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SECTION 365 VERSUS 362: APPLYING THE AUTOMATIC STAY TO PREVENT UNILATERAL TERMINATION IN A BANKRUPTCY SETTING

ROBERT J. VERGA

INTRODUCTION

Section 365 of the Bankruptcy Reform Act of 1978 governs the rights of parties to executory contracts after one of the parties becomes a debtor in a bankruptcy proceeding. Generally, section 365 attempts to balance the bankruptcy policy objective of achieving a successful reorganization against a nondebtor's right to receive the benefit of its original contractual bargain. In particular, section 365(a) enables a debtor to assume or reject any executory contract. Section 365(c), however, provides some


Although § 365 also governs unexpired leases, the main thrust of this Note deals with executory contracts.

3. The goals of the Bankruptcy Code include rehabilitation of the debtor and the orderly and equitable distribution the debtor's assets. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179-80. Underpinning the goal of rehabilitation is the premise that greater economic and social value can be achieved by employing assets in the industries for which they were designed as opposed to liquidating them for scrap. See id. at 220, reprinted in 1978 U.S.C.C.A.N. at 6179 (“It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.”); see also Raymond T. Nimmer, Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain, 54 U. Colo. L. Rev. 507, 509 (1983) (the goal of rehabilitation stems from the premise of providing a debtor with a “fresh start”) (citing H.R. Rep. No. 595, supra at 220, reprinted in 1978 U.S.C.C.A.N. at 6179).

4. The term “nondebtor” in this Note is a general term designed to encompass both creditors and other parties to a contract who may not be considered creditors in the traditional sense.

5. See 1 Collier Bankruptcy Manual ¶ 365.01, at 365-1 to 365-2 (Lawrence P. King ed., 1992); see also Nimmer, supra note 3, at 522 (the bankruptcy goals of optimal distribution and rehabilitation must be balanced against the general contract law goals of facilitating and reinforcing contract activity). Moreover, Professor Nimmer points out that courts should be cognizant of the ramifications of their holdings on contractual relations with “financially distressed” entities who have not yet filed for bankruptcy protection. See id. at 538-44. He argues that the provision of § 365 that prohibits ipso facto or bankruptcy termination clauses may limit access of financially distressed debtors to contracts ordinarily available in a nonbankruptcy setting. See id.; see also Don Fogel, Executory Contracts and Unexpired Leases in the Bankruptcy Code, 64 Minn. L. Rev. 341, 347 (1980) (parties often add ipso facto clauses to their contractual arrangements in order to protect themselves in case of a bankruptcy).

6. Section 365(a) states in pertinent part as follows:
protection for a nondebtor by prohibiting the debtor from assuming or assigning those contracts, without the nondebtor's consent, that are non-assignable under applicable law.\(^7\) Section 365(c) also prevents a debtor from assuming or assigning credit contracts or contracts to provide “fi-

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\(^7\) The trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.


Professor Countryman, however, rejected this liberal definition for bankruptcy purposes and defined an executory contract as one in which “the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). This “material breach” test has been applied by various circuit courts. See, e.g., Terrell v. Albaugh (In re Terrell), 892 F.2d 469, 471-72 (6th Cir. 1989) (land sale contract); Griffel v. Murphy (In re Wegner), 839 F.2d 533, 536 (9th Cir. 1988) (contract for sale and purchase of personal property); Speck v. First Nat'l Bank (In re Speck), 798 F.2d 279, 279-80 (8th Cir. 1986) (contract for sale of real property); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045-46 (4th Cir. 1985) (technology licensing agreement), cert. denied, 475 U.S. 1057-58 (1986); Collingwood Grain, Inc. v. Coast Trading Co. (In re Coast Trading Co.), 744 F.2d 686, 692-95 (9th Cir. 1984) (contract to provide grain shipments); Benevides v. Alexander (In re Alexander), 670 F.2d 885, 887 (9th Cir. 1982) (contract for sale of real property); Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980) (per curiam) (licensing agreement).

A minority of courts have declined to limit themselves to one specific definition of an executory contract and instead have applied a “functional” test that seeks to further bankruptcy policy objectives. See, e.g., Chattanooga Memorial Park v. Still (In re Jolly), 574 F.2d 349, 351 (6th Cir.) (proper approach “to deciphering the meaning of the executory contract rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish”), cert. denied, 439 U.S. 929 (1978); Camp v. National Union Fire Ins. Co. (In re Government Secs. Corp.), 101 B.R. 343, 348 n.2, 348-49 (Bankr. S.D. Fla. 1989) (same), aff'd, 111 B.R. 1007 (S.D. Fla. 1990); In re G-N Partners, 48 B.R. 462, 465-66 (Bankr. D. Minn. 1985) (contract was not executory if “a rejection by the trustee would neither add to nor detract from the estate's benefits or liabilities”) (quoting Jenson v. Continental Fin. Corp., 591 F.2d 477, 481 n.5 (8th Cir. 1979)). For a brief discussion of this definition and examples of other cases that have employed this test, see Lawrence J. La Sala, Note, *Partner Bankruptcy and Partnership Dissolution: Protecting the Terms of the Contract and Ensuring Predictability*, 59 Fordham L. Rev. 619, 624-25 n.30 (1991).

For the purposes of this Note the author assumes that a contract is executory pursuant to any of the applicable definitions.

7. Section 365(c) provides in pertinent part as follows:

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

(1)(A) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity
nancial accommodations” for the benefit of the debtor.  

In addition to the interaction between sections 365(a) and (c), section 365(e) also balances the competing interests inherent in a bankruptcy setting. Section 365(e)(1) aims to protect the debtor by explicitly prohibiting *ipso facto* or bankruptcy termination clauses. These clauses call for the modification or termination of a contract upon the filing of a bankruptcy petition. Section 365(e)(2)(A), however, provides an exception to this prohibition in cases where applicable law excuses the nondebtor from accepting performance from a trustee or assignee of the contract. Further, in precisely the same language used in section

other than the debtor or the debtor in possession, whether or not such contract

prohibits or restricts assignment of rights or delegation of duties; and

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

(2) such contract is a contract to make a loan, or extend other debt financing or

financial accommodations, to or for the benefit of the debtor . . . .


Considering the amorphous nature of the term “applicable law,” courts disagree over the scope of this exception to the general power of a debtor to assume or reject any executory contract. See infra notes 32-37 and accompanying text.

8. See supra note 7. Unlike ¶ (1)—which allows assumption or assignment upon the consent of the nondebtor—¶ (2) makes no reference to the consent of the nondebtor. While some courts believe this omission is inadvertent, others believe it is by design. For a discussion of the differing viewpoints, see infra notes 49-50 and accompanying text.


10. Section 365(e)(1) states in pertinent part as follows:

Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . of the debtor may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . . . that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.


12. Section 365(e)(2) states in pertinent part as follows:

Paragraph (1) of this subsection does not apply to an executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if—

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

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

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.
365(c)(2), section 365(e)(2)(B) exempts credit contracts and other contracts to extend financial accommodations from the purview of section 365(e)(1).

When one or more of the foregoing exceptions to section 365(a) applies, the focus shifts to the automatic stay provision of section 362. That is, must a nondebtor seek relief from the stay before terminating a contract that it believes is governed by section 365(c) or (e)(2)? Section 362(a) provides that the filing of a bankruptcy petition operates as a stay against any act to obtain possession of, or control over, property of the estate. Debtors contend that even if a contract is arguably nonassumable or nonassignable under section 365(c) or (e)(2), the automatic stay precludes a nondebtor from unilaterally terminating the contract. They claim that before walking away from the contract a nondebtor must first obtain relief from the automatic stay. Nondebtors, however, maintain that the applicability of either section 365(c) or (e)(2) renders a contract nonassumable and nonassignable as a matter of law. Consequently, they argue that court approval is not a prerequisite for terminating the contract.

This Note takes the position that the automatic stay should be invoked to prevent unilateral termination by a nondebtor even if the contract arguably falls within the scope of section 365(c) or (e)(2). This solution best comports with the goals of the Bankruptcy Code in general, and section 365 in particular.

Part I provides background information on sections 365 and 362. This Part also discusses section 541—property of the estate—and its interrelationship with section 362. Given this framework, Part II examines the current disagreement over the applicability of the automatic stay to executory contracts that arguably fall within the purview of section 365(c) or (e)(2). Part III synthesizes legislative intent, statutory interpretation, and public policy to support the conclusion that a nondebtor must first seek relief from the stay before terminating these contracts.

I. BACKGROUND: SECTIONS 365, 362, AND 541

A. Section 365: Balancing a Debtor’s Right to Assume or Reject Against a Nondebtor’s Right to Receive the Benefit of Its Bargain

1. Section 365(a): Debtor’s Right to Assume or Reject

Section 365(a) of the Code provides that a trustee or debtor in pos-

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13. See id.
14. Section 362(a) provides in pertinent part as follows:
   [A] petition filed ... operates as a stay, applicable to all entities, of—
   ... (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate ....
15. In Chapter 11 reorganization cases, § 1104(a) provides that the court may ap-
session\textsuperscript{16} may, with the court's approval, assume or reject any executory contract.\textsuperscript{17} This section is designed to assist a debtor's rehabilitation effort by allowing a debtor to reject contracts that are burdensome to the estate while assuming those that are more favorable.\textsuperscript{18} Consequently, section 365(a) provides the debtor with a powerful rehabilitation device,\textsuperscript{19} which, in turn, promotes a primary goal of the Bankruptcy Code.\textsuperscript{20} Section 365(a) is particularly powerful in reorganization cases

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\textsuperscript{16} Although the language of § 365(a) refers to the trustee, a debtor will often continue to manage the affairs of his estate after a bankruptcy filing. See Collier Bankruptcy Code, § 1104 comment, at 585-86 (Asa S. Hertzog & Lawrence P. King eds., 1990-1991). In these instances the debtor becomes known as the "debtor in possession." See id. § 1101 comment, at 572; see also 2 Collier Bankruptcy Manual, supra note 5, ¶ 1101.02, at 1102 (the debtor is a "debtor in possession" until the court appoints a trustee). Section 1107(a) of the Code provides that the debtor in possession generally has all the same rights and powers as a trustee. See 11 U.S.C. § 1107(a) (1988); see also United States Dep't of the Air Force v. Carolina Parachute Corp., 907 F.2d 1469, 1472 n.4 (4th Cir. 1990) (section 1107(a) authorizes the debtor in possession to exercise the same power as a trustee with regard to assumption or rejection of executory contracts); In re Hardie, 100 B.R. 284, 285 (Bankr. E.D.N.C. 1989) ("[D]ebtor in possession has the same right to assume or reject under section 365 as the trustee."); In re Harms, 10 B.R. 817, 822 (Bankr. D. Colo. 1981) ("Since the debtor-in-possession stands in the shoes of the trustee . . . he is, then, for all interests and purposes, the equivalent of a trustee appointed by the court."); S. Rep. No. 989, 95th Cong., 2d Sess. 116 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5902 ("This section places a debtor in possession in the shoes of a trustee in every way."). Because the issue of assumption or rejection of an executory contract is so prevalent in Chapter 11 reorganization cases, this Note will generally use the term "debtor in possession" or "debtor" rather than "trustee."

\textsuperscript{17} See supra note 6.

\textsuperscript{18} See H.R. Rep. No. 595, supra note 3, at 347, reprinted in 1978 U.S.C.C.A.N. at 6303-04; 1 Collier Bankruptcy Manual, supra note 5, ¶ 365.01, at 365-1; Benjamin Weintraub & Alan N. Resnick, From the Bankruptcy Courts: What is an Executory Contract? A Challenge to the Countryman Test, 15 UCC L.J. 273, 273 (1983) (citing Countryman, supra note 6, at 450); see also Nimmer, supra note 3, at 513 ("Section 365 is an integral facet of the bankrupt's ability to restructure its business operations into an economically viable format.").

\textsuperscript{19} See In re Hardie, 100 B.R. 284, 285 (Bankr. E.D.N.C. 1989); In re Compass Van & Storage Corp., 65 B.R. 1007, 1010 (Bankr. E.D.N.Y. 1986); In re G-N Partners, 48 B.R. 462, 465 (Bankr. D. Minn. 1985); In re Norquist, 43 B.R. 224, 225 (Bankr. E.D. Wash. 1984); see also Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1310 (5th Cir. 1985) (the section makes it more likely for a debtor to rehabilitate by "forc[ing] others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so"); In re Sun City Investments, Inc., 89 B.R. 245, 248 (Bankr. M.D. Fla. 1988) (the right of a debtor in possession "to reject certain contracts is fundamental to the bankruptcy system and provides a mechanism through which severe financial burdens may be lifted while the debtor attempts reorganization"). Howards Buschman III, Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts, 5 Bankr. Dev. J. 341, 346 (1988) ("A debtor-in-possession's ability to continue to perform and to compel performance with respect to assumable executory contracts is usually the life-blood of its reorganization.").

\textsuperscript{20} See supra note 3.
where it enables a debtor in possession to assume or reject an executory contract at any time prior to the confirmation of the reorganization plan.21 Moreover, pursuant to section 1123(b)(2), executory contracts may be assumed, rejected, or assigned in a plan of reorganization.22

Although there are no formal requirements for approving a debtor's decision to assume or reject a particular contract,23 courts generally adhere to a business judgment standard.24 In cases in which there has been a pre-petition default, the debtor may not assume the executory contract unless it "cures"25 or provides "adequate assurance"26 that it will cure the default, and provides adequate assurance of future performance under the contract.27 If the debtor in possession chooses to reject the executory contract, any claim the nondebtor may have becomes an unsecured pre-petition claim.28

2. Section 365(c): Exception to a Debtor's Right to Assume or Reject

While section 365(a) grants a debtor in possession broad power to assume or reject any executory contract, section 365(c) carves out an exception to this power.29 Recognizing that a bankruptcy filing alters the relationship between the contracting parties, section 365(c) attempts to

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24. See Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36, 39 (3d Cir. 1989); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1309 (5th Cir. 1985); Carey v. Mobile Oil Corp. (In re Tilco, Inc.), 558 F.2d 1369, 1372-73 (10th Cir. 1977); In re Patterson, 119 B.R. 59, 60 (Bankr. E.D. Pa. 1990); In re J.M. Fields, Inc., 26 B.R. 852, 856 (Bankr. S.D.N.Y. 1983); see also Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045 (4th Cir. 1985) (honoring a debtor's decision unless the decision is so unreasonable that it could not be based on sound business judgment, but only on bad faith or whim), cert. denied, 475 U.S. 1057 (1986).


26. See cases cited supra note 25.


provide some protection for nondebtors. Essentially it allows a nondebtor to reevaluate the contract based on the new circumstances that surround the relationship.

Section 365(c)(1) provides that the debtor may not assume an executory contract without the nondebtor’s consent if the contract is nonassignable under applicable law. Although Congress has defined the amorphous term “applicable law” to mean “applicable nonbankruptcy law,” this definition remains vague. Consequently, courts are divided over the appropriate scope to be accorded to section 365(c)(1). Some courts subscribe to the view that section 365(c)(1) should be construed narrowly and applied solely to nondelegable, personal service contracts.

30. This prohibition against assumption or assignment attempts to ensure that the nondebtor receives at least the most critical elements of his original bargain. See Nimmer, supra note 3, at 537.

31. See id. Section 365(c) is designed to protect the nondebtor from being forced to accept performance from an entity other than the one with whom it originally contracted. This protection is most relevant when the particular identity of a party is a critical element of the underlying contract. See id. at 544.

Certain contracts are premised on the expectation that specific persons will render performance. In these circumstances, a nondebtor should not have to accept performance from a third party assignee. See, e.g., 1 Norton Bankruptcy Law and Practice § 23.08.70, at 19 (William L. Norton, Jr. ed., 1991) (with regard to a contract with a renowned artist for the production of a specific painting, nondebtor need not accept performance from an assignee).


34. Underlying the holdings in these cases is an inherent balance between the right of the debtors to assume those contracts that are beneficial to their reorganization and the right of the nondebtors to receive the benefit of the original bargain. See Nimmer, supra note 3, at 522; see also In re Cardinal Indus., Inc., 116 B.R. 964, 981-82 (Bankr. S.D. Ohio 1990) (“[I]t is a balancing of the estate’s right to determine whether to assume or reject its executory contracts against the rights of the nondebtor parties to those executory contracts that is at the heart of 11 U.S.C. § 365(c) and (e)(2).”).

35. Personal service contracts involve an exchange of “special knowledge, judgment, taste, skill, or ability” and are nonassignable by the party under obligation to perform such service without the consent of the other party. 6A C.J.S. Assignments § 32 (1975 & Supp. 1992). This type of contract is an exception to the general rule of assignability of contracts. See John D. Calamari & Joseph M. Perillo, The Law of Contracts §§ 18-28, at 760 (3d ed. 1987); Restatement (Second) of Contracts § 318, cmt. c, illus. 5 (1981). Compare In re Noonan, 17 B.R. 793, 798 (Bankr. S.D.N.Y. 1982) (debtor’s recording contract with Arista Records was nonassignable personal service contract) and Foster v. Callaghan & Co., 248 F. 944, 947 (S.D.N.Y. 1918) (contract between author and publisher was a personal service contract that could not be assigned by one party without the other’s consent) and Paige v. Faure, 127 N.E. 898, 899 (N.Y. 1920) (contract which involved “personal trust” and “confidence” among the parties is nonassignable) with In re Rooster, Inc., 100 B.R. 228, 233-34 (Bankr. E.D. Pa. 1989) (nondebtor’s control and veto power over debtor’s performance under the contract conclusively cuts against labeling this contract as one for personal services) and In re Bronx-Westchester Mack Corp., 20 B.R. 139, 143 (Bankr. S.D.N.Y. 1982) (fact that debtor purchased distributorship from third party shows that contract was not contingent on personal services) and Sentry
This line of reasoning is based primarily on a theory of statutory construction and legislative intent underpinning the Bankruptcy Code. Another series of cases, however, rejects the narrow construction applied


There are many cases that narrowly construe the scope of § 365(c)(1) to nondelegable personal service contracts. See, e.g., In re Sunrise Restaurants, Inc., 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (holding that a franchise agreement which did not require “special knowledge” was assumable and assignable by debtor in possession); In re Tom Stimus Chrysler-Plymouth, Inc., 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991) (franchise agreement that is not a “personal service contract based on special trust and confidence” may be assigned by debtor even though it is terminable under applicable Florida statutes); In re Fastrax, Inc., 129 B.R. at 278 (subcontract that was not “dependent on any special personal relationship,” could be assigned to another computer software company); In re Ontario Locomotive & Indus. Railway Supplies (U.S.) Inc., 126 B.R. 146, 148 (Bankr. W.D.N.Y. 1991) (government Anti-Assignment Act did not preclude debtor from assuming contract that did not call for “personal” and “non-delegable” duties); Secretary of the Army v. Terrace Apartments, Ltd. (In re Terrace Apartments, Ltd., 107 B.R. 382, 384 (Bankr. N.D. Ga. 1989) (since exception in § 365(c) is limited to contracts that are dependent upon a “special relationship, special knowledge, special skill, or talent,” the debtor may assume executory lease notwithstanding federal statute to the contrary); see also 1 Norton Bankruptcy Law and Practice, supra note 31, § 23.08.70 at 19 (supporting the line of cases that limit the scope of § 365(c)(1) to nondelegable personal service contracts).

36. The case of Abney v. Fulton County, Ga. (In re Fulton Air Serv., Inc.), 34 B.R. 568 (Bankr. N.D. Ga. 1983), sets forth the rationale for a narrow construction of § 365(c). In Fulton, the debtor, Fulton Air Service, and Fulton County entered into a lease for property located at the Fulton County Airport. See id. at 569. Several years later the debtor filed a bankruptcy petition under Chapter 11 and sought to sell and assign the lease. See id. at 570. The County objected to the sale and assignment citing a county ordinance that required approval from the Fulton County Commission for an assignment of this type of lease. See id. at 571. The County argued that since it did not consent to the assignment, the lease was nonassignable under applicable law and therefore nonassumable and nonassignable under § 365(c)(1). See id.

The court in Fulton disagreed with the County and held that the § 365(c) prohibition against assumption and assignment should be interpreted narrowly to encompass solely nondelegable personal service contracts. See id. at 572. The court concluded that a broad reading of the term “applicable law” in § 365(c)(1) would render the assignment provision of § 365(f) meaningless. See id. Section 365(f)(1) provides that “notwithstanding a provision in . . . applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.” Id. at 572 (quoting 11 U.S.C. § 365(f)(1) (1988)). This conclusion is premised on the theory that a statute should be read and interpreted in light of all its provisions so as not to render any one section meaningless or redundant. See id.

In applying a narrow construction to § 365(c), the Fulton court also relied on Congress’ goal of allowing financially troubled entities to rehabilitate themselves. The court noted that often a particular lease is the debtor’s primary asset and an integral part of a reorganization. See id. Accordingly, the court reasoned that prohibiting a debtor from enjoying the fruits of an assignment would be tantamount to depriving it of a realistic chance of rehabilitation. See id. Further, the court stated that a broad interpretation of Section 365(c)(1) would enable local governments to enact laws that “thwart[] the legislative purpose of § 365 altogether.” Id.
to section 365(c). These cases construe the term "applicable law" broadly and literally to encompass both contracts involving nondelegable personal duties and contracts in which assignment is prohibited by statute or common law.\textsuperscript{37}

Extending this broad interpretation even further, some courts hold that section 365(c)(1) precludes assumption when the entity seeking to assume the contract is a post-petition debtor in possession. These courts reason that section 365(c)(1) creates a hypothetical test—if applicable law excuses the nondebtor from accepting performance from someone other than the debtor or the debtor in possession, then even the debtor in possession may not assume the contract without the nondebtor's consent.\textsuperscript{38} This interpretation of subsection (c)(1) is quite literal and treats the debtor in possession as a separate and distinct entity from a pre-petition party to a contract.\textsuperscript{39} Courts adopting this reasoning rely on the amendments to section 365(c)(1)(A) to support their position.\textsuperscript{40}

\textsuperscript{37} See, e.g., In re West Electronics Inc., 852 F.2d 79, 83 (3d Cir. 1988) (since contract was nonassignable under applicable federal law, § 365(c)(1) precluded debtor in possession from assuming it); In re Pioneer Ford Sales, Inc., 729 F.2d 27, 28-29 (1st Cir. 1984) (where state statute allows a manufacturer to veto an assignment, § 365(c) precludes assignment without manufacturer's consent); Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 943 (5th Cir. 1983) ("If Congress had intended to limit § 365(c) specifically to personal service contracts, its members could have conceived of a more precise term than "applicable law" to convey that meaning."); United States Dep't of Air Force v. Carolina Parachute Corp. (In re Carolina Parachute Corp.), 108 B.R. 100, 102-03 (M.D.N.C. 1989) (section 365(c) precludes assumption of contract by debtor in possession where federal statute prohibits assignment of contract without consent of government), rev'd on other grounds, 907 F.2d 1469 (4th Cir. 1990); In re Lile, 103 B.R. 830, 839 (Bankr. S.D. Tex. 1989) (state statute prohibiting assignment of leasehold rendered executory lease nonassignable under § 365(c)); In re Alltech Plastics, Inc., 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987) (patent rights, nonassignable under federal law, are nonassignable under § 365(c)); Pennsylvania Peer Review Org., Inc. v. United States (In re Pennsylvania Peer Review Org., Inc.), 50 B.R. 640, 645 (Bankr. M.D. Pa. 1985) (federal statute that prohibited transfer of government contract rendered executory contract nonassignable pursuant to § 365(c)); In re Nitec Paper Corp., 43 B.R. 492, 497-98 (S.D.N.Y. 1984) (federal statute creating nonassignable duties and rights with respect to contracts for "replacement power" rendered contract nonassignable under § 365(c)(1)).


\textsuperscript{39} See cases cited supra note 38.

\textsuperscript{40} Section 365(c)(1)(A) has been amended twice since its enactment. In 1984 Congress substituted in § 365(c)(1)(A):

"[Applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties" for "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."
Although this interpretation is facially reasonable, it is not without its critics. Interestingly, courts that criticize the "separate entity" theory also point to the congressional amendments to section 365(c)(1)(A) for support.

In addition to section 365(c)(1), section 365(c)(2) provides further protection for the nondebtor by restricting the debtor's ability to assume certain credit contracts. These include contracts to provide loans, debt financing, or other "financial accommodations" for the benefit of the debtor. Although the Code does not define "financial accommodation," it has generally been described as an executory contract that provides financial support, other than an ordinary loan, on behalf of the debtor.

In 1986, § 365(c)(1)(A) was amended again in order to strike the words "or an assignee of such contract or lease" after the phrase "debtor in possession." Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 283(e)(1), 100 Stat. 3088, 3117. The court in West, for example, argues that this second amendment "clarified Congress' original intent" and removed any doubt that the literal interpretation was correct. See West, 852 F.2d at 83 n.2. Significantly, the West court held that "in the context of assumption and assignment of executory contracts, a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially distinct entities." Id. at 83.

41. See, e.g., West, 852 F.2d at 84 (Higginbotham, J., concurring in part and dissenting in part) ("I do not believe that when it enacted Section 15 of Title 41, Congress considered the issue of whether a debtor in possession should be viewed as a party different than the debtor."); In re Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc., 126 B.R. 146, 148 (Bankr. W.D.N.Y. 1991) ("Congress did not intend to bar assumption of any contract as long as it will be performed by the debtor or debtor in possession.").


43. See supra note 7.

44. Paragraph (2) is limited in scope, however, and does not apply to all contracts to extend credit. See Collier 15th ed., supra note 2, § 365.05[1], at 365-45.

45. See, e.g., Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089, 1092 (9th Cir. 1991) (agreement to provide financing for boats sold by debtor constituted a "financial accommodation" contract for the benefit of the debtor); Gil v. Eazebe Enters. (In re Eazebe Enters.), 900 F.2d 1417, 1420 (9th Cir. 1990) (option to purchase real property over a five year period constituted a nonassumable "financial accommodation"); Watts v. Pennsylvania Hous. Fin. Co. (In re Watts), 876 F.2d 1090, 1095 (3d Cir. 1989) (commitment to provide mortgage assistance pursuant to state program constituted a nonassumable "financial accommodation" under § 365(c)(2)); Edwards Mobile Home Sales, Inc. v. Ohio Casualty Ins. Co. (In re Edwards Mobile Home Sales, Inc.), 119 B.R. 857, 859 (Bankr. M.D. Fla. 1990) (surety bond issued on behalf of debtor was held to be a "financial accommodation"); Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.), 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985) (same); Government Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (In re Adana Mortgage Bankers, Inc.), 12 B.R. 977, 986 (Bankr. N.D. Ga. 1980) (guaranty agreements that enabled debtor to sell securities in the secondary market were "financial accommodations" under § 365(c)(2)).
The primary purpose of paragraph (2) is to prevent a nondebtor from being compelled to finance the reorganization of the bankrupt entity. Congress, however, mandated a strict construction of this paragraph that did not extend to "incidental financial accommodations" accompanying ordinary contracts to provide goods or services. Courts have generally adhered to this approach as a way of promoting a debtor's rehabilitation. Additionally, section 365(c)(2) makes no mention of a consent

46. The House Report provides as follows:

The purpose of this subsection, at least in part, is to prevent the trustee from requiring new advances of money or other property. The section permits the trustee to continue to use and pay for property already advanced, but is not designed to permit the trustee [sic] to demand new loans or additional transfers of property under lease commitments.


The purpose of this subsection is to make it clear that a party to a transaction which is based upon the financial strength of a debtor should not be required to extend new credit to the debtor in the form of loans, lease financing, or the purchase or discount of notes.


Section 365(c)(2) is an effort by Congress to protect creditors from being forced to provide "financial accommodations" to a bankrupt entity based on a pre-bankruptcy contract. See Easebe, 900 F.2d at 1419; In re TS Indus., 117 B.R. 682, 686 (Bankr. D. Utah 1990); Airlines Reporting Corp. v. Charrington Worldwide Enter. (In re Charrington Worldwide Enter.), 110 B.R. 973, 975 (M.D. Fla. 1990); Whinnery v. Bank of Onalaska (In re Taggatz), 106 B.R. 983, 990-91 (Bankr. W.D. Wis. 1989); In re The Travel Shoppe, Inc., 88 B.R. 466, 470 (Bankr. N.D. Ga. 1988); In re Farrell, 79 B.R. 300, 304 (Bankr. S.D. Ohio 1987); In re Placid Oil Co., 72 B.R. 135, 139 (Bankr. N.D. Tex. 1987); see also Louis W. Levit, Use and Disposition of Property Under Chapter 11 of the Bankruptcy Code: Some Practical Concerns, 53 Am. Bankr. L.J. 275, 276 (1979) ("The Code provides explicitly that there is no way that a debtor can assume [a financing agreement] and thus compel its lender to continue to advance funds during reorganization.").

In addition to protecting nondebtors, this provision also assists companies that are on the brink of bankruptcy. Financially impaired companies may be able to obtain quite reasonable rates from financial institutions given the fact that the contract will be both unassumable and terminable after the commencement of a bankruptcy case. See Nim-mer, supra note 3, at 536 (without the protection provided by § 365(c)(2) a party approaching bankruptcy would have a very difficult time obtaining credit).


requirement, and a literal reading of this section would prohibit the debtor from assuming an executory contract with or without the nondebtor's consent. This literal interpretation, however, has not been widely accepted. Pointing to the Code's objective of providing debtors with an opportunity to rehabilitate, several courts have declined to read section 365(c)(2) so formally. Rather, they have allowed the debtor in possession to assume an otherwise nonassumable contract provided the creditor has consented.

3. Section 365(e): Prohibition of ipso facto Clauses

The provisions of section 365(e) also balance a nondebtor's right to receive the benefits of the original contractual bargain with a debtor's ability to attempt a successful reorganization. Section 365(e)(1), for example, renders unenforceable ipso facto or bankruptcy termination clauses. In this regard, the Code seeks to promote a debtor's

49. See Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089 (9th Cir. 1991). In Sun Runner, the Ninth Circuit expounded several arguments for holding that subsection 365(c)(2) prohibited assumption of a financing agreement by the debtor even if the creditor consented to such assumption. First, the court pointed out that while § (2) makes no mention of a consent requirement, § (1) explicitly permits assumption if the nondebtor consents. See id. at 1092. Thus, it was not likely to be a mere oversight on the part of the drafters. See id. Second, the court stated that permitting Sun Runner to assume the contract would enable Transamerica to receive full payment at the expense of other creditors. See id. at 1093. The court noted that § 364 governs post-petition financing by allowing a debtor to offer specific incentives to potential creditors. These incentives include allowing a creditor to receive an administrative expense priority claim under § 364(b), a "super-priority" claim pursuant to § 364(c)(1), or a lien on unencumbered assets under § 364(c)(2) or (3). See id. at 1092-93. In sum, the court stated the following: "[T]he section 365(c)(2) prohibition against the assumption of financial accommodation contracts protects all unsecured creditors, not just the lender, and the lender's consent alone is not sufficient to abrogate it." Id. at 1093; see also In re Placid Oil Co., 72 B.R. 135, 139 (Bankr. N.D. Tex. 1987) (court prohibited debtor in possession from assuming financial accommodation despite creditor's consent); 1 Norton Bankruptcy Law and Practice, supra note 31, § 23.08.60, at 17 (termination of a credit contract upon the filing of a bankruptcy petition protects third party creditors who will be potential claimants against the estate).


Section 365(e)(2), however, provides some protection for creditors and other nondebtors by excepting certain executory contracts from the purview of section 365(e)(1). For instance, employing language closely parallel to section 365(e)(1), section 365(e)(2)(A) provides that the prohibition against *ipso facto* clauses does not apply to contracts where "applicable law" excuses the nondebtor from accepting performance from a third party. Once again, arriving at a precise meaning of "applicable law" becomes a central issue. That is, if one interprets the language in section 365(c)(1) liberally, to encompass more than nondelegable personal service contracts, then *ipso facto* clauses pursuant to section 365(e)(2)(A) will be frequently enforced. If, however, one construes the exception in section 365(c)(1) narrowly to include only nondelegable personal service contracts, then *ipso facto* clauses will have considerably less impact. Keeping with the spirit of this latter view, some courts have held that assumption by a debtor in possession does not constitute a prohibited assignment within the meaning of section 365(e)(2)(A).

Paragraph (B) of section 365(e)(2) provides additional protection for

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52. The legislative history states in pertinent part as follows:

Subsection (e) invalidates *ipso facto* or bankruptcy clauses. These clauses, protected under present law, automatically terminate the contract or lease, or permit the other contracting party to terminate the contract or lease, in the event of bankruptcy. This frequently hampers rehabilitation efforts. If the trustee may assume or assign the contract under the limitations imposed by the remainder of the section, then the contract or lease may be utilized to assist in the debtor's rehabilitation or liquidation.

The unenforceability of *ipso facto* or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the court will have to insure that the trustees performance under the contract or lease gives the other contracting party the full benefit of his bargain.

H.R. Rep. No. 595, supra note 3, at 348-49, reprinted in 1978 U.S.C.C.A.N. at 6304-05; S. Rep. No. 989, supra note 16, at 59, reprinted in U.S.C.C.A.N. at 5845; see also Nimmer, supra note 3, at 340-41 (discussing impetus behind § 365(e)(1)). Professor Nimmer also points out that although this provision is intended to help a post-bankrupt entity rehabilitate, it may make some nondebtors quite hesitant to deal with a financially distressed entity. Thus, this provision may ironically result in more bankruptcy filings. See id. at 543-44.

53. See supra note 12.

54. See supra notes 32-37 and accompanying text.

55. See cases cited supra note 37.

56. See cases cited supra note 35; see also 2 Collier 15th ed., supra note 2, § 365.06[1], at 365-50 (expressing the view that § 365(e)(2) exception to the prohibition against *ipso facto* clauses is limited to nondelegable personal service contracts).

57. See, e.g., In re Cardinal Indus., Inc., 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990) ("[A]ssumption of the contracts by the Trustee on behalf of the estate with performance..."
nondebtors.\textsuperscript{58} In the same language used in section 365(c)(2),\textsuperscript{59} this paragraph exempts credit contracts from the prohibition on \textit{ipso facto} clauses provided for in section 365(e)(1).\textsuperscript{60} Again, this provision is designed to guard against the possibility of a nondebtor being forced to finance a debtor's rehabilitation effort.\textsuperscript{61} Given the paramount importance of achieving a successful reorganization, however, courts have construed this provision narrowly.\textsuperscript{62}

Assuming that section 365(c) or (e)(2) applies to an executory contract, the question remains whether the nondebtor must seek relief from the automatic stay of section 362 before terminating the contract. Sections 365(c) and (e)(2) do not address this question, and currently no consensus has been reached among the bankruptcy courts. Before analyzing the arguments presented by the various sides and offering a solution, however, it is important to become familiar with the automatic stay provision of section 362. This, in turn, requires an understanding of the definition of property of the estate as defined by section 541 of the Code.

B. \textit{Sections 362 and 541: The Automatic Stay of Actions Against Property of the Estate}

1. General Language of Sections 362(a) and 541(a)

Section 362—the automatic stay provision—is a very significant part of the Bankruptcy Code. Once triggered, the stay stops all collection efforts, all harassment, and all foreclosure actions against the debtor.\textsuperscript{63} By delaying these acts and proceedings, the stay gives the debtor a

\begin{flushleft}
\textsuperscript{58} See supra note 12.
\textsuperscript{59} See supra note 7.
\textsuperscript{60} See, e.g., Watts v. Pennsylvania Hous. Fin. Co. (\textit{In re Watts}), 876 F.2d 1090, 1095 (3d Cir. 1989) (commitment by government agency to make mortgage payments on behalf of eligible homeowners was an executory contract falling within the scope of § 365(c)(2) and (e)(2)(B) and thus could be suspended during a bankruptcy proceeding); Wegner Farms Co. v. Merchants Bonding Co. (\textit{In re Wegner Farms Co.}), 49 B.R. 440, 444 (N.D. Iowa 1985) (surety bond issued on behalf of debtor constituted a “financial accommodation” within the meaning of § 365(c) and (e)(2) and could be terminated upon the debtor’s bankruptcy filing); Dean v. Postle Enters., Inc. (\textit{In re Postle Enters., Inc.}), 48 B.R. 721, 725 (Bankr. D. Ariz. 1985) (funding agreement which permitted debtor to demand $150,000 cash transfer constituted a “financial accommodation” which could be terminated upon commencement of a bankruptcy proceeding pursuant to § 365(e)(2)(B)); \textit{In re New Town Mall}, 17 B.R. 326, 327 (Bankr. D. S.D. 1982) (contract to provide financing is exempt from the prohibition barring “ipso facto” clauses in § 365(e)(1)).
\textsuperscript{61} See supra note 46.
\end{flushleft}
“breathing spell” from his creditors. It provides the debtor with an opportunity to assess his situation and develop a reorganization or repayment plan. In addition, the stay provides protection for creditors by preventing some creditors from obtaining more than their fair share of the estate by unilaterally seeking a remedy.

Section 362(a) sets out the scope of the stay by listing the various acts that are halted by the commencement of a bankruptcy proceeding. Specifically, section 362(a)(3) provides that the filing of a bankruptcy petition operates as a stay of “any act to obtain possession of property of the estate.”

The legislative history indicates that Congress intended the scope of this provision to be “broad”—encompassing, among other things, “tangible or intangible property.”

2. Executory Contracts as Property of the Estate:
   Historical Background

Historically, executory contracts were not included as part of the property of the estate until assumed by the debtor or trustee. The holding in Cheadle v. Appleatchee Riders Ass’n (In re Lovitt), a Ninth Cir-


67. See supra note 14.


71. 757 F.2d 1035 (9th Cir.), cert. denied, 474 U.S. 849 (1985).
cuit case decided under the Bankruptcy Act,72 is representative of this "exclusionary view":

Because executory contracts and leases involve future liabilities as well as rights, . . . an affirmative act of assumption by the trustee is required to bring the property into the estate in order to ensure that the estate is not charged with the liabilities except upon due deliberation. Thus, executory contracts and leases—unlike all other assets—do not vest in the trustee as of the date of the filing of the bankruptcy petition. They vest only upon the trustee's timely and affirmative act of assumption.73

Supporters of this view argue that the exclusionary theory was codified in the Bankruptcy Act by virtue of the 1938 Chandler Act amendments.74 Further, they claim that when the Code was enacted in 1978, it adopted the basic language of the Act in this area, and there is no indication in the legislative history that Congress intended to alter the underlying exclusionary doctrine.75

Detractors of the exclusionary theory counter that it has no foundation in the Code and that it actually circumvents the entire purpose of section 541(a).76 They argue that Congress espoused a "broad" reading of section 541(a) that consisted of "‘all kinds of property, including tangible or intangible property.’"77 Further, section 541 contains no provision for adding to the property of the estate those contracts assumed under section 365.78 Critics have also observed that the "[exclusionary theory] forces us to evade and distort the whole structure of section 541, creating manifold possibilities for confusion and error."79

Various circuit court opinions also reflect this divergence of views among legal scholars. Courts that adhere to an exclusionary theory hold that a debtor's interest in a contract governed by section 365(c) or (e)(2) is not property of the estate since the contract is nonassumable and nonassignable. As such, a nondebtor need not seek relief from the automatic stay before terminating the contract.80 Other courts counter that a

73. Lovitt, 757 F.2d at 1041 (citations omitted).
78. See Westbrook, supra note 76, at 325; see also Douglas W. Bordewieck, The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract, 59 Am. Bankr. L.J. 197, 200 n.18 (1985) ("Surely the debtor's interest in an executory contract is property of the estate.").
79. Westbrook, supra note 76, at 325.
80. See, e.g., Watts v. Pennsylvania Hous. Fin. Co. (In re Watts), 876 F.2d 1090, 1095-96 (3d Cir. 1989) (to hold the stay applicable to § 365(e)(2)(B) contracts would
debtor's interest in a contract becomes property of the estate immediately upon the filing of a bankruptcy petition. Consequently, a nondebtor must seek relief from the stay before terminating a contract that it believes is nonassumable and nonassignable under section 365(c) or (e)(2).  

If the automatic stay is imposed, or if a nondebtor simply seeks relief from the stay as a precautionary measure, courts generally hold that establishing the applicability of section 365(c) or (e)(2) is sufficient to establish "cause" for relief from the stay. Thus, the various interpretations accorded to section 365(c) and, by analogy, to section 365(e)(2), will directly impact a nondebtor's ability to obtain relief from the stay.

81. See, e.g., Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.), 824 F.2d 725, 728 (9th Cir. 1987) ("Even if [the nondebtor] had a valid reason for terminating the Agreement, it still was required to petition the court for relief from the automatic stay under section 362(d)."); Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.), 49 B.R. 440, 445 (Bankr. N.D. Iowa 1985) (applying the automatic stay to § 365(c) and (e) contracts is wholly consistent with the purposes and policies of the Bankruptcy Code); Government Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (In re Adana Mortgage Bankers, Inc.), 12 B.R. 977, 983 (Bankr. N.D. Ga. 1980) (automatic stay requires that nondebtor prove "applicability of [section 365(e)(2)] to the [c]ourt before taking action to terminate the contract").

82. See infra note 101.

83. Section 362(d) states in relevant part as follows:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; . . . .


85. See supra notes 32-37 and accompanying text.

86. See supra notes 53-57 and accompanying text.

87. If relief from the stay is not a prerequisite for termination but a nondebtor erroneously terminates the contract thinking it falls within the purview of section 365(e) or (e)(2), then it may be liable for contempt damages. See cases cited infra note 142.
II. THE INTERPLAY BETWEEN SECTIONS 362 AND 365

A. Automatic Stay Not Applicable to Nonassumable or Nonassignable Contracts under Section 365(c) or (e)(2)

In holding that the automatic stay is not applicable to contracts falling within the purview of section 365(c) or (e)(2), courts have relied primarily on a theory of statutory interpretation and legislative intent. The Third Circuit's holding in *Watts v. Pennsylvania Housing Finance Co. (In re Watts)*,\(^8\) is a leading example of this line of reasoning. In *Watts*, Pennsylvania's Homeowner's Emergency Mortgage Assistance Program ("HEMAP") authorized the Pennsylvania Housing Finance Agency ("PHFA") to pay monthly mortgage payments directly to mortgagees on behalf of needy homeowners.\(^9\) The program was a governmental effort designed to reduce the growing number of mortgage foreclosures.\(^9\) Because HEMAP operated with limited funds, however, the program called for the suspension of all payments during a bankruptcy proceeding, since the automatic stay prohibited foreclosure during this period.\(^9\) The debtor-homeowner plaintiffs in *Watts* brought the action after receiving notice that their assistance under HEMAP was being terminated. They claimed that PHFA's suspension of monthly assistance following the filing of their bankruptcy petitions violated the automatic stay provision of section 362.\(^9\)

The Third Circuit found that PHFA's commitments to the plaintiffs were executory contracts to "make a loan or extend other debt financing" under section 365(c)(2) and thus were terminable under section 365(e)(2)(B).\(^9\) More importantly, the court held that the automatic stay provision did not prohibit the unilateral termination of such contracts.\(^9\) The court reasoned that since the Code explicitly permits the post-filing termination of executory contracts to make loans, staying such termination under section 362 "would be at worst anomalous, and at best an imposition of a pro forma requirement that the creditor must ask for what the Code plainly grants him."\(^9\) The court concluded that because Congress explicitly prohibited assumption or assignment of contracts falling within the scope of section 365(c) or (e)(2), section 362 should not be interpreted to give the debtor a benefit to which it was not entitled.\(^\)

\(^8\) 876 F.2d 1090 (3d Cir. 1989).
\(^9\) See id. at 1091.
\(^9\) See id.
\(^9\) The program allowed the debtor to reapply for the assistance after the court lifted the stay or upon termination of bankruptcy proceedings making foreclosure imminent. See id.
\(^9\) See id. at 1092.
\(^9\) See id. at 1095-96.
\(^9\) See id. at 1096.
\(^9\) Id.; see also Buschman, supra note 19, at 348-49 (termination of nonassumable executory contracts not barred by automatic stay).
More specifically, the court stated that "the intention of Congress in enacting section 362(a)(3) cannot be considered in isolation without regard for the rest of the Bankruptcy Code."97

The Watts court recognized contrary authority arguing for the application of the automatic stay in these instances.98 Nevertheless, the Third Circuit stated that in the bankruptcy setting, as in other legal settings, a "post-hoc challenge suffices to protect relevant interests."99 In particular, the court analogized a nondebtor's unilateral termination to that of a party's refusal to perform a contractual obligation in a nonbankruptcy setting believing that the other party has breached.100 The court stated, "While a declaratory judgment would no doubt be comforting, if one party's breach justifies the second's nonperformance, the second may take a chance and not perform when it perceives the first breached."101

Other courts, while not directly addressing the issue of the automatic stay, explicitly adhere to the exclusionary theory.102 These courts hold that a debtor's interest in an executory contract does not automatically vest in the bankruptcy estate at the time of filing the petition.103 They

97. Id. at 1095; see also In re New Town Mall, 17 B.R. 326, 329 (Bankr. D. S.D. 1982) ("Where one section of the Bankruptcy Code explicitly governs an issue, another section should not be interpreted to cause an irreconcilable conflict.") (citing Richards v. United States, 369 U.S. 1, 11 (1961)).
98. See Watts, 876 F.2d at 1096.
99. Id. (footnote omitted).
100. See id. at 1096 n.11.
101. Id. Although the court in Watts was comfortable with "a post-hoc challenge" to a nondebtor's unilateral termination, it noted that a nondebtor may want to seek relief from the stay in a close case in order to avoid liability for ex parte action that is later found to be unlawful. See id.

Moreover, the fact that the state designed the program to assist needy families may have influenced the holding in Watts. The court noted, "We would be extremely reluctant to bar the [government agency] in the future from taking steps required by Pennsylvania law and authorized by the Bankruptcy Code to protect the HEMAP fund." Id. at 1095 n.8. Additionally, the court pointed out that holding the stay inapplicable under the facts of this case would not undermine its underlying policy of providing the debtor with a "breathing spell." Id. at 1096. Thus, the holding in Watts may be limited to its particular facts and circumstances.

The holding in In re New Town Mall, 17 B.R. 326 (Bankr. D. S.D. 1982), a case cited by Watts, may also be limited to its facts. In this case, the unsecured creditors committee joined the debtor in possession in arguing that the automatic stay tolled the expiration of a loan commitment issued to the debtor by an insurance company. See id. at 326-27. After concluding that the loan commitment was terminable under § 365(e)(2)(B) and not assumable or assignable under § 365(e)(2), the court held that the automatic stay should not be construed to toll the expiration of the commitment. See id. at 327-29. Significantly, the court concluded that since "tolling" did not require any affirmative steps on the part of the nondebtor, it was not an "act" encompassed by § 362. See id. at 328-29. Thus, potentially, this court may hold that unilateral termination of the contract—arguably an "act" under § 362—is precluded by the automatic stay.

102. See supra notes 70-75 and accompanying text.
require a trustee to assume the contract in order for a debtor's interest in it to become property of the estate.104 Because the trustee cannot assume contracts governed by section 365(e) or (e)(2), a debtor's interest in these contracts cannot become part of the estate.105 Thus, since section 362(a)(3) stays only those actions to obtain property of the estate, presumably this approach would not require the nondebtor to seek relief from the automatic stay in this situation.106

This exclusionary approach as well as the plain meaning/legislative intent reasoning espoused in Watts have met with considerable criticism. The jurisprudence in this area is shifting toward a broader interpretation of sections 541 and 362—one that implicitly holds that contractual rights vest in the property of the estate immediately upon the filing of a petition. Moreover, this line of reasoning also relies on legislative intent and the precise language of the pertinent sections of the Code for support.

B. **Automatic Stay Applicable to Contracts Governed by Sections 365(c) and (e)(2)**

In contrast to Watts and the other cases discussed above, another line of reasoning holds that a nondebtor must seek relief from the automatic stay before unilaterally terminating an executory contract with a debtor.107 The Ninth Circuit case *Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*,108 is a leading example of this treatment of the interaction between sections 362 and 365.109 *Computer Communications* involved a communication equipment manufacturer, Codex, that entered into an agreement to purchase equipment and computer software from Computer Communications, Inc. (CCI). CCI subsequently filed a bankruptcy petition, and Codex terminated the agreement pursuant to a bankruptcy termination provision or *ipso facto* clause.110 CCI then brought suit claiming that Codex's unilateral termination violated the automatic stay.111 Codex countered by claiming that the termination clause was enforceable under section 365(e)(2) and, as a

104. See cases cited supra note 103.
105. See id.
106. See La Sala, supra note 6, at 635-36 n.90.
108. 824 F.2d 725 (9th Cir. 1987).
109. Interestingly, the Ninth Circuit seemed to disavow its earlier position in Chendle v. Appleatchee Riders Ass'n (In re Lovitt), 757 F.2d 1035, 1041 (9th Cir.), *cert. denied*, 474 U.S. 849 (1983), wherein it expressly advocated the preclusion-from-the-estate concept.
110. See *Computer Communications*, 824 F.2d at 726-27.
111. See id.
result, the automatic stay did not preclude unilateral termination.\textsuperscript{112}

The Ninth Circuit agreed with CCI, holding that even if the contract was terminable under section 365(e)(2), section 362 automatically stayed termination.\textsuperscript{113} As support for this approach, the court cited legislative intent as well as the overall statutory scheme and purpose of the Bankruptcy Code.\textsuperscript{114} The court began by stating that Congress imposed the automatic stay to give the debtor a “breathing spell” from creditors so it could begin a successful reorganization.\textsuperscript{115} The court added that the scope of the stay is broad: “All proceedings are stayed, including arbitration, license revocation, administrative, and judicial proceedings. Proceeding in this sense encompasses civil actions as well, and all proceedings even if they are not before governmental tribunals.”\textsuperscript{116}

Since section 362 stays acts against property of the estate, the Ninth Circuit then focused on the definition of property as provided in the Code. The court noted that section 541(a) provides that property of the estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”\textsuperscript{117} In interpreting this provision, the court looked to the House Report issued with the Code: “The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property.”\textsuperscript{118} Moreover, although section 362 stays immediate acts against property of the estate, the court stated that it is not designed to permanently deprive a party of its property.\textsuperscript{119} Instead, upon notice and a hearing, a nondebtor may obtain relief from the stay for “cause.”\textsuperscript{120}

Notwithstanding the broad scope of sections 362 and 541, defendant Codex argued that executory contracts do not vest in property of the

\textsuperscript{112} See id.

\textsuperscript{113} See id. at 730; see also Edwards Mobile Home Sales, Inc. v. Ohio Casualty Ins. Co. (In re Edwards Mobile Home Sales, Inc.), 119 B.R. 857, 859-60 (Bankr. M.D. Fla. 1990) (even though surety bond issued on behalf of debtor was a “financial accommodation,” bonding company was required to seek relief from the automatic stay before terminating the bond); Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.), 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985) (same).

\textsuperscript{114} See Computer Communications, 824 F.2d at 729.


\textsuperscript{117} Id. (quoting 11 U.S.C. § 541(a)(1) (1988)).

\textsuperscript{118} Id. (quoting H.R. Rep. No. 595, supra note 3, at 367, reprinted in 1978 U.S.C.C.A.N. at 6323; see also Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.), 49 B.R. 440, 443 (Bankr. N.D. Iowa 1985) (contractual rights constitute intangible property which is included within the definition of property of the estate); Westbrook, supra note 76, at 325 (contract interests, which are often used to secure financing, certainly fall within this broad definition).

\textsuperscript{119} See Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.), 824 F.2d 725, 729 (9th Cir. 1987).

\textsuperscript{120} See id. (citing 11 U.S.C. § 362(d) (1988)); see also supra note 83 (for terminology of § 362(d)).
estate until they are assumed by the trustee.\textsuperscript{121} The Ninth Circuit rejected this argument, citing the version of section 541(c)(1) in effect at the time the contract was executed.\textsuperscript{122} At that time, section 541(c)(1) provided that an interest of the debtor in a contract became property of the estate despite "any provision" restricting assignability or "conditioned on the insolvency or financial condition of the debtor."\textsuperscript{123} Cognizant of the expansive scope of section 541 espoused by Congress, the court interpreted the phrase "any provision" broadly to include any contract provision or any state or other federal law provision restricting assignment.\textsuperscript{124} Moreover, the court noted that Congress subsequently broadened the scope of section 541(c)(1) to read "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law."\textsuperscript{125} This amendment further buttressed the court's holding that a debtor's interest in contract vests upon filing of a bankruptcy petition, notwithstanding the potential applicability of section 365(c) or (e)(2).\textsuperscript{126}

In addition to legislative history and the actual language of the Code, courts requiring nondebtors to seek relief from the stay also premise their conclusion on the statutory scheme of the Code. This approach reasons that although Congress expressly exempted certain actions from the automatic stay,\textsuperscript{127} none of the exceptions can be interpreted to embrace unilateral termination of an executory contract arguably governed by section 365(c) or (e)(2).\textsuperscript{128} Congress also expressly overrode the provi-
sions of the stay in certain instances,\textsuperscript{129} but did not do so in section 365(c) or (e)(2).\textsuperscript{130}

Additionally, courts adhering to this expansive reading of sections 362 and 541 point to public policy reasons for support. The court in \textit{Computer Communications}, for example, summarized the policy underlying the automatic stay as follows:

Congress designed [the automatic stay] to protect debtors and creditors from piecemeal dismemberment of the debtor's estate. The automatic stay statute itself provides a summary procedure for obtaining relief from the stay. All parties benefit from the fair and orderly process contemplated by the automatic stay and judicial relief procedure. Judicial toleration of an alternative procedure of self-help and post hoc justification would defeat the purpose of the automatic stay.\textsuperscript{131}

Finally, the court in \textit{Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.)}\textsuperscript{132} concluded that

bringing these kinds of contracts within the ambit of the automatic stay ensures that the legal question of whether a particular contract may be terminated will be decided in the proper forum, after a full briefing by the parties, rather than by a nondebtor party acting unilaterally and perhaps erroneously.\textsuperscript{133}

\begin{footnotesize}
\begin{enumerate}
\item[(129)] See, e.g., 11 U.S.C. § 1110 (1988 & Supp. III 1991) (nullifying the provisions of the automatic stay and the power of the court to enjoin a creditor from taking possession of aircraft equipment or vessels unless debtor complies with certain conditions within 60 days after commencement of a case).
\item[(130)] See \textit{Computer Communications}, 824 F.2d at 730; \textit{Wegner}, 49 B.R. at 444.
\item[(131)] \textit{Computer Communications}, 824 F.2d at 731; \textit{see also Edwards Mobile Home Sales}, 119 B.R. at 859 (quoting \textit{Computer Communications}, 824 F.2d at 731); \textit{Adana Mortgage Bankers}, 12 B.R. at 997:

The stay insures that all of the property of the Debtor will be brought into the custody of the "bankruptcy court by the filing of the petition, and no interference with that custody can be countenanced without the court's permission."

Without such a provision the orderly liquidation or rehabilitation of the Debtor would be impossible.

\begin{footnotesize}
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\item[(132)] 49 B.R. 440 (Bankr. N.D. Iowa 1985).
\item[(133)] Id. at 445. A debtor's chances for a successful reorganization would be severely impaired by an erroneous termination of a contract that is a valuable asset of the debtor's estate. See id. at 445-46; \textit{see also Edwards Mobile Home Sales, Inc. v. Ohio Casualty Ins. Co. (In re Edwards Mobile Home Sales, Inc.)}, 119 B.R. 857, 860 (Bankr. M.D. Fla. 1990) (quoting \textit{Wegner}, 49 B.R. at 445).

If a nondebtor is forced to seek relief from the stay before terminating the contract, the particular interpretation accorded § 365(c) and (e)(2) will become crucial to its chances of success. \textit{See supra} notes 32-37, 53-57 and accompanying text. For example, a nondebtor would be more likely to obtain relief from the stay under a broad interpretation of these two exceptions to the general rule permitting assumption than under a narrow interpretation.
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III. SOLUTION: THE AUTOMATIC STAY SHOULD PRECLUDE NONDEBTORS FROM UNILATERALLY TERMINATING NONASSUMABLE AND NONASSIGNABLE CONTRACTS UNDER SECTION 365(c) OR (e)(2)

While Watts's "isolation" theory and In re Lovitt's "exclusionary theory" may appear convincing at first view, neither comports with the language of the Code, nor the legislative intent underlying it. Both theories disregard the broad language of sections 541 and 362 as well as the policy reasons underpinning the automatic stay. In contrast, the reasoning in Computer Communications more correctly interprets the language of section 541 as well as the interplay between sections 362 and 365. Consequently, this approach achieves a primary goal of bankruptcy—rehabilitation of the debtor—in the most efficient manner.

A. The Reasoning of Watts Is Unsound

The Watts opinion does not address the issue of property of the estate for purposes of the automatic stay because the court concluded that the "intention of Congress in enacting section 362(a)(3) cannot be considered in isolation without regard for the rest of the Bankruptcy Code."134 The Third Circuit was unwilling to grant protection under section 362 "when the [contrary] intent of Congress appears clear at 11 U.S.C. § 365."135 Basically, the court declined to construe section 362 in a manner that would conflict with the intent behind sections 365(c) and (e)(2).

This reasoning is flawed because one could counter that sections 365(c) and (e)(2) should not be considered in isolation with respect to the automatic stay of section 362. In fact, the argument that Code sections cannot be viewed in isolation supports the application of the automatic stay to contracts that may or may not be assumable or assignable. For example, although Congress explicitly exempted specific actions from the stay and expressly overrode the stay in other instances, contracts governed by section 365(c) or (e)(2) do not fall within either category.136 Moreover, the Watts holding does not address the broad definition of "property of the estate" present in 541(a).137 Thus, although the Third Circuit purports to reject an interpretation of the Code that views each section in "isolation," the decision ironically seems to do just that.

Watts also analogizes unilateral termination by the nondebtor under these circumstances to a situation in which a party to a contract refuses to perform because it believes the other party has breached.138 The court stated that "in the bankruptcy context, as in other legal contexts, a post-

135. Id. at 1096 (quoting In re New Town Mall, 17 B.R. 326, 329 (Bankr. D. S.D. 1982)).
136. See supra notes 127-30 and accompanying text.
137. See Watts, 876 F.2d at 1095.
138. See id. at 1096 n.11.
hoc challenge suffices to protect relevant interests." In the bankruptcy context, however, the stakes are much higher. A debtor's interest in an executory contract may be its primary asset. To deprive a debtor of such an asset—perhaps erroneously—would preclude any chance of a successful reorganization. Also, in the bankruptcy context, a nondebtor who incorrectly terminates a contract thinking it is nonassumable and nonassignable under section 365(c) or (e)(2) may be liable for contempt in addition to contract damages.

B. Exclusionary Theory Should Be Rejected

While the Watts opinion fails to consider sections 365(c) and (e)(2) in the context of the entire Code and underestimates the delicate nature of a bankruptcy setting, the court does not address the issue of timing—the point at which a contract becomes property of the estate for purposes of the automatic stay. While older cases decided under the Bankruptcy Act held that a debtor's interest in contract did not become property of the estate until it was assumed, the trend under the Code has been toward recognizing immediate vesting upon filing of a petition. While it never expressly mandated abandonment of the exclusionary theory, Congress defined “property of the estate” very broadly in section 541(a) of the Code to include “all legal or equitable interests of the debtor” as of the commencement of the case. Furthermore, the legis-

139. Id. at 1096.
141. See id.
143. See, e.g., Palmer v. Palmer, 104 F.2d 161, 163 (2d Cir.) (lease “does not pass to a trustee in bankruptcy, unless he adopts it”), cert. denied, 308 U.S. 590 (1939); Hall v. Perry (In re Cochise College Park, Inc.), 703 F.2d 1339, 1352 (9th Cir. 1983) (same); Commercial Trading Co. v. Lansburgh (In re Garfinkle), 577 F.2d 901, 905 n.5 (5th Cir. 1978) (same).
144. See cases cited supra note 107. But see cases cited supra note 80. The Ninth Circuit, for example, although adhering to the exclusionary theory in In re Lovitt—a case decided under the Act—expressly disavowed this position in Computer Communications. See supra text accompanying notes 121-25.
145. See Andrew, supra note 74, at 20.
146. 11 U.S.C. § 541(a)(1) (1988). Section 541(a) “creates an estate” comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.” Id. (emphasis added). By contrast, § 70a of the Bankruptcy Act vested the trustee “by operation of law with the title of the bankrupt as of the date of the filing” in the bankrupt's property. Chandler Act of 1938, ch. 575, § 70a, 52 Stat. 840. Thus, even Professor Andrew recognizes that the intermediating “title” concepts are rapidly becoming “antiquated.” See Andrew, supra note 75, at 865.
ative history indicates that Congress clearly intended the scope of this paragraph to be very broad. As the court stated in Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), "The plain language of 541 sweeps in every kind of prepetition interest of the debtor in property not expressly excepted. Nothing in the Code suggests that some kinds of interests lurk in limbo outside the estate until assumed."

In the area of statutory interpretation, the Supreme Court has held that the plain meaning is conclusive unless it would yield a result contrary to the intent of the drafters. Here, the plain language encom- passes interests in potentially nonassumable executory contracts. Applying the stay in these instances to prevent unilateral termination does not undermine the goals of the Code. A nondebtor may obtain re- lief from the stay by showing the applicability of section 365(c) or (e)(2) to the contract. Thus, a debtor's interest in an executory contract should vest in the property of the estate upon filing of a petition. This interpretation comports with the plain language of the statute without undermining the intent of Congress.

In addition to section 541(a), the language of section 541(c) also sup- ports the conclusion that a debtor's interest in a contract vests upon filing despite the potential applicability of section 365(c) or (e)(2). Section 541(c) provides that a debtor's interest in property becomes "property of the estate" despite "any provision in an agreement, transfer instrument, or applicable nonbankruptcy law" that restricts assignability or that is "conditioned on the insolvency or financial condition of the debtor." This language clearly indicates that section 541(c) supersedes state and federal laws that restrict assignability of contracts. As such, contractual interests that fall within the purview of sections 365(c) and (e)(2) as a result of such laws, still become property of the estate upon filing of the petition.

C. Public Policy

Invoking the automatic stay to prevent unilateral termination in these instances also promotes the goal of debtor rehabilitation while imposing only a minimal burden on nondebtors. Considering the case law sup- porting the notion that Congress intended sections 365(c) and 365(e)(2) to be narrow exceptions to the general rule, the automatic stay merely

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147. See supra notes 68-69 and accompanying text.
149. Id.; see also Westbrook, supra note 76, at 324 ("The exclusionary analysis requires us to ignore the language and the structure of the Code.").
151. See supra text accompanying notes 82-84.
154. See Citizens & S. Nat'l Bank v. Thomas B. Hamilton Co. (In re Thomas B. Ham-
protects against an erroneous termination. It requires that the section 365(c) or (e)(2) determination be made by the court after adequate notice and a full hearing.155 Also, the stay does not permanently prohibit the nondebtor from terminating an executory contract.156 A nondebtor may obtain relief from the stay by showing the applicability of section 365(c) or (e)(2) to an executory contract.157 Moreover, the stay is primarily designed to provide the debtor with a “breathing spell” so it can attempt to rehabilitate itself.158 During this period the debtor may reevaluate his situation and possibly offer the nondebtor valuable concessions.159

In general, nondebtors in a bankruptcy proceeding are similar to those people standing in line at a bakery. That is, if they remain patient and stay in line, they will receive their fair share of the cake. If, however, they cut the line and run to the front, the orderly distribution process employed by the bakery will eventually be destroyed. As the court in In re Cardinal Industries, Inc.160 eloquently summarized it,

It is important that all parties impacted by a bankruptcy filing recognize that reorganization in bankruptcy is a collective process. If a few rush to grab what only arguably is theirs and others follow suit, those who have more carefully observed the law or have given the legal remedy an opportunity to work are hurt. And the collective nature of the remedy is destroyed. That approach is antithetical to the legal process. Even though parties may not want to be involuntarily involved in a


bankruptcy proceeding, that fact does not affect the Court's duty to
insure that the bankruptcy laws are properly interpreted and
implemented.\textsuperscript{161}

As this reasoning indicates, bankruptcy is a collective process, the goal of
which is to prevent any one creditor from exacting more than its fair
share of the estate. Allowing a nondebtor to unilaterally terminate a con-
tract would circumvent this process.\textsuperscript{162}

CONCLUSION

Legislative intent, statutory interpretation, and public policy all point
toward the application of the automatic stay to prevent unilateral termi-
nation of contracts falling within the purview of sections 365(c) and
(e)(2). The stakes in bankruptcy are high and, in many cases, a debtor's
interest in an executory contract is its most valuable asset. An erroneous
termination of the contract may destroy any opportunity that the debtor
had for a successful rehabilitation. The stay protects against such a ter-
mination by providing the debtor with a temporary "breathing spell,"
thereby giving the debtor a chance to regroup and develop a plan of reha-
bilitation. Depending on the nature of the contract and its significance to
any effort at rehabilitation, the debtor may also use this opportunity to
offer more favorable terms to a nondebtor.

Since the stay provision of section 362 is not permanent and may be
lifted for cause, it strikes an equitable balance between a debtor's goal of
rehabilitation and a nondebtor's right to receive the full benefit of its
bargain. It gives the debtor an opportunity to reorganize while not im-
posing an undue burden on a nondebtor. Accordingly, this approach re-
flects an interplay between sections 362 and 365 that achieves a primary
goal of the Bankruptcy Code in a very efficient manner.

\textsuperscript{161} Id. at 971.
\textsuperscript{162} See id.