EXECUTORY CONTRACTS AND PERFORMANCE DECISIONS IN BANKRUPTCY

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INTRODUCTION

This Article analyzes the treatment in bankruptcy of a debtor's "executory contracts"—contracts under which the debtor still owes (or is owed) performance at the time the debtor files for bankruptcy. Under the laws of most countries, including the United States, the bankruptcy trustee generally disposes of an executory contract in one of two ways: she either 1) seeks performance of the contract; or 2) "rejects" the contract, in which case any resulting damage claim is treated as a prebankruptcy unsecured claim.[1] Since such claims are typically paid only a fraction of their face amount, the usual consequence of rejection is that an injured party receives much less than full compensation.

The Article explains that the ability of the bankruptcy trustee to reject executory contracts without fully compensating the in-

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This Article is part of a larger project on the distribution of a debtor's bankruptcy estate among its creditors. An earlier Article focused on the division of value between secured and unsecured creditors. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996). This is the first of two Articles that will examine the treatment of parties whose contracts with the debtor are still executory when the debtor files for bankruptcy. Another Article will focus on the division of value among unsecured creditors.

1. *See* 11 U.S.C. § 365(a) (1994).

jured party can give the bankruptcy trustee an incentive to reject value-creating contracts that, from an efficiency perspective, should be performed. The Article then puts forward for consideration and analyzes a variety of arrangements designed to eliminate this distortion, including three rules that adjust the contract price in favor of the bankruptcy estate.[2]

A bankruptcy filing automatically creates a separate legal entity—the "bankruptcy estate."[3] The debtor's assets become property of the estate and are managed by the bankruptcy trustee.[4] The debtor's liabilities are converted into claims against the estate.[5] An important purpose of the bankruptcy proceeding is to preserve the business' value as a going concern, if any.[6] The trustee also has a duty to maximize the payout rate for unsecured claims,[7] whether the business is ultimately liquidated, sold as a going concern to a third party, or reorganized.[8]

Most debtors enter bankruptcy with some contracts that are still "executory."[9] Depending on its terms, an executory contract

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2. As George Triantis has observed, the problem of excessive breach arises not only in bankruptcy but whenever a promisor is insolvent and damage claims arising out of breach are not paid in full. *See* George G. Triantis, *The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment*, 43 U. TORONTO L.J. 679 (1993). Triantis' solution to the problem of excessive rejection in bankruptcy, which is different from the arrangements put forward here, is discussed and analyzed *infra* notes 104-07 and accompanying text.

3. *See* 11 U.S.C. § 541(a) (1994).

4. The trustee is an individual appointed to administer the estate of the debtor. *See* 11 U.S.C. §§ 1104, 1302. In Chapter 11 reorganization proceedings, the estate is usually managed by the debtor's management, as "debtor-in-possession" ("DIP"), which has the same powers and duties as a trustee. *See* 11 U.S.C. § 1107. However, for convenience I will use the term "bankruptcy trustee" to refer to the person(s) managing the bankruptcy estate.

5. *See* 11 U.S.C. §§ 501-60 (1994).

6. *See* Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 509 (1983); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 350 (1993).

7. *See* Steven J. Wadyka, *Executory Contracts and Unexpired Leases: Section 365*, 3 BANK. DEV. J. 217, 224-25 (1986).

8. *See* Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 231-32 (1989). In practice, a trustee may seek to preserve her job or advance the interests of a particular class of claimants at the expense of maximizing the value of the estate as a whole. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 671-72, 683-88 (1993). The assumption that the trustee seeks to maximize the payout rate for unsecured claims is made for convenience and is not critical to the analysis.

9. *See* Nimmer, *supra* note 6, at 512. The results of an informal study of bankrupt-

can be an asset or liability to the debtor's estate.[10] Unlike ordinary assets, executory contracts do not automatically enter the estate. Instead, Section 365 of the Bankruptcy Code provides the trustee with a choice: she can either "assume" or "reject" the executory contract.[11] If the executory contract is assumed, the debtor's estate becomes bound to it.[12] If the executory contract is rejected, the rejection is treated as a prebankruptcy breach by the *debtor* (not the bankruptcy estate). As a result, claims for damages arising from rejection are treated as any other general prebankruptcy unsecured claims against the debtor: they share ratably in the assets available to pay general unsecured creditors.[13] Because general unsecured creditors in most U.S. bankruptcies are generally paid only a fraction of their claims,[14] the usual effect of the current rule—which I call the "ratable damages" ("RD") rule—is to enable the bankruptcy estate to benefit from the

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cy case data that I conducted are consistent with Nimmer's observation. *See infra* note 21.

10. Suppose, for example, that Builder contracts to build a factory for Firm for $100, and Builder has not yet constructed the factory. If Firm enters bankruptcy before Builder has constructed the factory or Firm has paid Builder $100, and Firm's bankruptcy estate values the factory at $120, Firm's right under the contract to pay Builder $100 for the factory represents an asset to the estate worth $20 ($120 - $100). If, on the other hand, Firm's estate values the factory at only $80, the obligation to pay Builder $100 represents a liability to the estate of $20 ($100 - $80).

11. *See* 11 U.S.C. § 365(a) (authorizing the trustee to accept or reject contracts subject to court approval).

12. In certain cases, the trustee may "assign" an assumed contract to a third party. *See infra* note 41.

13. I assume that the nonbankrupt party is unsecured and not entitled to specific performance or any other type of injunctive relief.

14. *See, e.g.*, Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 311 (finding that average payout promised—but not necessarily paid—to general unsecured creditors in reorganization cases was about 30 cents on the dollar). In a more recent study of the reorganizations of large, publicly traded corporations—where payout rates are generally the highest—the average payout was slightly less than 50 cents on the dollar. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 142 (1990). However, the payout rate to ordinary unsecured creditors in liquidation bankruptcies (which make up the overwhelming majority of bankruptcy cases) is on average less than 5%. *See, e.g.*, LoPucki, *supra*, at 311 (finding that 80% of business liquidations in bankruptcy yielded no distribution to general creditors; among those liquidations where there was a payout, general creditors received on average 4.5 cents on the dollar); Michelle J. White, *Bankruptcy, Liquidation, and Reorganization*, *in* HANDBOOK OF MODERN FINANCE E7-1, E7-34 (Dennis E. Logue ed., 3d ed. 1994) (reporting that in a sample of small firms liquidating in bankruptcy under Chapter 7, the expected payout rate was 4%).

debtor's favorable contracts while dramatically reducing the cost of unburdening itself from the debtor's most unfavorable contracts.[15]

Section 365 has been invoked by parties ranging from the actress Tia Carrere, who filed for bankruptcy in order to reject a contract to act in "General Hospital" so that she could appear in another TV show, "The A-Team,"[16] to Continental Airlines, which sought to reject a collective bargaining agreement with one of its unions.[17] However, most Section 365 proceedings appear to involve small to medium-sized businesses seeking to reject garden-variety commercial contracts, such as leases, licenses, and purchase and sale agreements.[18]

The use of Section 365 to reject unfavorable contracts has become increasingly widespread.[19] Indeed, it is believed that thousands of bankruptcy cases are filed each year for the primary purpose of rejecting executory contracts.[20] However, most executory contracts are rejected in cases that were probably filed for other reasons.[21]

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15. The loss from performance of an unfavorable executory contract may be less than the ratable damages that would be paid to the other party in the event of rejection. In such a case, (existing) unsecured creditors would be better off if the contract is performed.

16. *See In re* Carrere, 64 B.R. 156, 157 (Bankr. C.D. Cal. 1986).

17. *See* Westbrook, *supra* note 8, at 229 n.4 (1989) (citing *In re* Continental Airlines Corp., 38 B.R. 67, 71–72 (Bankr. S.D. Tex. 1984)).

18. *See infra* notes 42–50 and accompanying text.

19. *See* Westbrook, *supra* note 8, at 229.

20. *See id.*

21. Contracts are automatically deemed rejected in Chapter 7 liquidation proceedings unless the trustee seeks permission to assume the contract within 60 days of the order for relief, apparently even when the business is being sold as a going concern. *See* 11 U.S.C. § 365(d)(1) (1994). In Chapter 11, where the trustee generally may assume or reject an executory contract any time before the confirmation of the plan, *see* 11 U.S.C. § 365(d)(2), the proposal for rejecting an executory contract is often found in the plan itself. The court's confirmation of the plan has the effect of approving the rejection.

With the exception of several case studies of large business bankruptcies, there is little data available on business bankruptcy (including the frequency with which business debtors reject contracts under § 365). *See* Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1258 n.1 (1994). This will soon change. Teresa Sullivan, Elizabeth Warren, and Jay Westbrook are currently gathering and analyzing data from bankruptcy cases filed in 23 federal districts in 1994 as part of their Business Bankruptcy Project. For a description of the Project's methodology, see Teresa A. Sullivan, *Methodological Realities: Social Science Methods and Business Reorganizations*, 72 WASH. U. L.Q. 1291 (1994).

To obtain a rough estimate of the frequency of contract rejection in bankruptcy, I examined twenty Chapter 7 cases and twenty-seven Chapter 11 cases that were randomly drawn from a sample of business bankruptcy cases that had been collected by the Project

As the use of Section 365 has grown, its application has drawn strong criticism from both the business community and academic commentators.[22] Much of this criticism has focused on cases in which the courts have held that the effect of rejection is to return the parties to the same position they were in before the contract was signed.[23] In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[24] for example, the Fourth Circuit held that a technology licensor that had filed for bankruptcy not only could breach its continuing obligations under the license agreement, but could cancel the license altogether, thereby forcing the licensee to give up its rights to the technology.[25]

The furor caused by *Lubrizol* led Congress to amend Section 365 in order to clarify that rejection of a technology license does not cancel the license, but only releases the estate from performing its affirmative obligations under the agreement.[26] Unfortunately, Congress has not yet clarified the effect of rejection on other sorts of contracts, including ordinary personal property leases and copyright agreements. As a result, much of the jurisprudence relating to Section 365 continues to be controversial, and there are calls for a complete overhaul of the statute.[27]

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for study. Of the twenty debtors whose bankruptcy proceedings commenced under Chapter 7 ("Chapter 7 debtors"), eleven (55%) were party to at least one executory contract. Of the eleven Chapter 7 debtors entering bankruptcy with at least one executory contract, six (55%) were party to only one contract and five (45%) were party to more than one executory contract. Seven of the eleven cases in which there was at least one executory contract had been completed at the time of the survey; it appeared that all of the contracts in these seven cases had been automatically rejected or rejected by motion of the debtor.

Of the twenty-seven debtors whose bankruptcy proceedings commenced under Chapter 11 ("Chapter 11 debtors"), nineteen (70%) were party to at least one executory contract. Of the nineteen Chapter 11 debtors entering bankruptcy with at least one executory contract, four (21%) were party to only one contract and fifteen (79%) were party to more than one contract. Of the four cases involving single-contract Chapter 11 debtors, three had been completed or dismissed. In each of those three cases, the executory contract was assumed (or, in some of the dismissed cases, not rejected). Of the fifteen cases involving multiple-contract Chapter 11 debtors, eight had been completed or dismissed. In three of those cases, all of the contracts had been rejected. In the other five multiple-contract Chapter 11 cases, at least one contract had been assumed.

22. *See, e.g.*, Westbrook, *supra* note 8, at 228–29.

23. *See id.* at 306–07. The injured party is, however, allowed to sue for any resulting damages.

24. 756 F.2d 1043 (4th Cir. 1985).

25. *See id.* at 1047–48.

26. *See* Westbrook, *supra* note 8, at 307; 11 U.S.C. § 365(n) (1994).

27. *See* Westbrook, *supra* note 8, at 230. The National Bankruptcy Review Commis-

However, there is little controversy surrounding the principle behind Section 365—that a damage claim resulting from rejection is to be treated as a prebankruptcy unsecured claim against the debtor. That principle, which has been embodied in U.S. bankruptcy law long before Section 365 was enacted[28] and is reflected in the treatment of executory contracts in other bankruptcy systems as well,[29] is broadly supported by bankruptcy scholars.[30] The most commonly-given justification for the RD rule is that it implements the important bankruptcy principle of equality.[31] This principle is believed to require that damage claims arising from rejection be treated no differently than any other general unsecured claim against the debtor.[32]

This view ignores the possibility that the law's treatment of a rejection claim may influence the trustee's decision of whether to reject or assume the contract *in the first instance*.[33] That decision, in turn, may determine whether the resources of the bankruptcy estate and the other party to the contract are allocated to their highest-value use. Thus, the law's treatment of the rejection claim may affect not only the nonbankrupt party's relative share of the bankruptcy estate, but also the total value available to the nonbankrupt party and the debtor's other creditors.

As the Article will explain, the RD rule fails to align the trustee's goal of maximizing the payout rate for unsecured claims with the social goal of maximizing total value. In particular, the

sion, which advises Congress on amending the Bankruptcy Code, is currently preparing a number of proposals for revising Section 365.

28. In the United States, the rule originated in caselaw and was first codified in sections 63(c) and 70(b) of the Bankruptcy Act in 1938. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 845, 856–81 (1988) (detailing the history of the rule's development from 19th-century English law); *see also* Lee Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 467–72 (1964).

29. *See generally* DENNIS CAMPBELL, INTERNATIONAL CORPORATE INSOLVENCY LAW (1992) (analyzing various countries' bankruptcy laws); EUROPEAN CORPORATE INSOLVENCY (Harry Rajak et al. eds., 2d ed. 1995) (same).

30. *See, e.g.*, DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 119 (1993); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 108–09 (1986); Andrew, *supra* note 28, at 866–81; Westbrook, *supra* note 8, at 252–53.

31. *See* JACKSON, *supra* note 30, at 108–09.

32. It should be noted that while treating a rejection claim as any other unsecured claim against the estate is consistent with the norm of equality, giving the other party the right to full performance in the event of assumption is not. The RD rule is therefore not completely consistent with the norm of equality.

33. *See* Triantis, *supra* note 2, at 690–96.

rule sometimes provides the bankruptcy trustee with an incentive to reject executory contracts when performance would increase the total value available to all of the parties affected. This distortion arises because the RD rule does not force the estate to internalize the full cost of rejection to the nonbankrupt party. As a result, the trustee sometimes has an incentive to reject when rejection makes the estate better off but makes the other party worse off by a greater amount—that is, when rejection reduces total value.

After describing the principle of ratable damages embodied in Section 365 and the distorted incentive created by the RD rule in Part I, I consider two approaches to solving the resulting problem of excessive rejection. Under the first approach, which I examine in Part II, the bankruptcy court would prevent the trustee from rejecting a contract that the court determines is value-creating. This approach would build on the existing but rarely-applied "balancing test" doctrine, which allows a court to prevent rejection if the resulting harm to the nonbankrupt party far outweighs the benefit to the estate. I explain, however, that incorporating a modified "balancing test" into Section 365 may be neither a desirable nor effective approach to solving the problem of excessive rejection.

The second approach to solving the problem of excessive rejection would give the bankruptcy trustee complete discretion to assume or reject the executory contract, but would align the trustee's objective of maximizing the payout rate for unsecured claims with the social goal of maximizing total value. In Part III, I put forward and analyze three rules that would give the trustee the proper performance incentives by adjusting the contract price in favor of the bankruptcy estate by an amount sufficient to offset any distortion in favor of rejection. After explaining how each price-adjustment rule would eliminate this distortion, I attempt to identify drawbacks and additional advantages of each rule, relative to the RD rule. I consider, among other things, the amount of litigation that may be associated with each price-adjustment rule, the effect of the rule on the timing of performance decisions in bankruptcy, and the effect of the rule on performance decisions made in anticipation of bankruptcy. I also identify and compare the distributional effects of the alternative rules from an *ex post* perspective.

Part IV of the Article then identifies and briefly considers two *ex ante* effects of making the treatment of executory contracts in bankruptcy more favorable to the bankruptcy estate: 1) the effect on the incentive of firms to file for bankruptcy; and 2) the effect on the ability of financially distressed firms to enter into contracts. These effects also must be considered in determining the optimal treatment of executory contracts in bankruptcy.

The purpose of this Article is not to advocate the replacement of the RD rule. As we will see, none of the alternatives I consider is superior to the RD rule in all respects. Rather, the Article's purposes are: 1) to describe a problem with the RD rule that should be taken into account in determining the proper treatment of executory contracts in bankruptcy; 2) to offer for consideration various arrangements for solving the problem of excessive rejection; and 3) to conduct a preliminary investigation into the potential costs and benefits of these arrangements.

I. RATABLE DAMAGES UNDER SECTION 365

A. *Section 365 and the Ratable Damages Rule*

The treatment of executory contracts in bankruptcy is governed by 11 U.S.C. § 365. In relevant part, § 365(a) provides that "the [bankruptcy] trustee, subject to the court's approval, may assume or reject any executory contract . . . of the debtor."[34] For purposes of this Article, an executory contract is a contract under which at least one party still owes performance (other than payment) at the time of the bankruptcy filing.[35]

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34. The last clause of § 365(a) reads: "may assume or reject any executory contract *or unexpired lease* of the debtor." 11 U.S.C. § 365(a) (emphasis added). An "unexpired lease" is a true lease (i.e., not a disguised secured loan) that has not terminated before the date of the bankruptcy filing. *See In re* Pacific Express, Inc., 780 F.2d 1482, 1487 (9th Cir. 1986) (holding that a lease that is a disguised secured loan will not be subject to Section 365). This Article uses the term "executory contract" to include an "unexpired lease."

35. The Bankruptcy Code does not provide a definition of the term "executory contract." The definition of "executory contract" most widely used for purposes of Section 365 is that set out almost thirty years ago by Vern Countryman, a leading bankruptcy scholar. *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 260 (1973). According to Professor Countryman, a contract should be considered executory (and thus subject to Section 365) if "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." *Id.* Some courts applying Countryman's definition have held that a contract under which only one side owes performance is not "executory" for purposes of Section 365. *See, e.g., In re* Pacific Express, Inc., 780 F.2d 1482, 1487 (9th Cir. 1986). The usual effect of imposing such a bilateral "executoriness" requirement is to deny the trustee the right

If the trustee "assumes" the contract, Section 365 binds the bankruptcy estate to the contract, permitting the estate to seek performance from the other party under the contract's original terms.[36] Under U.S. bankruptcy law, obligations in connection with assumed contracts—including any damage claims against the estate for post-assumption breach—are treated as postpetition administration claims, which are paid first and usually in full.[37] Thus, the effect of assumption is that the estate acquires all of the debtor's rights *and* obligations under the contract.

If the trustee "rejects" the contract, the injured party may sue for damages under state contract law.[38] The rejection "constitutes a [prepetition] breach" and the injured party's damage claim is treated *pari passu* with other prebankruptcy general unsecured claims against the debtor.[39] The damage claim is thus paid its ratable share of the value available for distribution to general unsecured creditors.

In most cases, the effect of rejection under the RD rule is that the party injured by rejection is paid much less than the party's full damage claim.[40] The RD rule thus permits the estate to benefit from the debtor's favorable contracts while reducing the cost of ridding itself of contracts that are very burdensome. The

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to assume a contract with respect to which one side has already substantially performed. *See In re* Continental Properties, Inc., 15 B.R. 732 (Bankr. D. Hawaii 1981). In the discussion paper version of this Article, I explain why this bilateral "executoriness" requirement reduces the efficiency performance of Section 365. In particular, I show that the requirement of bilateral "executoriness" can prevent value-increasing contracts from being assumed (and is not necessary to prevent value-reducing contracts from being assumed and performed). *See* Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy* 36–37, Discussion Paper No. 201, John M. Olin Center for Law, Economics, and Business at Harvard Law School (Oct. 1996) (on file with the *Duke Law Journal*).

36. In certain cases, an assumed contract can be assigned to a third party. *See infra* note 41. If there has been a default in the contract, the trustee may not assume the contract unless she provides adequate assurance that the estate will promptly cure the default, compensate the other party for any pecuniary loss resulting from the default, and perform its future obligations under the contract. *See* 11 U.S.C. § 365(b)(1). Certain types of contracts, including financial accommodation contracts, may not be assumed by the trustee. *See id.* § 365(c).

37. *See id.* §§ 507(a)(1), 503(b); Westbrook, *supra* note 8, at 232.

38. *See* 11 U.S.C. § 502(g). Certain provisions may limit the amount of damages the nonbankrupt party can claim. *See id.* § 502(b)(6) (capping damages for claims by real property lessors); § 502(b)(7) (capping damages for employees under an employment contract).

39. *See id.* §§ 365(g)(1), 502(g). I am assuming throughout that the injured party is unsecured. *See supra* note 13.

40. *See supra* note 14 and accompanying text.

trustee is generally given discretion to decide which course of action—assumption or rejection—best serves the estate.[41]

To illustrate the effect of the RD rule, suppose that Firm agrees to pay Builder $100 for construction of a factory that will cost Builder $60 to build. Suppose further that before the factory is constructed and any payment is made, Firm enters bankruptcy. Finally assume that the expected payout rate for general unsecured claims at the end of the bankruptcy proceeding is 30%.

Under ordinary principles of contract law, a party to a contract must either perform or pay damages that are sufficient to put the other party in the same position as performance would have. Thus, outside of bankruptcy, Firm would have a choice between 1) paying $100 for the factory and 2) breaching and paying Build-

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41. In certain cases, the trustee may have a third choice: assumption of the executory contract, followed by assignment of the contract to a third party. *See* 11 U.S.C. § 365(f). If the contract is assigned, the bankruptcy estate is released from any liability arising from the assignment (even if the contract's own terms bar such an assignment). *See id.* §§ 365(f), (k). This treatment is unlike that under state law, where an anti-assignment provision either renders the assignment ineffective or makes the assigning party liable for any damages arising from the assignment. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 317(2), 322(2) (1981); U.C.C. § 2-210(1)-(3) (1995). The incentives created by the no-damages ("ND") assignment rule are analyzed elsewhere. *See* Jesse M. Fried, *Assignment Under Contract and Bankruptcy Law* (unpublished manuscript) (on file with author). There I show that the ND assignment rule somewhat mitigates the problem of value-wasting rejection identified in this Article, but gives rise to the problem of excessive assignment. However, since the ND assignment rule under § 365 does not alter the main results of this Article, I abstract here from the possibility of assignment in order to focus on the choice between rejection and performance.

Until the disposition of an executory contract is determined, the contract is generally not enforceable against the estate. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 532 (1984). However, a trustee may elect to obtain the benefits of the contract by paying the other party fair value, which is generally the contract price. *See In re* Tirenational Corp., 47 B.R. 647, 650 (Bankr. N.D. Ohio 1985). An estate that is under a nonresidential real property lease or certain personal property leases must perform all of the debtor's obligations under the lease. *See* 11 U.S.C. § 365(d)(3), (10). For discussions of the status of executory contracts during this "limbo" period, see Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197 (1985); Howard C. Buschman, III., *Benefits and Burdens: Post-Petition Performance of Unassumed Contracts*, 5 BANKR. DEV. J. 341 (1988); Neil P. Olack, *Executory Contracts and Unexpired Leases: Right to Adequate Protection Prior to Assumption or Rejection*, 4 BANKR. DEV. J. 421 (1987).

In a Chapter 7 liquidation proceeding, executory contracts that the trustee does not seek to assume (and then either perform or assign) or reject are deemed rejected after a certain period of time elapses. *See* 11 U.S.C. § 365(d)(1), (4). In a successful Chapter 11 reorganization, such contracts may "ride through" bankruptcy unaffected and continue to bind the debtor. *See, e.g., In re* Parkwood Realty Corp., 157 B.R. 687, 690 (Bankr. W.D. Wash. 1993).

er $40—the profit Builder anticipates from performance of the contract.

Under Section 365, Firm's bankruptcy estate also has two choices. It may "assume" the contract with Builder and pay $100 for construction of the factory—the same result had Firm sought performance outside of bankruptcy. Or, Firm's bankruptcy estate may "reject" the contract with Builder. The rejection would be treated as if Firm had breached—and Builder's $40 damage claim had arisen—before Firm entered bankruptcy. As a result, the damage claim would be bundled with all of the other general unsecured claims against Firm and paid thirty cents on the dollar. Section 365 thus gives Firm's bankruptcy trustee a choice between 1) assuming the contract and paying $100 for the factory and 2) rejecting the contract and paying Builder $12 (30% of $40).

The trustee's ability under Section 365 to reject a contract without paying full damages frequently makes rejection an attractive option. Bankruptcy trustees have used (or attempted to use) Section 365 to cancel a licensee's right to manufacture and market technical instruments (so that the debtor-licensor could capture all of the expected profits from sale of the instruments);[42] cancel a metal coating technology license (so that the debtor-licensor could enter into a more favorable arrangement with another party);[43] escape from an expensive lease of retail space;[44] rescind a purchase and sale agreement requiring the debtor to sell a $2.4 million property for $1.9 million;[45] undo an out-of-court settlement agreement barring the debtor from future litigation;[46] escape a provision in a franchise contract that barred the debtor from competing with the franchisor;[47] avoid a requirement in a shareholder agreement that the debtor-shareholder offer to sell his shares to the company at a low, fixed price;[48] cancel a multi-year, multimillion dollar employment contract with debtor's general coun-

42. *See In re* Petur U.S.A. Instrument Co., 35 B.R. 561, 562 (Bankr. W.D. Wash. 1983).

43. *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045 (4th Cir. 1985).

44. *See In re* Federated Dep't Stores, Inc., 131 B.R. 808, 810 (Bankr. S.D. Ohio 1991).

45. *See In re* Chi-Feng Huang, 23 B.R. 798, 799 (B.A.P. 9th Cir. 1982).

46. *See In re* Walnut Assocs., 145 B.R. 489, 491–92 (Bankr. E.D. Pa. 1992).

47. *See* Burger King Corp. v. Rovine Corp. (*In re* Rovine Corp.), 6 B.R. 661, 662–63 (Bankr. W.D. Tenn. 1980).

48. *See In re* Parkwood Realty Corp., 157 B.R. 687, 689 (Bankr. W.D. Wash. 1993).

sel;[49] and void a partnership dissolution agreement barring the debtor accountant from providing services to former clients of the partnership.[50]

Congress and the courts typically justify the RD rule on the grounds that it assists the rehabilitation of the debtor[51] and serves bankruptcy's goal of increasing the value of the estate on behalf of all unsecured creditors. Bankruptcy scholars support the ratable damages rule on different grounds: namely, that treating the rejection claim of the injured party the same as those of other general unsecured creditors ensures that the fundamental bankruptcy principle of equality is not violated.[52] Consider the view of one prominent bankruptcy scholar who has written extensively on bankruptcy from an economic perspective:

> [The other party to the executory contract] is just like the [bankrupt Firm's] other unsecured creditors: a party with a nominal claim that, because [Firm] is insolvent, will not have its expectancies met in full. There is no reason [the other party] should have its claim paid in full (by requiring adherence to the contract) when all other unsecured creditors are getting only a few cents on the dollar. Rejection, then, provides a way of *equalizing* things among creditors when the liability represented by the contract exceeds the value of the asset represented by a contract.[53]

This analysis misses an important point: The treatment of the rejection claim may affect whether the trustee decides to reject or perform in the first instance. That decision determines the use to which the assets of the estate and the other party are put. How these assets are deployed can in turn affect the total amount of value available to the estate and the other party. Thus, the treatment of the rejection claim affects not only the injured party's relative share of the bankruptcy estate but also the total amount

49. *See* Cohen v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 694 (Bankr. S.D.N.Y. 1992).

50. *See In re* Silver, 26 B.R. 526, 528 (Bank. E.D. Pa. 1983).

51. *See In re* Booth, 19 B.R. 53, 60 (Bankr. D. Utah 1982) (noting that "[e]xecutory contracts should be handled to 'assist in the debtor's rehabilitation'" (citing H.R. REP. NO. 95-595, at 348 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6304)).

52. *See, e.g.*, BAIRD, *supra* note 30, at 117; JACKSON, *supra* note 30, at 109; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 791 (1987); Westbrook, *supra* note 8, at 252-53.

53. JACKSON, *supra* note 30, at 108-09.

of value available to all of the parties affected by the rule.[54] And, as the following Section will explain, the RD rule sometimes gives the bankruptcy trustee an incentive to make decisions that reduce the total value available to the estate and the other party to the executory contract.

B. *Distorted Performance Incentives Under the Ratable Damages Rule*

This Section will explain why the RD rule underlying Section 365 sometimes gives the bankruptcy trustee an incentive to reject contracts that are value-creating.[55] For purposes of the analysis, a contract is considered to be value-creating if and only if, as of the time the performance decision is made, performance would increase the total amount of value that would be available to the estate and the other party to the contract.[56] Total value would increase if the party receiving performance would value it more than it would cost the other party to perform: the amount of the increase would be the difference between the cost and the value of performance.[57]

Before proceeding with the analysis, it will be useful to consider parties' breach/performance incentives outside of bankruptcy. Outside of bankruptcy, the "expectation damages" ("ED") rule requires that a party breaching a contract pay damages to "put the [injured party] in as good a position as he would have been had the [breaching party] kept his contract."[58] In other words, the breaching party must pay damages in an amount that compensates

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54. As we will see later in the Article, the treatment of executory contracts in bankruptcy will also have efficiency consequences even before the debtor enters bankruptcy.

55. The analysis in Parts I–III focuses mostly on the incentives that various rules give the trustee to perform or reject executory contracts once a firm has filed for bankruptcy. As we will see later in the Article, however, the treatment of executory contracts in bankruptcy will also affect other aspects of the parties' behavior in bankruptcy, as well as decisions made in anticipation of bankruptcy.

56. To focus the analysis, I assume throughout that performance does not generate any negative or positive externalities on third parties—that is, the bankruptcy estate and the nonbankrupt party to the contract are the only parties affected by performance.

57. The price of the contract is irrelevant to the determination of whether performance would be value-increasing: the price is merely a zero-sum transfer of money between the parties that would have no effect on the total value to be shared.

58. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988) (quoting Hawkins v. McGee, 146 A. 641, 643 (N.H. 1929)).

the injured party fully for the loss of profit or gain the injured party expected from performance—no more and no less. As a result, a party will not have an incentive to breach when its gain from breach (the loss from performance it avoids by breach) would be less than the loss imposed on the other party (the gain from performance that is not realized by the other party because of the breach)—that is, when breach would be value-wasting.[59] At the same time, a party will have an incentive to breach when its gain from breach would be greater than the loss imposed on the other party—that is, when breach would be value-increasing.[60] Thus, as is already a familiar point in the literature, the ED rule generally discourages value-wasting breach and facilitates breach when performance is value-wasting.[61] As a result, the ED rule tends to give the parties to a contract the incentive to make value-increasing breach/performance decisions.[62]

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59. For example, suppose that Firm has agreed to pay $100 to Builder for construction of a factory that would cost Builder $60 to build. Builder therefore expects the contract to generate a profit of $40 ($100 - $60). Suppose further that, when the factory is to be constructed, Firm would value the factory at only $80. Since the contract price is $100, Firm would prefer, everything else equal, not to pay for the factory. However, since breach would cost Firm $40 in expectation damages (the profit expected by Builder), and performance would reduce Firm's wealth by only $20 ($100 - $80), the ED rule gives Firm an incentive to perform—the desirable course of action because performance would increase the value available to both parties by $20 (the value of the factory to Firm less the cost of construction to Builder: $80 - $60).

60. For example, suppose that Firm has agreed to pay $100 to Builder for construction of a factory that would cost Builder $60 to build. Builder therefore expects the contract to generate a profit of $40 ($100 - $60). Suppose further that, when the factory is to be constructed, Firm would value the factory at only $40. Since breach would cost Firm $40 in expectation damages (the profit expected by Builder), and performance would reduce Firm's wealth by $60 ($100 - $40), the ED rule gives Firm an incentive to breach—the desirable course of action because performance would reduce the value available to both parties by $20 (the cost of building the factory less its value to Firm: $60 - $40).

61. *See, e.g.*, RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW (4th ed. 1991), 117–26; John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277, 283–89 (1972); Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284–86 (1970); Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980). For an argument that the expectation damages rule does not fully compensate the injured party and thus may permit value-wasting breach, see Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 6–7 (1989).

62. In any given case, the ability of the ED rule to provide desirable incentives depends on the parties estimating properly the damages from breach and the cost of performance, and the ability of injured parties to recover any litigation expenses incurred in recovering damages. *See* Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1444–45 (1980).

We are now ready to examine the performance incentives created by the RD rule. As we saw, the RD rule gives the bankruptcy trustee a choice between performing an executory contract according to its original terms and rejecting the contract and paying less than 100% of any resulting damage claim. The ability to pay less than full damages means that the estate is not required to internalize the loss that rejection imposes on the nonbankrupt party.[63] Consequently, the trustee may have an incentive to reject even if the estate's gain from rejection[64] is much smaller than the other party's loss. Indeed, the trustee has an incentive to reject any value-creating contract that makes the estate worse off as long as the estate's benefit from rejection is greater than the amount the injured party receives as an unsecured creditor.

Example. To examine the perform/reject incentives created by the RD rule, again suppose that Firm agrees to pay $100 for construction of a factory that would cost Builder $60. However, before the factory is built or payment is made, Firm enters bankruptcy.[65] Assume that the payout rate to unsecured creditors is expected to be thirty cents on the dollar. Thus, under the RD rule Firm's estate may either pay $100 for construction of the factory, or reject and pay Builder 30% of its $40 damage

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Unless specified otherwise, the numerical examples assume for simplicity that each party knows the value and cost of performance and that litigation expenses are negligible relative to the amounts at stake (and thus can be ignored).

63. To be precise, the value of the estate itself (that is, the value of the assets of the estate) is not affected by rejection. Rejection only increases the amount of claims against those assets. However, the effect of rejection on the *payout rate* for unsecured claims (and therefore the effect of rejection on the amount received by the debtor's other unsecured creditors) is the same as if the estate were reduced by an amount equal to the ratable damages the party injured by rejection ultimately receives as an unsecured creditor.

64. The estate's gain from rejection equals the reduction in the value of the estate that would have resulted from performance.

65. Unless otherwise stated, I assume that Firm is the party in bankruptcy (rather than Builder). The analysis would apply equally if Builder were the party in bankruptcy (although the terms would change to reflect the reversal of the parties' positions—e.g., rejection damages would be calculated as the difference between Firm's valuation of the factory and the contract price, rather than as the difference between the contract price and Builder's cost of performance). I also assume that the debts of the party in bankruptcy exceed its assets and that the assets of the party outside bankruptcy exceed its debts. Although a debtor need not be balance-sheet insolvent to enter bankruptcy, application of the RD rule when the party in bankruptcy has a positive net worth is no different than the application of the ED rule when the party has a positive net worth and is outside bankruptcy: every claim against such a debtor in bankruptcy would also, in principle, be paid in full.

claim—$12. Suppose that Firm's estate would value performance at $80. Thus performance would make the estate worse off by $20 ($100 - $80). Since rejection would cost the estate only $12, the estate has an incentive to reject the contract, which would be an undesirable result since performance would create $20 of value (the value of $80 Firm places on performance less Builder's cost of $60). Indeed, Firm's bankruptcy trustee does not have an incentive to perform as long as the estate would value performance at less than $88—that is, even if performance would create as much as $28 ($88 - $60) of value.[66]

As the preceding example illustrates, under the RD rule a bankruptcy estate may find it worthwhile to reject even though the cost of rejection to the other party is greater than the benefit to the estate of not performing the contract. The severity of the distortion in favor of rejection depends on the expected payout rate for unsecured claims—the lower the expected payout rate, the greater the distortion in favor of rejection. As the payout rate decreases, so does the cost of rejection, and the more attractive rejection becomes.

Although some studies suggest that the payout rate for unsecured creditors in Chapter 11 bankruptcy is, on average, about 30%,[67] in Chapter 7 liquidations—which comprise the majority of bankruptcy cases—the payout rate is much less. In fact, the average payout rate to general unsecured creditors in Chapter 7 liquidation proceedings is less than 5%.[68] In such cases, trustees have a very strong incentive to reject unfavorable contracts, even if performance would be substantially value-increasing.[69]

Example. To illustrate the effect of a lower payout rate on the trustee's incentive to perform, suppose again that Builder has agreed to build Firm a factory for $100 that would cost Builder $60 (generating a benefit of $40 for Builder). However, now the

66. The cost of rejection would be $12; thus the estate has an incentive to perform as long as performance either 1) would reduce the value of the estate by less than $12 or 2) would increase the value of the estate (the estate would value performance at more than the contract price of $100). Since the contract price is $100, performance would make the estate worse off by $12 when the estate would value the factory at $88. Thus if the estate would value the factory at more than $88, the trustee has an incentive to seek performance of the contract.

67. *See supra* note 14.

68. *See id.*

69. To be sure, the typical contract in a Chapter 7 case is not as likely to be substantially value-increasing as one in a Chapter 11 proceeding.

payout rate for unsecured claims is 5% rather than 30%. The expected cost of rejection to Firm's estate now would be only $2 (5% of $40) rather than $12 (30% of $40). Therefore, the trustee does not have an incentive to perform even if the estate would value performance as high as $98—that is, even if performance would create as much as $38 of value. By contrast, we saw in the previous example that at a payout rate of 30% the trustee has an incentive to perform if the estate would value performance at more than $88.[70]

As the previous example indicates, the number of value-creating contracts rejected—and the average value lost when those contracts are rejected—would tend to increase as the payout rate for general unsecured claims declines.[71]

C. *A Note on the Significance of the Problem*

Although the RD rule distorts the trustee's performance incentives in favor of rejection, the RD rule only provides an *incentive* for the trustee to reject certain value-creating contracts that would make the estate worse off; the RD rule does not necessarily *cause* the trustee to reject these contracts. This Section considers three factors that might, to a greater or lesser degree, mitigate the problem of excessive rejection under the RD rule.

1. *The Possibility of Renegotiation.* As is by now a standard and familiar point in the contracts literature, both parties to a value-creating contract that might otherwise be breached have an incentive to renegotiate and perform the contract because the surplus created by performance can be shared in such a way to make both parties better off than under breach.[72] Of course, it is recognized that whether renegotiation occurs (and if it occurs, whether it is successful) will depend on the "transaction costs"—including those arising from the parties' incentive to engage in strategic behavior—associated with renegotiation.[73] In the non-

70. *See supra* note 66 and accompanying text.

71. The distortion in favor (and the social cost) of value-wasting rejection is also greater when courts interpret Section 365 to permit the estate to cancel an executory contract (such as a license agreement), not merely breach the debtor's affirmative obligations under the contract. *See supra* note 25 and accompanying text. An economic analysis of the effect of interpreting Section 365 to permit cancellation can be found in the discussion paper version of this Article. *See* Fried, *supra* note 35, at 31–35.

72. *See* Craswell, *supra* note 58, at 638–40.

73. *Id.* at 638–39; Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: To-*

bankruptcy context, it is believed that transaction costs and strategic behavior by the parties can sometimes make successful renegotiation very difficult.[74] The fact that thousands of firms are unable to avoid a costly bankruptcy proceeding by renegotiating with their creditors outside of bankruptcy indicates that impediments to renegotiation can be substantial.

In bankruptcy, there at least three factors that may make renegotiation even more difficult: 1) the possibility of severe time constraints; 2) the limited authority of the trustee (combined with frequent managerial turnover); and 3) potential uncertainty over which party will take control of the emerging business. Each of these factors will be explored in turn.

First, the need to conserve cash or stem losses may require the trustee to decide the disposition of dozens (or even hundreds) of executory contracts within a short period of time after the debtor files for bankruptcy. Time constraints might make it impossible for the trustee to enter into negotiations with many of these parties. And if the values of some of the contracts are interdependent, the failure to successfully renegotiate one contract may require the trustee to reject many others as well. For example, suppose that Firm has, after contracting with Builder to construct a factory, entered into contracts with other parties for machines, raw materials, and other inputs. Concessions may be needed from all of these parties in order to make construction and operation of the factory profitable for Firm's estate. If any one of these other parties refuses to renegotiate the price with the trustee of Firm's estate, the trustee may be required to reject all of the contracts.

Second, during the bankruptcy proceeding there is no single party that has complete, continuous control of the estate. Although the trustee is generally free to make routine business decisions, the trustee's more important decisions may be challenged by any party that believes that it will be adversely affected. As a result, the trustee cannot negotiate with as much authority as a firm's management can outside of bankruptcy, which may make renegotiation more difficult. Renegotiation may also be disrupted by the high rate of management turnover in bankruptcy.[75]

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wards a General Theory of Contractual Obligation, 69 VA. L. REV. 967, 982-83 (1983).

74. Goetz & Scott, *supra* note 73, at 982-83.

75. *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355, 370 (1990) (reporting that over half of the CEOs of the 110 NYSE and

Third, executory contracts are often rejected as part of the plan that is approved at the end of a Chapter 11 proceeding. When there is only one plan on the table, a party seeking performance of an executory contract with the debtor may have an incentive to negotiate with the party behind the proposed plan. However, there are often multiple, competing plans. When it is not clear whose plan will ultimately prevail, a party seeking performance of an executory contract with the debtor will have less of an incentive to negotiate with any of the parties proposing plans.[76]

To be sure, rejection of a contract in bankruptcy does not necessarily mean that a similar contract will not be performed after the debtor emerges from bankruptcy. After bankruptcy, the factors that make renegotiation in bankruptcy especially difficult would no longer be present. There would thus be fewer obstacles to reaching agreement. If performance still would be value-creating, the parties may well contract for it again.

However, there are likely to be many cases in which a contract that would be value-creating at the time the debtor is in bankruptcy is no longer value-creating one, two, or three years later when the debtor emerges from Chapter 11. Business conditions may have changed. The debtor may have abandoned the line of business to which the contract related. The other party may no longer be able to enter the contract because it has since entered into a mutually exclusive contract. In these cases, rejection of a value-creating contract in bankruptcy may well mean a permanent loss of value.

AMEX firms that were restructured or filed for Chapter 11 bankruptcy left their jobs within two years of the event).

76. Divergent expectations over the payout rate for unsecured claims could also affect the likelihood and success of renegotiation, but they would not necessarily make renegotiation more difficult. If the nonbankrupt party's estimate of the payout rate for unsecured claims is higher than that of the trustee, its willingness to adjust the price in favor of the estate will be less than it would be outside of bankruptcy. If, on the other hand, the nonbankrupt party's estimate of the payout rate for unsecured claims is lower than that of the trustee, it will be more willing to compromise than outside of bankruptcy. However, uncertainty over the payout rate could cause the trustee to delay renegotiation (or delay making a unilateral decision to perform or reject) until it is able to form a more accurate estimate of the expected payout rate.

2. *Reputational Considerations.* It might be argued that even when renegotiation is not possible, there could be reputational reasons for the bankruptcy trustee to perform an unfavorable contract that makes the other party much better off.[77] Opportunistic rejection of a contract in bankruptcy, the argument might go, could harm the debtor's reputation and make it more costly for the debtor to transact business both during and after the bankruptcy proceeding. Thus, reputational concerns might deter a bankrupt firm from rejecting an executory contract when performance would be significantly value-increasing.[78]

However, there are three reasons why reputational concerns may not deter a bankruptcy trustee from rejecting value-creating contracts under the RD rule. First, for the bankrupt firm's reputation to be damaged by rejection, other parties must be able to observe that performance would be value-increasing.[79] But in practice it may be very difficult for those outside the bankrupt firm to determine whether a particular contract would be value-creating or value-wasting. This distinction turns on the value the firm would attach to performance, which ouly those controlling the firm may know. Second, even if it could easily be determined whether a particular rejection is value-creating or value-wasting, the firm's reputation may have been so badly damaged by the problems that forced it into bankruptcy in the first place that the marginal cost to its reputation of rejecting a particular value-creating contract would be insignificant.[80]

Finally, except for large publicly-traded companies, most firms entering bankruptcy end up being liquidated or sold to new owners.[81] Over 70% of firms entering bankruptcy file under the liqui-

77. For an analysis of the effect of reputation on the incentive to breach outside of bankruptcy, see Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691 (1983).

78. *See* Lemma W. Senbet, Comment, *Protecting Stakeholder Interests in Bankruptcy Reorganizations*, 43 U. TORONTO L.J. 717, 718 (1993).

79. I assume a party in a long-term relationship would not incur reputational costs from rejecting a contract the other party knows is value-wasting since rejection would increase the amount of total value available to both parties.

80. *See* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT. REV. L. & ECON. 223, 227–31 (1991).

81. *See* 1995 BANKRUPTCY YEARBOOK AND ALMANAC 8 (Christopher M. McHugh, ed.).

dation provisions of Chapter 7,[82] meaning that they are either liquidated or acquired by new owners. These firms—many of which operate as going businesses for at least part of a Chapter 7 proceeding—face no reputational constraints.[83] Of the remaining 30% that enter bankruptcy through Chapter 11—that is, the firms most likely to care about their reputations—a majority are either liquidated or sold to new owners before a plan is confirmed.[84] Consequently, most firms are likely to discount heavily the future reputational benefit of performing an unfavorable contract—particularly since performance of such a contract may reduce the likelihood that the firm will survive long enough to reap any benefit from this investment.[85]

3. *Opting Out of the RD Rule with Security Interests.* I have argued that *ex post* renegotiation and reputational considerations may not substantially reduce the problem of excessive rejection under the RD rule. However, two parties to a contract could, in principle, avoid the consequences of the RD rule by taking security interests in each other's assets.

The RD rule applies only when the rejection claim is unsecured. If the nonbankrupt party obtains a nonvoidable security interest in the debtor's assets before the debtor files for bankruptcy, the security interest would give any rejection claim priority in

82. *See id.*

83. *See* Nimmer, *supra* note 6, at 523.

84. *See* Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKR. L.J. 99, 106–07 (1983); *see also In re* Petur U.S.A. Instrument Co., 35 B.R. 561, 564 (Bankr. W.D. Wash. 1983) (taking judicial notice that since the effective date of the 1978 Bankruptcy Code only 3.5% of the Chapter 11 cases in the court's district had resulted in confirmed plans, and that most of the confirmed cases involved partial or total liquidation of the debtor business).

85. Even if the bankrupt firm's management were inclined to perform an unfavorable contract in order to preserve the business' reputation, unsecured creditors might oppose any step to reduce the tangible value of the estate (thereby increasing the likelihood that the unsecured creditors will not be paid) in order to obtain an intangible future benefit. *See* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 468–69 (1991).

> In some circumstances creditors complain because the DIP is making business choices that are hostile to the creditors' interests. Creditors may be interested in asset protection or liquidation, while the DIP may wish to gamble assets in the hope of a long-range comeback . . . . If the disputes between [the DIP] and creditors become really serious, the creditors may seek appointment of a trustee to run the business.

Id.

the underlying collateral over all other claims. Since any rejection claim would therefore be paid in full (or up to the value of the collateral), the debtor's estate would be forced to internalize more (if not all) of the cost that rejection imposes on the other party, giving the debtor's estate a greater incentive to perform value-creating contracts. And, if the trustee were to reject, the non-bankrupt party would receive more compensation than if it were unsecured. Thus one might believe that if rejection under the RD rule is expected to be costly to the contracting parties, the parties simply would take security interests in each other's assets to effectively "opt out" of the RD rule.

But two parties to a contract are generally unlikely to use security interests even if, in the event of bankruptcy, the RD rule would impose a significant cost on one of them. First, a firm may not have sufficient unencumbered assets to routinely collateralize the dozens or hundreds of non-loan contracts it may enter into each year. Second, even if there were sufficient collateral, the use of a security interest would be costly: the security interest would tie up the assets serving as collateral, restricting the granting party's ability to transfer, sell, or pledge the assets serving as collateral in order to enter into new projects or pay for current expenses.[86] There would also be substantial transaction expenses associated with creating and maintaining a valid security interest.[87] The costs associated with the use of a security interest would be incurred by the parties whether or not either party enters bankruptcy.

In contrast, the cost of rejection by one party ("Firm A") would be borne by the other party ("Firm B") only if: 1) Firm A enters bankruptcy while the contract is still executory; 2) Firm A's bankruptcy estate is better off rejecting the contract than performing; and 3) the rejection causes a loss to Firm B.[88] The probability that a typical firm will enter bankruptcy during the term of

86. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 878 (1996); F. H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1437–39 (1986); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 247–48 (1992).

87. *See* Bebchuk & Fried, *supra* note 86, at 877–78.

88. This analysis assumes that the owners of Firm A do not benefit from rejection, that is, that all of the benefit from rejection under the RD rule flows to the firm's unsecured creditors. To the extent Firm A's owners do benefit from rejection, then the net loss imposed on the owners of Firm A and Firm B by the RD rule is the loss to Firm B less the benefit received by the owners of Firm A in bankruptcy.

any particular contract may well be rather small, and the likelihood that all three of these conditions will be met may, for a typical firm, therefore be negligible. As a result, the *expected* cost of the RD rule in the typical transaction may well be very small.[89] Thus, even if rejection under the RD rule would be very costly to the parties if it occurs, using security interests to contract around the RD rule may not be worthwhile. The apparently infrequent use of security interests in connection with non-loan contracts thus cannot be taken as evidence that, once the firm is in bankruptcy, the problem of value-wasting rejection under the RD rule is insignificant.[90]

II. JUDICIAL LIMITATIONS ON REJECTION

Part I explained why the ability of the bankruptcy estate to reject without compensating the other party in full can provide the estate with an incentive to reject certain value-creating contracts. This Part explores one possible approach to eliminating the resulting problem of excessive rejection: prohibiting trustees from rejecting any contract that the court determines would be value-creating.

Under current law, a bankruptcy court has the authority to prevent a trustee from assuming or rejecting an executory contract under Section 365.[91] Nevertheless, the decision whether to reject a contract is usually left to the business judgment of the trustee.[92]

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89. If one of the contracting firms is financially distressed, the expected cost of the RD rule would, of course, be higher.

90. It has been suggested to me that another approach to opting out of the RD rule would be to incorporate into a contract a liquidated damages clause that increases the nonbankrupt party's claim by an amount sufficient to ensure that application of the RD rule to the damage claim would yield a payment to the nonbankrupt party equal to its actual damages (to ensure such an outcome, the clause would stipulate that the nonbankrupt party is entitled to expectation damages divided by the payout rate for unsecured claims). However, such a "gross-up" clause is unlikely to be enforceable under current law. First, the effect of rejection is generally to disable liquidated damages clauses. *See, e.g., In re* TransAmerican Natural Gas Corp., 79 B.R. 663, 667 (Bankr. S.D. Tex. 1987) (finding that enforcing the liquidated damages clause would effectively enforce the rejected contract). Second, such a clause might also be considered inoperative under 11 U.S.C. § 365(e)(1) (which strikes down any contract provision that is conditioned on the debtor entering bankruptcy). And even if a "gross-up" clause could be enforced, it would not be effective unless there were sufficient assets to pay the resulting claim.

91. *See* 11 U.S.C. § 365(a) (1994).

92. *See, e.g., In re* TS Indus., Inc., 117 B.R. 682, 685 (Bankr. D. Utah 1990) (applying the business judgment test).

This hands-off approach is generally supported by bankruptcy commentators, who believe that two of the important purposes of Section 365—maximizing the value of the estate and assisting in the rehabilitation of the debtor—are well served by permitting the trustee to choose whichever course of action she believes is in the best interest of the estate.[93]

However, bankruptcy courts occasionally refuse to give a trustee permission to reject a contract. When denying the trustee permission to reject, the court will usually invoke one of two doctrines, the "burdensome test" doctrine or the "balancing test" doctrine, each of which specifies situations in which rejection should not be allowed. In Section A, I describe the "burdensome test" doctrine and examine how incorporating this doctrine into Section 365 would affect the level of desirable performance in bankruptcy. As we will see, incorporating the "burdensome test" doctrine into Section 365 would not always prevent the trustee from rejecting a value-wasting contract.

Section B describes and analyzes the "balancing test" doctrine. It explains that incorporating the "balancing test" doctrine as it is currently formulated into Section 365 would not always prevent the trustee from rejecting a value-creating contract, but that incorporating a modified "balancing test" into Section 365 could prevent the trustee from rejecting any value-creating contract. Although incorporation of such a modified "balancing test" into Section 365 could, in principle, eliminate any problem of excessive rejection under the RD rule, Section B also identifies certain problems with this approach to solving the problem of excessive rejection that may make it both undesirable and ineffective.

A. *The "Burdensome Test" Doctrine*

The doctrine that is most frequently invoked by courts denying permission to reject is the "burdensome test" doctrine. Under this doctrine, a trustee is not permitted to reject a contract unless performance would cause an absolute reduction in the value of the estate.[94] In other words, the estate may not reject an executory contract whose performance would increase the value of the estate

93. *See* Andrew, *supra* note 28, at 895-96; Westbrook, *supra* note 8, at 249-51.

94. *See In re* Jackson Brewing Co., 567 F.2d 618, 621 (5th Cir. 1978); *In re* Stable Mews Assocs., Inc. 41 B.R. 594, 596 (Bankr. S.D.N.Y. 1984).

in order to enter into another arrangement that would make the estate even better off.

To illustrate the operation of the "burdensome test" doctrine, suppose that Firm has agreed to pay Builder A $100 to build a factory; that the factory would cost Builder A $60 to construct; and that Firm would value the factory at $120. At the time Firm enters bankruptcy, neither party has performed or paid. Shortly thereafter, Builder B appears, offering to construct an identical factory for a price of $90. Under the "burdensome test" doctrine, Firm would not be permitted to reject the contract with Builder A because performance of the original contract would not reduce the value of the estate but rather increase it by $20 (the value Firm would place on the factory, $120, less the price of the factory under the contract with Builder A, $100).

Application of the "burdensome test" doctrine can in certain cases prevent value-wasting rejection. Suppose that, in the example above, the cost to Builder B of building the factory would be $80 ($20 more than the cost to Builder A). In that case, rejection of the contract with Builder A would cause Builder A to lose $40 ($100 - $60) in profits, while providing Builder B with $10 ($90 - $80) in profits and reducing Firm's building costs by $10 ($100 - $90). Since rejection would reduce total value by $20 ($40 - $10 - $10), application of the "burdensome test" to prevent rejection would thus yield a desirable result.

However, the "burdensome test" doctrine could not prevent value-wasting rejection in many cases. Recall that the "burdensome test" would apply only when performance of the original contract would *increase* the value of the estate. A trustee would seek to reject such a contract only when there is a possibility of entering into an even more beneficial arrangement. Many rejections are likely to involve contracts the performance of which would *reduce* the value of the estate. In these cases, the "burdensome test" would not apply, and therefore could not prevent value-wasting rejection.

Moreover, the application of the "burdensome test" doctrine could actually prevent the rejection of value-wasting contracts. Returning to our example, suppose that the cost to Builder B of building the factory would not be $80 but rather $40 ($20 *less* than the cost to Builder A). In that case, rejection of the contract with Builder A (and performance of the $90 contract with Builder B) would, as before, cause Builder A to lose $40 in profits, but would provide Builder B with $50 ($90 - $40) in profits and reduce Firm's building costs by $10. As a result, rejection of the contract with Builder A would create a net gain of $20 ($50 + $10 - $40). Application of the "burdensome test" to deny rejection would therefore yield a worse outcome than if the rejection decision were left to the trustee's discretion.

In short, the analysis I have offered indicates that incorporating the "burdensome test" into Section 365 would not solve the problem of excessive rejection under the RD rule and might actually reduce the overall level of desirable performance in bankruptcy.[95]

B. *The "Balancing Test" Doctrine*

The second of the two doctrines invoked to prevent a trustee from rejecting an executory contract is the "balancing test" doctrine. Under this doctrine, the trustee is not permitted to reject an executory contract if the damage to the other party from rejection would be disproportionately greater than the benefit to the estate. For example, in the case of *In re Petur U.S.A. Instrument Co.*,[96] the bankruptcy trustee was not permitted to "reject" (which the court interpreted to mean "cancel," not merely "breach"[97]) a license agreement, on grounds that cancellation of the agreement would destroy the licensee's business while providing only speculative benefit to the estate's creditors.[98]

The "balancing test" doctrine, which is justified on grounds of equity,[99] actually serves as a (partial) efficiency test. When it is

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95. Raymond Nimmer has suggested applying a modified "burdensome test" to executory contracts for "unique" goods for the purpose of making other parties more willing to enter into contracts with financially distressed firms. *See* Nimmer, *supra* note 6, at 529–30. Nimmer would require that a bankrupt debtor perform if 1) performance is not burdensome to the bankruptcy estate; 2) performance is feasible within the bankruptcy proceeding (long-term performance would not be considered feasible where the trustee seeks to liquidate); and 3) the nonbankrupt party has relied on the debtor's promise. *See id.* While Nimmer's rule would be more favorable to financially distressed firms in bankruptcy than the currently-used "burdensome test", it would lead to two distortions in bankruptcy. First, as under the current rule, the trustee may be required to perform even if performance is inefficient. Second, in certain cases, Nimmer's rule could give the trustee an incentive to inefficiently liquidate the debtor in order to avoid performance of a burdensome but value-creating contract.

96. 35 B.R. 561 (Bankr. W.D. Wash. 1983).

97. *See supra* note 25 and accompanying text.

98. *See In re Petur*, 35 B.R. at 563.

99. *See id.* at 564.

applied, it prevents the estate from rejecting when rejection is especially value-wasting. As such, the doctrine *increases* the level of value-creating performance under Section 365, a benefit that has been overlooked by the commentators critical of its use.[100]

As currently formulated, the "balancing test" doctrine applies only when the cost of rejection to the nonbankrupt party would be greatly disproportionate to the benefit received by the estate. Thus the "balancing test" currently can at best prevent only highly value-wasting rejection. When rejection would result in harm to the nonbankrupt party that is greater, but not disproportionately greater, than the benefit to the estate, the "balancing test" would permit rejection of a value-creating contract. This problem could be eliminated by requiring the court to deny the trustee permission to reject whenever the cost of rejection to the nonbankrupt party would be even slightly greater than the benefit to the estate. This modified "balancing test" could solve the problem of excessive rejection.

Unfortunately, there would be at least two problems with incorporating a modified "balancing test" into Section 365. The first is that such a rule would be inconsistent with two of the important purposes behind Section 365—to spread the loss occasioned by the debtor's default as equally as possible and to assist in the rehabilitation of the debtor. Under an improved "balancing test" rule, a court could require the estate to perform unfavorable value-creating contracts that the estate would have rejected under the RD rule. Performance under these circumstances would shift some of the loss that would have been borne by the other party to the contract under the RD rule to the debtor's unsecured creditors, undercutting the norm of equal treatment.[101] Forcing the estate to perform an unfavorable contract that it would have rejected under the RD rule would also deplete the assets of the estate, making rehabilitation more difficult.[102]

The second (and perhaps more) significant problem with the use of a modified "balancing test" under Section 365 is that while

100. *See, e.g.*, Andrew, *supra* note 28, at 898–99.

101. The current "balancing test" doctrine has been criticized for violating the bankruptcy norm of equal treatment. *See* Andrew, *supra* note 28, at 898–99. *See also* Nimmer, *supra* note 6, at 528–29 (observing that requiring the estate to perform a contract would violate the bankruptcy norms of rehabilitation and equal treatment).

102. *See* Nimmer, *supra* note 6, at 528–29.

in principle such a rule would prevent value-wasting rejection, in practice it may be difficult to enforce. In particular, if claims arising from the breach of a contract prior to bankruptcy are treated as any other prebankruptcy unsecured claim, then a firm entering bankruptcy could easily avoid specific performance of a value-creating contract under the modified "balancing test" rule by breaching any time prior to filing for bankruptcy.[103]

103. It might appear that another problem with incorporating the modified "balancing test" rule into Section 365 is that such a rule would increase the total litigation costs associated with resolving disputes over executory contracts in bankruptcy. However, this need not be the case.

As under the RD rule, litigation could occur under the modified "balancing test" rule whenever the trustee seeks to reject (or the nonbankrupt party breaches). The nonbankrupt party would breach with the same frequency under both the RD rule and modified "balancing test," since under both rules it would be required to pay full expectation damages. However, there would be less rejection under the modified "balancing test" rule than the RD rule. For while under the RD rule the trustee has an incentive to reject whenever rejection makes the estate better off than performance, under the modified "balancing test" rule the trustee would have an incentive to reject only when rejection would make the estate better off than performance *and* the trustee believes that the court would uphold its decision to reject, should the other party contest it. Consequently, the *frequency of litigation* would be lower under the modified "balancing test" rule than under the RD rule.

But when the trustee would seek to reject under the modified "balancing test" rule and the nonbankrupt party challenges the rejection, the court would be required to determine both the cost of performance to the estate and the value of performance to the nonbankrupt party. Under the RD rule, the court need calculate only the value of performance to the nonbankrupt party. The *cost per case* may therefore be higher under the modified "balancing test" rule than under the RD rule. As a result, *total litigation costs* under the modified "balancing test" rule could be higher or lower than under the RD rule.

Nor would the modified "balancing test" rule delay performance in bankruptcy (relative to the RD rule). Under the modified "balancing test" rule, there would be cases in which: 1) rejection would make the estate better off than performance; 2) the trustee believes that the court would uphold its rejection decision if challenged; 3) the other party believes that the court would compel the estate to perform; and 4) the court in fact compels the estate to perform. Since litigation would precede performance only when rejection would have made the estate better off, litigation would arise under the modified "balancing test" rule only in those cases where the trustee would have simply rejected the contract under the RD rule. Thus, relative to the RD rule, the modified "balancing test" rule would not delay performance.

In fact, the modified "balancing test" rule could lead to earlier performance than the RD rule. The reason is that the trustee would need less information to make her decision under the modified "balancing test" rule than under the RD rule. To see why this is the case, assume that performance would be costly to the estate, but would benefit the nonbankrupt party. Under the RD rule, the trustee must estimate the payout rate for unsecured claims, the value to the other party of performance, and the cost to the estate of performance in order to determine whether rejection would be more or less costly than performance. Under the modified "balancing test" rule, the trustee would be

III. ELIMINATING THE UNDERLYING DISTORTION IN FAVOR OF REJECTION: THE PRICE-ADJUSTMENT APPROACH

A. *Towards the Price-Adjustment Approach*

Part II described one possible approach to eliminating the problem of excessive rejection in bankruptcy: denying the trustee permission to reject an executory contract that the court determines would be value-creating. It explained that one of the two doctrines currently used by courts to prevent a trustee from rejecting under Section 365—the "balancing test" doctrine—could be modified to achieve this result. Unfortunately, the use of the modified "balancing test" rule in Section 365 would suffer from at least two problems: 1) it would be inconsistent with two of the purposes behind Section 365—assisting in the rehabilitation of the debtor and spreading more widely the loss caused by the failure of the debtor; and 2) it could be easily circumvented—a firm contemplating bankruptcy could avoid performing an unfavorable but value-creating contract by breaching the contract prior to bankruptcy.

This Part explores a different approach to solving the problem of excessive rejection in bankruptcy: eliminating the underlying distortion in favor of rejection and leaving the performance decision to the trustee. A useful way to think about this distortion is as follows: under the ED rule, the *relative* cost of nonperformance (the cost of nonperformance relative to the cost of performance) is high enough so that each party has an incentive to perform any contract that is value-creating (but not so high that either party has an incentive to perform a contract that is value-wasting). The RD rule, by not requiring the estate to compensate the other party in full for any damages resulting from rejection, reduces the relative cost of nonperformance. This reduction in the relative cost of nonperformance creates the distortion in favor of rejection. Eliminating the distortion in favor of rejection therefore requires

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required to estimate only the value to the other party and the cost to the estate of performance. If the trustee determines that the value of performance to the other party exceeds the cost of performance to the estate, the trustee would have an incentive to perform (because she would believe that the court would not uphold a decision to reject). Otherwise, the trustee would have an incentive to reject. Since the court's decision would be independent of the payout rate for unsecured claims, the payout rate would have much less effect on the trustee's decision to perform or reject under the "balancing test" rule. Thus, the trustee would have less of an incentive to delay the decision in order to obtain a better estimate of the payout rate.

increasing the relative cost of nonperformance to its level under the ED rule.

One straightforward approach to increasing the relative cost of nonperformance to its appropriate level would be to raise the cost of nonperformance to its level under the ED rule: that is, to require the estate to pay expectation damages in the event of rejection.[104] Such a rule would give the trustee the same performance incentives as a (solvent) party outside of bankruptcy. It would thus ensure that if the decision is left in the hands of the trustee, the trustee would have an incentive to perform if the contract is value creating.

However, the use of the ED rule under Section 365 would suffer from the same problems as the use of the modified "balancing test." First, the ED rule would be inconsistent with the two important purposes that are offered for Section 365 and, indeed, for the bankruptcy system as a whole: to enhance the value of the estate and to spread equitably the loss occasioned by the debtor's default.[105] The use of an ED rule in bankruptcy would be even more problematic, at least in terms of undermining the norm of equal treatment. Relative to the RD rule, the modified "balancing test" rule would shift the loss from the other party to the executory contract to the debtor's unsecured creditors only when the estate is compelled to perform a value-creating contract that it would have rejected under the RD rule. The ED rule, in contrast, would shift the loss to the debtor's unsecured creditors when the estate performs a value-creating contract that it would have rejected under the RD rule as well as when the estate rejects a value-wasting contract that it would have also rejected under the RD rule.[106]

104. This is the solution offered by George Triantis in his analysis of the problem of excessive rejection. *See* Triantis, *supra* note 2, at 696.

105. *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 790–92 (1987); Westbrook, *supra* note 8, at 227. This point is acknowledged by Triantis as well. *See* Triantis, *supra* note 2, at 696.

106. The ED rule would not necessarily make rehabilitation more difficult than the use of the modified "balancing test" under Section 365. The reason for this is as follows: under both rules, all unfavorable value-creating contracts are (in principle) performed and all unfavorable value-wasting contracts are rejected. As a result, the only difference between the rules is that the other party has a larger claim under the ED rule than under the modified "balancing test" in the event of rejection.

However, claims arising from rejection do not deplete the assets of the estate. They become claims against those assets that are paid at the end of the bankruptcy proceeding. Thus, while the total claims against the estate would be higher under the ED rule

Second, as long as claims arising from a prebankruptcy breach were still subject to the RD rule (just like any other prebankruptcy unsecured claim), a firm anticipating bankruptcy could easily circumvent an ED rule under Section 365 by breaching some time before it enters bankruptcy.[107]

Requiring the estate to pay expectation damages is, of course, not the only means of increasing the relative cost of nonperformance to its appropriate level. Another way to increase the relative cost of nonperformance to that which would prevail under the ED rule would be to *reduce* the cost of performance by an appropriate amount. I call this the "price-adjustment" approach. Below, I put forward and analyze three rules that embody this approach: 1) the RD/Adjusted Price rule, which adjusts the price in favor of the bankruptcy estate by an amount sufficient to offset the distortion in favor of breach under the RD rule (Section B); 2) the ND/Adjusted Price rule, which gives the estate a choice between paying no damages for rejection or performing at a price that gives the bankruptcy estate all of the value created by performance (Section C); and 3) the Modified Price/ED rule, which modifies the contract price and then gives the trustees a choice between performing at the modified price or paying expectation damages (Section D). My aim is not to advocate the adoption of any of these rules in particular, or of the price-adjustment approach in general, but rather to begin exploring the costs and benefits of these three price-adjustment rules relative to the RD rule.

In principle, all three of the price-adjustment rules considered lead to more desirable performance than the RD rule. As we will see, however, some of the price-adjustment rules could give rise to more frequent litigation, and higher litigation costs, than the RD rule. Such litigation could delay (and, if the delay is long enough,

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than under the modified "balancing test" (and thus the payout for unsecured claims would be lower), the two rules would not have different effects on the value of the estate's assets (and, therefore, on the ability of the debtor to rehabilitate itself).

107. *See, e.g.*, Lynn M. LoPucki, Comment, *Stakeholder Interests in Bankruptcy*, 43 U. TORONTO L.J. 711, 715 (1993). LoPucki also points out that a firm that finds itself with an unfavorable executory contract in bankruptcy under the ED rule could dismiss its bankruptcy case, breach the contract, and then refile for bankruptcy sometime later. *See id.* One could adopt a reach-back provision under which claims arising from breaches in anticipation of bankruptcy are paid full damages. In principle, such a reach-back provision would prevent debtors from circumventing an ED rule under Section 365. In practice, however, it would be difficult to distinguish between breaches that were made in anticipation of bankruptcy and those that were not.

prevent) performance, reducing the rules' effectiveness in practice. Therefore, I will pay attention to the litigation costs associated with each rule and the effect of litigation under each rule on the timing of performance in bankruptcy.

In examining litigation costs and the effect of each price-adjustment rule on the timing of performance in bankruptcy, my baseline for comparison will be the RD rule. When the trustee is given complete discretion under the RD rule, there might be litigation only if rejection by the trustee (or breach by the other party) gives rise to a damage claim.[108] There would be no need for litigation if the parties proceed with performance or mutually abandon[109] the contract. As a result, any litigation that arises under the RD rule does not delay performance.

In the analysis of the three price-adjustment rules I will also pay attention to the *ex post* distributional effects of the rules, that is, how the rules allocate value between the debtor's bankruptcy estate and the other party to the executory contract.[110] This is of concern because increasing the assets of the bankruptcy estate facilitates the debtor's reorganization, an important purpose of bankruptcy law.[111] In the discussion of each rule's *ex post* distributional effects, the baseline for comparison again will be the RD rule. As explained, the RD rule transfers value from the nonbankrupt party only when the trustee rejects an executory contract.[112]

The *ex post* distributional effects of each rule are also important because they affect the parties' decisions prior to bankruptcy. In analyzing each rule, I will consider one important effect that is likely to vary among them: the effect of the rule on the timing and nature of performance decisions in anticipation of bankruptcy.[113] In analyzing these performance decisions, I assume that the

108. There need not be litigation, of course; the parties would have at least until the end of the bankruptcy proceeding to settle a claim out-of-court.

109. For purposes of the analysis, I use "rejection" to refer to the case in which the trustee refuses to perform a contract that would make the nonbankrupt party better off, "breach" to refer to the case in which the other party refuses to perform a contract that would make the estate better off, and "mutual abandonment" to refer to the situation in which both parties walk away from the contract because performance would make both worse off.

110. There may of course be *ex ante* price adjustments at the time of contracting that at least partially compensate the other party for these *ex post* effects.

111. *See supra* notes 101–02 and accompanying text.

112. *See supra* Section I.A.

113. These rules will also affect other decisions outside of bankruptcy, including the

management of each firm (like the trustee of the debtor's estate in bankruptcy) is seeking to maximize the value of the firm.[114]

The treatment of executory contracts in bankruptcy could have two types of effects on performance decisions in anticipation of bankruptcy. First, it could affect only the timing of the performance decision (but not the decision itself).[115] Second, it could affect both the timing and the nature of the decision.[116] Some of these effects—for example, causing a firm to perform inside bankruptcy instead of breaching outside bankruptcy—may be desirable. Others—for example, causing a firm to breach outside bankruptcy instead of performing inside bankruptcy—are clearly not.[117]

In analyzing the effect of each of the price-adjustment rules on performance decisions in anticipation of bankruptcy, the RD rule will again serve as the benchmark. Under the RD rule, neither party should have an incentive to delay performance until bankruptcy because the terms of performance in bankruptcy are the same as outside of bankruptcy. Likewise, neither party is better off delaying or accelerating breach. As a result, the RD rule

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decision to declare bankruptcy and whether to enter into an executory contract with another firm. *See infra* Part IV.

114. For convenience, I also assume that the party entering bankruptcy must pay (or perform) prior to receiving performance (or payment) from the other party.

115. The treatment of executory contracts in bankruptcy could 1) cause a party that would have performed (breached) outside bankruptcy to delay performance (breach) until bankruptcy or 2) cause a party that would have breached inside bankruptcy to breach outside bankruptcy (I assume that while a party can unilaterally choose to breach before it or the other party declares bankruptcy, it cannot compel the other party to accelerate performance). The timing of the performance decision may have efficiency consequences. *See* Craswell, *supra* note 58, at 632–40.

116. The treatment of executory contracts in bankruptcy could 1) cause a party that would have breached outside bankruptcy to perform inside bankruptcy or 2) cause a party that would have performed inside bankruptcy to breach outside bankruptcy.

117. If a party must make its performance decision prior to bankruptcy, then the decision will not be affected by the executory contract rule in bankruptcy. Consider the choice facing a financially distressed firm that anticipates entering bankruptcy, assuming that it must pay (or perform) prior to receiving performance (or payment) from the other party. If the financially distressed firm breaches, payment of any breach claim can be delayed until bankruptcy, at which point the breach claim will be treated like any other prebankruptcy unsecured claim and paid less than its face amount. Consequently, the financially distressed firm has the same type of incentive to reject value-creating contracts outside of bankruptcy as it would inside bankruptcy under the RD rule. This distortion would arise under any regime where unsecured claims that arise before bankruptcy need not be paid in full, regardless of the treatment of executory contracts *in* bankruptcy.

should have no effect on the timing and nature of performance decisions shortly before bankruptcy.

B. *The Ratable Damages/Adjusted Price Rule*

1. *The Operation of the RD/Adjusted Price Rule.* The first price adjustment rule considered is what I call the "ratable damages and adjusted price" ("RD/Adjusted Price") rule. Under the ordinary RD rule, once a bankruptcy estate chooses to perform an executory contract, the estate becomes subject to the same contract rules that prevail outside of bankruptcy.[118] That is, the estate must perform according to the contract's original terms (or pay damages in full). However, if the trustee rejects the contract, the estate generally need pay only a small portion of any damages sustained by the other party. As Part I explained, the resulting reduction in the relative cost of nonperformance distorts the trustee's choice in favor of rejection.

The RD/Adjusted Price rule, like the RD rule, allows the estate to treat the other party's damage claim as a prebankruptcy unsecured claim, thereby reducing the cost of rejection by the same amount as the RD rule. However, the RD/Adjusted Price rule restores the relative cost of nonperformance to its appropriate level by making an offsetting adjustment to the contract price. The size of this adjustment is exactly equal to the amount of the reduction in the cost of nonperformance under the RD rule—no more and no less.[119]

> **Example.** To illustrate the operation of the RD/Adjusted Price rule, suppose again that Firm has agreed to pay Builder \$100 for construction of a factory that would cost Builder \$60 to build.

118. *See supra* notes 36-37 and accompanying text.

119. Any less of an adjustment would not eliminate the distortion in favor of rejection; any more of an adjustment would eliminate the distortion in favor of rejection, but create a distortion in favor of performance. For example, consider a rule requiring that the other party perform and then treating the other party's claim for payment as a prebankruptcy unsecured claim against the estate. *See* Nimmer, *supra* note 6, at 512. Under such a rule, the cost of performance to the estate of a bankrupt buyer would be reduced by a fraction (equal to 1 - x, where x is the payout fraction for unsecured claims) of the contract price. As under the RD rule, the cost of nonperformance would be reduced by that fraction (1 - x) of the nonbankrupt seller's profits. The nonbankrupt seller's profits would be some amount that is less than the contract price. Thus, the estate would receive a discount for performance greater than the discount for rejection. As a result, the estate would sometimes have an incentive to demand performance even when performance is value-wasting.

Assume that the expected payout rate for unsecured claims is 30%. In the event of the estate's rejection, Builder would therefore have a damage claim of $40 ($100 - $60). However, under the principle of ratable damages the estate would be required to pay only 30% of the $40 damage claim—$12. Thus, the cost of rejection to the estate would be $28 ($40 - $12) less than under the ED rule. The RD/Adjusted Price rule would therefore reduce the cost to the estate of performance by an equal amount ($28), so that the estate would face an adjusted price of $72 ($100 - $28). As a result, the RD/Adjusted Price rule would provide the trustee with a choice between rejecting the contract and purchasing the factory for $72.

Since the RD/Adjusted Price rule discounts the cost of performance and rejection by the same amount relative to the ED rule, it provides the same incentives to the bankruptcy estate as the ED rule (while making the bankruptcy estate better off).

Example. To illustrate the incentives created by the RD/Adjusted Price rule, let us return to the previous example, where the cost to Builder would be $60, rejection damages would cost the estate $12, and the price under the RD/Adjusted Price rule wonld be $72. First, suppose that the estate values the factory at more than the cost to Builder of producing the factory ($60)—i.e., performance would be value-creating. Here there are two possibilities: if the estate would value the factory at more than $72, performance would benefit the estate and the estate will perform. If the estate would value the factory at less than $72, but more than $60, the estate would lose from performance. However, the estate has an incentive to perform since the loss from performance would be less than the $12 cost of rejection. Thus when performance would be value-creating the estate has an incentive to perform—the desirable result.

Now, suppose that the estate would value the factory at less than $60—and therefore that performance would be value-wasting. In that case, performance at the price of $72 would make the estate worse off by more than $12. Since rejection would cost only $12, the estate has an incentive to reject—the right result.[120]

120. To illustrate the operation of (and incentives created by) the RD/Adjusted Price rule when Builder is the bankrupt party, suppose that Builder agrees to build Firm a factory for $100 before Builder enters bankruptcy. Suppose further that the cost to Builder's estate of building the factory would be $120, and that Firm would value the factory at $150, so that Firm's expected gain from performance would be $50 ($150 - $100). Finally,

2. *Litigation and the Timing of Performance in Bankruptcy.* Like the RD rule, the RD/Adjusted Price rule could give rise to litigation whenever there is breach or rejection. However, unlike the RD rule, the RD/Adjusted Price rule could give rise to litigation also in the event of performance. The *frequency* of litigation would be higher than under the RD rule. In the event of litigation, the court need determine only the value of performance to the other party—the same information it currently requires under the RD rule to determine damages. Thus, the *cost per case* may be the same as under the RD rule, but *total litigation costs* are likely to be higher.

Let us now consider the effect of the RD/Adjusted Price rule on the timing of performance in bankruptcy. Under the RD/Adjusted Price rule, the contract price would sometimes be adjusted in the event the trustee chooses performance. Whether the adjustment is determined by the court, or negotiated by the parties out-of-court, the process of determining the price would take time. The RD/Adjusted Price rule would thus appear to delay performance.

However, the RD/Adjusted Price rule would not delay performance because the rule would give the parties the incentive and the ability to make performance decisions even before the final price is ultimately determined (through litigation or by negotiation). To see why this is the case, suppose that Firm had contracted with Builder for construction of a factory before entering bankruptcy. Firm's trustee and Builder must now make their respective performance decisions. Under the RD/Adjusted Price rule, both parties would know that the price would be adjusted (down) in favor of Firm's estate to the extent that the RD rule would reduce the cost of rejection.

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assume that the payout rate for unsecured claims is 30%.

Under the RD rule, the cost to Builder's estate of rejection would be $15 (30% of $50, Firm's expected profit); performance would cost Builder $20 ($120 - $100). Since the RD rule would reduce the cost of rejection by $35, from $50 to $15, the estate has an incentive to reject even though the contract is value-creating.

Under the RD/Adjusted Price rule, the cost of rejection would be reduced by $35, from $50 to $15. But the RD/Adjusted Price rule would increase the contract price by $35, to $135, so that performance would now *benefit* Builder's estate by $15 ($135 - $120) rather than costing it $20. Builder's estate thus has an incentive to perform under the RD/Adjusted Price rule—the desirable outcome.

To begin, consider the decisionmaking process of Firm's trustee. Since under the RD/Adjusted Price rule the cost of performance (relative to the ED rule) and the cost of nonperformance (relative to the ED rule) would be reduced by an equal amount, the amount by which each would ultimately be reduced (which, of course, could be zero) becomes irrelevant to the trustee's comparison of the two costs. Thus, in comparing the cost of performance and the cost of rejection to the estate, the trustee need compare only the cost of performance under the ED rule and the cost of breach under the rule (the identical comparison Firm would be required to make outside bankruptcy under the ED rule). If the cost of performance under the ED rule would be less than the cost of breach under the ED rule, the trustee would have an incentive to seek performance, even if the contract price has not yet been determined. Otherwise, the trustee would have an incentive to reject.

Decisionmaking would also be no more difficult for Builder under the RD/Adjusted Price rule than it would be under the ED rule. Assume that Firm's trustee seeks performance and Builder must decide whether to begin building the factory or to breach. Consider two possibilities. The first is that Builder would have lost money under the original terms of the contract. If Builder's costs are such that it would have lost money under the original terms of the contract, then outside of bankruptcy Firm would not have been required to pay damages under the ED rule for breach, the RD rule would not reduce the price of nonperformance, and there would be no price adjustment under the RD/Adjusted Price rule. Builder would face the same decision that it would have faced outside bankruptcy under the ED rule: it would determine whether to breach or perform by comparing its cost of performance to the value of performance to the other party.

The other possibility is that Builder would have profited under the original terms of the contract. In that case there would be an adjustment in the price under the RD/Adjusted Price rule. However, Builder would not need to know the size of the adjustment in order to decide whether to perform. Whatever the size of the adjustment, Builder would be better off performing than breaching: if Builder would have profited under the original terms of the contract, it would also profit under the RD/Adjusted Price rule, because it would be paid its costs plus a fraction (equal to the payout rate for unsecured claims) of its expected profits.

On the other hand, if Builder refuses to perform, it could be liable for expectation damages (based on the adjusted price). Thus when Builder would have made a profit under the ED rule it would have an incentive to agree to performance under the RD/Adjusted Price even before the price is determined.[121]

If Builder responds to the estate's request for performance by initiating performance, the trustee may later seek an adjustment in price if she believes that Builder would have profited under the original terms of the contract. At that point, the parties may settle the price out of court or litigate the adjustment. However, performance would have already occurred or be under-way. Thus, any litigation over the price of performance would not delay performance itself.[122] If Builder breaches, Firm's estate could seek expectation damages based on the adjusted contract price.[123]

In fact, the RD/Adjusted Price rule could lead to earlier performance decisions by the parties than the RD rule. As explained above, the RD/Adjusted Price rule enables the trustee to make performance decisions without requiring her to estimate the payout rate for unsecured claims. In contrast, when performance is costly, the RD rule requires the trustee to estimate the payout rate for unsecured claims in order to compare the cost of rejection and the cost of performance to the estate. Thus, under the RD rule, trustees may have an incentive to delay decisionmaking until they can form a better estimate of the payout rate (an incentive they would not have under the RD/Adjusted Price rule).

121. Of course, Builder might be hesitant to agree to perform the contract because of doubts about the estate's ability to perform its obligations. But this situation would also arise under the RD rule when the trustee seeks performance. The Bankruptcy Code already partially addresses this problem by requiring the trustee to provide "adequate assurance" that the estate will fulfill its obligations under the contract before the estate may assume a contract with respect to which there has been a default. *See* § 365(b)(1)(C) (1994).

122. In contrast, if the parties must renegotiate the contract, desirable performance could not occur until the parties had reached agreement on the new performance price. Thus, value-creating contracts that the trustee has an incentive to reject under the RD rule are likely to be performed, if at all, only after they would have been performed under the RD/Adjusted Price rule.

123. Builder would breach only if it would have lost money under the original terms of the contract. In that case, the adjusted price that would have been faced by the estate in the event of performance is simply the original price.

3. *Distributional Effects in Bankruptcy and Performance Decisions Prior to Bankruptcy.* The distributional effect of the RD/Adjusted Price rule on the bankruptcy estate is, on average, more favorable than the RD rule. There is less rejection under the RD/Adjusted Price rule than under the RD rule because there is no incentive to reject value-creating contracts (as there is under the RD rule). As a result, the benefit to the estate from rejection is likely to be less under the RD/Adjusted Price rule than under the RD rule. However, the estate also benefits under the RD/Adjusted Price rule whenever the performance price is adjusted—that is, whenever there is performance that makes the other party better off. The benefit from performance would more than offset the reduction in the benefits from rejection.[124]

The RD/Adjusted Price rule would also affect performance decisions prior to bankruptcy. The RD/Adjusted Price rule could have two types of effects on performance decisions prior to bankruptcy. First, the rule could give a firm anticipating bankruptcy an incentive to delay performance until bankruptcy (rather than perform outside of bankruptcy) in order to take advantage of a price adjustment.[125] Second, the rule could give a firm anticipating bankruptcy an incentive to forego breaching a value-creating contract outside of bankruptcy in order to take advantage of the price adjustment in bankruptcy. The rule could thus reduce some of the inefficient breach that takes place outside of bankruptcy under the RD rule.[126]

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124. In those cases where the trustee has an incentive to reject a value-creating contract under the RD rule, the RD/Adjusted Price would adjust the price to provide an incentive for the trustee to perform the contract. The trustee would choose performance if it makes the estate better off than rejection. Thus, in those cases where rejection takes place under the RD rule but would not under the RD/Adjusted Price rule, the estate would be better off under the latter rule. In addition, the RD/Adjusted Price rule would transfer more value to the estate than the RD rule in some of the cases where performance would occur under both rules.

125. When the other party is not expected to profit from performance, the firm will not have an incentive to delay performance until bankruptcy because there will be no price adjustment.

126. The RD/Adjusted Price rule would not give the other party an incentive to delay breach or performance until bankruptcy. Nor would either party have an incentive to accelerate breach in anticipation of a party's bankruptcy.

4. *A Note on Fairness.* The RD/Adjusted Price rule might seem unfair to the nonbankrupt party relative to the RD rule because it can transfer value from that party not only in the event of rejection but also in the event of performance. This objection, which can be raised against any of the three price-adjustment rules presented, would of course have little force if the terms of parties' agreements with the debtor reflect the legal rule in effect and fully compensate the parties for the risk of loss associated with the debtor's bankruptcy. To the extent these parties are compensated for any increased risk of loss associated with a price-adjustment rule, the adoption of such a rule would not make these parties systematically worse off *ex ante.*

Moreover, even from a purely *ex post* perspective, the impact in bankruptcy of the RD/Adjusted Price rule on the nonbankrupt party would be much more limited than it might appear. As we will see, relative to the RD rule the RD/Adjusted Price rule does nothing more in the event of performance than to reduce the profits that the nonbankrupt party would have made if the contract had been performed outside bankruptcy.

To begin, suppose that Builder, the nonbankrupt party, expects to profit from performance under the original terms of the contract, where that profit is the amount by which the contract price exceeds Builder's cost of performance. Under the ED rule, Firm would be required to pay Builder 100% of that profit if Firm breaches. Under the RD rule, Firm's estate would pay a smaller percentage of those damages. The RD rule would therefore reduce the cost of rejection by a fraction of Builder's profit, where that fraction is the difference between 100% and the percentage of damages that must be paid under the RD rule.

Under the RD/Adjusted Price rule, the performance price would be reduced by that same fraction of Builder's profit. Since the adjustment would be less than 100% of Builder's profit, the reduction in the contract price would not eliminate Builder's profit—that is, it would not lower the contract price below the cost of performance—but merely reduce that profit. The RD/Adjusted Price rule thus would not convert a contract that is profitable for Builder into one that is money-losing. Indeed, as long as the payout rate for unsecured claims is positive, under the

RD/Adjusted Price rule Builder would enjoy some fraction of the profit it expected from performance.[127]

Now suppose that Builder would not have profited from performance. In that case Builder would not be entitled to damages under the ED rule if Firm breaches. The RD rule would not, therefore, reduce the cost of nonperformance to Firm's estate. Accordingly, the RD/Adjusted Price rule would not adjust the price of performance in favor of Firm's estate. As a result, if Builder would not have profited from performance under the ED rule it would be no worse off under the RD/Adjusted Price than it would be under the RD rule (or, for that matter, under the ED rule outside of bankruptcy).[128]

C. *The No-Damages/Adjusted Price Rule*

1. *The Operation of ND/Adjusted Price Rule.* Since the RD/Adjusted Price rule just discussed builds on—rather than replaces—the current RD rule, it might be somewhat easier to integrate into existing law than a rule that determines rejection damages differently. However, there is no a priori reason to limit consideration to rules that incorporate the principle of ratable damages. Suppose one favored a rule that sets damages in a way

127. Compare Builder's fate to that of a contracting party that had already performed and was awaiting payment on the day Firm files for bankruptcy. That party will not only give up any profit it had expected under the contract, but will also suffer a large loss.

128. The following example provides a numerical illustration of how the RD/Adjusted Price rule does nothing worse to the nonbankrupt party (relative to the RD rule) than reduce or eliminate the profit, if any, expected under the contract. Suppose that Builder has contracted with Firm to build a factory for $100, and the expected payout rate for general unsecured claims is 0%.

First consider the case in which the cost of performance to Builder would be $60. In the event of rejection, the loss sustained by Builder would thus be $40 ($100 - $60) but Firm's estate would be required to pay zero. Thus the reduction in damages would be $40. The RD/Adjusted Price rule would therefore reduce the performance price by $40, yielding an adjusted price of $60, which is equal to Builder's cost. Builder would therefore break even from performance. (One can see that if the payout rate were greater than 0%, Builder would enjoy some profit from performance since the reduction in the cost of rejection, and therefore the reduction in the price, would be less than $40.)

Now consider the same case as above except that Builder's cost of construction would be $150. Builder would thus stand to lose $50 from performance. In that case, Firm's estate would not be required to pay any damages upon terminating the contract under either the ED or RD rules. Thus, the reduction in damages under the RD rule would be zero. As a result, no adjustment would be made to the performance price under the RD/Adjusted Price rule—and Builder's position would be no worse than under the RD rule.

that makes the bankruptcy estate even better off than under the RD rule. There is a continuum of damage amounts (one-half ratable damages, one-third ratable damages, and so on) that would accomplish this result. The simplest rule, however, would be a no-damages ("ND") rule that simply bars the nonbankrupt party from receiving any rejection damages.[129]

If damages are reduced to zero and there is no adjustment of the performance price, there would of course be a distortion in favor of rejection. Indeed, the distortion would be even greater than under the RD rule (in those cases where the payout rate for unsecured claims is positive). Under the ND rule the bankruptcy estate would have an incentive to reject any contract that makes it worse off, no matter how value-creating performance might be. Thus there would be less value-creating performance under the ND rule than under the RD rule.[130] To correct the distortion, there must be an even greater price adjustment than under the RD/Adjusted Price rule. As we will see, the appropriate adjustment is one that would reduce the contract price to the cost of performance.[131]

> **Example.** To illustrate the operation of the ND/Adjusted Price rule, suppose that Firm orders a factory from Builder for $100 and then enters bankruptcy. The cost to Builder of producing the factory would be $60. Thus its anticipated profits—and the amount Firm would be required to pay in damages under the ED rule—is $40. The ND rule would reduce the cost of rejection by $40 (to $0). Accordingly, the price of the factory would also be reduced by $40, to $60. The estate would then face a choice between purchasing the factory for $60 or rejecting and paying no damages.[132]

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129. The ND rule is used in place of the RD rule in a number of other countries; in Italy, for example, the ND rule is used when the bankruptcy estate rejects a building or service contract, or a contract for delivery of property to the nonbankrupt party. *See* EUROPEAN CORPORATE INSOLVENCY, *supra* note 29, at 393. In Australia the ND rule applies to all executory contracts of the debtor in bankruptcy. *See* CAMPBELL, *supra* note 29, at 20. The ND rule is also the *de facto* rule in the many U.S. bankruptcy cases that yield no payment to general unsecured creditors. *See* LoPucki, *supra* note 14, at 311.

130. In Spain, certain contracts automatically terminate when a firm enters bankruptcy (apparently leaving neither side liable for any damages). *See* EUROPEAN CORPORATE INSOLVENCY, *supra* note 29, at 605. This automatic termination rule is equivalent to a bilateral ND rule and thus creates an incentive for value-wasting rejection twice as frequently as the ordinary ND rule.

131. If the nonbankrupt party is receiving performance, the price is adjusted up to the value that party places on performance.

132. To compare, under the same facts and assuming a 30% payout rate, the

The ND/Adjusted Price rule would work on the same principle as the RD/Adjusted Price rule. Indeed, it is merely a special case of the RD/Adjusted Price rule—that in which the payout rate is expected to be zero. By fixing rejection damages at zero, the RD/Adjusted Price rule reduces the cost of rejection (relative to the cost of breach under the ED rule) by an amount equal to the other party's profits from performance. As we saw, to ensure that there is no distortion against or in favor of performance, the performance price must be adjusted by same amount as the reduction in the cost of rejection. When the nonbankrupt party is the seller, reducing the contract price by the seller's expected profits would have the effect of adjusting the contract price to the seller's breakeven point—its cost.

Example. Continuing with the preceding example, suppose that performance would be value-creating—i.e., that Firm's estate would value the factory at more than $60. In that case, purchasing the factory for $60 would make the estate better off. On the other hand, rejection would leave the value of the estate unchanged. Thus the trustee will have an incentive to perform—the desirable outcome.

Suppose, on the other hand, that performance would be value-wasting—i.e., that Firm's estate would value the factory at less than $60. In that case, purchasing the factory for $60 would make the estate worse off. Since rejection again leaves the value of the estate unchanged, the trustee has an incentive to reject—the proper result.

2. *Litigation and the Timing of Performance in Bankruptcy.* Like the RD rule, the ND/Adjusted Price rule could give rise to litigation in the event the other party breaches. However, unlike the RD rule, the ND/Adjusted Price rule 1) would not give rise to litigation in the event the estate rejects but 2) could give rise to litigation in the event of performance. The *frequency* of litigation could be higher or lower than under the RD rule.[133] In the event of litigation, the court need learn only the value of performance to

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RD/Adjusted Price rule would give the trustee the choice between paying $72 for the factory or $12 in rejection damages.

133. The frequency of litigation would be lower under the ND/Adjusted Price rule than under the RD rule if rejection under the RD rule is more frequent than those cases under the ND/Adjusted Price rule where there would be performance *and* the trustee seeks a price adjustment.

the other party—the same information currently required under the RD rule to determine that party's damages. The *cost per case* may therefore be the same as under the RD rule; *total litigation costs* could be higher or lower than under the RD rule.

Since the ND/Adjusted Price rule is just a special case of the RD/Adjusted Price rule (that in which the payout rate for rejection damages claims is zero), the parties would have the same incentive and ability to make performance decisions prior to a determination of the performance price as under the RD/Adjusted Price rule.[134] As under the RD/Adjusted Price rule, the parties would need less information to make decisions than they would under the RD rule, and no more than they would under the ED rule. Thus performance decisions could be made more quickly than under the RD rule.

3. *Distributional Effects in Bankruptcy and Performance Decisions Prior to Bankruptcy.* From an *ex post* distributional perspective, there would be a transfer from the nonbankrupt party to the estate under the same circumstances as the RD/Adjusted Price rule, but the size of the transfer would be greater (except for those cases under the RD/Adjusted Price rule where the payout rate for unsecured claims would be zero and thus the rules would be effectively the same). However, it should be emphasized that since the ND/Adjusted Price rule is simply an extreme version of the RD/Adjusted Price rule, it at most would eliminate the profit the other party would have enjoyed under the original terms of the contract; it would not transfer value from the nonbankrupt party to the estate if the nonbankrupt party would have lost money under the original contract price.

The ND/Adjusted Price rule could have three types of effects on performance decisions prior to bankruptcy. First, like the RD/Adjusted Price rule, the ND/Adjusted Price rule could give a firm anticipating bankruptcy an incentive to delay performance until bankruptcy (rather than perform outside of bankruptcy) in order to take advantage of a price adjustment.[135] Second, like the RD/Adjusted Price rule, the ND/Adjusted Price rule could also

134. *See supra* Section III.B.2.

135. When the other party is not expected to profit from performance, the firm will not have an incentive to delay performance until bankruptcy because there will be no price adjustment.

reduce some of the inefficient breach that takes place outside of bankruptcy under the RD rule by giving a firm that would have breached outside of bankruptcy an incentive to defer the decision until bankruptcy and then seek performance at an adjusted price. Third, unlike the RD/Adjusted Price rule, the ND/Adjusted Price rule could give a firm anticipating bankruptcy an incentive to delay breach until bankruptcy, where it could reject without paying any damages.

D. *The Modified Price/Expectation Damages Rule*

1. *The Operation of the Modified Price/ED Rule.* The RD/ Adjusted Price and ND/Adjusted Price rules take the level of damage reduction as given (by the RD and ND rules, respectively) and then adjust the price of performance accordingly to eliminate the distortion in favor of rejection. One problem with this type of approach is that it may create uncertainty about the performance price prior to bankruptcy. The third and final price adjustment rule considered—the "Modified Price/Expectation Damages" ("Modified Price/ED") rule—takes a different approach to solving the problem of excessive rejection under the RD rule: it adjusts the price of performance in favor of the estate by a fixed percentage that would be known by the parties when they initially contract, and sets the damage payment so that neither party has an incentive to terminate a value-creating contract. The adjustment percentage could be chosen in any number of ways. The percentage could be the same for all contracts in all bankruptcy cases, or it could depend on the type of contract or case. For concreteness, however, let us assume that the adjustment percentage is always 25%.

> **Example.** A 25% Modified Price/ED rule can be illustrated as follows. Suppose again that Builder has agreed to build Firm a factory for a price of $100 and that Firm subsequently enters bankruptcy. Suppose that the cost of construction would be $60 and that Firm's estate would value the factory at $80. Under the 25% Price Adjustment/ED rule, the price would be reduced to $75 ($100 - $25).
>
> The parties would not have the proper performance incentives unless a party refusing to perform must make the other party as well off as performance would have. At the modified price of $75, Builder would lose $15 ($75 - $60) if Firm's estate rejects and Firm's estate would lose $5 ($80 - $75) if Builder

breaches. Thus, to create the proper performance incentives, Firm's estate would be required to pay Builder $15 (that is, Builder would have a priority claim for $15) if Firm's estate rejects the contract and Builder would be required to pay Firm's estate $5 if Builder breaches. The performance incentives faced by the parties would be exactly the same as if the contract had been originally priced at $75 and the ED rule applied to both parties.[136]

2. *Litigation and the Timing of Performance in Bankruptcy.* Like the RD rule, the Modified Price/ED rule could give rise to litigation in the event the other party breaches or the trustee rejects. However, the frequency of rejection would be lower than under the RD rule, for two reasons. First, unlike under the RD rule, there would be no value-wasting rejection. Second, there would be less rejection of value-wasting contracts under the Modified Price/ED rule than under the RD rule. The reason for this perhaps surprising result is as follows: by adjusting the price in favor of the estate, the Modified Price/ED rule would make some value-wasting contracts that would have made the estate worse off and the other party better off under their original terms unprofitable for both parties. Under the RD rule, these contracts would be rejected and the other party would sue for damages. Under the Modified Price/ED rule, however, both parties would have an incentive to mutually abandon the contract without any litigation. However, although the frequency of *rejection* would be lower under the Modified Price/ED rule than under the RD rule, the frequency of *breach* by the nonbankrupt party would likely be higher. The reason that there might be more breach by the other party under the Modified Price/ED rule than under the RD rule is that modifying the price in favor of the estate might cause the estate to seek performance of value-wasting contracts that the parties would otherwise have mutually abandoned.[137] The *fre-*

136. Each of the other two price-adjustment rules—the RD/Adjusted Price rule and the ND/Adjusted Price rule—also requires a party breaching or rejecting to put the other in the same position as performance under the rule's adjusted price.

137. To see how this might occur, suppose that under the original contract Builder was to construct a factory for Firm for $100. Suppose that at the time the contract was to be performed, it would have cost Builder $120 to construct the factory and the factory would have had a value of only $80 to Firm. Since the contract price would have been $100, each party would be better off abandoning the contract and there would be no litigation over damages.

quency of litigation could thus be higher or lower than under the RD rule. In the event of litigation, the court would be required to learn only the value of performance to the injured party—the same information it currently requires under the RD rule. The *cost per case* may thus be the same as under the RD rule, but *total litigation costs* conld be higher or lower.

Since there would be no litigation in connection with performance, any litigation that arises would not delay performance. In fact, as under the other two price-adjustment rules, the trustee may be able to make performance decisions more quickly than under the RD rule because she would not need to estimate the payout rate for unsecured claims in order to decide whether performance would benefit the estate.

3. *Distributional Effects in Bankruptcy and Performance Decisions Prior to Bankruptcy.* The distributional effect of the Modified Price/ED rule relative to that of the RD rule wonld of course depend on the price adjustment factor: the larger the factor, the more the rule would favor the bankruptcy estate. However, two features of the rule are worth noting: First, in any given case, the Modified Price/ED rule conld make the bankruptcy estate better off or worse off than any of the other rules (including the RD rule).[138] Second, the Modified Price/ED rule would benefit the estate in a wider variety of circumstances than either of the other two price-adjustment rules. The RD/Adjusted

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Now suppose that Firm enters bankruptcy and the contract price is adjusted 25% in Firm's favor, to $75. After the adjustment, Firm would have an incentive to seek performance. Builder would then face a choice between performing (at a loss of $45 ($120 - $75)) or breaching (and paying $5 in damages ($80 - $75)). Builder would choose to breach, and there could be litigation over damages.

138. To illustrate, suppose that Builder agrees to construct a factory for Firm for $100, the cost to Builder is $60, and the payout rate for unsecured claims is 30%. Under the RD/Adjusted Price rule Firm's estate would be given a choice between rejecting and paying $12 in damages or paying $72 for the factory. Under the 25% Modified Price/ED rule, the estate would have the choice between rejecting and paying $25 in damages or purchasing the factory for $75. Thus in this case the Modified Price/ED rule would make the estate worse off than under the RD/Adjusted Price rule.

Now suppose instead that the cost to Builder of building the factory would be $80. In that case the RD/Adjusted Price rule would permit the estate either to reject and pay $6 (30% of $20) or purchase the factory for $86. The 25% Modified Price/ED rule, however, would allow the estate either to reject and pay no damages (since Builder would not have profitted from performance at a price of $75) or purchase the factory for $75. Here the 25% Modified Price/ED rule would make the estate better off than under the RD/Adjusted Price rule.

Price and ND/Adjusted Price rules would benefit the estate only when the other party would gain from performance under the original terms of the contract. By contrast, the estate would be better off under the Modified Price/ED rule than under the RD rule whenever there is performance, rejection, or breach by the other party, as well as in certain cases when the parties mutually abandon the contract.[139]

Let us now consider the effect of the Modified Price/ED rule on performance decisions outside of bankruptcy. The Modified Price/ED rule could delay performance decisions by a party anticipating bankruptcy in three situations. First, like the ND/Adjusted Price and RD/Adjusted Price rules, the Modified Price/ED rule could give a firm anticipating bankruptcy an incentive to delay performance until bankruptcy (rather than perform outside of bankruptcy) in order to take advantage of the price adjustment (however, unlike under the other two price-adjustment rules, this incentive would arise whether or not the other party would profit from performance). Second, like the ND/Adjusted Price and RD/ Adjusted Price rules, the Modified Price/ED rule could reduce excessive breach relative to the RD rule by giving a financially distressed firm that would have breached outside of bankruptcy an incentive to defer the decision until bankruptcy and then perform. Third, like the ND/Adjusted Price rule, but unlike the RD/Adjusted Price rule, the Modified Price/ED rule could give a firm anticipating bankruptcy an incentive to delay breach until bankruptcy, whenever the adjustment would make rejecting in bankruptcy less costly than breaching prior to bankruptcy (in which case the resulting breach claim would be paid, as any other prebankruptcy unsecured claim, ratable damages).

The Modified Price/ED rule could also cause either party to accelerate breach to before bankruptcy. A party entering bankruptcy would have an incentive to breach before bankruptcy if the cost of breach outside bankruptcy (payment of ratable damages) is

139. For example, if Builder agrees to build Firm a factory for $100 and Builder's cost of construction would be $120, then under the RD/Adjusted Price rule Builder would not suffer damages from rejection by Firm's bankruptcy estate. Thus the adjustment to the performance price under the RD/Adjusted Price rule would be zero. As a result, the RD/Adjusted Price rule would not make the estate better off than the RD rule whether the estates seeks performance or not. In contrast, a 25% Modified Price/ED rule would reduce the price to $75. This in turn would benefit Buyer's estate if performance occurs or if Firm's estate sues Builder for breach.

less than the cost of performance or rejection inside bankruptcy. The other party could also have an incentive to breach before the debtor files for bankruptcy if the other party expects to breach inside bankruptcy or if the cost of breach under the original price is less than the cost of performance under the adjusted price. Thus one of the drawbacks of the Modified Price/ED rule relative to the RD rule is that it could increase inefficient breach prior to bankruptcy.

4. *Another Note on Fairness.* The RD/Adjusted Price and ND/Adjusted Price rules would at most deprive the nonbankrupt party of the profit it expected under the original terms of the contract. In contrast, the Modified Price/ED rule could turn a contract under which the nonbankrupt party expected to make a profit into a contract under which it suffers a loss. The Modified Price/ED rule might appear even more vulnerable to a fairness objection than the other two rules. As explained earlier, however, contracting parties are likely to adjust their prices so that, on average, they are fully compensated for any expected loss from the other's bankruptcy.[140] Thus a rule such as the Modified Price/ED rule is—from an *ex ante* perspective—unlikely to make the parties against which it is applied systematically worse off.

However, even from an *ex post* perspective, forcing the nonbankrupt party to take a loss on the contract might not be any more unfair than the treatment received by the debtor's other unsecured creditors. A party to an executory contract with the bankrupt debtor that is forced to perform at 75% of the original contract price (regardless of its costs) would generally still be better off than other parties that have already rendered performance or extended credit and are awaiting (re)payment. These parties may recover only five cents on the dollar.[141] In contrast, a party that has been promised $100 for performance and is subject to a 25% price adjustment receives $75 for performance. The only difference between this party and one that receives $5 of the $100 owed to it for performance that occurred prior to bankruptcy is that the latter has performed and the former has not. It is not clear why this distinction should entitle the first party

140. *See supra* Section III.B.4.
141. *See supra* note 14.

to bė paid more than 75 cents on the dollar while the party that has already performed is paid only five cents on the dollar.

IV. EX ANTE EFFECTS OF MAKING EXECUTORY CONTRACT RULES MORE FAVORABLE TO THE BANKRUPTCY ESTATE

The focus of this Article has been on the effect of the treatment of executory contracts on performance decisions *in* bankruptcy. Part I explained why the currently used RD rule sometimes provides an incentive for trustees to reject value-creating contracts in bankruptcy. Part II considered the possibility of preventing the trustee from rejecting value-creating contracts in bankruptcy. Part III then presented three price-adjustment rules each of which, in principle, could eliminate any incentive to reject value-creating contracts in the first instance.

Of course, the treatment of executory contracts in bankruptcy affects more than just performance decisions in bankruptcy. As we saw in Part III, the executory contracts rule also affects the frequency (and total costs) of litigation and the timing of performance decisions by the trustee. The rule also affects performance decisions by both parties *in anticipation* of bankruptcy.

This Part considers other *ex ante* effects that could arise from adopting one of the price-adjustment rules presented and analyzed in Part III (or, indeed, any rule that would tend to be more favorable to the bankruptcy estate, and less favorable to the other party, than the RD rule). I first consider how making the treatment of executory contracts in bankruptcy more favorable to the estate might affect parties' incentives to enter bankruptcy (Section A). Next, I consider how making the executory contract rule less favorable to the nonbankrupt party might affect the ability of firms—particularly those in financial distress—to enter into contracts (Section B). The analysis offered below suggests that making executory contract rules more favorable to the bankruptcy estate (and less favorable to the nonbankrupt party) need not undesirably increase the use of bankruptcy or make it more difficult for firms to enter into value-creating contracts.

Before proceeding, it should be emphasized that this Part does not attempt to identify and explore all of the possible *ex ante* effects of making executory contract rules more favorable to the estate.[142] Nor does it aim to resolve fully the issues that are

142. For example, I do not consider the effect of making these rules more favorable

raised. Rather this Part, like the remainder of this Article, seeks to identify and briefly explore some of the issues that must be considered in selecting the appropriate treatment of executory contracts in bankruptcy.

A. *The Incentive to File for Bankruptcy*

The three price-adjustment rules—the RD/Adjusted Price rule, the ND/Adjusted Price rule, and the Modified Price/ED rule—would sometimes be more favorable to the bankruptcy estate than the RD rule. One might be concerned that adoption of any of these three rules could lead to an undesirable increase in the number of firms entering bankruptcy in order to take advantage of the rule.[143]

Whether or not an increase in the number of bankruptcy filings would be undesirable is an open question. In fact, it is widely believed that too few firms file for bankruptcy and that those that file often do so too late.[144] The problem is that the people who make the filing decision, the debtor's managers, usually do not expect to capture much of the efficiency gain that would arise from an earlier (and perhaps more orderly) liquidation or reorganization in bankruptcy. Instead, it is typical for managers who bring their firms into bankruptcy to lose their jobs.[145] Managers thus can have an incentive to take extreme—and often value-wasting—measures to keep their firms out of bankruptcy. Consequently, any increase in bankruptcy filings that resulted from adoption of one of these price-adjustment rules might in fact be desirable.

But whether or not an increase in bankruptcy filings would be desirable, adoption of a price-adjustment rule may well not have much of an effect on bankruptcy filings, for the following three reasons. First, the amount of value that a price-adjustment rule would transfer to the bankruptcy estate relative to the RD rule would often be rather limited. Consider the RD/Adjusted Price

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to the bankruptcy estate on the parties' willingness to engage in reliance.

143. By threatening to enter bankruptcy and invoke a price-adjustment rule, a firm might be able to use the rule to negotiate more favorable concessions outside of bankruptcy than under the RD rule. Thus, a firm need not enter bankruptcy to take advantage of a more favorable executory contracts rule.

144. *See* Warren, *supra* note 105, at 794–95; Baird, *supra* note 80, at 230–31.

145. *See infra* note 150 and accompanying text.

rule. Relative to the RD rule, the RD/Adjusted Price rule would make the bankruptcy estate better off only when, under the RD/ Adjusted Price rule, there is performance at an adjusted price: that is, only when performance would be value-creating and make the other party better off.[146] When there is performance at an adjusted price, the size of the transfer would be limited to the discount the RD rule provides for rejection. This discount, in turn, would not be greater than 100% of the profit that the other party would have made from performance under the original terms of the contract (which itself would be typically only a fraction of the contract price). And to the extent that there is a positive payout for unsecured claims, the adjustment would be less than 100% of this profit.[147]

Second, even if a price-adjustment rule would benefit the bankruptcy estate (relative to the RD rule), those making the decision whether to file for bankruptcy—the debtor's managers—would not be able to avail themselves (as shareholders or as employees) of most of that benefit. The managers of course would benefit to the extent that the extra value made available to the estate increases the likelihood that they can retain their jobs, or boosts the value of any equity that they may hold after the reorganization. But much of the increase in value would simply be redistributed to other participants in the bankruptcy proceeding, particularly the debtor's unsecured creditors, whose claims will have priority over those of shareholders.[148] The managers' share

146. Performance would not occur if it is value-wasting and there would be no adjustment to the price if the other party would be made worse off by performance.

147. The other two price-adjustment rules could also make the bankruptcy estate better off than under the RD rule, but by a greater amount and in a larger range of cases. Like the RD/Adjusted Price rule, the ND/Adjusted Price rule would make the estate better off than under the RD when there is performance at an adjusted price. However, the adjustment would be greater under the ND/Adjusted Price rule (except in those cases where the payout rate under the RD/Adjusted Price rule would be zero, in which case the adjustment would be the same). Unlike the RD/Adjusted Price rule, the ND/Adjusted Price rule would also make the estate better off than under the RD rule in the event of rejection (except in those cases where the payout rate under the RD/Adjusted Price rule would be zero, in which case the rules would have the same effect on the estate in the event of rejection).

The Modified Price/ED rule would make the estate better off than under the RD rule whenever there is performance, breach by the other party, or a situation in which application of the rule would lead to the mutual abandonment of a contract that the trustee would otherwise have been required to reject. Depending on the adjustment percentage, the Modified Price/ED rule could make the estate better off or worse off than under the RD rule when there is rejection.

148. This raises the possibility that, under a price-adjustment rule, unsecured creditors

of the extra value made available by a price-adjustment rule, if any, would therefore tend to be small.[149]

Third, even if the people who are making the decision whether to file for bankruptcy could capture some of the extra value that would be made available through these rules, they would not have an incentive to enter bankruptcy if the cost bankruptcy imposes on them is greater than their share of the value. Management can face two types of costs in bankruptcy. Bankruptcy may indirectly impose costs on managers by reducing the value of the business as a whole. The proceeding may reduce the value of the firm by imposing reputational and legal costs on the firm, diverting managers' time from running the business, and reducing the business' flexibility. These costs will be borne, in part, by the managers as employees or shareholders of the firm. In addition, bankruptcy may directly impose costs on managers by preventing them from taking steps to boost equity value at the expense of creditors, forcing them to give up salary or perquisites, or ending their control (and ownership) of the business.[150] This is not to say that managers could not benefit from a price-adjustment rule once they are in bankruptcy; the point is that in many cases the extra value that managers could capture as a result of the use of a price-adjustment rule would not be sufficient to make it worthwhile to file for bankruptcy when there is another option.

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could have an increased incentive to push firms into bankruptcy. In principle, sophisticated creditors with large claims and sufficient information about a debtor's contracts to believe that they would benefit from application of the price-adjustment rule would have an increased incentive to push the debtor into bankruptcy. However, existing law makes it difficult and risky for creditors to initiate involuntary bankruptcy proceedings. Thus, in practice, adoption of a price-adjustment rule is unlikely to have a significant effect on the number of involuntary filings.

149. In principle, managers could capture more of the increase in value resulting from application of a price-adjustment rule in those cases where all of the other claimants would be paid in full (as a result of application of the rule). This would not occur under the RD/Adjusted Price rule: if the payout rate for secured claims were 100%, there would be no price adjustment under the RD/Adjusted Price rule (and therefore no increase in value available to the estate resulting from application of the rule). However, the ND/Adjusted Price rule and the Modified Price/ED rule could both benefit the estate in some cases where all unsecured claims are paid in full.

150. *See* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 278 n.3 (1991). If they do not lose their jobs, they may find their decisions subject to judicial scrutiny. *See* Baird, *supra* note 80, at 227. The court may also reduce compensation to management. *See In re* Anglo Energy Ltd., 41 B.R. 337, 341 (Bankr. S.D.N.Y. 1984) (denying assumption of employment contracts with key personnel because assumption was not necessary to preserve the estate).

B. *The Ability of Firms to Enter Contracts*

The three price-adjustment rules—the RD/Adjusted Price, the ND/Adjusted Price, and the Modified Price/ED rule would sometimes be less favorable to the nonbankrupt party than the RD rule.[151] A price-adjustment rule would therefore increase the risk of loss that arises from the possibility that the other party to a contract will enter bankruptcy while the contract is still executory. When the contracting parties are relatively sophisticated (as is usually the case when the contract is between two businesses) and the amounts at stake are large enough, this increased risk of loss would be reflected in the terms of the initial contract. For example, firms facing a high risk of insolvency might be required to offer even more favorable terms to their contractual partners than they do currently in order to compensate for this increased risk. As a result, adoption of any of these three rules could make it more difficult for firms—especially those in financial distress—to enter into contracts.

Making it more difficult for financially distressed firms to enter into contracts with sophisticated parties would not necessarily be undesirable. First, not all contracts are value-creating. The owners of a firm will sometimes have an incentive to engage in high-risk activities that increase the expected value of their equity but reduce the value of creditors' claims by an even greater amount. This incentive can become especially strong when the firm is financially distressed.[152] Under these conditions the owners have little to lose from betting the firm's assets (because they are likely to lose control of the firm if they do not gamble) and much to gain. Thus if a modification of the executory contracts rule would make it more difficult for financially distressed firms to enter into contracts, the effect would, in some cases, be desirable.

151. It should be emphasized that when a price-adjustment rule would yield an outcome that is more favorable to the bankruptcy estate than the RD rule, it would not necessarily make the other party worse off than under the RD rule by an offsetting amount. When there is performance under a price-adjustment rule of a contract that would have been rejected under the RD rule, part or all of the gain to the estate would represent the efficiency gain from performance, which would not come at the expense of the other party. Under the Modified Price/ED rule, there would be situations in which application of the rule would actually leave both parties better off than under the RD rule.

152. *See* Credit Lyonnais Bank Nederland v. Pathe Communications Co., No. 12150, 1991 Del. Ch. LEXIS 215, at *107-09 (Del. Ch. 1991).

The second reason why it may be desirable to increase the risk faced by sophisticated contracting parties who contract with a financially-distressed firm is that it could encourage more desirable "monitoring" of the distressed firm.[153] The effect of adoption of a price-adjustment rule might be to give sophisticated parties more incentive to seek terms that reduce the likelihood that the other party will fail and therefore be unable to perform or pay damages in full.[154] The presence of such terms might make a value-creating contract even more efficient. Thus even with respect to value-creating contracts, increasing the risk of loss faced by the other party may have desirable effects.

However, adoption of a price-adjustment rule may not make it that much more difficult for higher-risk firms to enter into contracts for two reasons. First, a price-adjustment rule need not significantly increase the risk of loss associated with contracting with a financially distressed firm. Much of the risk associated with such contracting is independent of the treatment of executory contracts in bankruptcy. There is the risk that the financially distressed firm will enter bankruptcy after the other party has performed or paid (at least in part) but before the other party has received payment or performance from the firm entering bankruptcy. In that case the nonbankrupt party could suffer a loss as great as the value of the entire contract. There is also the risk that the financially distressed firm will breach before entering bankruptcy. In that case the nonbankrupt party could suffer a loss equal to its expected profits, if any. In both cases, of course, the amount of the loss will depend on the payout rate for unsecured claims. The higher the payout rate, the lower the loss will be.

The treatment of executory contracts in bankruptcy affects the risk of loss faced by a contracting party ouly to the extent that the contract is expected to be executory should the other party enter bankruptcy. Thus, for example, the RD rule itself imposes a loss upon the nonbankrupt party only if 1) the other party enters bankruptcy; 2) the contract is still executory when the other party enters bankruptcy; 3) the nonbankrupt party would profit from performance; and 4) the bankrupt party chooses to reject. In that

153. For an elaboration of this argument in the context of loan contracts, see Bebchuk & Fried, *supra* note 86, at 904–13.

154. *See* Nimmer, *supra* note 6, at 521.

case, the amount of loss would be the nonbankrupt party's profits (less whatever ratable damages it receives).

Under a price adjustment rule such as the RD/Adjusted Price rule, the risk of loss faced by a contracting party would be higher than under the RD rule only when, *ceteris paribus*: 1) the other party is expected to enter bankruptcy; 2) the contract is likely to be executory when the other party enters bankruptcy; 3) the nonbankrupt party would profit from performance; and 4) the party in bankruptcy would be expected to perform under the RD rnle. Depending on the circumstances, this increase in risk could be small relative to the total risk that the contracting party faces under the RD rule (including the risk that performance will be rendered before the other party pays and the risk that the other party will breach outside of bankruptcy).[155]

The second reason why a price-adjustment rule need not make it much more difficult for financially distressed firms to enter into executory contracts is that, even if such a rule would marginally increase the risk of loss associated with contracting with financially distressed firms, the rule would allow financially distressed firms to negotiate better terms with other creditors, making it easier to pay the higher risk premium demanded when entering into executory contracts. In particular, since the effect of a price-adjustment rule is mostly to transfer value among different unsecured claimamts, to the extent that a price-adjustment rule would increase the risk of loss faced by certain parties, it would reduce the risk of loss faced by creditors with unsecured claims. To the extent that these creditors could "adjust" the interest rate they charge the firm to reflect the effect on them of the executory contract rule in place,[156] they would lend on terms that reflect their lower risk of loss, and a price-adjustment rule would make it

155. To be sure, a price adjustment rule could have a number of other effects on the risk of loss faced by contracting parties. Most of these effects could in principle, either increase or decrease the risk of loss. For example, a price-adjustment rule may affect the choice of the firm's projects *ex ante*, the timing of performance, and so on. However, some of the effects of a price-adjustment rule will always tend to reduce the risk of loss associated with contracting with a financially distressed firm. For example, the payout rate for unsecured claims is likely to be higher under the RD/Adjusted Price rule than under the RD rule.

156. Lucian Bebchuk and I introduced the term "adjusting" to describe a creditor that adjusts the terms of its bargain with the debtor to reflect the effect on that creditor of the debtor's arrangements with other creditors. *See* Bebchuk & Fried, *supra* note 86, at 864.

easier for financially distressed firms to enter into contracts with these creditors. This would reduce the *effective cost* of entering into contracts with parties that are likely to be adversely affected *ex post* by the rule.

The RD/Adjusted Price rule, for example, would make the firm's other creditors better off than under the RD rule, since the value of the bankruptcy estate would generally be higher than under the RD rule. Thus, if the firm's other creditors are adjusting, they would, everything else equal, charge less interest under the RD/Adjusted Price rule than under the RD rule. So while the firm would be required to pay a higher price to enter into contracts under the RD/Adjusted Price rule than under the RD rule, its creditors, to the extent they are adjusting, would charge less interest.[157]

CONCLUSION

This Article has carried out an economic analysis of the treatment of executory contracts in bankruptcy. The analysis demonstrated that the long-standing and widely-used rule of "ratable damages"—which permits the bankruptcy trustee to reject executory contracts of the debtor without fully compensating the other party for any resulting loss—can provide the trustee with the incentive to reject value-creating contracts.

The Article then offered a preliminary analysis of two approaches to eliminating the problem of excessive rejection under the ratable damages rule. One approach, which would build on the existing but rarely-used "balancing test" doctrine, would bar the trustee from rejecting contracts when the harm to the nonbankrupt party is greater than the benefit to the estate. The Article explained that such an approach may not be desirable because it would undermine the bankruptcy norms of rehabilitation and equal

157. In fact, since the RD/Adjusted Price rule would increase the total value available to all of the parties—and thus increase the firm's creditors' share of the pie by more than it reduces the contracting party's share—the reduction in the interest charged the firm would be greater than the increase in the price the firm must pay to enter contracts. Thus, in a world where all creditors were perfectly adjusting, the RD/Adjusted Price rule would on balance reduce the costs faced by the firm and allow it to enter into *more* value-creating contracts.

treatment, and could be circumvented by a firm breaching such contracts prior to filing for bankruptcy.

The other approach examined—the "price adjustment" approach—would allow the trustee to decide whether to perform or reject an executory contract, but would adjust the terms of performance in favor of the bankruptcy estate in order to eliminate any incentive to reject value-creating contracts. The Article put forward and analyzed three price-adjustment rules. These rules were compared along a number of different dimensions—the amount of litigation likely to be associated with each rule, the effect of each rule on the timing of performance decisions in bankruptcy, *ex post* distributional consequences, and the effect of each rule on performance decisions prior to bankruptcy.

Finally, the Article explained how a price-adjustment rule would affect certain other decisions by the parties prior to bankruptcy. The Article considered two *ex ante* effects of adopting a rule, such as a price-adjustment rule, that would make the treatment of executory contracts more favorable to the bankruptcy estate: the effect of such a change on the incentive to file for bankruptcy; and the effect of such a change on the ability of firms—particularly those in financial distress—to enter into contracts. The analysis suggested that making the treatment of executory contracts in bankruptcy more favorable to the estate need not lead to an undesirable increase in bankruptcy filings nor make it difficult for financially distressed firms to enter into executory contracts.

The analysis in this Article is in many respects preliminary. My aim has been to explain a problem with the current treatment of executory contracts and to put forward and begin to analyze various approaches for remedying that problem. More work remains to be done before the best approach can be identified. I hope that my analysis provides a foundation for such an effort.