E.D.Pa.1993)*("Where Congress has not evidenced an intent to change established pre-Code law, courts should interpret the Code as continuing that legal principle").

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> 7 See e.g., Bussel, *supra note 4, at 330* f.48; see also David G. Epstein & Steve H. Nickles, The National Bankruptcy Review Commission's § 365 Recommendations and the 'Larger Conceptual Issues', *102 Dick. L. Rev. 679, 689 (Summer 1998)*; Mark R. Campbell & Robert C. Haste, Executory Contracts: Retention Without Assumption in Chapter 11--"Ride-through" Revisited, 2000 ABI JNL. LEXIS 41, 19 Am. Bankr. Inst. J. 33 (2000).

Ride-through has also been recognized by the United States Supreme Court in dicta, and has been alluded to by the Ninth Circuit as well. In his concurring and dissenting opinion in *National Labor Relations Board v. Bildisco, 465 U.S. 513, 546 n.12, 79 L. Ed. 2d 482, 104 S. Ct. 1188 (1984)*, Justice Brennan wrote:

> In the unlikely event that the contract is neither accepted nor rejected, it will "ride through" the bankruptcy proceeding and be binding on the debtor even after a discharge is granted. The nondebtor par-

> ty's claim will therefore survive the bankruptcy proceeding.

(Citations omitted). In *Smith v. Hill, 317 F.2d 539, 543 n.6 (9th Cir. 1963)*, the [**12] Ninth Circuit discussed the implications of a debtor's failure to affirmatively assume an executory contract under *§ 365(c)*:

> In Chapter XI proceedings failure to assume affirmatively an executory contract does not result at any time in rejection of the contract. Whether the debtor is in possession, or whether there is a receiver or trustee, the contract can be rejected only by affirmative action. Unless so rejected, the contract continues in effect.

(Citations omitted). While the Smith court does not specifically mention ride-through, the holding has been cited by other courts as support for the doctrine. See e.g., *In re Cajun Elec. Power Co-op., Inc., 230 B.R.715, 734 (Bankr. M.D.La. 1999)*(citing Smith for the proposition that a lease or executory contract that is neither rejected nor assumed passes through the bankruptcy to the reorganized debtor).

[HN9] Ride-through is thus a well-recognized and established legal doctrine. However, before the court determines if the doctrine should be applied in this case, it is useful to clarify exactly what the doctrine is and is not.

First and foremost, [HN10] ride-through is not an option for the treatment of an executory contract [**13] under *§ 365*. As previously stated, *§ 365* presents the debtor with two express options--assumption or rejection. Ride-through is not an affirmative choice available to the debtor under *§ 365*. Therefore, if an executory contract is addressed in a Chapter 11 plan pursuant to *§ 1123(b)(2)*, it must be either assumed or rejected. The debtor may not treat an executory contract in a Chapter 11 plan and at the same time, effect a ride-through of that contract--these are inconsistent proposals.

In addition, ride-through is not a de facto assumption. In their brief, the Objectors argue that the ride-through doctrine affords the Debtors all of the benefits of assumption, and in effect, allows the Debtors to assume an unassumable contract. This assertion is erroneous. A contract that is not assumed is not entitled to the benefits afforded by *11 U.S.C. § 365* such as insulation from *ipso facto* provisions or the right to cure arrearages within a reasonable period of time notwithstanding what the payment terms of the contract may be. Unless and until an executory contract is assumed, the debtor is not afforded any of the rights granted [*801] under *§ 365(e)*. The ride-through [**14] theory allows the debtor to retain the benefits as well as the burdens of the *contract,* not the benefits of *assumption.* [8] Consequently, ride-through is not the equivalent of formal assumption under *§ 365*. For example, in *In re O'Conner, 258 F.3d 392, 405 (5th Cir. 2001)* the Fifth Circuit held that an *unassumable* partnership could ride through the bankruptcy proceedings unaffected:

> The parties did *not* cite, nor did we find, any cases applying the pass-through theory when, under *§ 365(c)(1)*, the executory contract was *not* assumable. But, we see *no* reason why the theory should *not* apply. This is because there is *no* difference between a contract that, under *§ 365(c)(1)*, *cannot* be assumed, and one which is neither assumed nor rejected. Each is simply *unaffected* by the bankruptcy proceedings.

(Emphasis in original).

> 8 [HN11] The logical result of a ride-through contract is that claims which arise from the breach of such a contract cannot be discharged through a Chapter 11 plan. Accordingly the Debtors may not seek to discharge any of Hernandez' obligations under the Agreement through their amended plan:
>
> > In actual practice it often happens that parties to contracts and leases (including leases "deemed rejected" under subsections (4) and (5)) simply continue to perform thereunder as though the bankruptcy had not happened. This has been addressed by the courts, which have uniformly held that when a debtor continues to derive benefits under the contract or lease, *the debtor will also be burdened with the obligations,* and the lease or other contract will be deemed to "pass through" or "ride through" the bankruptcy unaffected by it.
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> *In re Texaco Inc., 254 B.R. 536, 557 (Bankr. S.D.N.Y. 2000)*(emphasis added). In this regard, some commentators have expressed the concern

that the case law on the ride-through doctrine is inconsistent with the broad definition of "claim established under *11 U.S.C. § 101(5)*:

> We believe these cases are inconsistent with the Bankruptcy Code's expanded definition of claim. A party to a lease or executory contract with a Chapter 11 debtor has a *section 101(5)* claim even before the lease or contract is assumed or rejected. Any such *section 101(5)* claim would be extinguished when the Chapter 11 debtor's plan was confirmed and so would not ride through the bankruptcy.

See Epstein, *supra note 7, at 690*; but see *In re Cochise College Park, Inc., 703 F.2d 1339, 1352 (9th Cir. 1983)*("Until rejection, however, the executory contract continues in effect and the non-bankrupt party to the executory contract is not a creditor with a provable claim against the bankrupt estate"); Even if *§ 101(5)* is broad enough to include an executory contract that has not been breached, the Debtors may address this issue by placing a provision in the amended Plan that excludes from discharge Hernandez' obligations under the Agreement.

[**15] The ride-through doctrine is simply the traditional manner in which the courts deal with executory contracts, that for some reason were not assumed or rejected pursuant to *§ 365* prior to or at confirmation. As the Objectors point out, the traditional application of the doctrine by the courts has been "backward-looking." When an executory contract is not addressed by the debtor in a Chapter 11 plan or by separate motion, the doctrine applies and the contract becomes binding on the reorganized debtor. In this manner, the contract is unaffected by the bankruptcy and the interests of both parties to the contract are preserved.

In this case, the Debtors originally raised ride-through as an auxiliary, or "fallback" position, for their assumption argument. According to the Debtors, if the Agreement cannot be assumed, it need not be rejected because the court can allow it to ride-through the bankruptcy. Now that the court has ruled against the Debtors on their assumption argument, the ride-through doctrine represents the Debtors's only possibility for confirmation of [*802] their Plan. However, the Debtors' current Plan still provides for the *assumption* of the Agreement. As previously stated, [**16] an executory contract may not be addressed in a Chapter 11 Plan and simultaneously ride through the bankruptcy unaffected. In their supplemental brief on ride-through, the Debtors essentially argue that the court should allow them to amend their Plan to remove all references to the assumption of the Agreement. The Debtors assert that once the Plan no longer provides for the assumption of the Agreement, it can be confirmed, and the Agreement would then ride through the bankruptcy unaffected pursuant to cases such as O'Conner and Polystat.

The Objectors argue that the ride-through doctrine is inapplicable under the facts of the present case. According to the Objectors, the ride-through theory is available only as a post-confirmation tool for dealing with problems arising out of a debtor's failure to address an executory contract before or at plan confirmation. The Objectors assert that all of the ride-through cases cited by the Debtors share a common distinction from the facts of this case: in all such cases, the non-debtor party failed to object to the plan or move the court to compel assumption or rejection of the contract prior to confirmation. In this case, unlike the cases [**17] cited by the Debtors, the Objectors have opposed confirmation of the Debtors' plan by filing numerous objections to confirmation as well as motions to compel rejection of the Agreement pursuant to *§ 365*. This is not a case in which the parties have overlooked the existence of an executory contract or simply continued to perform as if the bankruptcy had never occurred--to the contrary, the Agreement has been the focus of months of arduous litigation. Now, the Objectors have requested relief from the court in the form of an order deeming the Agreement rejected, and lifting the *§ 362* to permit Great Northern to terminate the Debtors' rights under the Agreement. [9]

> 9 The Objectors also argue that because there has been litigation in this case regarding the Agreement it cannot ride through the Debtors' case "unaffected." The court rejects such an interpretation. [HN12] Almost every executory contract to which a debtor is a party is affected by the filing of a bankruptcy case because of the imposition of the *§ 362* automatic stay. Even if the debtor and the non-debtor party continue to perform as they did prior to the filing of the case, the non-debtor party may be impacted in some manner by the debtor's filing for bankruptcy. The use of the word "unaffected" in the cases which have addressed the ride-through doctrine relates to the parties' rights *under the contract,* not to whether there has been some impact on the parties as a result of the filing of a bankruptcy case.

[**18] Indeed, the court has not found a case in which an executory contract has been allowed to pass through the bankruptcy in the face of an objection by the

non-debtor party. On the other hand, the court has not found a case in which a debtor has sought to effect a ride-through of an executory contract by intentionally failing to address it, [10] and has been prevented from doing so. [11] Given its historical [*803] acceptance and general application by the courts, the court believes that [HN13] the doctrine applies any time a debtor fails to address an executory contract, whether that failure is inadvertent or intentional. Consequently, the court will apply the doctrine in this case if it is equitable to do so. Thus, the proper inquiry at this time is not whether the Debtors may choose to have the Agreement ride through the bankruptcy, or whether the court should "allow" the Agreement to ride through. Rather, the question that must be decided now is whether or not the Debtors are required to address the Agreement in their Chapter 11 Plan--i.e., are the Debtors required to reject the Agreement because the Objectors have filed a motion under *§ 365(d)(2)* seeking that relief?

10 In fact, there is some support for the application of ride-through where an executory contract is intentionally ignored by the debtor. See Epstein, *supra note 7, at 690-91* (supporting the practice of ride-through in Chapter 11 and quoting Reforming the Bankruptcy Code: National Bankruptcy Conference Code Review Project 144-45 (rev. ed. 1997): "The debtor and the other party expect to perform these contracts without formality. In other words, the debtor's failure to schedule such contracts is not accidental or inadvertent"); see also Campbell, supra note 7 at 33-34.

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11 In this regard, the cases cited by the Objectors are likewise inapposite.

II. Assumption / Rejection

In their Motion to Compel Rejection, the Objectors petition the court for a determination that the Agreement is deemed rejected under *11 U.S.C. § 365*. According to the Objectors, *§ 365(d)(2) requires* a debtor to assume or reject an executory contract upon the request of a party-at-interest. The Objectors argue that these two alternatives are exclusive. Because the Debtors cannot assume the Agreement, the Debtors are bound to reject it sooner or later, and for this reason, the Objectors contend that the court should order the Agreement deemed rejected immediately.

The Debtors respond by asserting that the Bankruptcy Code does not require them to choose either to assume or reject the Agreement. According to the Debtors, both *§§ 365 and 1123* are discretionary provisions permitting a debtor to assume or reject an executory contract. Therefore, the Debtors are not bound to reject the Agreement, but instead, they may elect not to address it in their Plan.

[**20] [HN14] When interpreting the Bankruptcy Code, the court must begin with the statutory language. See *Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54, 117 L. Ed. 2d 391, 112 S. Ct. 1146 (1992)*; *In re Catapult, 165 F.3d 747, 750 (9th Cir. 1999)*. In the context of interpreting the Code, the plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters. See *United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)*; *In re Myrvang, 232 F.3d 1116, 1124 (9th Cir. 2000)*. In addition, *§ 365(d)(2)* must be interpreted in the context of the broad purposes of the entire Code. *Theatre Holding Corp. v. Mauro, 681 F.2d 102, 105 (2d Cir. 1982)*. *§ 365(d)(2)* provides:

> [HN15] In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the [**21] request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

§ 365(d)(2) [HN16] provides that a debtor *may* assume or reject an executory contract. The use of the term *may* (as opposed to the term *shall*) indicates the permissive nature of the section. Therefore, according to the plain meaning of *§ 365(d)(2)*, a debtor may *or may not* assume or reject an executory contract.

This interpretation of *§ 365(d)(2)* is consistent with other operative Code provisions. *§ 365(d)(4)* provides that [HN17] "notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired [*804] lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief ... then such lease is deemed rejected." [HN18] Because *§ 365(d)(4)* provides for the automatic rejection of commercial leases that are not assumed, a debtor is in essence forced to either assume or reject the lease--electing not to address the lease is not an option. Presumably, if Congress wanted to make the choice between [**22] assumption and rejection of all executory contracts mandatory, it could have made a provision similar to *§*

365(d)(4) applicable to such contracts. See e.g., *In re Griffith, 206 F.3d 1389, 1394 (11th Cir. 2000)*("where Congress knows how to say something but chooses not to, its silence is controlling").

In addition, *§ 1123(b)(2)* provides that a Chapter 11 plan [HN19] "*may* subject to 365 of this title, provide for the assumption, rejection, or assignment of any executory contract." (Emphasis added). [HN20] As with *§ 365(d)(2)*, the language of *§ 1123(b)(2)* is permissive in nature, and the debtor may choose not to address an executory contract under a Chapter 11 plan Thus, the treatment of executory contracts inside of a Chapter 11 plan is optional. *Texaco, 254 B.R. at 556* (holding that under *§ 1123(b)(2)*, "the right to assume or reject an executory contract is optional"). When read in conjunction with one another, *§ 1123* and *§ 365* establish a statutory framework in which the debtor is free to either assume or reject an executory contract through a plan, or elect not to address the contract within his plan and continue performance [12] outside the plan: [**23]

> *Section 1123(b)(2)* is permissive. The plan *may* provide for the assumption or assignment of an executory contract. On the other hand, the contract may "ride through" the plan as unaffected.

7 Collier on Bankruptcy, § 1123.02[2] (15th Ed. Rev. 1999)(emphasis in original); see also *In re Cole, 189 B.R. 40, 46 (Bankr. S.D.N.Y 1995)*; *Aetna Casualty & Surety Co. v. Gamel, 45 B.R. 345, 348 (N.D.N.Y 1984)*.

> 12 Of course, in many instances, the terms of the executory contract may bar continued performance by the debtor of a ride-through contract. Absent the protections of *§ 365*, the non-debtor party may move to enforce an *ipso-facto* clause, or other insolvency terms, which are routinely included as default provisions in many contracts. See Randolph J. Haines, Time to Eliminate Ipso Facto Clauses, Norton Bankruptcy Law Adviser (May 2002).

Thus, the Debtors may choose not to address the Agreement in their Plan. Nonetheless, the Objectors contend that [**24] even if the Debtors do not voluntarily address the Agreement, the court must, upon request of the Objectors, order them to do so. The Objectors argue that under *§ 365(d)(2)*, a creditor may petition the court to compel the debtor to either assume or reject an executory contract within a specified time. According to the Objectors, the court must act on such a request, and as such, the court must direct the Debtors to reject the Agreement immediately, as assumption is not an option.

The question of whether the court, upon the request of a non-debtor party, must direct the debtor to either assume or reject an executory contract was addressed by the Second Circuit in Mauro. In that case, the Second Circuit held that a bankruptcy court need not direct the debtor to make a decision immediately simply because the other party to the agreement has filed a motion under *§ 365(d)(2)*. Rather, the bankruptcy court, in its discretion, sets a reasonable time in which the debtor must decide whether to assume or reject. See *681 F.2d at 105* ("Under the new Code, as under the old Act, the trustee or debtor in reorganization is allowed a [*805] reasonable time to decide whether to assume [**25] or reject .... What constitutes a reasonable time is left to the bankruptcy court's discretion in the light of the circumstances of each case"); see also *In re Enron Corp., 279 B.R. 695, 702-03 (Bankr. S.D.N.Y. 2002)*; *In re Physician Health Corp., 262 B.R. 290, 292 (Bankr. D. Del. 2001)*. Other courts have since determined that, in exercising its discretion, a court has the power to deny a *§ 365(d)(2)* request. See also *Whitcomb & Keller Mortgage Co., 715 F.2d 375, 379 (7th Cir. 1983)*; *In re St. Mary Hospital, 89 B.R. 503, 513 (Bankr. E.D. Pa.1988)*.

Mauro and its progeny did not address the question of whether the filing of a motion under *§ 365(d)(2)* precludes an executory contract from riding through a Chapter 11 bankruptcy. [13] As previously stated, the court has not found a reported decision that addresses this issue. Therefore, in deciding this question, the court must turn to the statutory language. *§ 365(d)(2)* [HN21] establishes that the court, upon the request of a non-debtor party to the contract, *may* order the trustee to determine within a specified period of time whether to assume or reject the contract. [**26] (Emphasis added). Once again, the operative language of the statute is permissive. According to the statutory language, the court has discretion to determine whether or not to grant the request of the non-debtor party and direct the debtor to act.

> 13 In fact, in many instances these cases presume that a debtor must either assume or reject an executory contract by the time of confirmation. See e.g., *In re National Gypsum Co., 208 F.3d 498, 505 n.5 (5th Cir. 2000)*("The debtor may delay making a decision and simply provide for assumption or rejection in the plan itself"); *St. Mary Hospital, 89 B.R. at 513* ("Of course, in deciding a *§ 365(d)(2)* motion ... a bankruptcy court is empowered to deny the motion and allow the debtor to *wait until the normal deadline of confirmation to assume or reject the contract*")(emphasis added). However, the court has already determined, pursuant to the plain meaning of the statutory language of *§ 365(d)(2)* that a debtor may elect not to address an executory con-

tract in its plan and continue performance outside the plan. See *supra at p. 13*.

[**27] This interpretation is consistent with the legislative history of *§ 365(d)(2)*. The legislative history indicates that the first draft of *§ 365(d)(2)* stated:

> In a case under chapter [9 or 11] an executory contract or unexpired lease may be assumed at any time prior to the confirmation of a plan or in the plan, but [the court] upon request of any party to the lease or contract *shall* order the assumption or rejection by the trustee within a specified period of time, not exceeding thirty days, if further delay would result in prejudice to such a party.

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. 93-137, 93d Cong., 1st Sess., Part II § 4-602(a)(2) (1973) (emphasis added). In its original form, *§ 365* would have required the court to order the trustee to assume or reject an executory contract within 30 days upon the request of a non-debtor party to the contract. However, in reforming the statute, Congress substituted the word "may" for "shall," and dropped all references to a time limit. Thus, although Congress considered making the court's issuance of such an order mandatory, it instead opted to allow the court latitude to [**28] exercise discretion in this area. [14]

> 14 This interpretation is also consistent with *§ 1123*. As explained in Collier on Bankruptcy: "However a party to the contract may insist that it either be rejected or fully assumed under the plan if the contract has not already been dealt with separately from the plan." 7 Collier on Bankruptcy, § 1123.02[2] (15th Ed. Rev. 1999). While the treatise provides that a non-debtor party may "insist" that the debtor either assume or reject an executory contract, it is evident that here, the author is concerned with protecting the contractual rights of the non-debtor party: "This type of party has a right to be heard in respect to assumption or rejection of the contract at the time of the confirmation hearing under *section 1128* or prior to such date, in order to assure adequate protection of its interests." Id. A contract that rides through the case unaffected remains binding on the debtor, and as such affords the non-debtor party all of the protections available under the original contract.

[**29] [*806] Accordingly, under the plain meaning doctrine cited earlier in this decision, the court may, but is not required to issue an order directing the Debtors to reject the Agreement. If the court does not order rejection of the Agreement, the Debtors will presumably amend their plan and the Agreement will ride through the bankruptcy. The court must therefore turn to the question of what standards should be applied in determining whether the circumstances of this case justify permitting the Agreement to ride through. [HN22] The four part test set out in Mauro for determining whether a debtor should be permitted to delay the assumption or rejection decision serves as a useful guide for analyzing when ride through of an executory contract should be permitted. The four factors are: (1) the damage that other party to contracts would suffer, beyond compensation available under the Bankruptcy Code; (2) the importance of the contracts to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusivity period has terminated

In applying the *Mauro* [**30] factors, the court confronts a difficult balancing task. If the Debtors are permitted to amend their plan to eliminate any treatment of the Agreement, the Objectors will not receive any compensation under the Bankruptcy Code for their damages because, as set forth earlier, the Objectors will not have a claim which can be treated or discharged under an amended plan. The Objectors allege that they have sustained substantial damages as a result of the Debtors' attempts to assume the Agreement. During that time, the automatic stay of *§ 362* has prevented the Objectors from concluding litigation in state court which they assert would terminate the Debtors' rights under the Agreement. The Objectors did not, however, specifically seek stay relief until October 16, 2002--thus, some of the time delay is arguably the result of their own inaction. At the same time, once the Objectors appeared in the case in 2001 they actively opposed confirmation of the Debtors' plan and assumption of the Agreement. [15]

> 15 The court also notes that the Objectors and the Debtors agreed to defer confirmation while they attempted to settle their disputes through mediation. (See Dkt. # 93).

[**31] The court must balance the Objectors' alleged damages against the second prong of the Mauro test, which is the importance of the Agreement to the Debtors' potential reorganization. If the court requires the Agreement to be rejected there will be no reorganization because the exclusive funding source for the Debtors' attempted reorganization is the income they will receive by exercising their purported rights under the Agreement. Of course, the Objectors assert that the Debtors forfeited their rights under the Agreement as a result of

their alleged breach. However, if the Agreement is deemed rejected all of the Debtors' rights under the Agreement will be automatically cancelled regardless of whether they have breached the Agreement. The court finds therefore, that requiring [*807] the Debtors to reject the Agreement will result in significant harm to the Debtors and their creditors which outweighs the harm caused to the Objectors by the delay of the state court litigation and the cost of litigating confirmation and *§ 365* issues in this court. [16] Accordingly the court will exercise its discretion and will not issue an order requiring the Debtors to reject the Agreement. Instead the Debtors [**32] shall have thirty days to amend their Plan to eliminate the section that provides for the assumption of the Agreement. The Debtors will, of course, face the burden of demonstrating that such an amended plan is confirmable under *11 U.S.C. § 1129*.

16 The remaining factors under Mauro are not particularly relevant to the court's decision regarding whether the Debtors should be required to reject the Agreement. The Debtors have had ample time to appraise their financial situation and exclusivity ran long before the Debtors proposed a plan in February of 2001.

III. Motion to Lift Stay

In their Motion for Relief form the Automatic Stay, the Objectors contend that cause exists as a matter of law to lift the automatic stay in regards to the Agreement under *§ 362(d)(1)*. The court agrees. In this case, the court has already determined that the Debtors cannot assume the Agreement, or otherwise treat it in their Plan. Therefore, cause exists to lift the automatic stay and allow the [**33] Objectors to enforce whatever rights they may have under applicable non-bankruptcy law.

IV. Plan Confirmation

The Objectors have asserted that allowing the Agreement to ride through the case will accomplish nothing because the Debtors will not be able to confirm their Chapter 11 Plan even if the Agreement is permitted to ride through. In support of this contention, the Objectors present two arguments: First, the Objectors maintain that because the Agreement is unassumable, it is not property of the Bankruptcy Estate, and cannot be used to create value for the creditors. However, even if the Objectors are correct in their assertion that an unassumable contract is not estate property, [17] that does not mean it cannot create value for the creditors. For example, individual Chapter 11 debtors routinely propose plans which are funded from non-estate assets, such as the income derived from services the debtor performs post-petition. See *11 U.S.C. § 541(a)(6)*. In light of the fact that such Plans are often confirmed, the court does not consider the fact that the Agreement will be treated outside the Plan as an obstacle to confirmation.

17 There is some divergence within the 9th circuit as to whether an unassumable contract is property of the estate. In *In re Qintex Entertainment, Inc., 950 F.2d 1492, 1495 (9th Cir. 1991)*, the Ninth Circuit determined that "an executory contract does not become an asset of the estate until it is assumed pursuant to *§ 365* of the Code." By contrast, the court in *In re Computer Communications, Inc., 824 F.2d 725, 728-29 (9th Cir. 1987)*, held that an unassumed and unassumable contract is nevertheless property of the estate and entitled to the protections of the *§ 362* automatic stay.

[**34] Second, the Objectors allege that the Debtors cannot rely on any prospective income from their continued use of the patent license granted to the Debtors under the Agreement to fund an amended plan. In this regard, the Objectors point out that the Agreement is the subject of ongoing state court litigation. According to the Objectors, the Debtors breached the Agreement by entering into a subcontracting arrangement with a third party. The Objectors assert that once the *§ 362* automatic stay is lifted in this case, the pending [*808] state court litigation will be able to proceed and Great Northern will eventually terminate the Debtors' rights under the Agreement. The Debtors contend that their subcontracting arrangement complies with the terms of the Agreement and that Great Northern is, itself, in breach of the Agreement.

The litigation that is pending in state court between the Debtors and the Objectors regarding these issues will now be able to proceed to conclusion since this court has lifted the automatic stay with respect to the Agreement. The Debtors claim that they will prevail in that litigation and that there will, therefore, be income available to fund an amended plan. [HN23] Chapter [**35] 11 plans which depend for funding on the outcome of litigation may be confirmable under the right circumstances. See e.g., *In re Applied Safety, Inc., 200 B.R. 576, 587 (Bankr. E.D. Pa.1996)*. Since the amended Plan is not yet before the court, the court cannot determine if this may be such a case. Until that determination is made, after both the Debtors and the Objectors have a full opportunity to present their arguments, the court cannot find that permitting the Agreement to ride through the Debtors' bankruptcy case will make it impossible for them to propose a confirmable plan.

CONCLUSION

The Debtors are not required to reject the Agreement, but instead may file an amended Plan within thirty days which permits the Agreement to ride through the case. However, the *§ 362* automatic stay is lifted in this case with respect to the Agreement. The foregoing constitutes the court's findings of fact and conclusions of law pursuant to Bankr. R. Proc. 9021. A separate order consistent with the terms of this Memorandum Decision will be issued this date.

Dated this 12th day of December, 2002.

EILEEN W. HOLLOWELL

UNITED STATES BANKRUPTCY [**36] JUDGE

Caution
As of: Feb 07, 2012

IN THE MATTER OF: MIRANT CORPORATION, Debtor, BONNEVILLE POWER ADMINISTRATION, Appellant, VERSUS MIRANT CORPORATION, Appellee.

No. 04-11264

UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

440 F.3d 238*; *2006 U.S. App. LEXIS 3438*; *Bankr. L. Rep. (CCH) P80,453*; *55 Collier Bankr. Cas. 2d (MB) 1050*; *46 Bankr. Ct. Dec. 13

February 13, 2006, Filed

PRIOR HISTORY: [**1] Appeal from the United States District Court For the Northern District of Texas.

CASE SUMMARY:

PROCEDURAL POSTURE: Defendant federal power marketing agency appealed from a judgment of the United States District Court For the Northern District of Texas that affirmed two bankruptcy court orders holding that the agency violated *11 U.S.C.S. § 362(a)*'s automatic stay and denying relief from the stay. The agency argued it could terminate its executory contract with the debtor power producer under an ipso facto clause under *11 U.S.C.S. § 365(e)(2)(A)*.

OVERVIEW: Section *§ 365(e)(2)(A)* mandated an actual test. If law to be applied to a *§ 365(e)(2)(A)* determination could not apply to the case and the record in fact or law, *§ 365(e)(2)(A)*'s exception did not give an ipso facto clause effect. The automatic stay preceded enforcing an ipso facto clause. The debtor's contract interest, even if ultimately terminable, was property of the estate upon the bankruptcy filing. Even if *11 U.S.C.S. § 365(e)(2)(A)* would ultimately permit the agency to terminate the contract due to the combined effect of *§ 365(e)(2)(A)*, applicable law (such as the Anti-Assignment Act, *41 U.S.C.S. § 15*, and its effect on an executory contract), and an ipso facto clause, it first had to seek relief from stay. The agency's termination of the contract violated the stay and no cause was shown to lift the stay; the Anti-Assignment Act did not apply because no assignment prohibited by the Act occurred between the prepetition debtor and the Chapter 11 debtor. The debtor never assumed or rejected the contract and the agency never moved to force assumption or rejection. The agency conceded no assignee in fact. No transfer prohibited by the Act occurred or was attempted.

OUTCOME: The district court's judgment was affirmed.

LexisNexis(R) Headnotes

Bankruptcy Law > Reorganizations > Debtors in Possession > Powers & Rights
[HN1] Under the Bankruptcy Code, a Chapter 11 debtor remains in possession of its estate. *11 U.S.C.S. § 1101.*

Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview
[HN2] A debtor in possession means a debtor, except when a person that has qualified under *11 U.S.C.S. § 322* of the Bankruptcy Code is serving as trustee in the case. *11 U.S.C.S. § 1101.*

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Estate Property
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Exceptions
[HN3] *11 U.S.C.S. § 362* provides for an automatic stay of, among other actions, any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate, *11 U.S.C.S. § 362(a)(3)*, and provides exceptions to the automatic entry of stay, *11 U.S.C.S. § 362(b)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
[HN4] *11 U.S.C.S. § 365* provides for the administration of contracts, including the debtor's assumption or rejection of such a contract. *11 U.S.C.S. 365(a)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Exceptions > General Overview
[HN5] A forward contract merchant must be a person under the plain text of the Bankruptcy Code. *11 U.S.C.S. § 101(26)*.

Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > Clear Error Review
Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > De Novo Review
Civil Procedure > Appeals > Standards of Review > Clearly Erroneous Review
Civil Procedure > Appeals > Standards of Review > De Novo Review
[HN6] An appellate court reviews questions of law, including the interpretation of statutory language, de novo. An appellate court's review of a bankruptcy court's findings of fact is for clear error. This appellate court may affirm if there are any grounds in the record to support the judgment, even if those grounds were not relied upon by the courts below.

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Appeals
Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > Abuse of Discretion
Civil Procedure > Appeals > Standards of Review > Abuse of Discretion
[HN7] The bankruptcy court's denial of a motion for modification of a stay is reviewed for abuse of discretion.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN8] Generally, *11 U.S.C.S. § 365(e)* bars the enforcement of ipso facto clauses in executory contracts. *11 U.S.C.S. § 365(e)(1)*. However, an exception to this general rule appears in *11 U.S.C.S. § 365(e)(2)(A)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN9] See *11 U.S.C.S. § 365(e)(2)(A)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN10] *11 U.S.C.S. § 365(e)(1)* provides the general rule barring the enforcement of ipso facto clauses in executory contracts.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN11] See *11 U.S.C.S. § 365(e)(1)(B)*.

Public Contracts Law > Performance > Assignment & Novation
Public Contracts Law > Terminations > General Overview
[HN12] See *41 U.S.C.S. § 15(a)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses

[HN13] *11 U.S.C.S. § 365(c)* precludes a trustee from assuming or assigning an executory contract if applicable law excuses a nondebtor party to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, and such party does not consent to such assumption or assignment. *11 U.S.C.S. § 365(c)(1)*. Although the language of *11 U.S.C.S. § 365(c)(1)* and *11 U.S.C.S. § 365(e)(2)* are similar, they are by no means parallel overall or identical in effect. The two are not sufficiently similar that caselaw interpreting the one should be given any more than informative weight in interpreting the other.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN14] The plain text of *11 U.S.C.S. § 365(e)(2)(A)* requires an actual test for determining whether a law is "applicable" under the exception, permitting enforcement of an ipso facto clause. According to the statute's plain language, an executory contract's ipso facto clause may be enforced if applicable law excuses a nondebtor party from accepting performance from or rendering performance to an assignee of such contract and that non-debtor party does not consent to such assumption or assignment. *11 U.S.C.S. § 365(e)(2)(A)*. Congress might have chosen the exception to apply if any law prohibited the assignment, but instead Congress tethered the exception to "applicable" law that "excuses a party." It is axiomatic that an applicable law must apply to a set of circumstances; a contracting party creates smoke and erects mirrors when it argues that a contract not assignable as a matter of law, even if no such assignment existed in fact and no excuse existed in fact for the nondebtor party to refuse acceptance or performance in a particular situation, satisfies the language chosen by Congress in drafting the *§ 365(e)(2)(A)* exception.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN15] The law that releases a nondebtor from the general rule foreclosing the enforcement of an ipso facto clause must apply to something and must excuse the nondebtor from some specific performance or acceptance, *11 U.S.C.S. § 365(e)(2)(A)*; thus, if the debtor demonstrates that no application exists or that no excuse obtains on a given record, then the congressional language announces such a circumstance is material, making the *§ 365(e)(2)(A)* exception unavailable. The applicability of the law under *§ 365(e)(2)(A)* is determined not in the abstract but on the record at hand.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN16] *11 U.S.C.S. § 365(e)(2)(A)(ii)* provides that the *§ 365(e)(2)(A)* exception lies only where such nondebtor party does not consent to such assumption or assignment. The combination of the plain text and the overall structure of the test that must be met in order for the exception to arise communicates that Congress intended *§ 365(e)(2)(A)* to apply to a given factual situation rather than to a class of executory contracts.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
[HN17] Congress's use of the adjective "such" to modify "assignment" in *11 U.S.C.S. § 365(e)(2)(A)(ii)* mandates the use of an actual test. The modifier "such" references the assignments provided in the preceding subsection and does not, on its own, require an as-applied approach to the determination of whether a law applies to permit an ipso facto clause's enforcement. However, in combination with the other factors that demand a case-by-case inquiry into whether a nonbankruptcy law applies to permit termination by ipso facto clause, the United States Court of Appeals for the Fifth Circuit cannot agree with

so broad an analysis as permitted by the entirely theoretical approach countenanced by those courts adopting the hypothetical approach.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Public Contracts Law > Performance > Assignment & Novation
Public Contracts Law > Terminations > General Overview
[HN18] In theory, a law of general applicability might exist to merit application in most if not all circumstances under *11 U.S.C.S. § 365(e)(2)(A)*, but the Anti-Assignment Act, *41 U.S.C.S. § 15*, is, by its own terms, not so broadly applicable. *41 U.S.C.S. § 15(a)* provides a general rule for annulment of a public contract upon a transfer by a party other than the United States. *41 U.S.C.S. § 15(b)*, though, limits the application of the general rule, and the limitation applies on the basis of specific facts.

Public Contracts Law > Terminations > General Overview
[HN19] See *41 U.S.C.S. § 15(b)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Public Contracts Law > Terminations > General Overview
[HN20] Both the text of the Anti-Assignment Act, *41 U.S.C.S. § 15*, and the text of *11 U.S.C.S. § 365(e)(2)(A)* require a case-by-case inquiry into the application of the Act to the executory contract or lease at issue in the bankruptcy proceeding. As such, with respect to *§ 365(e)(2)(A)* and the Anti-Assignment Act, the actual test must be used to determine the Act's applicability to a given case. When the law to be applied to a *§ 365(e)(2)(A)* determination cannot apply to the case and the record before the bankruptcy court in fact or law, then *§ 365(e)(2)(A)*'s exception cannot give effect to an ipso facto clause.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > General Overview
[HN21] The automatic stay must precede any enforcement of an ipso facto clause ultimately permitted by a bankruptcy court under *11 U.S.C.S. § 365(e)(2)(A)*.

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Estate Property
Bankruptcy Law > Estate Property > Content
[HN22] *11 U.S.C.S. § 362* provides for an automatic but not permanent stay against any act to obtain possession of property of the estate from which a party may seek relief for cause, including the lack of adequate protection of an interest in property. *11 U.S.C.S. § 362(a)(3), (d)(1)*. The Bankruptcy Code itself requires that the stay's effect be automatically triggered upon the filing of a petition for bankruptcy. *11 U.S.C.S. § 362(a)*. *11 U.S.C.S. § 541(c)(1)* provides that a debtor's estate includes the debtor's interest in property that becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law that is conditioned upon the commencement of a bankruptcy case.

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Relief From Stays > General Overview
Bankruptcy Law > Estate Property > Content
[HN23] Bankruptcy courts will presume protection of property when faced with uncertainty or ambiguity. Likewise, the bankruptcy court's discretion to grant a modification or lift of the automatic stay is broad.

Bankruptcy Law > Practice & Proceedings > General Overview
[HN24] The Bankruptcy Code must be read and must function as a whole.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Exceptions > General Overview
[HN25] *11 U.S.C.S. § 362(b)* provides particular exceptions to the entry of automatic stay, but no exception is provided in the case of executory contracts. Elsewhere in the Bankruptcy Code, Congress expressly overrode the stay provision but did not do so in *11 U.S.C.S. § 365*. Not exempting executory contracts containing ipso facto clauses is consistent with the purposes and policies underlying the staying of actions against a debtor postpetition.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > General Overview
[HN26] The automatic stay must precede any termination permitted by an ipso facto clause and *11 U.S.C.S. § 365(e)(2)(A)*.

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > Estate Property
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Relief From Stays > General Overview
Public Contracts Law > Terminations > General Overview
[HN27] The Anti-Assignment Act, 42 U.S.C.S. § 15, provides the government with an option to rescind its contracts upon transfer. The Anti-Assignment Act permits the United States to elect its response to the transfer of a contract to which it is a party. The United States may either waive its rights under the Act and continue performance, or it may terminate the contract. Thus, the Act does not provide for automatic recision of the public contract upon transfer; annulment of the contract at issue requires a response by the United States. The Anti-Assignment Act, and its effect on a given executory contract in bankruptcy, may be raised by the government after the entry of a bankruptcy court's automatic stay under, at a minimum, the provision for stay modification. *11 U.S.C.S. § 362(d)*.

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Relief From Stays > Cause
[HN28] The Bankruptcy Code does not precisely define "cause" under *11 U.S.C.S. § 362(d)(1)*, and courts have noted that this lack of definition affords flexibility to the bankruptcy courts.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Termination Clauses
Bankruptcy Law > Case Administration > Administrative Powers > Stays > Relief From Stays > Cause
[HN29] A bankruptcy court's discretion in lifting the automatic stay under *11 U.S.C.S. § 362(d)* is limited by the text of *11 U.S.C.S. § 365(e)(2)(A)*, that is, in the case in which a law proffered as applicable under *§ 365(e)(2)(A)* is determined to apply to the case, then the stay must be lifted or modified in such a way that permits the entitled nondebtor party to exercise its termination option accordingly.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers
[HN30] According to *11 U.S.C.S. § 365(f)(2)(A)*, assumption must precede assignment.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
[HN31] See *11 U.S.C.S. § 365(d)(2)*.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Assignments
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Nonassumable Contracts
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Rejections
Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Time Limitations
Public Contracts Law > Terminations > General Overview
[HN32] No transfer occurs under the Anti-Assignment Act, *41 U.S.C.S. § 15*, where the debtor neither assumes nor attempts to assume the executory contract, the nondebtor concedes there is no assignment in fact, and the nondebtor, seeking to invoke the combined effect of the Anti-Assignment Act and *11 U.S.C.S. § 365(e)(2)(A)*,

fails to move for assumption or rejection under *11 U.S.C.S. § 365(d)(2)*. In such a circumstance, where no party has moved to assume the executory contract before the bankruptcy court, no assignment occurs between prepetition debtor and debtor in possession with respect to the Anti-Assignment Act and *§ 365(e)(2)(A)*.

COUNSEL: For BONNEVILLE POWER ADMINISTRATION, Appellant: Jeffrey A. Clair, William Kanter, US Department of Justice Civil Division, Washington, DC.

For MIRANT CORPORATION, Appellee: Robin E. Phelan, Amy M. Walters, Frances A. Smith, Haynes & Boone, Dallas, TX; Thomas E. Lauria, White & Case, Miami, FL.

JUDGES: Before GARWOOD, SMITH, and DeMOSS, Circuit Judges.

OPINION BY: DeMOSS

OPINION

[*240] DeMOSS, Circuit Judge:

Bonneville Power Administration ("BPA") appeals the district court's affirmance of two orders entered by the bankruptcy court. Debtor Mirant Corporation and related entities filed a petition under Chapter 11 of the Bankruptcy Code, triggering a dispute between the parties regarding the ability of BPA to terminate an executory contract for the future purchase of electric power. On the one hand, the Bankruptcy Code's automatic stay, effective upon the filing of a Chapter 11 petition, precludes any act to obtain possession of or exercise control over property of the estate. *See 11 U.S.C. § 362(a)*. On the other hand, in an executory contract related to the future call of energy purchase [**2] by BPA, *see generally § 365*, the parties agreed to an ipso facto clause that provided for default and a termination payment in the event of a bankruptcy filing, *see § 365(e)*. [1] BPA argues that the Bankruptcy Code (or the "Code") permits it to terminate the executory contract pursuant to the contract's ipso facto clause. *See § 365(e)(2)(A)*. The parties now dispute the priority of the two Chapter 11 provisions: the automatic stay and the termination arguably permitted by the combined effect of the ipso facto clause and *§ 365(e)(2)(A)*.

1 *See* BLACK'S LAW DICTIONARY 847 (8th ed. 2004) (defining *ipso facto* clause as a "contract clause that specifies the consequences of a party's bankruptcy").

[*241] This appeal requires us to address the intersection of three relevant statutory provisions: *11 U.S.C. § 362(a)* (the automatic bankruptcy stay); *11 U.S.C. § 365(e)(2)(A)* (permitting a nondebtor party to an executory contract to terminate or modify such contract [**3] when applicable law excuses the nondebtor from accepting or rendering performance to the trustee or an assignee); and the Anti-Assignment Act (or "the Act"), *41 U.S.C. § 15* (prohibiting transfer of contracts to which the United States is a party).

Concluding that the bankruptcy stay precedes any termination permitted by either the Anti-Assignment Act or the agreement of the parties, we affirm the district court's order declaring BPA to have violated the automatic stay. Finding no abuse of discretion in the court's determination that cause was not shown where the Anti-Assignment Act is not an applicable law under *§ 365(e)(2)(A)*, we affirm also the denial of BPA's motion to lift or modify the stay.

I. Background

A. Factual Background

Mirant Corporation is an international energy company that produces and sells electricity in the United States and abroad. Appellee Mirant Americas Energy Marketing, L.P. ("Mirant") is a subsidiary of Mirant Corporation and engages in asset risk management, including commodities, energy, and financial product trading. Mirant is responsible for procuring fuel and selling power for Mirant Corporation's operating [**4] facilities.

BPA is a federal power marketing agency within the United States Department of Energy. BPA was created in 1937 by Congress to market low-cost hydroelectric power generated by a series of federal dams along the Columbia River in the Pacific Northwest. *See generally* Bonneville Project Act of 1937, *16 U.S.C. § 832*. Originally, BPA marketed the energy produced for the benefit of the public, particularly domestic and rural customers, giving preference and priority to public bodies and cooperatives. *See § 832c(a)*. For some time, surplus in energy production meant BPA could market freely to all who desired to purchase in the area. In 1980, increasing demands upon the supply triggered, in part, Congress's enactment of the Pacific Northwest Electric Power Planning and Conservation Act, *16 U.S.C. §§ 839-839h*, which required BPA to offer new contracts to its customers. *See Aluminum Co. of Am. v. Cent. Lincoln Peoples' Util. Dist., 467 U.S. 380, 382, 104 S. Ct. 2472, 81 L. Ed. 2d 301 (1984)*. Thereafter, BPA was authorized to acquire additional resources in order to increase the supply of federal power. *See 16 U.S.C. § 839d(a)(2)*. [**5] Accordingly, BPA entered certain contracts related to the marketing of federal power. *See § 832a(f)*.

BPA and Mirant are parties to the Western Systems Power Pool Agreement (the "WSPPA"), a contract the parties agree is standard for electric power sales. The WSPPA is an umbrella agreement governing electric power transactions. Subject to the WSPPA, BPA and Mirant's predecessor in interest (Southern Company Energy Marketing, L.P.)[2] entered two agreements: (1) the Agreement to Enable Future Purchases, Sales, and Exchanges of Power and Other Services No. 99PB-10588 (the "Enabling Agreement") and (2) an option contract though which BPA purchased a one-time call option for the future [*242] purchase of a set amount of firm power from Mirant over a three-year period commencing in 2004 (the "Confirmation Agreement").

2 Mirant Corporation was originally a wholly owned subsidiary of Southern Company Energy Marketing.

Together, the WSPPA, the Enabling Agreement, and the Confirmation Agreement (collectively, the [**6] "Agreement") form the sum of the parties' contractual rights and obligations. [3] Under the terms of the Agreement, BPA owed no obligation to exercise its option, and if it did not do so, the option expired on the strike date provided, December 23, 2003. The parties agree, and the lower courts noted, that BPA did not exercise and, in practical terms, would not have exercised its option because the option price bargained for in the Agreement exceeded the market price of energy during the relevant period of the Agreement.

3 Although the parties below disputed the integration of the contracts, some of which were executory in nature and others of which were not, the bankruptcy court assumed without deciding that the Confirmation Agreement was an executory contract and that the three contracts formed a single agreement. In their briefings to this Court, both parties treat the three contracts as an integrated agreement.

The Agreement includes a default provision, or ipso facto clause, that authorizes BPA to terminate [**7] the contract and claim liquidated damages if Mirant petitioned for bankruptcy before the option period expired. The Agreement provides that default by the institution of a bankruptcy proceeding triggers the non-defaulting party's "right to terminate all transactions between the Parties under this Agreement upon written notice" and the non-defaulting party's right to a termination payment. Upon termination, the non-defaulting party may liquidate all transactions with the debtor and demand a termination payment equal to the market-based cost of replacing the option contract. [4] The Agreement also provides that all transactions under the agreement are forward contracts and that the parties are forward contract merchants as defined by the Bankruptcy Code. *See 11 U.S.C. § 556.*

4 As a practical matter, the bankruptcy court noted that the peculiar facts of this case mean the primary dispute between the parties is the termination payment. Because market prices were lower than the option price of the Agreement during the relevant period, both parties acknowledged that the Agreement would never have been performed. According to the bankruptcy court, BPA seeks to declare Mirant's default and thereby obtain a claim against Mirant in bankruptcy proceedings for the amount of the termination payment.

[**8] On July 1, 2003, BPA wrote to Mirant requesting, pursuant to the Agreement, adequate assurances of Mirant's ability to perform. Mirant responded by letter on July 3, stating its willingness to wire assurance but disputing the reasonable estimate of the amount of assurance. On July 7, Mirant wired to BPA $ 523,389 as adequate assurance of its ability to perform.

B. Procedural Background

On July 14, 2003, Mirant Corporation and 82 of its direct and indirect subsidiaries, including Mirant, filed voluntary Chapter 11 bankruptcy petitions. That day, the court held a hearing and entered an interim order authorizing the Debtors to comply with the terms of prepetition trading contracts and to enter into postpetition trading contracts in the normal course of business and setting a final hearing for the entry of a final order of authorization. The bankruptcy court also approved the joint administration of the Debtors' cases. [5]

5 The United States Trustee for the Northern District of Texas appointed three official committees in the jointly administered cases.

[**9] [HN1] Under the Code, Mirant as a debtor remains in possession of its estate. *See 11 U.S.C. § 1101.* [6] [*243] Mirant continues to conduct its business in the ordinary course. On July 16, 2003, the bankruptcy court ordered the parties, specifically including all governmental units, to comply with the Code's automatic stay provision, *§ 362*, and its provision regarding executory contracts and unexpired leases, *§ 365* (the "Order to Comply"). [7] The Order to Comply enjoined BPA from multiple acts affecting Mirant or the debtor estate, including interference in any way with any and all of the property of any of the Debtors. The Order to Comply expressed that it had no effect upon any exceptions to the automatic stay, based upon any section of the Bankruptcy Code, or upon the right of any party to seek relief from the automatic stay according to *§ 362(d).*

6 [HN2] A debtor in possession "means debtor except when a person that has qualified under *section 322* of this title is serving as trustee in the case." *11 U.S.C. § 1101.*

7 [HN3] *Section 362* provides for automatic stay of, among other actions, "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate," *11 U.S.C. § 362(a)(3)*, and provides exceptions to the automatic entry of stay, *§ 362(b)*.

[HN4] *Section 365* provides for the administration of contracts, such as the one at issue here, including the debtor's assumption or rejection of such a contract. *11 U.S.C. § 365(a)*.

[**10] BPA terminated its Confirmation Agreement with Mirant shortly thereafter, and Mirant characterizes this termination as a violation of the bankruptcy court's order and stay. On July 30, 2003, BPA notified Mirant in writing that the Chapter 11 petition constituted default under the parties' Agreement and that accordingly, BPA terminated all transactions with Mirant. BPA stated that under the terms of the Agreement, both parties were forward contract merchants and that the Agreement was a forward contract for purposes of *11 U.S.C. § 556*. BPA also demanded a termination payment from Mirant under the Agreement of $ 1,085,040 [8] and set forth terms for the payment of that amount in light of the assurance Mirant had already provided and the amount BPA yet owed Mirant under the Agreement. BPA requested payment of the remaining amount allegedly owed by Mirant, $ 533,026, within three days of receipt of the July 30 letter. [9]

8 BPA calculated the termination payment based upon market quotes for replacement transactions on July 30, 2003.

9 By its own description, the July 30 letter constituted a contracting officer's final decision under *41 U.S.C. § 605*, permitting Mirant to appeal the decision to either the Department of Energy Contract Board of Appeals or the United States Court of Federal Claims.

[**11] In response to BPA's termination letter and termination payment demand, Mirant wrote to BPA on August 7, 2003, challenging BPA's status as a forward contract merchant under the Code, describing BPA's purported termination of the Agreement as a violation of *§§ 362* and *365* of Chapter 11, and demanding that BPA immediately withdraw its purported termination of the Agreement and perform. BPA later responded by letter, notifying Mirant of BPA's refusal to withdraw the termination letter.

On August 27, 2003, the bankruptcy court entered its final authorization order to Debtors, permitting compliance with prepetition trading contracts and entrance into post-petition trading contracts in the ordinary course of business, providing credit support for trading contracts, and authorizing assumption of prepetition trading contracts. This final authorization order contemplated the possible future event of a creditor, such as BPA, demanding acceptance or rejection of a trading option contract.

[*244] Before the bankruptcy court, on October 17, 2003, Mirant filed a motion to enforce the automatic stay and for contempt, arguing (1) that the transmission of BPA's July 30 termination letter violated the [**12] automatic stay, *11 U.S.C. § 362(a)*, because the act constituted an attempt to obtain possession of property of the estate and to exercise control over the estate; and (2) that BPA, as an entity of a government agency, cannot be a forward contract merchant under the Code's definition (the "Motion to Enforce"). BPA responded that under the Code, it was a forward contract merchant and that the Anti-Assignment Act, *41 U.S.C. § 15*, bars any assignment of the Agreement, thus permitting BPA's termination of the Agreement consistent with *11 U.S.C. § 365(e)(2)(A)*. The bankruptcy court heard argument on November 12, 2003, [10] ruled that BPA had violated the stay, and offered BPA an option either to rescind its termination or to return for a continued hearing on the motion for contempt related to that violation. [11]

10 During the hearing, BPA represented that the only basis for Mirant's default under the Agreement was the filing of a bankruptcy petition.

11 The bankruptcy court also ruled BPA was not a forward contract merchant. [HN5] A forward contract merchant must be a person under the plain text of the Code. *11 U.S.C. § 101(26)*. The bankruptcy court reasoned that because a governmental entity is not a person under the code, *see §§ 101(26)*, *101(41)*, BPA could not be a forward contract merchant. As such, the court concluded, BPA is not authorized by the Code to enjoy the exceptions to automatic stay provided to forward contract merchants under *§§ 362(b)(6)* and *556*. BPA waived its challenge to the bankruptcy court's interpretation of "forward contract merchant" on appeal to this Court.

[**13] On November 17, 2003, the court entered an order, to which the parties had agreed in the interim, declaring that BPA had violated the automatic stay, denying the relief sought by BPA, ordering BPA to rescind its termination of the Confirmation Agreement, and returning the parties to the status quo that existed imme-

diately prior to the delivery of the Termination Letter (the "Stay Violation Order"). [12] BPA appealed the Stay Violation Order to the district court. During this period, other creditors, aside from BPA, filed motions for modification of the stay and motions to require Mirant's assumption and assignment or rejection of various trading contracts, and they received bankruptcy court rulings on those motions.

> 12 BPA subsequently wrote to counsel for Mirant, withdrawing its Termination Letter and reinstating the Confirmation Agreement. BPA noticed its retention of rights under the Agreement and applicable law and expressed that its compliance with the Stay Violation Order did not constitute waiver of those rights. The issue of waiver -- whether BPA waived its challenge to the Stay Violation Order by agreeing to withdraw its termination -- was presented to the district court, which concluded that BPA did not waive its challenge to the Stay Violation Order because the bankruptcy court had already ruled that BPA violated the stay when the court presented BPA the option of either rescission of the termination letter or continuation on the motion for contempt. Mirant does not argue BPA waived its ability to challenge the Stay Violation Order on appeal to this Court.

[**14] On December 5, 2003, BPA filed a motion to modify the automatic stay retroactively to permit termination of the Confirmation Agreement (the "Motion to Modify Stay"). At that time, the option of the Confirmation Agreement was soon to expire on December 23. The bankruptcy court held a December 17 hearing on the motion and responses, and the court subsequently denied the Motion to Modify Stay. In its memorandum opinion, the bankruptcy court cited the Ninth Circuit in holding that (1) the stay applies to prevent unilateral termination even if a contract is unassumable and contains a valid ipso facto [*245] clause and (2) the stay must be modified before the ipso facto clause may be invoked. *See In re Computer Communs., 824 F.2d 725, 729-30 (9th Cir. 1987)*; 3 *COLLIER ON BANKRUPTCY P 365.06[1][f]* (15th ed. rev. 2005). The bankruptcy court clarified that its refusal to modify the stay stemmed from BPA's failure to make a sufficient showing of cause as required by *§ 362(d)(1)*. BPA could not, according to the court's holding, show cause in the absence of Mirant's default and even if the ipso facto clause [**15] could be enforced to trigger default, BPA failed to demonstrate cause for relief where BPA would suffer no harm by the continued enforcement of the stay.

BPA appealed the order denying the Motion to Modify Stay, and the district court consolidated BPA's appeals of the two bankruptcy court orders. The district court affirmed the bankruptcy court's Stay Violation Order and denial of BPA's Motion to Modify Stay on August 13, 2004. BPA timely appealed to this Court.

II. Discussion

A. Standard of Review

[HN6] We review questions of law, including the interpretation of statutory language, *de novo. See, e.g., Fed. Trade Comm'n v. Nat'l Bus. Consultants, Inc., 376 F.3d 317, 319 (5th Cir. 2004)*; *United States v. Bridges, 894 F.2d 108, 111 (5th Cir. 1990)*. Our review of a bankruptcy court's findings of fact is for clear error. *Zer-Ilan v. Frankford (In re CPDC, Inc.), 337 F.3d 436, 440-41 (5th Cir. 2003)*. "This Court may affirm if there are any grounds in the record to support the judgment, even if those grounds were not relied upon by the courts below." *Bustamante v. Cueva (In re Cueva), 371 F.3d 232, 236 (5th Cir. 2004)* [**16] (internal quotation marks omitted).

[HN7] The bankruptcy court's denial of a motion for modification of a stay is reviewed for abuse of discretion. *See, e.g., Chunn v. Chunn (In re Chunn), 106 F.3d 1239, 1242 (5th Cir. 1997)*.

B. The Parties' Arguments

The parties agree that the Confirmation Agreement here is an executory contract under the Bankruptcy Code and that therefore the Code's provision for executory contracts applies. *See 11 U.S.C. § 365*. [13] [HN8] Generally, *§ 365(e)* of the Code bars the enforcement of ipso facto clauses in executory contracts, such as the ipso facto clause in the Agreement here. *§ 365(e)(1)*. [14] However, an exception to [*246] this general rule appears in *subsection (e)(2)(A)*,

> [HN9] (2) Paragraph (1) of this subsection does *not* apply to an executory contract . . ., if --
>
> (A)(i) 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 to 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
>
> (ii) [**17] such party does not consent to such assumption or assignment
>
> . . . .

§ 365(e)(2)(A) (emphasis added).

13 "The legislative history of *§ 365(a)* indicates that Congress intended the term [executory contract] to mean a contract 'on which performance remains due to some extent on both sides.'" *NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984)*(quoting H.R. Rep. No. 95-595, at 347 (1977)), *superseded by statute on other grounds, 11 U.S.C. § 1113 (1984)*. We accept the parties' characterization of the Agreement and assume, without addressing the issue, that the Agreement is an executory contract under Chapter 11.

14 [HN10] *Section 365(e)(1)* provides the general rule,

> [HN11] (1) 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, 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 a provision in such contract that is conditioned on --
>
> . . .
>
> (B) the commencement of a case under this title . . . .

§ 365(e)(1).

[**18] BPA argues that the subsection (e)(2)(A) exception applies to this case, permitting the Agreement's ipso facto clause to have effect, terminating the Agreement as of Mirant's Chapter 11 filing, and precluding any review by the bankruptcy court. According to BPA, the exception applies because the Anti-Assignment Act is an "applicable law" under the text of *§ 365(e)(2)(A)* that excuses BPA "from accepting performance from or rendering performance to the trustee or to an assignee" of the Agreement. *§ 365(e)(2)(A)*.

The Anti-Assignment Act provides,

> [HN12] No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned.

41 U.S.C. § 15(a).

BPA explains the Act's application to this Agreement as follows. BPA argues that *§ 365(e)(2)(A)* carves out a class of executory contracts whose ipso facto clauses may be given effect when nonbankruptcy, applicable law renders the contract unassignable (in the abstract as opposed to upon a factual showing) to "the [**19] trustee or an assignee" without consent of the nondebtor party. This Agreement is such an executory contract, according to BPA, because the Anti-Assignment Act excuses the United States from accepting performance from an assignee. In this vein, BPA asks this Court to join other circuits that have held that *§ 365(e)(2)(A)* creates a hypothetical test, under which a debtor is precluded from assuming or assigning an executory contract even if the applicable law would not bar assignment in the actual circumstances before the court but does bar assignment to a hypothetical third party, "*i.e.*, under the applicable law, could the government refuse performance from [an assignee]." *See In re West Elecs., Inc., 852 F.2d 79, 83 (3d Cir. 1988)*; *see also Perlman v. Catapult Entertainment (In re Catapult Entertainment), 165 F.3d 747, 750 (9th Cir. 1999)*. [15]

15 BPA secondarily argues that if the Act must be applied to the facts, rather than in the abstract, then the assignment here occurs as a result of Mirant's change in status from prepetition entity to debtor in possession. But before the bankruptcy court, BPA conceded there was no assignment on this record from Mirant prepetition to Mirant as debtor in possession. BPA argued instead that subsection (e)(2)(A)'s text contemplates a hypothetical, rather than actual, test of assignment.

> THE COURT: "[A] debtor is not an assignee when property passes to an estate, not for tax purposes, not for anything. In fact, there is no assignee here? Who's the assignee?"
>
> COUNSEL FOR BPA: "Your Honor, there isn't one. But that's what (a)(2) contemplates. It's a hypothetical test."

[**20] BPA asks this Court to hold that under a hypothetical test, *§ 365(e)(2)* permits automatic termination of the Agreement prior to judicial review and prior

to the entry of automatic stay, or in the alternative, [*247] that *§ 365(e)(2)* requires a bankruptcy court to lift the automatic stay in order for the ipso facto clause to be enforced. Accordingly, BPA challenges both the bankruptcy court's entry of automatic stay and denial of a modification to the stay because the ipso facto clause and the Anti-Assignment Act permit BPA to terminate the Agreement automatically upon Mirant's Chapter 11 filing prior to any review by or approval of the bankruptcy court under *§ 365(e)(2)(A)*.

Mirant responds that the automatic stay provision, *§ 362(a)*, is violated by BPA's termination of the Agreement, that is, BPA's attempt to exercise control of property of the estate without the oversight of the bankruptcy court. Mirant argues the bankruptcy court did not abuse its discretion in entering the stay because the stay is automatic and either the Anti-Assignment Act does not apply because there was no transfer or, even if the Act does apply, the stay's automatic entry precedes any termination permitted [**21] by the combined effect of the Act, *§ 365(e)(2)(A)*, and the ipso facto clause of the Agreement. Mirant also argues the bankruptcy court did not err in denying BPA's motion to modify the stay because BPA failed to show the cause required under *§ 362(d)(1)*. In support, Mirant urges this Court to adopt an actual, or as-applied, analysis to determine whether the Anti-Assignment Act applies to this case and to conclude that it does not (thereby foreclosing termination via the ipso facto clause) because no assignment occurred here.

C. Analysis

1. Hypothetical vs. Actual Test

We begin by addressing the question that affects each of the issues raised by BPA, that is, whether this Circuit adopts the actual or hypothetical approach to the text of *§ 365(e)(2)(A)*. The hypothetical test was first announced and adopted in the sole circuit opinion to address the conjunctive effect of *§ 365* and the Anti-Assignment Act. *West, 852 F.2d at 82*. In *West*, a divided panel addressed similar facts and held the bankruptcy court abused its discretion in denying a lift of the Chapter 11 stay, which had the effect of preventing the government from terminating an executory [**22] contract under the two statutes. *852 F.2d at 82*. Addressing *§ 365(c)*, [16] as opposed to *§ 365(e)(2)* at issue here, the *West* majority created a hypothetical test for the determination of whether the Anti-Assignment Act was an "applicable law" such that the government could refuse performance under the Act. The *West* majority rejected an as-applied determination of whether assignment had occurred under the Act. *Id.* Concluding that hypothetically speaking the Anti-Assignment Act was an "applicable law" because it made the contract generally unassignable, the majority in *West* held that *§ 365(c)(1)* foreclosed the debtor's ability to assume the contract. *Id. at 83*. The majority reasoned:

> We think that by including the words "or the debtor in possession" in *11 U.S.C. § 365(c)(1)* Congress anticipated an argument like the one here made and wanted that section to reflect its [*248] judgment that in the context of the assumption and assignment of executory contracts, a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially distinct entities. While the relevant case law is very sparse, [**23] it supports our understanding of the interplay between . . . *§ 365(c)(1)* and *41 U.S.C. § 15*.

Id. (footnote omitted).

> 16 [HN13] *Section 365(c)* precludes a trustee from assuming or assigning an executory contract if "(1)(A) applicable law excuses a [nondebtor] party . . . to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession . . . and (B) such party does not consent to such assumption or assignment." *11 U.S.C. § 365(c)(1)*. Although the language of subsections (c)(1) and (e)(2) of *§ 365* are similar, they are by no means parallel overall or identical in effect. The two are not sufficiently similar that caselaw interpreting the one should be given any more than informative weight in interpreting the other.

In other words, under the Third Circuit's hypothetical approach, which rested on language in *§ 365(c)(1)* that does not appear in *§ 365(e)(2)(A)*, a court must ask [**24] whether BPA could refuse to accept performance of the Agreement from *any* assignee because the Anti-Assignment Act makes the Agreement unassignable as a matter of law. If so, then irrelevant is the fact that the debtor did not actually assign, intend to assign, or attempt to assign the contract, and consequently the executory contract is terminable by its ipso facto provision under *§ 365(c)*. *See id.*; *see also RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004)* (addressing *§ 365(c)* and copyright law); *Catapult, 165 F.3d at 747* (addressing *§ 365(c)* and federal patent law); *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534, 537 (11th Cir. 1994)* (addressing *§ 365(c)* and a municipal ordinance regarding franchise rights).

In contrast, the *West* dissent believed that Congress did not intend for "a 'solvent contractor and an insolvent debtor in possession going through bankruptcy' [to be] different entities for the purposes of the [Anti-Assignment Act]." *West, 852 F.2d at 84* (Higginbotham, J., dissenting in part) [**25] (citation omitted). Likewise, those courts that have rejected *West*'s hypothetical analysis adopt an actual test to determine a law's applicability under *§ 365. See Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 613 (1st Cir. 1995)*; *see also Cajun Elec. Members Comm. v. Mabey (In re Cajun Elec. Power Coop., Inc.), 230 B.R. 693, 705 (Bankr. M.D. La. 1999)*; *In re Lil' Things, Inc., 220 B.R. 583, 587 (Bankr. N.D. Tex. 1998)*; *Texaco Inc. v. La. Land & Exploration Co., 136 B.R. 658, 669 (Bankr. M.D. La. 1992)* (concluding the *West* hypothetical test is incorrect for three primary reasons); *In re Hartec Enters., Inc., 117 B.R. 865, 871 (Bankr. W.D. Tex. 1990)* (stating that the *West* hypothetical test "does not fulfill the purposes of the non-assignment statutes it seeks to enforce, creates inherent inconsistencies in the language of . . . the Code, and fails to adequately account for" amendments to the Code), *vacated by settlement, 130 B.R. 929 (W.D. Tex. 1991)*.

The actual or as-applied determination of whether a law is "applicable" under *§ 365(c)* and *(e)(2)(A)* was first [**26] adopted by the First Circuit. *Summit Inv., 69 F.3d at 613*. The actual test requires on a case-by-case basis a showing that the nondebtor party's contract will actually be assigned or that the nondebtor party will in fact be asked to accept performance from or render performance to a party -- including the trustee -- other than the party with whom it originally contracted. *Id. at 612*. The actual test contemplates that in a case where no assignment has taken place, *§ 365(e)(2)(A)*'s exception is not available and, as such, an ipso facto clause is invalidated. *See id.*; *see also Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997), abrogated on other grounds by Hardemon v. City of Boston, 144 F.3d 24 (1st Cir. 1998)*; *In re Cardinal Indus. Inc., 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990)*.

Although this Circuit has addressed *§ 365(c)(1)*, we have yet to address *§ 365(e)* or to name the test we apply to the determination of whether a nonbankruptcy [*249] law applies under either *§ 365(c)(1)* or *§ 365(e)(2)(A)*. *See Stumpf v. McGee (In re O'Connor), 258 F.3d 392, 402 (5th Cir. 2001)*; [**27] *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 943 (5th Cir. 1983)*. Review of this Circuit's law, however, reveals that our adoption today of the actual test, in resolving the availability of *§ 365(e)(2)(A)*'s exception, is consistent with prior caselaw. In *O'Connor*, a panel of this Court determined that a Louisiana statute regarding partnership was an applicable law under *§ 365(c)* and engaged in an as-applied analysis to determine whether an exception to the general rule applied to the case at hand to permit the assumption of the executory contract. *258 F.3d at 403-04* (concluding that the exception was not applicable and declaring the contract unassumable). In *Braniff*, a nondebtor objected to the district court's order that authorized the debtor in possession to assign its lease agreements with the United States for use of space at Washington National Airport to a different airline under the version of *§ 365 (c)* that existed prior to the 1984 amendment. *700 F.2d at 942*. Reversing the district court and prohibiting the assignment of the lease, the panel concluded that the broad [**28] language of *§ 365(c)* was not limited in application solely to personal service contracts. *Id. at 943*. The *Braniff* court held that the Code of the District of Columbia and a federal regulation enacted pursuant to that Code were "applicable law" under *§ 365(c)*, which prevented the lease's assignment because, in fact, the assignment had been attempted and ordered by the district court and the assignee airline had not been approved to perform by the agency vested with the authority for such approval. *Id. at 942-43*. *Braniff* did not address the hypothetical approach; indeed, the split between actual and hypothetical approaches had not yet emerged nor had any court yet approved a hypothetical approach to the determination of whether a law is applicable. Instead, *Braniff* addressed the language of *§ 365(c)* prior to its amendment in 1984. However, the pre-amendment language of *§ 365(c)* more closely tracks the current language of *§ 365(e)(2)(A)* than it does the current form of *§ 365(c)*. [17] Thus, the approach taken in *Braniff* informs our approach to *§ 365(e)(2)(A)* on this record, even in light of the statutory amendment to *§ 365(c)* and [**29] the post-amendment development of a split between the hypothetical and actual tests.

17 "Before the 1984 amendment, the pivotal language in section *§ 365(c)* read precisely like the current version of *section 365(e)(2)*; that is, it adverted to the 'applicable law excusing a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance *to the trustee or to an assignee* of such contract or lease . . . .'" *Summit Inv., 69 F.3d at 613* (alteration in original). In 1984, Congress made no change to the statute we address today, *§ 365(e)(2)(A)*, and with respect to *§ 365(c)*, it replaced the phrase "to the trustee or to an assignee of such contract or lease" that still appears in *§ 365(e)(2)(A)* with the phrase "to an entity other than the debtor or debtor in possession." *See* Leasehold Management Bankruptcy Amendments Act of 1983, Pub. L. No. 98-353, §

362, 98 Stat. 333, 361 (July 10, 1984); *see also Summit Inv., 69 F.3d at 613.*

[**30] [HN14] The plain text of *§ 365(e)(2)(A)* requires an actual test for determining whether a law is "applicable" under the exception, permitting enforcement of an ipso facto clause. According to the statute's plain language, an executory contract's ipso facto clause may be enforced if "applicable law excuses a [nondebtor] party . . . from accepting performance from or rendering performance . . . to an assignee of such contract" and that non-debtor party does not consent to "such assumption or assignment." [*250] *11 U.S.C. § 365(e)(2)(A).* Congress might have chosen the exception to apply if any law prohibited the assignment, but instead Congress tethered the exception to "applicable" law that "excuses a party." It is axiomatic that an applicable law must apply to a set of circumstances; BPA creates smoke and erects mirrors when it argues that a contract not assignable as a matter of law, even if no such assignment existed in fact and no excuse existed in fact for the nondebtor party to refuse acceptance or performance in a particular situation, satisfies the language chosen by Congress in drafting the *§ 365(e)(2)(A)* exception. [HN15] The law that releases a nondebtor from the general [**31] rule foreclosing the enforcement of an ipso facto clause must apply to something and must excuse the nondebtor from some specific performance or acceptance, *see § 365(e)(2)(A)*; thus, if the debtor demonstrates that no application exists or that no excuse obtains on a given record, then the congressional language announces such a circumstance is material, making the *§ 365(e)(2)(A)* exception unavailable. The applicability of the law under *§ 365(e)(2)(A)* is determined not in the abstract but on the record at hand. *See Cajun Elec., 230 B.R. at 705*; *Lil' Things, 220 B.R. at 587*; *Texaco, 136 B.R. at 669*; *Cardinal Indus., 116 B.R. at 974-75.*

That applicability is determined based upon the case is supported also by the congressional choice to structure the exception as a two-part test, the second portion of which requires a fact-based showing. *See 11 U.S.C. § 365(e)(2)(A)(i)-(ii).* [HN16] Subsection (ii) provides that the *§ 365(e)(2)(A)* exception lies only where "such [nondebtor] party does not consent to such assumption or assignment." *§ 365(e)(2)(A)(ii).* The combination of the plain text [**32] and the overall structure of the test that must be met in order for the exception to arise communicates that Congress intended *§ 365(e)(2)(A)* to apply to a given factual situation rather than to a class of executory contracts as BPA urges.

BPA argues that the use of the adjective "such" merely refers to the assumption and assignment provided in the preceding subsection and does not demand that Congress intended an actual test would determine the exception's availability. We are not persuaded that standing alone, [HN17] Congress's use of the adjective "such" to modify "assignment" in *§ 365(e)(2)(A)(ii)* mandates the use of an actual test. The modifier "such" references the assignments provided in the preceding subsection and does not, on its own, require an as-applied approach to the determination of whether a law applies to permit an ipso facto clause's enforcement. However, in combination with the other factors that demand a case-by-case inquiry into whether a nonbankruptcy law applies to permit termination by ipso facto clause, we cannot agree with so broad an analysis as permitted by the entirely theoretical approach countenanced by those courts adopting the hypothetical approach.

[**33] Finally, the plain text of the law proffered by BPA as applicable here, the Anti-Assignment Act, cuts against the broad application advanced by BPA. [HN18] In theory, a law of such general applicability might exist to merit application in most if not all circumstances under *§ 365(e)(2)(A)*, but the Anti-Assignment Act is, by its own terms, not so broadly applicable. Subsection (a) of the Act provides a general rule for annulment of a public contract upon a transfer by a party other than the United States. *41 U.S.C. § 15(a).* *Subsection (b)*, though, limits the application of the general rule, and the limitation applies on the basis of specific facts. [HN19] "The provisions of subsection (a) of this section *shall not apply* in any *case in which* the moneys due or to become due from the United States [*251] . . . under a contract providing for payments aggregating $ 1,000 or more, are assigned to a bank, trust company, or other financing institution" given other fact-based circumstances. *§ 15(b)* (emphasis added). [HN20] Both the text of the Anti-Assignment Act and the text of *§ 365(e)(2)(A)* require a case-by-case inquiry into the application of the Act to the executory contract or lease [**34] at issue in the bankruptcy proceeding. As such, we hold that with respect to *§ 365(e)(2)(A)* and the Anti-Assignment Act, the actual test must be used to determine the Act's applicability to a given case. [18] When the law to be applied to a *§ 365(e)(2)(A)* determination cannot apply to the case and the record before the bankruptcy court in fact or law, then *§ 365(e)(2)(A)*'s exception cannot give effect to an ipso facto clause.

18 Although we join the First Circuit in requiring an actual test to determine whether a law applies under *§ 365(e)(2)(A)*, we do not entirely join its reasoning. *See Summit Inv., 69 F.3d at 612-14.* Interpreting *§ 365(e)(2)(A)*, the First Circuit found that the statute's plain text permitted both the actual and hypothetical tests and adopted the actual test on the basis of legislative history and a determination that no assignment existed when prepetition debtors became debtors

> in possession under the Bankruptcy Code. *Id. at 612-13.* Instead, Congress's choice to trigger *§ 365(e)(2)(A)*'s exception upon the application of a law to a particular case dictates that an abstract approach should not be read into the statute.

[**35] **2. Automatic Stay**

Given that the actual test applies based upon the plain language of *§ 365(e)(2)(A)*, we next conclude that [HN21] the automatic stay must precede any enforcement of an ipso facto clause ultimately permitted by a bankruptcy court under *§ 365(e)(2)(A)*.

[HN22] *Section 362* provides for an automatic but not permanent stay against "any act to obtain possession of property of the estate" from which a party may seek relief "for cause, including the lack of adequate protection of an interest in property." *11 U.S.C. § 362(a)(3), (d)(1)*; *Cueva, 371 F.3d at 236*; *see also Computer Commc'ns, 824 F.2d at 729*. The Code itself requires that the stay's effect be automatically triggered upon the filing of a petition for bankruptcy. *See § 362(a)*; *Cueva, 371 F.3d at 236. Section 541(c)(1)* provides that a debtor's estate includes the debtor's interest in property that becomes property of the estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law" that is conditioned upon the commencement of a bankruptcy case. *§ 541(c)(1)*. Recently, Chief Judge Jones explained [**36] the principle at issue,

> Sweeping all of the debtor's property into the bankruptcy estate created at filing is the means by which the Code achieves effective and equitable bankruptcy administration. Only through a comprehensive administration of the debtor's property, wherever located and by whomever controlled, can the court shield the property from creditors' unauthorized grasp; prevent harassment of debtors; and ultimately ensure equal distribution among creditors.

*Burgess v. Sikes (In re Burgess), 438 F.3d 493, 2006 U.S. App. LEXIS 2056, 2006 WL 205043, at *15, No. 04-31089 (5th Cir. Jan. 27, 2006)* (Jones, C.J., dissenting).

Furthermore, this Court has recognized the automatic stay's broad application and noted that such breadth reflects a congressional intent that [HN23] courts will presume protection of property when faced with uncertainty or ambiguity. *Brown v. Chesnut (In re Chesnut), 422 F.3d 298, 303 (5th Cir. 2005)*. Likewise, the bankruptcy court's discretion to grant a modification [*252] or lift of the automatic stay is broad. *Cueva, 371 F.3d at 236.*

Here, Mirant's interest in the Agreement, even if it were ultimately terminable, became [**37] property of the estate upon Mirant's filing on July 14, 2003. Accordingly, the Agreement was subject to review by the bankruptcy court, and a party with an interest in an executory contract or lease must come before the bankruptcy court to move for a modification or lift of the stay under *§ 362(d)* in order to effect the terms of an ipso facto clause under *§ 365(e)(2)(A)*.

[HN24] The Bankruptcy Code, which must be read and must function as a whole, demands this conclusion. The Ninth Circuit has noted three compelling reasons to read the Code in this manner. *See Computer Commc'ns, 824 F.2d at 730* (citing *Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.), 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985))*. First, [HN25] *§ 362(b)* provides particular exceptions to the entry of automatic stay, but no exception is provided in the case of executory contracts. *Id.*; *see also 11 U.S.C. § 362(b)*. Second, "elsewhere in the [Bankruptcy Code], Congress expressly overrode the stay provision but did not do so in *§ 365*; and finally . . . not exempting this brand of executory contracts is consistent with the purposes and policies underlying [**38] the staying of actions against a debtor postpetition." *Computer Commc'ns, 824 F.2d at 730-31* (internal quotation marks omitted).

Moreover, on this record, the interplay of the Bankruptcy Code and the Anti-Assignment Act in particular comports with the conclusion that [HN26] the automatic stay must precede any termination permitted by an ipso facto clause and *§ 365(e)(2)(A)*. While the Bankruptcy Code and this Court's caselaw interpreting it require that the initiation of the broad automatic stay is immediate upon filing, such automatic triggering is absent from the text of the Anti-Assignment Act and caselaw interpreting the Act. According to BPA, the termination permitted by *§ 365(e)(2)(A)* and the ipso facto clause of the Agreement here is automatic upon Mirant's filing for relief under the Bankruptcy Code and precedes the entry of automatic stay. We disagree. [HN27] The Anti-Assignment Act, instead, provides the government with an option to rescind its contracts upon transfer. The Anti-Assignment Act permits the United States to elect its response to the transfer of a contract to which it is a party. The United States may either waive its rights under the Act and continue performance, [**39] or it may terminate the contract. *See Tuftco Corp. v. United States, 222 Ct. Cl. 277, 614 F.2d 740, 744 (Ct. Cl. 1980)* (permitting the United States to waive the Anti-Assignment Act's prohibition of transfer where the government was aware of, assented in writing to, and

recognized the assignment); *see also NRG Co. v. United States, 31 Fed. Cl. 659, 661 (1994)*. Thus, the Act does not provide for automatic recision of the public contract upon transfer; annulment of the contract at issue requires a response by the United States. The Anti-Assignment Act, and its effect on a given executory contract, may be raised by the government after the entry of a bankruptcy court's automatic stay under, at a minimum, the provision for stay modification. *See 11 U.S.C. § 362(d)*.

Accordingly, the automatic stay prohibited BPA from terminating the Agreement. Even when *§ 365(e)(2)(A)* will ultimately permit a nondebtor party to terminate an executory contract by virtue of the combined effect of *§ 365(e)(2)(A)*, applicable law, and an ipso facto clause, the nondebtor party must seek relief from the stay before the bankruptcy court under [*253] *§ 362(d)*. [**40] Therefore, we affirm the bankruptcy court's Stay Violation Order.

3. The Denial of Modification to Stay

We next address BPA's contention that the lower courts erred in failing to lift or modify the stay under *§ 362(d)(1)*. Based upon our conclusion that the Anti-Assignment Act has no application on this record, we cannot say the bankruptcy court abused its discretion in denying BPA's Motion to Modify Stay. The bankruptcy court denied BPA's motion because the court concluded that BPA failed to show cause for relief from stay under *§ 362(d)(1)*, although a portion of the court's conclusion also necessarily rested upon the legal determination that the Anti-Assignment Act is not an applicable law under *§ 365(c)(1)* or *(e)(2)(A)*.

[HN28] The Bankruptcy Code does not precisely define "cause" under *§ 362(d)(1)*, and in the past we have noted that this lack of definition affords "flexibility to the bankruptcy courts." *Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (In re Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986)* (explaining that lack of good faith is sufficient for "cause" and discussing the inherent balancing required for the court's determination [**41] of whether a stay should be lifted under *§ 362(d)*). Mirant argues that a contractual right to terminate does not constitute sufficient cause to grant relief from the automatic stay. *See Elder-Beerman Stores Corp. v. Thomasville Furniture Indus. Inc. (In re Elder-Beerman Stores Corp.), 195 B.R. 1019, 1023 (Bankr. S.D. Ohio 1996)*. The exception provided by *§ 365(e)(2)(A)* discredits such a broad understanding of the limits on a potential relief from stay, and a bankruptcy court's discretion is not so broad as Mirant argues. Although the district court did not abuse its discretion here to deny the stay's modification, on a record differing in fact, procedure, or both, [HN29] a bankruptcy court's discretion is limited by the text of *§ 365(e)(2)(A)*, that is, in the case in which a law proffered as applicable under *§ 365(e)(2)(A)* is determined to apply to the case, then the stay must be lifted or modified in such a way that permits the entitled nondebtor party to exercise its termination option accordingly.

Here, BPA has not demonstrated cause because the Anti-Assignment Act is not an applicable law on this record because here there has been no transfer. In order for the Act [**42] to apply to this case, it must be said that the Agreement was "transferred" within the meaning of the Act. *See 41 U.S.C. § 15*. The caselaw, however, does not support BPA's reading of transfer under the Act. On this record, the Anti-Assignment Act cannot apply because no assignment, which would be prohibited by the Act, occurred between prepetition debtor and debtor in possession for three salient reasons. First, Mirant never affirmatively assumed or rejected the Agreement. *See 11 U.S.C. § 365(a)*. [19] [HN30] According to *§ 365(f)(2)(A)*, assumption must precede assignment. *See § 365(f)(2)(A); see also Cinicola v. Scharffenberger, 248 F.3d 110, 120 (3d Cir. 2001)*. Here, Mirant did not assume the Agreement. Second, BPA might have moved under *§ 365(d)(2)* [20] for the court to order [*254] Mirant to determine, within time constraints, whether it would assume or reject the Agreement. But BPA never so moved the court, nor did it make any effort apparent on the record (other than the letter, sent to Mirant, unilaterally terminating the Agreement) to either the bankruptcy court or with opposing counsel to resolve the question of assumption [**43] or rejection. Finally, BPA conceded to the bankruptcy court that there was no assignee in fact. On such a record, no transfer - prohibited by the Anti-Assignment Act - has occurred or even been attempted, and therefore the Act is not an applicable law.

19 We have previously recognized that in Chapter 11 proceedings, an executory contract might be neither assumed, rejected, nor assigned and that in such a circumstance, the contract would ride through the proceedings, leaving the nondebtor's claim to survive the bankruptcy. *Century Indem. Co. v. NGC Settlement Trust (In re Nat'l Gypsum Co.), 208 F.3d 498, 504 n.4 (5th Cir. 2000)*.

20 *Section 365(d)(2)* vested BPA with the procedure to demand Mirant's action with respect to the Agreement. [HN31] "The court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease." *§ 365(d)(2)*. This statutory provision, as the bankruptcy court noted, offered BPA the means to obtain the information it

needed, whether Mirant would assume or reject the Agreement after filing for bankruptcy, and in the time in which BPA urged that an answer was needed.

[**44] The parties dispute whether, as a matter of law, a transfer or assignment occurs as a result of the change in status from prepetition debtor to debtor in possession. If the change in the status produces a transfer of the executory contract, then according to BPA, the Anti-Assignment Act applies. If the change in status is nominal only and there is no transfer or assignment as a matter of law, then, as Mirant argues, the Anti-Assignment Act may have no applicability in the absence of a transfer. *See 41 U.S.C. § 15* (providing that "any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned"). We need not, on this record, resolve this res nova question. [21] We hold only what this record permits, that is, [HN32] no transfer occurs under the Anti-Assignment Act where the debtor neither assumes nor attempts to assume the executory contract, the nondebtor concedes there is no assignment in fact, and the nondebtor, seeking to invoke the combined effect of the Anti-Assignment Act and *§ 365(e)(2)(A)*, fails to move for assumption or rejection under *§ 365(d)(2)*. In such a circumstance, where no party has moved [**45] to assume the executory contract before the bankruptcy court, no assignment occurs between prepetition debtor and debtor in possession with respect to the Anti-Assignment Act and *§ 365(e)(2)(A)*.

21 Though other courts have concluded no assignment exists with respect to an executory contract or lease as a result of the change in status between a prepetition debtor and a debtor in possession, *see Summit Inv., 69 F.3d at 613-14* (discussing *Bildisco, 465 U.S. at 528*); *United States v. Gerth, 991 F.2d 1428 (8th Cir. 1993)*, we cannot agree that the Supreme Court has conclusively resolved this question. Instead, in *Bildisco*, the Court merely stated, "for our purposes, it is sensible to view the debtor-in-possession as the same 'entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have done absent the bankruptcy filing." *465 U.S. at 528*. That "sensible view," necessary only for the purposes of that case, does not support in all cases the proposition that no assignment or transfer occurs as a matter of law between prepetition debtor and debtor in possession. Accordingly, neither the Supreme Court nor this Circuit has resolved the argument presented by BPA that rights obtained in bankruptcy require that a debtor in possession be treated as a distinct legal entity from a prepetition debtor.

[**46] **III. Conclusion**

For the foregoing reasons, the bankruptcy court correctly determined that a Chapter 11 automatic stay must precede the enforcement of any eventual right a nondebtor may have to terminate an executory contract under *§ 365(e)(2)(A)*. Accordingly, we affirm the bankruptcy [*255] court's Stay Violation Order. Also, the bankruptcy court did not abuse its discretion to deny modification or lift of stay where no assignment or transfer had occurred or been attempted. On such a record, the Anti-Assignment Act is not an applicable law under *§ 365(e)(2)(A)*.

AFFIRMED.

The Intersection of Bankruptcy Law With Criminal Law

Discharge, Confirmation, and the Fifth Amendment Privilege against Self-Incrimination

FACT PATTERN

Alfonzo Edward Scheme (known to his friends as "Fonz E. Scheme") was a securities broker and investment advisor who specialized in matching his clients with off-market, high-yield mutual funds and investment portfolios. One such vehicle was Pyramid LLC, an investment firm that, according to Pyramid, utilized groundbreaking, real-time proprietary algorithms to consistently win high rates of return in the foreign exchange markets.

Two of Alfonzo's clients, Mr. and Mrs. Gullible, were impressed with Alfonzo's description of Pyramid's clockwork returns and proven track record of delivering impressive results. "In fact," Alfonzo confessed to the Gullibles, "I have over a million dollars of my own personal money at Pyramid." He showed the Gullibles several glossy quarterly statements from Pyramid that showed consistent performance. At the conclusion of this presentation, the Gullibles directed Alfonzo to invest substantially all of their children's educational trust in Pyramid.

Over time, the truth about Pyramid became more clear. While the firm continued to post impressive gains on paper, and to faithfully distribute funds to certain of its clients making withdrawals, many investors, including the Gullibles, became spooked when Pyramid became unwilling or unable to allow them to access their money. The ensuing run on Pyramid caught the attention of the SEC and FBI. Criminal charges were filed against Pyramid in federal court. Pyramid was also forced into a liquidation under the Securities Investor Protection Act (SIPA).

Devastated by these events and other financial difficulties, Alfonzo and his investment firm filed jointly for chapter 11 relief.

Infuriated by feeling lied to, and incensed at the notion that Alfonzo might be able to walk away from it all in chapter 11, the Gullibles and other like-minded investors filed a complaint in Alfonzo's bankruptcy case seeking a determination that his debts to them were non-dischargeable under Bankruptcy Code section 523(a)(2) because he obtained their money as a result of "false pretenses, a false representation, or actual fraud."

In the ensuing evidentiary hearing, Alfonzo repeatedly refused to answer questions relating to the investors' claims of fraud and misrepresentation, invoking his Fifth Amendment right against self-incrimination. The hearing was adjourned to give the investors an opportunity to seek and obtain a grant of immunity for Alfonzo under Bankruptcy Code section 344, which they did. Upon the resumption of the proceedings, Alfonzo again refused to answer the questions posed, invoking his Fifth Amendment rights. At the conclusion of the hearing, the

Court declined to enter a judgment on the complaint, deferring the matter to be decided in connection with confirmation.

Alfonzo proposed a joint chapter 11 plan that would make a fractional distribution to holders of claims such as the Gullibles through the proceeds of the sale of certain personal property. The plan did not provide for the continuation of Alfonzo's investment and advisory business.

At the confirmation hearing, the investors objected vociferously to granting Alfonzo a discharge. First, they argued that the Court was entitled to draw a negative inference from Alfonzo's refusal to testify, thus supporting their claims of fraud and rendering Alfonzo's debts to them non-dischargeable under Bankruptcy Code section 523(a)(2). Second, the investors argued that the failure of Alfonzo to testify demonstrated a lack of good faith under Bankruptcy Code section 1129(a)(3), thus rendering his plan unconfirmable. Third, the investors argued that discharge was blocked by Bankruptcy Code section 1141(d)(3) because the plan provided for the liquidation of the estate, Alfonzo did not plan to continue his business after consummation of the plan, and he would have been denied a discharge under section 727(a)(6) for refusing to testify after the grant of immunity. Finally, the investors argued that their questioning of Alfonzo was intended to be in his capacity as a representative of his investment firm, which was also a debtor in the consolidated cases. Accordingly, they argued that he was not entitled to invoke the Fifth Amendment at all, since a corporate entity enjoys no such protection. Alfonzo opposed the investors' arguments on each point.

Following argument, the Court issued an opinion and order confirming Alfonzo's chapter 11 plan and granting him a discharge. The Court ruled, first, that under the circumstances of the case it did not find that a negative inference from Alfonzo's refusal to testify was warranted. In the absence of such testimony, the Court found the evidence in support of the investors' claims of fraud and malfeasance to be insufficient; thus, section 523(a)(2) did not apply to bar discharge. The Court found further that Alfonzo's refusal to testify, standing alone, was insufficient to support a finding that the plan was not proposed in good faith under Bankruptcy Code section 1129(a)(3). In addition, the Court ruled that the investors' invocation of Bankruptcy Code section 1141(d)(3) failed to block Alfonzo's discharge because the Court believed Alfonzo intended to provide investment services in the future, notwithstanding the fact that the plan did not provide explicitly for a continued business enterprise, thus overriding section 1141(d)(3)(B). Finally, as to the issue of Alfonzo's questioning in his corporate capacity, the Court found that the investors failed to preserve the argument by not making Alfonzo's capacity clear in their questioning of him in the first instance.

The Gullibles and other interested investors appealed the confirmation order to the District Court. The matter has been briefed and is set for argument.

Relevant Statutory Citations and Case Law

The Bankruptcy Code

Key Sections:

- **11 U.S.C. § 344. Self-incrimination; immunity**

Immunity for persons required to submit to examination, to testify, or to provide information in a case under this title may be granted under party V of title 18.

- **11 U.S.C. § 523(a). Exceptions to discharge**

A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition . . . .

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny

- **11 U.S.C. § 1129(a)(3). Confirmation of plan**

The court shall confirm a plan only if all of the following requirements are met: . . . (3) The plan has been proposed in good faith and not by any means forbidden by law.

- **11 U.S.C. § 1141(d). Effect of confirmation**

(2) A discharge under this chapter does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title.

(3) The confirmation of a plan does not discharge a debtor if—

(A) the plan provides for the liquidation of all or substantially all of the property of the estate;

(B) the debtor does not engage in business after consummation of the plan; and

(C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

- **11 U.S.C. § 727(a)(6). Discharge**

The court shall grant the debtor a discharge, unless—(6) the debtor has refused, in the case—

(A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;

(B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify; . . . .

Relevant Case Law

- The Fifth Amendment Privilege against Self-Incrimination Applies in Bankruptcy
    - *Martin-Trigona v. Belford (In re Martin-Trigona)*, 732 F.2d 170 (2d Cir. 1984)
        - "There is no doubt that the Fifth Amendment privilege extends to bankruptcy proceedings." *Id.* at 175 (*citing McCarthy v. Arndstein*, 266 U.S. 34 (1924)).

- Assertion of Fifth Amendment Privilege and Dischargeability of Debts in Bankruptcy

(a) Mere Assertion of the Fifth Amendment Privilege Insufficient Grounds to Deny Discharge

- *In re McCormick*, 49 F.3d 1524 (11th Cir. 1995)
    - Bankruptcy Court denied debtor's Chapter 11 reorganization plan for lack of good faith, stating that "[t]he Debtor's invocation of his Fifth Amendment privilege in connection with this case demonstrates that the Plan of Reorganization was not filed in good faith" and "[t]he district court affirmed without opinion." *Id.* at 1525.
    - On appeal, the Eleventh Circuit held that "the debtor's assertion of the Fifth Amendment in a related adversary proceeding, standing alone, when all aspects of his Chapter 11 Plan of Reorganization are consistent with the goals of the Bankruptcy Code, is not sufficient evidence of bad faith to merit denial of his plan." *Id.*
        - "[C]ourts have interpreted 'good faith' [as used in 11 U.S.C. § 1129(a)(3)] as requiring that there is a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Code." *Id.* at 1526 (internal citations omitted).
        - "The focus of a court's inquiry is the plan itself, and courts must look to the totality of the circumstances surrounding the

plan, keeping in mind the purpose of the Bankruptcy Code is to give debtors a reasonable opportunity to make a fresh start." *Id.* (internal citations omitted).

- "The Bankruptcy Code does not dictate nor have we found any other court to have held that a bankruptcy court may deny confirmation of a reorganization plan solely because the debtor refused to testify on the basis of the privilege against self-incrimination in a related proceeding during the pendency of a Chapter 11 case." *Id.*

- *In re Growers Packing Co., Inc.*, 150 B.R. 82 (Bankr. S.D. Fla. 1993)
  - Court devised a method by which the Debtor could preserve his Fifth Amendment right against self-incrimination while maintaining the dischargeability of his debts in bankruptcy.
    - Debtor required to assert privilege in response to particular deposition questions. Court would subsequently review debtor's assertion of privilege on a question by question basis.
    - "If the Debtor is granted immunity and continues to refuse to testify, or incorrectly asserts the Fifth Amendment privilege, the Court may deny Debtor his discharge." *Id.* at 84.
  - "[T]o preserve and effectuate the Fifth Amendment privilege, it appears the Debtor's assertion of the privilege should not be the sole ground for denial of his discharge. To hold otherwise would dilute the privilege by allowing the drawing of adverse inferences from the Debtor's failure to respond to evidence against him." *Id.* at 83.

(b) Debtor May Not Use Fifth Amendment Privilege to Take Advantage of Innocent Creditors

- *In re Lederman*, 140 B.R. 49 (Bankr. E.D.N.Y. 1992)
  - Creditor brought adversary proceeding pursuant to 11 U.S.C. §§ 523(a)(2)(B) and 523(a)(4) "seeking a determination that a debt owed to it by [debtor] is non-dischargeable." *Id.* at 51.
  - "The debtor cannot use the bankruptcy court to broaden the benefits afforded to an accused by the Fifth Amendment. To do so would allow the debtor to use the Fifth Amendment as a shield, while impermissibly using the Bankruptcy Code as a sword with which to take an unfair advantage of creditors." *Id.* at 53 (*citing Piperi v. Gutierrey (In re Piperi)*, 137 B.R. 644, 647 (Bankr. S.D. Tex. 1991)).
  - "Moreover, in § 727(a)(6)(B) Congress specifically preserved a debtor's rights to raise the privilege against self-incrimination, absent a grant of immunity, with respect to oral examination and testimony without prejudice to the right to a discharge. The lack of a similar provision in § 523 leads to the inescapable conclusion that none was intended." *Id.*
  - "Furthermore, since the relief of a fresh start is intended to benefit an *honest* debtor, . . . and since a court sitting in a civil case is permitted

to draw adverse inferences from a defendant's invocation of the Fifth Amendment privilege . . . [debtor] cannot defeat [creditor's] complaint by invoking his Fifth Amendment privilege." *Id.* (emphasis in original) (internal citations omitted).

- *Matter of Metzgar*, 127 B.R. 708 (Bankr. M.D. Fla. 1991)
  - "While a debtor is entitled to invoke his fifth amendment right to refuse responses in a bankruptcy proceeding, . . . a discharge in bankruptcy is neither an inherent nor a constitutional right." *Id.* at 711.
  - "A debtor seeking relief from his obligations pursuant to the Bankruptcy Code and in a Bankruptcy Court does so willingly and voluntarily and is not entitled to as much consideration in being compelled to testify as would be another witness who had no interest in the proceeding." *Id.* (*citing In re Larkham*, 24 B.R. 70, 72 (Bankr. D.Vt. 1982)).

- Non-Dischargeability of Indebtedness Under 11 U.S.C. § 523(a)(2)(A)
  - *In re Grant*, 237 B.R. 97 (Bankr. E.D. Va. 1999)
    - Plaintiffs claimed that debtor not entitled to discharge under 11 U.S.C. § 523(a)(2)(A), alleging "false pretenses, false representations, and actual fraud."
    - "To further the policy of providing a debtor with a fresh start in bankruptcy, exceptions to discharge are construed strictly against the creditor and liberally in favor of the debtor." *Id.* at 112 (*quoting In re Barr*, 194 B.R. 1009, 1016 (Bankr. N.D.Ill. 1996)).
    - "In a § 523(a) matter (as made applicable here by 11 U.S.C. § 1141(d)(2)), the objecting creditor must establish nondischargeability by a preponderance of the evidence." *Id.* (*citing* Grogan v. Garner, 498 U.S. 279, 291 (1991)).
    - "Most courts agree that the traditional elements of an action for fraud must be established to prevail on a claim of nondischargeability under § 523(a)(2)(A)." *Id.* (*citing In re Simos*, 208 B.R. 188, 191 (Bankr. M.D.N.C. 1997)).
    - The traditional elements of an action for fraud are:

      (1) That the debtor made a representation;
      (2) That at the time of the representation was made, the debtor knew the representation was false;
      (3) That the debtor made the false representation with the intention of deceiving the creditor;
      (4) That the creditor relied on such representation; and
      (5) That the creditor sustained the alleged loss and damage as the proximate result of the false representation.

      Id. (internal citations omitted).

Bankruptcy Litigation, the Crime-Fraud Exception to the Attorney-Client Privilege and *In Pari Delicto*

FACT PATTERN

Bob, the CEO of XYZ Corporation ("XYZ"), is a member of the Board of Directors of ABC, Inc. ("ABC"), a wholly-owned subsidiary of XYZ Corporation. ABC's board of directors consists of nine individuals, five of which are also directors of XYZ. The other four directors, including the chairman of the ABC board, are independent.

ABC manufactures several lines of beauty products, including the small but popular "Secrets of the Bible" line - a line of all-natural creams and moisturizers that contain spearmint leaf oil as a key ingredient.

During a golf outing, Bob is told by his golf partner, a human resources manager at the Federal Drug Administration (FDA), that he heard that the FDA would be investigating spearmint leaf oil's effects on long-term health. The FDA manager knew Bob was the CEO of XYZ, but did not know of the connection between XYZ and ABC.

In response to this information, Bob proposes a corporate reorganization to the XYZ Corporation board of directors that includes the formation of a new company, New ABC, Inc., to take over the assets and liabilities of ABC's beauty product lines, with the exception of the Secrets of the Bible line, which would remain with ABC. The XYZ board is informed of the reason for the proposed reorganization and consequently approves the reorganization. New ABC, Inc. is formed and provided funds to acquire the non-natural manufacturing operations of ABC.

During a meeting of the ABC board of directors, Bob discusses the corporate reorganization proposal. Although the ABC board appears to favor the transaction, the chairman is concerned about the propriety of the transaction and decides he would prefer to appoint a three member special committee. The special committee is composed of Joe, ABC's VP of corporate affairs, and two independent members of the Board. After reviewing the proposed transaction, the special committee recommends approval to the ABC board. The board promptly approves

the acquisition of all its manufacturing assets and liabilities, with the exception of the Secrets of the Bible line, by New ABC, Inc.

Immediately upon approval of the acquisition, all documents relating to the Board's consideration and the special committee's underlying review are destroyed in accordance with historical company practices.

The cash received by ABC in consideration is reinvested in the Secrets of the Bible line, allowing ABC to increase manufacturing and distribution of the product. ABC's sales soar during the next year and ABC doubles its profit from the preceding year.

At the time that ABC was engaging in the asset sale transaction, the State of Hawaii held a judgment against ABC for false advertising for based using of a body double in advertising the youth restoring properties of the "Secrets of the Bible" line. In connection with its appeal, Joe works with litigation counsel to fashion an affidavit that states that ABC would continue to have sufficient assets to pay the judgment after the asset sale.

Eighteen months after New ABC's acquisition of ABC's assets, the FDA releases its findings that spearmint leaf oil is extremely dangerous to one's health. ABC's sales plummet as the lawsuits skyrocket. ABC has no choice but to seek bankruptcy protection.

The unsecured creditors' committee of ABC (the "OCC") obtains authority to file an adversary proceeding alleging XYZ fraudulently stripped ABC of its profitable assets, knowing all along that the FDA was investigating the health-effects of spearmint leaf oil, and refused to address the ABC product formulation or warn ABC of the FDA investigation.

As part of its discovery, the OCC seeks all communications relating to the affidavit filed in connection with the State of Hawaii litigation. ABC objects to the discovery on the basis of the attorney-client privilege. The OCC asserts the crime/fraud exception to the privilege.

After the completion of discovery, the OCC files a motion in limine seeking an adverse inference regarding the purposes of the transaction based on spoliation of evidence. XYZ files a motion for summary judgment raising the *in pari delicto* defense.

Relevant Rules, Case Law, and Articles

The Delaware Lawyers' Rules of Professional Conduct

- **Del. Prof. Cond. R. 1.6. Confidentiality of information**

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: . . . (3) to prevent, mitigate, or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services

Relevant Case Law

(1) The Crime-Fraud Exception

- Application of the Crime-Fraud Exception
    - *In re Southern Air Transp., Inc.*, 255 B.R. 706 (Bankr. S.D. Ohio 2000)
        - "Where an attorney is used in the perpetration of a crime or fraud, there is no basis for allowing the assertion of the privilege . . . For the fraud exception to apply: (1) a *prima facie* case must be presented that a fraud has occurred; and (2) there must be a connection between the privileged communications at issue and the *prima facie* violation." *Id.* at 714 (*citing In re Antitrust Grand Jury*, 805 F.2d 155, 164 (6th Cir. 1986)).
    - *Ocean Spray Cranberries, Inc. v. Holt Cargo Sys., Inc.*, 785 A.2d 955, 959 (N.J. Super. Law Div. 2000)
        - "[P]ublic policy requires that the term fraud 'be given the broadest interpretation". It includes *virtually all kinds of deception and deceit*, even though they might not otherwise warrant criminal or civil sanctions." *Id.* at 521-22 (internal citations omitted)(emphasis in original).
- Client's Intent Controls but Court May Find Evidence of Attorney's Constructive Knowledge of Fraudulent Intent
    - *In re Rigby*, 199 B.R. 358 (Bankr. N.D. Tex. 1995)
        - "Included as part of the prima facie case of fraud is evidence of an intent to deceive." *Id.* at 361 (*citing Industrial Clearinghouse, Inc. v. Browning Mfg. Div. of Emerson Elec. Co.*, 953 F.2d 1004, 1008 (5th Cir. 1992)).
        - Court found that "a prima facie case [had] been established" that the Debtor and his wife transferred his assets with the "*sole* intent . . . to protect their assets by attempting to place the assets beyond the reach of the IRS." *Id.* (emphasis in original).
        - Further, the Court noted that "[w]hether or not [the Debtor's attorney] was aware of the Rigbys' apparent fraudulent intent for dividing their

community property and establishing the Trust is irrelevant to the application of the crime-fraud exception to the attorney-client privilege." *Id.* (*citing In re Grand Jury Proceedings*, 43 F.2d 966, 972 (5th Cir. 1994)).

- "It is the intent of the Rigbys that controls and not that of [the attorney] in preparing the documents. However, because Dobbs was assisting the Rigbys in their IRS troubles at the same time he prepared the Partition Agreement and the Trust, the Court is of the opinion he should have been aware of the Rigbys' fraudulent intent." *Id.*

- *Ocean Spray Cranberries, Inc. v. Holt Cargo Sys., Inc.*, 785 A.2d 955, 959 (N.J. Super. Ct. Law Div. 2000)
  - "The exception applies even if the attorney is unaware of the client's criminal or fraudulent intent, and applies of course where the attorney knows of the forbidden goal." *Id.* at 959 (applying New Jersey law).

(2) The *In Pari Delicto* Defense

- <u>The "Adverse Interest" Exception</u>
  - *In re Lemington Home for the Aged*, 659 F.3d 282 (3d Cir. 2011)
    - "[T]here is an exception to the applicability of *in pari delicto*, when the complained-of action did not actually benefit the corporation. . . . This "adverse interest" exception was set forth succinctly in Lafferty as follows: 'Under the law of imputation, courts impute the fraud of an officer of a corporation when the officer commits the fraud (1) in the course of his employment, and (2) for the benefit of the corporation.'" *Id.* at 293 (*quoting Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 358 (3d Cir. 2001)).

- <u>Parent Corporation's Fraud May Be Imputed to Wholly-Owned Subsidiary to Apply *In Pari Delicto* Defense</u>
  - *Nisselson v. Lernout & Hauspie*, 469 F.3d 143 (1stCir. 2006)
    - Background:
      - "In the underlying series of events, a corporate shark, using fraudulent means, induced an allegedly innocent target corporation to enter into an ill-advised merger." *Id.* at 147.
        - To effect the merger, Old Dictaphone, a Delaware corporation, merged into the wholly-owned subsidiary of Lernout & Hauspie, a Belgian corporation to create a new entity, New Dictaphone. Both Lernout & Hauspie and New Dictaphone subsequently filed for bankruptcy protection. *Id.* at 148.
      - Trustee of litigation trust created by New Dictaphone's chapter 11 plan of reorganization brought merger-related claims on behalf of New Dictaphone against, among others, "the officers,

directors, investment bankers, attorneys, and auditors of L&H." *Id.* at 149.

- "In pari delicto is both an affirmative defense and an equitable defense. Broadly speaking, the defense prohibits plaintiffs from recovering damages resulting from their own wrongdoing." *Id.* at 151 (internal citations omitted).
- Application of the defense is limited "to those situations in which (i) the plaintiff, as compared to the defendant, bears at least substantially equal responsibility for the wrong he seeks to redress and (ii) preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest." *Id.* at 152 (internal citations omitted).
  - "L & H was the main player in the alleged fraud and its parlous behavior must be imputed lock, stock, and barrel to its offspring (New Dictaphone). It follows inexorably that New Dictaphone, in contemplation of law, bears at least as much responsibility for the asserted wrongdoing as any of the defendants." *Id.* at 157.
  - "In the absence of any compelling public policy reason to allow New Dictaphone to seek damages from those that assisted in executing the fraudulent scheme—and the trustee has identified non—the in pari delicto doctrine precludes New Dictaphone (and, hence, the trustee) from advancing the type of claims that are at issue here." *Id.* at 158.

- <u>*In Pari Delicto* Defense Will Not Bar Action On Behalf of Innocent Third-Party Creditors</u>
  - *Trenwick Am. Lit. Trust v. Ernst & Young, L.L.P., et al.*, 906 A.2d 168 (Del. Ch. 2006)
    - Trustee of Litigation Trust brought claims breach of fiduciary duty, "deepening insolvency", and fraud against former members of a debtor-parent's and debtor-subsidiary's boards of directors. *Id.* at 170.
    - Although Court of Chancery dismissed trustee's claims, it declined to rely on defendants' *in pari delicto* defense, noting in dicta that "[t]he doctrine of *in pari delicto* has never operated in Delaware as a bar to providing relief to the innocent by way of a derivative suit." *Id.* at 212, n.132.

Relevant Articles

Beverly Weiss Manne, *Courts Weigh In on In Pari Delicto: 3d Circuit Says Defense Cannot by 'Woodenly Applied'*, J. OF CORP. RENEWAL, Turnaround Management Association (Nov. 2009), available at http://www.turnaround.org/Publications/Articles.aspx?objectID=13383.

- Discusses Third Circuit's recent application of the *in pari delicto* defense in *Official Comm. of Unsecured Creditors of Allegheny Health, Educ., and Research Found. v. PricewaterhouseCoopers*, 607 F.2d 346, 2010 WL 2134619 (3d Cir. 2010).
- Provides general overview of exceptions to *in pari delicto* doctrine

Catherine E. Vance, *In Pari Delicto, Reconsidered*, ABI JOURNAL., Vol. XXVIII, No. 9 (Nov. 2009), available at www.dsi.biz/articles/2009Nov_ABIJ_InPariDelictoReconsidered.pdf.

- Compares recent application of the *in pari delicto* doctrine with its historical application

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