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EXECUTORY CONTRACTS AND PERFORMANCE DECISIONS IN BANKRUPTCY

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

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TABLE OF CONTENTS

JEL Class K12, G33

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Abstract

This paper focuses on the treatment in bankruptcy of a debtor's "executory contracts"--contracts under which the debtor still owes (or is owed) performance at the time it files for bankruptcy. Under the bankruptcy laws of most countries, including the U.S., the bankruptcy trustee usually disposes of an executory contract in one of two ways: either by (1) "assuming" and seeking performance of the contract; or by (2) "rejecting" the contract, and treating any resulting damage claim as a prebankruptcy unsecured claim. Since such unsecured claims are typically not paid more than 20-30 cents on the dollar, rejection generally means that the injured party is paid only a fraction of its damage claim. This approach is widely supported by U.S. bankruptcy commentators.

The analysis of the paper points out a problem with the current approach that has not been recognized by these commentators. In particular, the paper shows that it gives the bankruptcy trustee an incentive to reject value-creating contracts that, from a social perspective, should be performed. It is also shown that the manner in which the rule is actually applied by U.S. courts worsens the problem. The paper then investigates various arrangements that may be able to eliminate the distortion. Four such arrangements are considered, including several rules that adjust the contract price in favor of the bankruptcy estate. The paper compares these various arrangements in terms of their *ex post* distributional effects, the information that is required to implement them, and their effect on the parties' behavior prior to bankruptcy.

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I. Introduction

This paper 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 it files for bankruptcy. Under the bankruptcy laws of most countries, including the U.S., the bankruptcy trustee generally disposes of an executory contract in one of two ways: by either (1) seeking performance of the contract; or (2) "rejecting" the contract, in which case any resulting damage claim is treated as a prebankruptcy unsecured claim. Since prebankruptcy unsecured claims are typically only paid 20-30 cents on the dollar, the consequence of rejection is that the injured party is paid only a fraction of its damage claim.

This paper demonstrates that compensating the other party gives the bankruptcy trustee an incentive to reject value-creating contracts that, from a social perspective, should be performed -- a problem that has so far escaped the attention of the U.S. bankruptcy literature. The analysis also shows that the manner in which the rule is actually applied by U.S. courts worsens the problem. The paper then considers various arrangements that are designed to eliminate the distortion.[1]

When a debtor enters bankruptcy, a separate legal entity, the "bankruptcy estate" is automatically created. The assets of the debtor are considered to pass to the estate and the liabilities of the debtor are converted into claims against the estate. The estate is then managed

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[1] An article in a Canadian law journal that also identifies the excessive-rejection problem (but offers a solution different from the ones I focus on) was recently brought to my attention. *See* George G. Triantis, *The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment*, 43 U. TORONTO L. J. 679 (1993). The solution offered by Triantis is discussed and analyzed *infra* ______.

by the bankruptcy trustee.[2] The purpose of the bankruptcy proceeding is to preserve the business' going concern value (if any), and in any event to maximize the payout rate for unsecured claims. The trustee has a duty to maximize the value of the estate and to contest the claims against it.

Most debtors enter bankruptcy with at least some contracts that are still "executory", that is, if at least one party still owes performance (other than payment) under the contract. For example, if "Builder" contracts to build a factory for "Firm" for $100, and Builder has not yet constructed the factory, the contract is considered executory, whether or not Firm has made any payment. However, if Builder has constructed the factory and Firm has not paid the Builder $100, the contract is no longer executory; Builder simply has a claim against the Firm for $100.

Depending on its terms, an executory contract may represent either an asset or a liability to the debtor's estate. For example, if, in the example above 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).

Unlike ordinary assets, executory contracts do not automatically become part of the estate. Instead, Section 365 of the Bankruptcy Code permits the trustee to either "assume" or

[2] In Chapter 11 reorganization proceedings, the estate is usually managed by the debtor itself, as "debtor-in-possession" ("DIP"). However, for convenience I will use the term "bankruptcy trustee" to refer to the person(s) managing the bankruptcy estate.

"reject" the contract.[3] If the contract is "assumed," the debtor's estate becomes bound to the contract, allowing it to seek performance from the other party. If the executory contract is not assumed but rather "rejected," the rejection is treated as a prebankruptcy breach by the *debtor* (not the bankruptcy estate). Therefore, a claim for damages arising from rejection is treated as any other prebankruptcy general unsecured claim against the debtor: it shares ratably in the assets available to pay general unsecured creditors.[4] In most U.S. bankruptcies, such creditors are paid no more than 20-30 cents on the dollar.[5] As a result, the usual effect of this rule -- which I call the "ratable damages" (or "RD") rule -- is to permit the bankruptcy estate to benefit from the debtor's favorable contracts while avoiding the debtor's obligations under unfavorable contracts at a reduced cost.

Section 365 has been invoked by parties ranging from Continental Airlines, which used

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[3] 11 U.S.C. 365(a).

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

[5] *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 32 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 and 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, E-34 (Dennis E. Logue ed., 1995) (reporting that in a sample of 90 small firms liquidating in bankruptcy, the expected payout rate was 4%).

the provision to reject a union collective bargaining agreement,[6] to the actress Tia Carrere, who filed for bankruptcy to reject a contract to act in "General Hospital" in order to enter a more lucrative agreement to appear in the TV show "A-Team."[7] However, the vast majority of Section 365 proceedings involve small and medium-sized businesses seeking to reject more garden-variety commercial contracts, such as leases, licenses, and purchase and sale agreements.

The use of Section 365 to reject unfavorable contracts has become increasingly widespread.[8] Indeed, it is believed that thousands of bankruptcy cases are filed for the purpose of rejecting executory contracts.[9] Contracts are also routinely rejected in cases filed that are filed primarily for other reasons.[10]

As the use of Section 365 has grown, the manner in which it has been applied by judges has drawn strong criticism from both the business community and academic commentators. In particular, the courts have been attacked for holding that the effect of "rejection" is to return the parties to the same position they were in before the contract was signed (although the injured party is allowed to sue for any resulting damages).

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[6] *See* Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 229 n.4 (1989).

[7] *See* In re Carrere, 64 B.R. 156, 160 (Bankr. C.D. Cal. 1986)

[8] *See* Westbrook, *supra* note 6, at 227-229.

[9] *Id.*

[10] Contracts are automatically deemed rejected in Chapter 7 liquidation proceedings unless the trustee seeks permission to assume the contract within 60 days of the filing, even when the business is being sold as a going concern. 11 U.S.C. 365 (d)(1). In Chapter 11, where the trustee generally may assume or reject an executory contract any time before the confirmation of the plan, 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.

An example of this approach is found in Lubrizol Enters. Inc. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), in which the Fourth Circuit held that a technology licensor that had gone bankrupt could not only breach its continuing obligations under the license agreement -- but cancel the license altogether, thereby forcing the licensee to give up its rights to the technology under the license.

The furor caused by Lubrizol led Congress to amend Section 365 to clarify that rejection of a technology license does not cancel the license - but means only that the estate is released from performing any further obligations under the agreement. Unfortunately, Congress has not yet clarified the effect of rejection in a number of other contexts, including ordinary personal property leases and copyright agreements. As a result, much of the jurisprudence under Section 365 continues to be controversial.

However, there is apparently little controversy over the principle underlying Section 365 -- that a damage claim resulting from rejection is treated as just another prebankruptcy unsecured claim against the debtor. That principle -- which has been embodied in U.S. bankruptcy law since long before Section 365 was enacted[11] and governs the treatment of executory contracts in other bankruptcy systems as well [12] -- is broadly supported by both traditional scholars as

[11] In the U.S., the rule originated in case law and was first codified in Sections 63c and 70b of the Bankruptcy Act of 1938. For a history of the rule's development from 19th century English law, *see* Michael Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, U. COLO. L. REV. 845, 856-883 (1988).

[12] *See* generally INTERNATIONAL CORPORATE INSOLVENCY LAW, (Campbell, ed. 1992); EUROPEAN CORPORATE INSOLVENCY, (Rajak et. al., eds. 1995).

well as bankruptcy commentators writing from an economic perspective.[13] The most commonly given justification for the ratable damages (RD) rule is that it implements the important bankruptcy principle of equality. That is, it is proper to treat a damage claim arising from rejection no better or worse than any other general unsecured claim against the debtor.[14]

However, the U.S. bankruptcy literature appears to have overlooked an important point: that the treatment of a rejection claim may influence the trustee's decision whether to reject or to seek performance of the contract in the first instance.[15] That decision, in turn, may determine whether the resources of the bankruptcy estate and the other party to the contract are allocated to their best use. Thus, the treatment of the party at the other end of the executory contract may more than affect that party's relative share of the bankruptcy estate ("the bankruptcy pie"); it may also affect the *total* value available to the other party and the debtor's creditors ("the total pie").

As this paper demonstrates, the RD rule fails to align the trustee's incentive to maximize the size of the bankruptcy pie with the larger goal of maximizing the size of the total pie. In particular, the analysis shows that the rule sometimes provides the bankruptcy trustee with an incentive to reject executory contracts when performance would increase the total value available

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[13] *See, e.g.*, Andrew, *supra* note 11, at 856-878 (1988); DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 119 (1993); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 108-109 (1986); Westbrook, *supra* note 6, at 252-3.

[14] However, the effect of assumption under the RD rule is to give the other party to the executory contract the full benefit of its bargain even though unsecured creditors are paid only a fraction of their claims. Thus the RD rule would appear to violate the principle of equality with respect to the treatment of assumed contracts.

[15] To my knowledge, the only other commentator who has recognized this problem is Triantis, *supra* note x.

to the estate and the other party. This distortion arises because the RD rule does not force the estate to internalize the full cost of rejection imposed on the other party to the contract. As a result, the trustee sometimes has an incentive to reject when performance would make the estate worse off but make the other party better off by an even greater amount -- that is when performance would increase the size of the total pie.

After analyzing the RD rule, the paper considers the current controversy over the judicial application of Section 365. The analysis indicates that the distortion in favor of rejection is exacerbated by the manner in which courts currently interpret and apply Section 365. The paper also demonstrates that, in applying Section 365, courts may prevent bankruptcy estates from assuming and performing value-creating contracts. The paper shows that there is even less value-creating performance under Section 365 as currently applied than there would be under an ordinary RD rule.

The paper also takes a preliminary look at four arrangements that might be able to reduce the problem of value-wasting rejection identified in the paper. Under the first arrangement, the other party could move to have the bankruptcy court bar the trustee from rejecting a value-creating contract. This judicial-intervention approach builds on the existing but rarely-applied "balancing test" doctrine, under which a court may prevent rejection if the resulting harm to the nonbankrupt party is disproportionately greater than the benefit to the estate.

An alternative approach is to replace the RD rule with a rule that gives the bankruptcy trustee complete discretion to assume or reject, but aligns the trustee's goal of increasing the size of the bankruptcy pie with the goal of total wealth maximization. Here I consider three such arrangements. Each adjusts the contract price in favor of the bankruptcy estate by a different amount. Each of the rules also ensures that the estate's cost of performance and cost of rejection are such that the estate would be required to internalize fully the cost of rejection on the other party.

In addition to identifying various alternative arrangements to the RD rule, the analysis seeks to identify the drawbacks and additional advantages of these arrangements relative to the RD rule. Among other things, I seek to examine some of the institutional and informational problems that might be involved in implementing these arrangements. In particular, I consider how frequently the courts might be required to become involved in valuation disputes and what information they would need to resolve those disputes. I also identify and compare the distributional effects of the alternative arrangements from an *ex post* perspective.

Most of the paper focuses on the operation and effects of the RD rule and the four alternative rules once the debtor is already in bankruptcy. However, the treatment of executory contracts in bankruptcy also affects the parties' behavior prior to bankruptcy (a point that has also been largely overlooked by bankruptcy commentators). The last part of the paper identifies and briefly consider some of these *ex ante* effects. In particular, the paper examines the effect of the perform/reject rule in bankruptcy on (1) the incentive to file for bankruptcy; (2) performance decisions prior to bankruptcy; and (3) initial contract pricing. These effects also must be considered in determining the optimal treatment of executory contracts in bankruptcy.

I want to emphasize that the aim of the paper is not to advocate that the RD rule should be replaced. As the analysis will show, none of the alternatives considered is problem-free. The main contributions that the paper seeks to make are (1) to identify a problem with the RD rule that has not been generally recognized and should be taken into account in determining the proper treatment of executory contracts in bankruptcy; (2) to show that the manner in which U.S. courts apply the RD rule worsens the problem; (3) to offer for consideration various arrangements for solving the problem of excessive rejection; and (4) to conduct a preliminary investigation of the potential costs and benefits of these arrangements.

The paper is organized as follows: Part II describes the principle of ratable damages that is embodied in Section 365 of the U.S. Bankruptcy Code. Part III explains how the RD rule creates incentives for the bankruptcy trustee to reject certain executory contracts when performance would increase the amount of value available to all of the participants in the bankruptcy. Part IV uses the paper's analytical framework to examine the current controversy surrounding Section 365. Part V describes and analyzes four possible arrangements for reducing the problem of excessive rejection under the RD rule. Part VI considers how the treatment of executory contracts in bankruptcy affects parties' *ex ante* behavior. Part VII provides concluding remarks.

II. The Ratable Damages Rule 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, 11 U.S.C. 365(a) provides that "the [bankruptcy] trustee, subject to the court's approval, may assume or reject an executory contract ... of the debtor."[16]

If the trustee "assumes" the contract, Section 365 binds the bankruptcy estate to the contract, permitting it to seek performance from the other party under its original terms.[17] 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.[18] 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.[19] The rejection "constitutes a [prepetition] breach" and the injured party's

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[16] The last clause of Section 365(a) reads: "may assume or reject an executory contract *or unexpired lease (italics added)* of the debtor." 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. The paper uses the term "executory contract" to include an "unexpired lease."

[17] If there has been a default under the contract, the estate may not assume the contract unless it provides adequate assurance that it 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. 11 U.S.C. 365(b). Certain types of contracts, including financial accommodation contracts, may not be assumed by the estate. 11 U.S.C. 365(c).

[18] *See* 11 U.S.C. 507(a)(1); Westbrook, *supra* note 6, at 232.

[19] *See* 11 U.S.C. 502(g). Certain provisions may limit the amount of damages the nonbankrupt party can claim. *See* 11 U.S.C. 502(a)(6)-(7) (capping damages for claims by real property lessors and employees under an employment contract).

damage claim is treated pari passu with other prebankruptcy general unsecured claims against the debtor.[20] 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 claim of the party injured by rejection is paid much less than 100 cents on the dollar.[21] The RD rule thus permits the estate to benefit from the debtor's valuable contracts while reducing the loss associated with any contracts that are burdensome. Under the business judgment rule, the trustee is generally given discretion to decide which course of action -- assumption or rejection -- best serves the estate.[22]

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[20] *See* 11 U.S.C. 365(g)(1); 11 U.S.C. 502(g).

[21] *See supra* note 5.

[22] In certain cases, the trustee may have a third choice: assignment of the executory contract to a third party. 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* 11 U.S.C. 365(f), (k). This treatment is in contrast to 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.

I analyze the incentives created by the no-damages ("ND") assignment rule elsewhere. *See* Fried, "Assignment Under Contract and Bankruptcy Law" (Harvard Law School, mimeo). There I show that the ND assignment rule somewhat mitigates the problem of value-wasting rejection identified in this paper, but gives rise to the problem of excessive assignment. However, since the ND assignment rule under Section 365 does not alter the main results of this paper, I abstract here from the possibility of assignment in order to focus on the choice between rejection and performance.

If the trustee does not seek to assume, assign, or reject a contract, there are a number of possible outcomes for the contract. In a Chapter 7 liquidation, executory contracts are deemed rejected after a certain period of time elapses. *See* 11 U.S.C. 365(d)(1), (4). If the bankruptcy trustee does not assume or reject the contract in a successful Chapter 11 reorganization, there is a split of opinion as to the fate of the contract. Some courts have held that if the debtor emerges from bankruptcy, the contract will "rides through" bankruptcy unaffected and continues to bind the debtor. *See, e.g.*, In re Parkwood Realty Corp., 157 B.R. 687, 690 (Bankr. W.D. Wash. 1993).

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 to Firm's general unsecured creditors 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.[23] Thus, outside of bankruptcy, Firm would have a choice between (1) paying $100 for the factory and (2) breaching and paying Builder $40 ($100-$60) -- 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 30 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 at reduced cost to the estate frequently makes rejection an attractive option. Bankruptcy trustees have used (or attempted to

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[23] *See infra* Section III.B.

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);[24] cancel a metal coating technology license (so that the debtor licensor could enter into a more favorable arrangement with another party);[25] escape from an expensive lease of retail space;[26] rescind a purchase and sale agreement requiring the debtor to sell a $2.4 million property for $1.9 million;[27] undo an out-of-court settlement agreement barring the debtor from future litigation;[28] escape a provision in a franchise that barred the debtor from competing with the franchisor;[29] avoid a requirement in a shareholder agreement that the debtor-shareholder offer to sell his shares to the company at a low, fixed price;[30] cancel a multi-year, multi-million dollar employment contract with the debtor's general counsel;[31] and void a partnership dissolution agreement barring the debtor accountant from providing services to former clients of the partnership.[32]

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[24] *See* In re Petur U.S.A. Instrument Co., Inc., 35 B.R. 561 (Bankr. W.D. Wash. 1983)

[25] *See* Lubrizol Enterprises, Inc. v. In re Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).

[26] *See* In the Matter of Federated Department Stores, Inc. and Allied Stores Corporation, et. al., 131 B.R. 808 (Bankr. S.D.Ohio 1991)

[27] *See* In re Florence Chi-Feng Huang, 23 B.R. 798 (Bankr. 9th Cir. 1982).

[28] *See* In re Walnut Associates, 145 B.R. 489 (Bankr. E.D.Pa. 1992)

[29] *See* In re Rovine Corp., 6 B.R. 661 (Bankr. W.D. Tenn. 1980).

[30] *See* In Re Parkwood Realty Corp., 157 B.R. 687 (Bankr. W.D. Wash. 1993).

[31] *See* In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

[32] *See* In re Lewis P. Silver, 26 B.R. 526 (Bank. E.D. Penn. 1983)

B. Support for the Ratable Damages Rule

As we will see in Part IV, there is considerable controversy over how Section 365 should be interpreted and applied in certain cases.[33] However, there is a widespread consensus that the RD rule underlying Section 365 is itself desirable. Congress and the courts typically justify the rule on the ground that it assists in the rehabilitation of the debtor[34] and serves bankruptcy's goal of increasing the size 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.[35] Consider the view of Professor Thomas Jackson, a prominent bankruptcy scholar who has written extensively on bankruptcy from an economic perspective:

> "[Rejection under Section 365] appears at first glance to be simply a wealth transfer from [the other party to the contract] to Firm's other general creditors, with no effect on the group as a whole. Permitting the rejection nonetheless is proper in bankruptcy, because of the notion of relative values. [The other party to the contract] is just like the 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* [emphasis in the original] things among creditors when the liability represented

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[33] *See infra* Part IV.

[34] *See* In re Booth, 19 B.R. 53, 60 (Bankr. D. Utah 1982) ("Executory contracts should be handled to 'assist in the debtor's rehabilitation,'" citing H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 348 (1977), U.S. Code Cong. & Admin. News, p. 6304).

[35] *See, e.g.*, Baird, *supra* note 13, at 117; Jackson, *supra* note 13, at 9; Westbrook, *supra* note 6, at 252-3.

by the contract exceeds the value of the asset represented by the contract."[36]

However, commentators such as Professor Jackson have overlooked an important point: namely, that the treatment of the nonbankrupt party to the executory contract may affect whether the trustee decides to reject or perform in the first instance. That decision, in turn, 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 that is available to the estate and the other party. Thus, the treatment of the nonbankrupt party affects not only that party's relative share of the bankruptcy pie but also the size of the total pie available to all of the affected parties.[37] And, as the next Part explains, the RD rule sometimes gives the bankruptcy trustee an incentive to make decisions that reduce the size of that total pie.

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[36] *See* Jackson, *supra* note 13, at 108-109.

[37] The treatment of executory contracts in bankruptcy will also have efficiency consequences even before the debtor enters bankruptcy. *See infra* Part VI.

III. The Distorted Incentive Created by the Ratable Damages Rule

This Part will demonstrate that the RD rule underlying Section 365 gives the bankruptcy trustee an incentive to reject certain contracts that are value-creating. But before proceeding with the analysis, it will be useful to explore the concepts of value-creating and value-wasting performance, as well as consider parties' breach/performance incentives outside of bankruptcy under the expectation damages ("ED") rule. Readers who are familiar with these concepts may wish to proceed directly to Section III.C.

A. Value-Creating Performance

The analysis in Parts III-V (this and the subsequent two Parts) will focus on the incentive various rules give the trustee to perform or reject executory contracts once the debtor has filed for bankruptcy. As we will see later in the paper, however, the rule governing the treatment of executory contracts in bankruptcy will also affect many of the parties' decisions prior to bankruptcy, such as the decision whether to file for bankruptcy in the first place and the decision whether to perform or terminate the contract outside of bankruptcy. In Part VI, I examine how the various rules considered might affect the parties' decisions before bankruptcy. But at this stage I want to focus only on how the treatment of executory contracts affects the parties' behavior in bankruptcy.[38]

From this *ex post* perspective, a rule will be considered desirable to the extent that it

[38] For this reason, I want to defer consideration of other factors that may affect the trustee's performance decisions--such as the possible willingness of the other party to renegotiate the price, and reputational considerations--until Section III.D.

gives the trustee (and the other party to the contract) incentives to make performance decisions that, *as of the time these decisions are made*, increase the size of the total pie they share.[39] Performance enlarges the size of the pie whenever the party receiving performance values it more than it costs the other party to perform. The value created by performance is the difference between the value and the cost of performance to the two parties. Thus, the price of the contract is irrelevant for determining whether performance is value-increasing.[40] But the price of a value-increasing contract does determine how the value is shared: that is, whether performance (1) makes both parties better off or (2) increases one party's piece of the pie by more than it reduces the other's.

However, the fact that performance is desirable from a pie-maximizing perspective does not ensure that performance takes place. Performance occurs if, and only if, each party to the contract is better off performing than not performing. And whether each party is better off performing than not performing depends, in turn, on the consequence of each choice under the prevailing legal rule.

B. The Expectation Damages Rule Outside Bankruptcy

Outside of bankruptcy, general principles of contract law require that a party breaching

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[39] To focus the analysis, I assume 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.

[40] The payment of the contract price is merely a zero-sum transfer of money between the parties that has no effect on the size of the total pie they share.

a contract pay damages to make the other party as well off as under performance.[41] In other words, the breaching party must pay the nonbreaching party an amount that compensates the nonbreaching party fully for the loss of the profit or gain the nonbreaching party expected from performance. As is already familiar, this rule -- referred to as the "expectation damages" ("ED") rule -- generally discourages breach when performance is value-creating and encourages breach when performance is value-wasting.[42]

The reason the ED rule discourages the breach of value-creating contracts is as follows: By making the breaching party bear no less than the entire cost breach imposes on the other party, the ED rule forces the breaching party to internalize fully the cost of breach to the other party. Thus, a party will not have an incentive to breach when its gain from breach (its anticipated loss from performance that is avoided by breach) is less than the loss imposed on the other party (the other party's foregone gain from performance) -- that is, when performance increases the size of the total pie shared by both parties.

However, the ED rule tends to facilitate the breach of value-wasting contracts by not forcing the breaching party to bear more than the cost breach imposes on the other party. This encourages a party to breach any time its gain from breach (its anticipated loss from performance avoided by breach) is greater than the loss breach imposes on the other party (its foregone gain from performance) -- that is, any time performance reduces the size of the total

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[41] *See* generally Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988).

[42] *See, e.g.*, John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 2 (1977); RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW (4th ed. 1991), 117-126; Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980).

pie. The ED rule thus tends to give the parties an incentive to make desirable breach/performance decisions.[43] Readers unfamiliar with this point may wish to consider the following example before proceeding to Section III.C.

Suppose that Firm has agreed to pay $100 to Builder for construction of a factory that costs Builder $60 to build.[44] Builder therefore expects the contract to build a profit of $40. The ED rule thus requires Firm to pay Builder $40 if it breaches. Consider two cases.

First, suppose that Firm values the factory at $80. Since the contract price is $100 and Firm values the factory at only $80, it prefers not to go through with the contract, everything else equal. However, since breach would cost Firm $40 and performance reduces Firm's wealth by only $20 ($100-$80), the ED rule gives Firm an incentive to perform -- the desirable course of action because performance increases the size of the pie by $20 (the value of the factory to Firm less Builder's cost of performance $80-$60).

Now suppose that Firm values the factory at only $40. Firm prefers not to perform, everything else equal, since performance makes it worse off by $60 ($100-$40). Again, the ED rule requires that Firm pay Builder $40 in the event of breach. However, the ED rule now does not create an incentive to perform, making it more likely that Firm will breach -- the desirable

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[43] 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. Unless specified otherwise, the numerical examples assume for simplicity that each party knows the value and cost of performance.

[44] Although in the example $60 represents the cost to Builder of building the factory, it could also be conceptualized as the opportunity cost to Builder of building the factory for Firm rather than using its assets for another project (i.e., the price that another customer would be willing to pay for a building constructed with the assets used to make the factory). Similarly, the value placed on performance by Firm can be understood either as the value the factory is expected to generate or the cost of having another builder construct the factory.

result since performance would reduce the size of the total pie by $20 (the difference between the cost of performance, $60, and the value of performance to Firm, $40).

C. Distorted Performance Incentives under the Ratable Damages Rule

Let us now turn to examine the performance incentives created by the RD rule. As we saw, the RD rule gives the bankruptcy trustee a choice between (1) performing an executory contract according to its original terms and (2) rejecting and paying less than 100% of any resulting damage claim. This section will demonstrate that the ability of a bankruptcy trustee to reject without fully compensating the other party may give the bankruptcy trustee an incentive to reject contracts that are value-creating. The reason is that since the estate need not fully internalize the loss rejection imposes on the other party, the trustee may have an incentive to reject even if the estate's gain from rejection 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.

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 will cost Builder $60. However, before the factory is built or payment is made, Firm enters bankruptcy.[45] Assume that the payout rate

[45] 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 throughout that the party in bankruptcy is insolvent (liabilities exceed assets) and the party outside bankruptcy is solvent. Although a debtor need not be insolvent to enter bankruptcy, application of the RD rule when the party in bankruptcy is solvent is no different than to unsecured creditors is expected to be 30 cents on the dollar. 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 claim -- $12.

Suppose that Firm's estate values performance at $80. Performance makes the estate worse off by $20 (the contract price, $100 - $80, the value placed on the factory by the estate). Since rejection costs the estate only $12, the estate has an incentive to reject the contract, which would be an undesirable result since performance creates $20 of value (Firm's value of $80 less Builder's cost of $60). Indeed, Firm's bankruptcy trustee does not have an incentive to perform as long as the estate values performance at less than $88 -- that is, even if performance increases the size of the pie by as much as $28 ($88-$60).[46]

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

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the application of the ED rule when the party is solvent and outside bankruptcy: every claim against a solvent debtor in bankruptcy would also, in principle, be paid in full. Thus, if the bankrupt party is solvent, application of the RD rule would require that party to pay full damages for rejection -- the same result as under the ED rule.

[46] The cost of rejection is $12; thus the estate has an incentive to perform as long as performance either (1) reduces the value of the estate by less than $12 or (2) increases the value of the estate (i.e., the estate values performance at more than the contract price of $100). Since the contract price is $100, performance makes it worse off by $12 when the estate values the factory at $88. If the estate values the factory at more than $88, the trustee has an incentive to seek performance of the factory contract.

more attractive rejection becomes. Although the payout rate for unsecured creditors in Chapter 11 bankruptcy is on average 30%,[47] 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%.[48] In such cases, trustees have a very strong incentive to reject unfavorable contracts, even if performance substantially increases the size of the pie.

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 and that performance would generate a benefit of $40 for Builder. However, now the payout rate for unsecured claims is 5% rather than 30%. The expected cost of rejection to Firm's estate is thus now 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 values performance as high as $98 -- that is, even if performance increases the size of the pie by as much as $38. By contrast, we saw in the previous example that at a payout rate of 30% the trustee has an incentive to perform if it values performance more than $88.[49] Thus the number of value-creating contracts rejected -- and the average value lost when those contracts are rejected -- increase as the payout rate for general unsecured claims declines.

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[47] *See supra* note 5.

[48] *See supra* note 5.

[49] *See supra* note 45 and accompanying text.

D. A Note on the Significance of the Problem

We just saw that the RD rule distorts the trustee's performance incentives in favor of rejection. However, the RD rule only provides an *incentive* for the trustee to reject certain value-creating contracts that 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.[50] This observation has led a number of commentators to take the position that renegotiation may be able to ensure that a value-creating contract will be performed regardless of the legal rule in effect. It therefore might be argued that it does not matter whether the RD rule or some other rule governs the treatment of executory contracts in bankruptcy -- the outcome will be the same in any event.

In essence, this renegotiation point is simply an application of the Coase Theorem which states that -- absent transaction costs -- parties will contract around any inefficient legal rule to reach a value-creating result.[51] In an imaginary world with no transaction costs and perfect

[50] *See* Craswell, *supra* note 41, at 638-640 and sources cited there.

[51] *See* Craswell, *supra* note 41, at 635.

information, it is clear that renegotiation would eliminate the problem of excessive rejection. The important question is how often renegotiation can avoid value-wasting rejection in the real world, where there are transaction costs and informational imperfections. In the nonbankruptcy context, it is believed that there are many cases where transaction costs or strategic behavior by the parties make successful renegotiation impossible.[52]

In bankruptcy, there are likely to be even more cases where renegotiation is unable to succeed. Four factors that may make renegotiation especially difficult in bankruptcy are (1) the existence of more severe time constraints; (2) uncertainty over whether the debtor will survive, which might make it difficult for the estate to make credible commitments to the other party; (3) the fact that control of the company in bankruptcy is diffused among a number of parties with different objectives; and (4) assuming that the debtor is able to emerge from bankruptcy, uncertainty over which party will take control of the emerging business. Each of these factors will be explored in turn.

First, the trustee might be required to decide the disposition of tens (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 debtor to enter into negotiations with many of these parties. The trustee's inability to renegotiate contracts is likely to be exacerbated to the extent the values of the contracts are interdependent; in such a case, the failure to successfully renegotiate one contract may require it to reject many others as well.

Second, the other party may be reluctant to contract with a bankrupt debtor, particularly

[52] *See, e.g.*, Charles J. Goetz and Robert E. Scott, *The Mitigation Principle: Towards a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983).

if it underestimates the debtor's probability of survival. For example, suppose that the contract calls for the bankrupt debtor to provide services over a period of time and requires that the nonbankrupt party make a contract-specific investment. Suppose further that the bankrupt debtor has an 80% chance of survival and (on that assumption) the contract creates a surplus that can be shared by the two parties. If the other party believes that the debtor has only a 50% chance of emerging from bankruptcy, then it may believe that it is simply not worth renegotiating contract, and instead find a supplier whose survivability is less in doubt.

Third, during the bankruptcy proceeding there is no one party that has complete, continuous control of the bankrupt debtor. During the proceeding, power is shared among various parties whose interests can be conflicting. Although the trustee (or debtor's managers) is generally free to make routine business decisions, the trustee's more important decisions may be challenged by parties which believe that their interests are adversely affected. Management turnover in bankruptcy is also very high. Thus the trustee (or the debtor's managers) has less authority in negotiating with an outside party than does a CEO outside of bankruptcy, which may reduce the other party's incentive to enter into renegotiations in the first instance.

Finally, many executory contracts are 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, parties with executory contracts with the debtor can identify the party with which they should negotiate: the party behind the proposed plan. However, there are often multiple, competing plans. When it is not clear whose plan will ultimately prevail, the nonbankrupt parties' incentive to renegotiate with any particular plan proposer is further reduced.

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

However, there are likely to be many cases in which a contract that is value-creating when 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 change. The debtor may have dropped 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.

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. 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 significantly enlarge the size of the pie but make the bankrupt firm worse off.

However, there are three reasons why reputational concerns are unlikely to deter a bankruptcy trustee from rejecting unfavorable 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.[53] But in practice it is very difficult for those outside the bankrupt firm to determine whether a particular contract is value-creating or value-wasting. This distinction turns on the value the firm attaches to performance, which only those controlling the firm are likely to know.

In addition, 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 contract is insignificant.

Finally, except for large publicly trade companies, most firms entering bankruptcy end up being liquidated or sold to new owners. Over 70% of firms entering bankruptcy file under the liquidation provisions of Chapter 7,[54] 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 Chapter 7 proceeding -- face no reputational constraints. Of the remaining 30% that enter bankruptcy through Chapter 11 -- i.e., the firms most likely to care about their reputation -- a majority are either liquidated or sold to new owners before a plan is confirmed.[55]

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[53] 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 size of the pie shared by both parties.

[54] *See* 1995 BANKRUPTCY YEARBOOK AND ALMANAC 8.

[55] *See* Lynn M. Lopucki, *The Debtor in Full Control--Systems Failure under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKRUPTCY L. J. 99, 107 (1983); In re Petur U.S.A. Instrument Co., Inc., 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).

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 benefit from this investment. Thus, even if other parties could determine that a particular rejection decision is value-wasting, the expected reputational benefit from performance is likely to be too low to influence the trustee's decision.[56]

3. Opting Out of the RD Rule with Security Interests

I have argued that *ex post* renegotiation and reputational considerations are unlikely to 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 security interest in the debtor's assets before the debtor files for bankruptcy, the security interest gives any rejection claim priority in the underlying collateral over all other claims. Since any rejection claim must be paid in full (or up to the value of the collateral), the debtor's estate must internalize more (if not all) of the cost of rejection to the nonbankrupt party,

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[56] It should be noted that even if those running the bankrupt firm are inclined to perform an unfavorable contract in order to preserve the business' reputation, they might well be challenged by unsecured creditors, who would be opposed to their reducing the tangible value of the estate in order to obtain an intangible future benefit. *See* ELIZABETH WARREN & JAY L. 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.")

giving it a greater incentive to perform value-creating contracts. And, if the trustee does reject, the nonbankrupt party will receive more compensation than if it is unsecured. Thus one might believe that when rejection under the RD rule is expected to be costly to the contracting parties, the parties could take security interests in each other's assets to effectively "opt out" of the RD rule.

However, parties are generally unlikely to use security interests even if, in the event of bankruptcy, the RD rule would impose a significant cost on the parties. First, a firm is unlikely to 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 is sufficient collateral, the use of a security interest is costly: the security interest ties 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. There are also substantial transaction expenses associated with creating and maintaining a valid security interest.[57] These costs must be incurred by the parties whether or not either party enters bankruptcy.

By contrast, the cost of rejection by the other party is borne only if (1) that party enters bankruptcy while the contract is still executory; (2) that other party's bankruptcy estate is better off rejecting the contract than performing; and (3) the rejection causes a loss to the nonbankrupt party.[58] Since the probability that a typical firm will enter bankruptcy during the term of any

[57] *See* Lucian Arye Bebchuk and Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE. L. J. 857, 877 (1996).

[58] This assumes that the owners of the firm that is now in bankruptcy do not benefit from rejection--i.e., that all of the benefit from rejection under the RD rule flows to the firm's unsecured creditors. If that party does benefit from rejection (i.e., the firm's owners share in the bankruptcy pie), then the net loss imposed on the two parties by the RD rule is the damage sustained by the nonbankrupt party less the benefit received by the party whose firm is in

particular contract is usually very small -- the likelihood that all three of these conditions will be met is, for a typical firm, likely to be negligible. As a result, the expected cost of the RD rule in the typical transaction is likely to be very small.[59] Thus, even if rejection under the RD rule is very costly to the parties *when* it occurs, using security interests to contract around the RD rule will generally not be worthwhile.[60]

bankruptcy.

[59] If one of the contracting firms is financially distressed, the expected cost of the RD rule will of course be higher. Thus as a firm's financial problems mount, it is more likely to offer a security interest to parties with which it contracts.

[60] 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.

IV. The Current Controversy Over Section 365

Although there is a general consensus that the rule of ratable damages is desirable, there is considerable controversy over how Section 365 -- the provision embodying that rule in the U.S. Bankruptcy Code -- should be interpreted and applied. The dispute focuses on two issues: (1) the effect of "rejection" under Section 365 on the nonbankrupt party's rights under an executory contract; and (2) whether Section 365 permits a trustee to "assume" or "reject" a contract when performance is due from only one party.

Many judges apparently continue to believe that (1) the effect of rejection under Section 365 is to cancel the contract -- terminating all of the other party's rights under it; and that (2) a contract is not "executory" for purposes of Section 365 -- and therefore may not be "assumed" -- unless material performance is owed by both parties. As we will see, the courts' approach to interpreting applying Section 365, tends to further reduce the level of value-creating performance in bankruptcy.

A. The Meaning and Consequences of "Rejection"

1. The Controversy Over "Rejection"

Section 365 makes it clear that a party injured by the bankruptcy estate's rejection of an executory contract may sue for damages and that its damage claim is treated as a general unsecured claim.[61] However, there is considerable disagreement over the effect of rejection or the other party's rights under the contract. Some courts have held that rejection does not

[61] *See supra* Section II.A.

eliminate the other party's rights under the contract (e.g., a lessee's right to continue to use the property subject to the lease), but instead only relieves the debtor of its continuing obligations under the contract (e.g., a lessor's obligation to service the property leased under the contract). Others have held that rejection cancels the contract and puts the parties in the position they were in before the contract was assigned, except that the other party can sue for damages resulting from rejection (e.g., a lessee must return the leased property to the debtor-lessor, but can then sue for damages).

The consensus among leading bankruptcy commentators is that "rejection" has the same effect as "breach" outside of bankruptcy; that is, rejection means only that the estate declines to perform any more of the debtor's obligations under the contract.[62] On this view, the rejection of a contract under which the debtor leases and services a vehicle means only that the debtor's estate refuses to perform the debtor's servicing obligations under the contract; it does not mean that the lessee must return the leased vehicle before the lease would otherwise terminate.

An increasing number of courts are embracing the "rejection-as-breach" approach -- which has been strongly advocated by Professors Andrew and Westbrook.[63] However, a majority of federal circuit courts still believe that a bankruptcy estate's ability to "reject" a contract means that the estate may not only refuse to perform the debtor's outstanding obligations under the contract, but also may cancel or "avoid" the contract itself, terminating all

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[62] *See, e.g.*, Andrew, *supra* note 11, at 874-77; Baird, *supra* note 13, at 117-127; Jackson, *supra* note 13, at 108-113; Westbrook, *supra* note 6, at 280.

[63] *See, e.g.*, Drexel Burnham Lambert Group, Inc., 138 B.R. 687, 696-697 (Bankr. S.D.N.Y. 1992).

of the other party's rights under the contract. In the leading case of Lubrizol Enters. Inc. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), for example, the Fourth Circuit held that Section 365's "avoiding-power" rejection permitted a bankrupt licensor to cancel a technology license it had already granted to a licensee in order to enter into a more favorable arrangement with another party.

Decisions such as Lubrizol created so much turmoil in the business community that Congress was forced to respond by enacting a special amendment to Section 365 clarifying that rejection of a technology license does not affect the licensee's rights under the contract (except for its right to seek specific performance under certain circumstances).[64] However, this and similar amendments have not completely eliminated the ability of bankruptcy trustees to cancel contracts by rejecting them under Section 365.[65]

2. The Effect of the "Rejection-as-Cancellation" Approach

When the courts interpret "rejection" to mean "cancellation," the damage caused to the nonbankrupt party by rejection is at least as great as, and possibly much greater than, the damage caused by mere breach-- meaning the bankruptcy estate's refusal to perform its *future* obligations under the contract. As a result, the distortion in favor (and social cost) of value-wasting rejection under the Section 365 is greater when "rejection" is interpreted to mean "cancellation" rather than "breach".

To illustrate, suppose that "Licensor" licenses the exclusive rights to manufacture a

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[64] *See* 11 U.S.C. 365(n).

[65] *See* Westbrook, *supra* note 6, at 306-07.

computer chip to "Licensee," and agrees to provide technical support services to Licensee. Suppose further that the license is expected to generate profits of $120, $20 of which must be paid to Licensor as royalties. The license is worth $100 to Licensee. Assume that the service contract is worth $20 to the Licensee.

Licensor becomes insolvent and enters bankruptcy, where the expected payout rate for unsecured creditors is 30%. Suppose that the exclusive rights to manufacture the computer chip are worth $80 in the hands of Licensor, and that the cost of providing services to Licensee under the service contract is $10.

Under the "rejection-as-breach" approach, Licensor is permitted to reject the service contract -- i.e., refuse to perform its future obligations under the agreement. However, Licensor cannot rescind the license. Rejection of the service contract would give rise to a damage claim of $20 but, on our assumptions, save Licensor's bankruptcy estate $10. Since the expected payout rate for unsecured claims is only 30%, rejection enlarges the estate by $4 ($10-$6). The trustee thus has an incentive to reject the service contract -- an outcome that wastes $10.

Under the "rejection-as-cancellation" approach, Licensor may cancel the license. Such a move would lead to a damage claim of $100 that would ultimately cost the estate only $30. However, termination of the license agreement makes the estate better off by $80 (the value of the license in the hands of the Licensor) less $20 (the expected value of royalties foregone by the Licensor), or $60. The trustee has an incentive to cancel the license, a result that reduces the size of the pie by $40 ($120 - $80). Under the "rejection-as-cancellation" approach, the trustee has an incentive to rescind the entire agreement, leading to a loss $30 larger than under the "rejection-as-breach" approach.[66]

B. The Requirement of "Executoriness"

1. The Controversy Over "Executoriness"

Professors Andrew and Westbrook -- as well as other leading bankruptcy commentators -- believe that Section 365 applies to any unperformed contract that enters the bankruptcy estate. According to this approach, a debtor's bankruptcy estate may choose to reject or perform any contract that the debtor itself could have chosen to breach or perform if it were not in bankruptcy. On their view, there is no special bankruptcy policy in favor of "executoriness" that would justify applying Section 365 to some unperformed contracts but not to others.

The courts have taken a different a view. A majority of federal appeals courts consider the well-known definition of "executory contract" set out over twenty years ago by a leading bankruptcy scholar -- Professor Vern Countryman -- to be the exclusive definition of executory contract under Section 365.[67] According to Professor Countryman, a contract should be considered executory for purposes of 11 U.S.C. 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

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[66] In some cases, the trustee will choose not to reject if rejection is treated as a breach, but will choose to reject if rejection cancels the contract. If the cost of supplying services under the service contract is less than $6 (or the value of those services to the Licensee is greater than $33) Licensor's estate would not have an incentive to reject the service contract under the "rejection-as-breach" approach, but would have an incentive to reject the entire agreement under the "rejection-as-cancellation" approach.

[67] *See, e.g.*, Atlantic Richfield v. Herbert (In re Herbert), 886 F.2d 889, 893 (9th Cir. 1986).

material breach excusing the performance of the other."[68]

Since Countryman's definition of executory contract is one in which both sides owe material performance, some courts have held that a contract under which only one side owes performance is not "executory" for purposes of Section 365. Courts embracing this definition have denied bankruptcy trustees the right to "assume" a contract with respect to which one side has already rendered at least substantial performance or payment.[69]

2. The Effect of Requiring "Executoriness" for Assumption

As we will see, the consequence of applying the Countryman test (or any other) to deny the bankruptcy estate the right to assume a contract is that value-creating performance might not take place.

To illustrate, suppose Firm had paid Builder $10 for an option to purchase a factory for $100. Suppose further that the cost to Builder of constructing the factory would be $120 and the factory would be worth $150 to Firm's estate. Performance is therefore value-creating because it increases the size of the pie by $30 ($150-$120). However, a court applying the Countryman definition might conclude that an option held by the debtor at the time of filing is no longer "executory" because no performance is due on the part of the debtor, and therefore that the debtor's estate may not assume the option contract under Section 365. In this example, such a decision would prevent the performance of a value-increasing contract.

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[68] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1957).

[69] See, e.g., In re Continental Properties, Inc., 15 B.R. 732 (Bankr. D Hawaii 1981). When a trustee is not permitted to assume a contract, the effect generally is to terminate the contract. See id.

In fact, preventing the estate from assuming a contract under Section 365 is *never* desirable from the perspective of maximizing the size of the total pie. The reason for this is as follows: If the estate assumes the contract and seeks performance, the nonbankrupt party must perform or put the estate in the same position as performance (under the ED rule). Thus, if the estate seeks performance, the ED rule gives the other party an incentive to breach the contract if and only if it is value-wasting -- the desirable outcome. As a result, permitting the estate to assume the contract will *never* lead to value-wasting performance, and could lead to value-creating performance. Thus, prohibiting the estate from assuming a contract is not necessary to prevent undesirable performance while it may prevent value-creating performance. Consequently, barring the estate from assuming a contract under Section 365 for any reason tends to further reduce the amount of desirable performance in bankruptcy.[70]

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[70] If a court were to hold a contract not meeting the Countryman definition is not "executory," and therefore must be performed because it cannot be rejected, the efficiency consequences would depend on the particular case. If performance is value-creating, this approach leads to a desirable result. Otherwise it does not. Thus the overall effect of such an approach, unlike the use of the Countryman definition to deny assumption -- which is clearly undesirable, is ambiguous.

V. Possible Alternatives to the Ratable Damages Rule

A. Towards Encouraging Desirable Performance in Bankruptcy

This paper has shown that the ratable damages (RD) rule reduces the level of value-creating performance in bankruptcy, a problem that so far has been overlooked in the bankruptcy literature. The paper has also shown that the manner in which Section 365 is currently applied exacerbates this problem. I now consider several possible alternatives to the RD rule that are designed to eliminate the incentive for excessive rejection.

We saw that the ED rule gives a party an incentive to perform an unfavorable but value-creating contract by giving it a choice between performance under the contract's original terms or compensating *fully* the other party for breach. The problem with the RD rule is that it provides the trustee with the choice of performing under the contract's original terms or compensating *partially* the other party for rejection. The RD rule thus reduces the cost of nonperformance relative to the ED rule while keeping the cost of performance the same. By altering the balance between the cost of performance and the cost of nonperformance, the RD rule thus makes rejection -- on the margin -- relatively more attractive. This imbalance leads to the problem of excessive rejection.

One approach to solving the problem of excessive rejection, which I will explore, is to give the trustee permission to reject only when the contract is value-wasting. However, if the decision is to be left in the hands of the trustee, the only way to eliminate the distortion in favor of rejection is to restore the balance between the cost of performance and the cost of nonperformance that exists under the ED rule. Realigning the two costs requires either reducing the cost of performance or increasing the cost of rejection.

One straightforward solution would be to increase the cost of nonperformance to its level under the ED rule.[71] That is, the law could require the estate to pay damages in full upon rejection. 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 has an incentive to perform if and only if the contract is value-creating.

However, claims arising from a pre-bankruptcy breach would presumably still be subject to the RD rule, just like any other prebankruptcy unsecured claim. Thus a firm entering bankruptcy could easily circumvent the ED rule by breaching some time before it enters bankruptcy.[72] Furthermore, the bankruptcy estate may not always have sufficient assets to pay full damages. In those cases, the ED rule would not eliminate the distortion in favor of rejection. Thus there might be a number of practical problems with using the ED rule in bankruptcy.[73]

In any event, I will limit my attention to approaches that generally further two important

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[71] This is the solution offered by the only other commentator who has discussed the problem of excessive rejection. *See* Triantis, *supra* note x, at _____.

[72] In principle, one could adopt a reach-back rule under which claims arising from breaches in anticipation of bankruptcy are paid full damages. This would prevent debtors from circumventing the rule. But in practice it would be difficult to distinguish between breaches that were made in anticipation of bankruptcy and those that were not.

[73] There are other reasons why subjecting executory contracts to the ED rule might be undesirable. For example, giving the nondebtor party to the executory contract priority treatment in the event of either assumption or rejection may make it more likely that the debtor's shareholders and that party enter into a value-wasting contract (since more of the resulting loss will be borne by unsecured shareholders than under a rule -- such as the RD rule -- that makes the other party bear some of the loss in the event the debtor fails). For further elaboration of this idea, *see infra* Section VI.C.2.

purposes that are offered for Section 365 and, indeed, for the bankruptcy system as a whole -- to (1) enhance the value of the estate and (2) spread equitably the loss occasioned by the debtor's default. These are the purposes for bankruptcy that are given by Congress, the courts, and prominent bankruptcy commentators.[74] I will therefore confine my inquiry to rules that do not make the bankruptcy estate worse off than it is currently under Section 365, or at least not by much.

In investigating these rules, my aim is not to advocate any particular approach but rather to identify possible approaches to solving the problem of excessive rejection, and to begin exploring their relative costs and benefits. To this end, I examine two possible types of solutions to the problem of excessive rejection. The first type -- which I will examine in Section V.B -- is to require that the trustee obtain the court's permission for rejection. The court, in turn, would permit rejection -- and payment of ratable damages -- if and only if performance is value-wasting. Courts currently have -- but rarely exercise -- the discretion to prevent the estate from rejecting a contract under Section 365 (even if the court has recognized the contract as "executory" for purposes of the statute). Below I consider a doctrine that has been used by the courts to prevent rejection and show that it could in principle be slightly modified to prevent value-wasting rejection.

The other type of solution -- which I will explore in Sections V.C, D, and E -- involves leaving the performance decision with the trustee -- as is usually now done under Section 365. This type of solution would require designing a rule that gives the trustee the incentive to choose

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[74] *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U.CHI.L.REV. 775, 792 (1987); Westbrook, *supra* note 6, at 227.

the value-maximizing course of action. I explore three such rules. Each of these rules adjusts the contract price in favor of the bankruptcy estate. The first, the RD/Adjusted Price rule, retains the RD rule and adjusts the price to correct the resulting distortion in favor of rejection (Section V.C); the second, the ND/Adjusted Price rule, implements a rule of no damages and adjusts the price to eliminate the distortion that would otherwise result (Section V.D); and the third, the Modified Price/ED rule, adjusts the contract price in favor of the bankruptcy estate by a fixed percentage and requires the estate to pay expectation damages based on the modified price if it rejects the modified-price contract (Section V.E).

In principle, all four of the arrangements considered below produce the same desirable results when the proper information is available. But in practice the information necessary to adjudicate properly the types of disputes that come up under each of these arrangements may not be readily available. Thus I will pay attention to the informational requirements necessary to implement each rule. In particular, I will focus on two factors: (1) the number of situations under each rule in which a court might be asked to settle a valuation dispute; and (2) the type of information the court would need to settle a valuation dispute under each rule. As a very rough proxy for the frequency of valuation disputes, I assume that these disputes can arise whenever the performance price or the cost of rejection might depend on a disputable amount (i.e., the cost of performance to seller or the value of performance to the buyer).

In examining these informational problems, my baseline for comparison will be the RD rule. When the trustee is given complete discretion under the RD rule, the court might be asked to make a valuation decision only if either the trustee rejects or the nonbankrupt party breaches. If performance occurs or the parties mutually abandon the contract the court need not become involved in making a valuation decision. (For purposes of the informational requirements 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.) In the event of litigation following rejection or breach, the RD rule requires the court to determine either the cost or value of performance to the injured party.

In the analysis of these various arrangements I will also pay attention to the distributional effects of the rules *ex post*, that is, how the rules allocate value between the debtor's bankruptcy estate and the other party to the executory contract.[75] This is of concern because increasing the assets of the bankruptcy estate facilitates the debtor's reorganization, an important goal of bankruptcy law.[76] In this discussion, my baseline for comparison is the ED rule. Relative to the ED rule, the RD rule affects a transfer from the nonbankrupt party to the bankruptcy estate only when the trustee rejects[77] the contract.

[75] In this Part I limit my attention to the *ex post* distributional effects of the various rules considered. As we will see later in the paper, there are likely to be *ex ante* price adjustments when the debtor and the other party contract that at least partially compensate the other party for these *ex post* effects. *See infra* Section VI.C.

[76] *See supra* Part II.

[77] Again, I use "rejection" to refer to the case in which the trustee refuses to perform a contract that would make the other party better off.

B. Application of an Improved "Balancing Test"

1. Improving The "Balancing Test" Doctrine

Let us first consider how judicial intervention in the performance decision can in principle eliminate the problem of excessive rejection. Currently, the decision whether to assume or reject a contract that the court recognizes as "executory" is usually left to the trustee's business judgment.[78] This hands-off approach is generally supported by bankruptcy commentators, who believe that one of the important purposes of Section 365 -- maximizing the value of the estate and rehabilitating the debtor -- is best served by permitting the trustee to choose whichever course of action it thinks is in the best interest of the bankruptcy estate.[79]

However, in rare cases the courts do use their discretion to deny the trustee permission to reject an executory contract. One doctrine that is invoked to justify this intervention is the so-called "balancing test" doctrine. Under the "balancing test" doctrine, a bankruptcy estate is not permitted to reject an executory contract if the damage to the other party from rejection is disproportionately greater than the benefit to the estate. For example, in the case of In re Petur USA Instrument Co., 35 B.R. 561 (Bankr. W.D. Wash 1983), the bankruptcy trustee was not permitted to "reject" (which the court interpreted to mean "cancel," not merely "breach") a license agreement on the grounds that cancellation of the agreement would destroy the licensee's business while providing only speculative benefit to the estate's creditors.

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[78] *See, e.g.*, In re T.S. Indus., Inc., 117 B.R. 682 (Bankr. D. Utah 1990).

[79] *See, e.g.*, Andrew, *supra* note 11, at 895-96; Westbrook, *supra* note 6, at 249-51.

2. Effect on Performance Decisions

The "balancing test" doctrine, which is justified on grounds of "equity,"[80] actually serves as a (partial) efficiency test. When it is applied, it prevents the estate from rejecting when rejection is very value-wasting. As such, the "balancing test" *increases* the level of value-creating performance under Section 365, a benefit that has been overlooked by the commentators who have criticized this doctrine.[81]

As currently formulated, the "balancing test" doctrine applies only when the cost to the nonbankrupt party from the estate's rejection is greatly disproportionate to the benefit received by the estate. The "balancing test" doctrine currently can at best prevent only highly value-wasting rejection. When the rejection results in harm to the nonbankrupt party that is greater -- but not disproportionately greater -- than the benefit to the estate, the "balancing test" doctrine permits rejection of a value-creating contract.

However, this problem could be eliminated by requiring the court to deny the trustee permission to reject whenever the cost to the other party of rejection is even slightly greater than the benefit to the estate. Thus an improved "balancing test" rule could solve the problem of excessive rejection identified in the paper.[82]

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[80] *See* In re Petur USA Instrument Co., Inc., 35 B.R. 561, 564 (Bankr. W.D. Wash. 1983).

[81] *See, e.g.*, Andrew, *supra* note 11, at 898-99.

[82] The other doctrine invoked to prevent a bankruptcy estate from rejecting an executory contract is the "burdensome test" doctrine. Under the "burdensome test" doctrine, the trustee may not reject a contract unless performance would lead to an absolute reduction in the value of the estate. *See, e.g.*, In re Jackson Brewing Co., 567 F.2d 618 (5th Cir. 1978); In re Stable Mews Associates, Inc. 41 B.R. 594, 596 (Bankr. S.D.N.Y 1984) (collecting cases) That is, the bankruptcy estate may not reject an executory contract whose performance would increase the value of the estate in order to enter into another arrangement that would make the estate even

3. Informational Requirements and Distributional Effects

The informational requirements of an improved "balancing test" are greater than those under the RD rule. As under the RD rule, a court would be required to make a valuation decision only if the estate seeks to reject or the nonbankrupt party breaches. However, in those cases where the trustee seeks rejection, the court would need to learn the value of performance to *both* parties in order to compare the harm to the other party and the benefit to the estate. By contrast, under the RD rule the court needs to learn only the value placed on performance by the nonbankrupt party.

From a distributional perspective, the improved "balancing test" is worse for the bankruptcy estate than the RD rule. A court applying the improved "balancing test" will require the estate to perform unfavorable value-creating contracts that under the RD rule the estate would reject. Thus from both an informational and a (pro-debtor) distributional perspective the improved "balancing test" performs worse than the RD rule, even though in principle it avoids inefficient rejection. Let us now turn to consider the three price adjustment rules.

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better off.

Application of the "burdensome test" doctrine can lead to a desirable or undesirable result, depending on the situation. To see why this is the case, suppose that Firm has agreed to pay Builder $100 to build a factory; the factory would cost Builder $60 to construct; and that Firm would value the factory at $120. When Firm enters bankruptcy, neither party has yet performed. Shortly afterwards, Competitor appears, offering to construct an identical factory for Firm's estate for $40. Under the "burdensome" test a court would not permit Firm's estate to reject the contract with Builder in order to buy the cheaper factory, because performance of the Builder-Firm contract would not reduce the size of Firm's estate, but rather increase it by $20. This decision makes Builder $40 better off, but Firm's estate $60 worse off, thus reducing the size of the pie. But if Competitor is selling it for $80, not permitting rejection of the Builder-Firm contract increases the size of the joint pie by $20 (relative to rejection). Therefore, the "burdensome test" may prevent the rejection of both value-creating and value-wasting contracts.

C. The Ratable Damages/Adjusted Price Rule

1. The Operation of the RD/Adjusted Price Rule

The first price adjustment rule I consider is the ratable damages and adjusted price rule ("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.[83] That is, the estate must fully 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 we saw, a reduction in the cost of rejection coupled with no change in the cost of performance undesirably 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. However, the RD/Adjusted Price rule restores the balance between the cost of rejection and the cost of performance by making an offsetting adjustment to the contract price. The size of this adjustment is exactly equal to the size of the reduction in the cost of rejection -- no more and no less.[84]

To illustrate the operation of the RD/Adjusted Price rule, suppose again that Firm has

[83] *See supra* Section II.A.

[84] 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.

agreed to pay Builder $100 for construction of a factory that will cost Builder $60 to build. Assume that the expected payout rate to unsecured creditors is 30%. In the event of the estate's rejection, Builder would therefore have a damage claim of $40. However, under the principle of ratable damages the estate would be required to pay only 30% of the $40 damage claim -- $12. The cost of rejection to the estate is $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, or purchasing the factory for $72.

2. Effect on Performance Decisions

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).

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

Now, suppose that the estate values the factory at less than $60 -- and therefore that performance is value-wasting. In that case, performance at the price of $72 makes the estate worse off by more than $12. Since rejection costs only $12, the estate has an incentive to reject -- the right result.[85]

3. Informational Requirements and Distributional Effects

Under the RD/Adjusted Price rule, a court's involvement might be needed if there is (1) performance,[86] (2) rejection, or (3) breach by the other party. In the event of litigation the

[85] 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 Buyer for $100, and then Firm enters bankruptcy. Suppose further that the cost to Builder of building the factory would be $120; that Firm would value the factory at $150, and thus its expected gain from performance would be $50 ($150-$100). Finally, assume that the payout rate for unsecured claims is 30%.

Under the RD rule, the cost to Builder of rejection is $15 (30% of $50, Firm's expected profit); performance costs Builder $20 ($120-$100). Ratable damages reduces the cost of rejection $35 from $50 to $15. Under the RD rule, Builder thus has an incentive to reject even though the contract is value-creating.

Under the RD/Adjusted Price rule, the cost of rejection is also reduced $35 from $50 to $15. But the RD/Adjusted Price rule increases the price $35 to $135, so that performance now *benefits* Builder by $15 rather than costing it $20. Builder thus has an incentive to perform under the RD/ Adjusted Price rule -- the desirable outcome.

[86] If performance makes the nonbankrupt party worse off, then the hypothetical damages caused by the estate's rejection is zero. There would be no reduction to the estate's cost of rejection relative to the ED rule and, consequently, no adjustment made to the performance price under the RD/Adjusted Price rule. If both parties know that performance at the original price makes the nonbankrupt party worse off -- and therefore that performance would take place at the original contract price -- there would be no valuation dispute. However, the bankruptcy trustee may believe that the nonbankrupt party will be made better off at the original contract price, in which case under the rule it will have an incentive to challenge the nonbankrupt party's contention that its cost is above the contract price. Thus the court might become involved in a

court would need to determine the value or cost of performance to one of the parties.

The informational requirements are thus more burdensome than under the RD rule (where the court may need to intervene only when there is rejection or breach).[87] However, without further assumptions it is not possible to compare the informational requirements of the RD/Adjusted Price rule with those of the improved "balancing test" where a court might be asked to intervene whenever the bankruptcy estate seeks rejection (in which case it would need to determine the value and cost of performance) or the other party breaches (in which case the court might be required to determine the value of performance to the estate).

The distributional effect of the RD/Adjusted Price rule on the bankruptcy estate is more favorable than that of the RD rule (and therefore than that of the improved "balancing test" approach). Since 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), the total benefit to the estate from RD rejection is 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 performance under the original price makes the other party better off. The total benefit from performance more than offsets the

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valuation dispute even if ultimately the price is not adjusted.

[87] Note that the frequency of rejection is higher under the RD rule than under the RD/Adjusted Price rule because the value-wasting rejection that takes place under the former does not take place under the latter. However, in those cases where the trustee would have inefficiently rejected under the RD rule it will perform under the RD-Adjusted Price rule, requiring that the other party's cost or value of performance be determined. Thus, total informational costs will be higher under the RD/Adjusted Price rule.

reduction in the total benefits from rejection.[88]

4. A Note on Fairness

The RD/Adjusted Price rule might seem unfair to the nonbankrupt party relative to the RD rule and the improved "balancing test" approach because it transfers value from that party not only in the event of rejection but also sometimes when there is performance. This objection, which can be raised against any of the three price-adjustment rules presented, will be examined more closely later in the paper.[89] Nevertheless, it is worth pointing out here that the impact in bankruptcy of the RD/Adjusted Price rule on the nonbankrupt party is much more limited than it might appear. As we will see, relative to the RD rule the RD/Adjusted Price rule does nothing more than to reduce the profits that the nonbankrupt party would have made if the contract had been performed outside bankruptcy.

For example, suppose that Builder, the nonbankrupt party, expects to make a profit from performance, where that profit is the extent to 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 pays a smaller percentage of those damages. The RD rule therefore reduces the cost of rejection by a fraction of the Builder's profit, where

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[88] The reason for this is as follows: in those cases where the trustee has an incentive to reject a value-creating contract under the RD rule, the RD/Adjusted Price adjusts the price to provide an incentive for the trustee to perform the contract. Since in these cases the RD/Adjusted Price rule gives the trustee an incentive to perform, performance in these cases must make the estate better off than rejection. In those cases where rejection takes place under the RD rule but not the RD/Adjusted Price rule, the estate is better off under the latter rule. In addition, the RD/Adjusted Price rule gives the estate a larger share of the pie than the RD rule in some of the cases where performance occurs under both rules.

[89] *See infra* Section VI.C.

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 is reduced by that same fraction of the Builder's profit. Since that adjustment is less than 100% of the Builder's profit, the reduction in the contract price does not eliminate Builder's profit -- i.e., push the contract price below the cost of performance -- but merely reduces it. The RD/Adjusted Price rule never converts a contract that is profitable for Builder into one that causes a loss (in the usual *ex post* sense). Indeed, as long as the expected payout percentage for unsecured claims is positive, Builder will enjoy some positive fraction of its expected profit from performance under the RD/Adjusted Price rule.

Now suppose that Builder would not have profited from performance. In that case, Builder would not be entitled damages under the ED rule if Firm breaches. As a result, the RD rule cannot reduce the cost of nonperformance to Firm's estate. Accordingly, the RD/Adjusted Price rule does not adjust the price of performance in favor of Firm's estate. As a result, if Builder would not have profited from performance it is no worse off under the RD/Adjusted Price than it is under the RD rule (or, for that matter, under the ED rule outside of bankruptcy).[90]

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[90] 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 any expected profit under the contract. Suppose that the contract price is $100, and the expected payout rate to general unsecured creditors 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.)

D. The No-Damages/Adjusted Price Rule

1. The Operation of the 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 particular reason to limit consideration to rules that incorporate the principle of ratable damages. Suppose one favored a rule that sets damages in a way 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, etc.) that would accomplish this result. The simplest rule, however, would be the rule in which rejection damages are fixed at zero. This rule -- a no-damages ("ND") rule -- would simply bar the nonbankrupt party from receiving any rejection damages.

The ND rule is used in place of the RD rule in a number of other countries, including Italy and Australia.[91] The ND rule is also the *de facto* rule in the many U.S. bankruptcy cases that yield no payment to general unsecured creditors.[92]

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 is 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.

[91] The ND rule is used in Italy 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 12, at 393. In Australia the ND rule applies to all executory contracts of the debtor in bankruptcy. *See* INTERNATIONAL CORPORATE INSOLVENCY LAW, *supra* note 12, at 20.

[92] *See* Lopucki, *supra* note 5, at 311.

If damages are reduced to zero and there is no adjustment of the performance price, there will of course be excessive rejection. Indeed, the distortion will be even greater than under the RD rule (when general unsecured creditors would receive some value under the RD rule). Under the ND rule the bankruptcy estate has an incentive to reject any contract that makes it worse off, no matter how value-creating is performance. Thus there will be less value-creating performance under the ND rule than under the RD rule.[93] To correct the distortion, there must be an even greater offsetting price adjustment than under the RD/Adjusted Price rule. As we will see, the offsetting adjustment is one that reduces the contract price to the cost of performance.[94]

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 therefore reduces 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.[95]

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[93] 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 12, at 605. This automatic termination rule is equivalent to a bilateral ND rule, and thus creates twice as much incentive for value-wasting rejection as the ordinary ND rule.

[94] If the nonbankrupt party is accepting performance, the price is adjusted up to the value that party places on performance.

[95] To compare, under the same facts and assuming a 30% payout rate the RD/Adjusted Price rule would give the trustee the choice between paying $72 for the factory or $12 for rejection.

2. Effect on Performance Decisions

Let us now consider the incentives provided by the ND/Adjusted Price rule. Continuing with the preceding example, suppose that performance is value-creating -- i.e., that Firm's estate values the factory at more than \$60. In that case, purchasing the factory for \$60 will make the estate better off. On the other hand, rejection will the 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 is value-wasting -- i.e., that Firm's estate values the factory at less than \$60. In that case, purchasing the factory for \$60 will 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.

The ND/Adjusted Price rule works 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 adjustment in the cost of rejection. When the nonbankrupt party is the seller, reducing the contract price by the seller's expected profits has the effect of adjusting the contract price to the seller's break-even point -- its cost.

3. Informational Requirements and Distributional Effects

The informational requirements of the ND/Adjusted Price rule are exactly the same as those of the RD/Adjusted Price rule except that in the event of the estate's rejection of a contract the size of the damage claim need not be litigated.[96] In this respect the ND-Adjusted Price rule is superior to the RD/Adjusted Price rule.[97] However, without further assumptions it is not possible to know whether the ND/Adjusted Price rule requires more or less information to implement than the other rules.

From a distributional perspective, there is 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 is greater (except for those cases where the payout rate for unsecured claims is zero under the RD/Adjusted Rule and thus the rules are effectively the same). Thus the ND/Adjusted Price rule favors the estate more than any of the other rules examined so far. However, it should be emphasized that since the ND/Adjusted Price rule is simply an extreme version of the RD/Adjusted Price rule, it eliminates the profit the other party would have enjoyed under the original terms of the contract, but does not transfer value from the nonbankrupt party to the

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[96] This of course is also true for the simple ND rule. Thus, if in certain types of bankruptcy cases the expected payouts under the RD rule are expected to be only a few cents on the dollar, the ND rule -- which is already used in certain other countries, see *supra* Subsection V.D.1 -- might be preferable to the RD rule.

[97] It might appear that another advantage of the ND/Adjusted Price rule over the RD/Adjusted Price rule is that the adjusted performance price can be determined during the bankruptcy proceeding without knowing the payout rate for unsecured claims. However, the RD/Adjusted Price rule can be implemented even if at the time of performance there is uncertainty about the expected payout for unsecured claims. The reason is that when the price is adjusted under the RD/Adjusted Price rule, the price can be expressed as the cost (value) of performance plus (minus) the damage payment the nonbankrupt party would receive under the RD rule. Thus the price under the RD/Adjusted Price rule can be paid (charged) to the nonbankrupt party by compensating fully the nonbankrupt party for its costs (charging the nonbankrupt party a price equal to the value placed on performance) and giving the nonbankrupt party an unsecured claim for damages that is converted into cash at the end of the proceedings.

estate if the nonbankrupt party would have lost money under the original contract price.[98]

E. 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 the uncertainty that it would create about the performance price prior to bankruptcy. The third and final price adjustment rule considered -- the "Modified Price/Expectation Damages" ("Modified Price/ED") rule -- thus 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

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[98] If it is believed that the ND/Adjusted Price rule (or even the RD/Adjusted Price rule) is too favorable to the bankruptcy estate, one could implement a "Fractional Damages/Adjusted Price" ("FD/Adjusted Price") rule under which a party injured by rejection is either paid a fixed percentage of its rejection claim -- say 25% or 50% -- or performs at a price that is adjusted accordingly. Depending on the payout rate for unsecured claims and the fraction used in the FD/Adjusted Price rule, a nonbankrupt party might do better or worse under an FD/Adjusted Price rule than it would do under the RD rule. One could choose a fraction that is either higher or lower than the average payout rate for general unsecured claims. A higher fraction would, on average, lead to a smaller transfer to bankruptcy estates than the RD rule. A higher fraction would also increase the likelihood that the bankruptcy estate could not pay the required damages for breach. The FD/Adjusted Price rule would require the same amount of information as the RD/Adjusted Price rule to implement, and therefore more information than the ND/Adjusted Price rule.

could be the same for all contracts in all bankruptcy cases, or depend on the type of contract or case. The purpose of this preliminary analysis is not to determine how the adjustment percentage should be chosen or what it should be -- but rather to consider some of the consequences of a rule that adjusts the price in this manner. Thus for concreteness I will simply assume that the adjustment percentage is always 25%.

To illustrate the operation of a 25% Price Adjustment/ED rule, 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 is $60 and that Firm's estate values the factory at $80. Under the 25% Price Adjustment/ED rule, the price is reduced to $75 ($100-$75).

As we saw earlier, the parties would not have the proper performance incentives unless a party refusing to perform must make the other party as well off as under performance.[99] At the new "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 must pay Builder $15 (Builder would have a priority claim for $15) if it rejects the contract and Builder must pay Firm $5 if it breaches. In that case, 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 were in effect for both parties.

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[99]Each of the two previous 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 adjusted price of that rule.

2. Informational Requirements and Distributional Effects

Unlike under the RD/Adjusted Price and the ND/Adjusted Price rules, the performance price under the Modified Price/ED rule does not require that a valuation be made; it depends only on the original contract price and the adjustment percentage. Thus a court would not be asked to make a valuation determination in the case of performance. However, as under the ED and RD rules, such a determination might be necessary in the event of rejection by the estate or breach by the other party. In either case the court would need to determine only one disputable value (the cost of performance to the seller or the value of performance to the buyer), just as under the RD/Adjusted Price and ND/Adjusted Price rules.

At first glance, it would appear that the Modified Price/ED rule requires less court involvement than the RD/Adjusted Price rule. Under either rule, there are four possible outcomes: (1) performance; (2) rejection by the estate; (2) breach by the other party; or (4) mutual abandonment of the contract. Under the Modified Price/ED rule, judicial valuation might be necessary only in the event of rejection or breach, while under the RD/Adjusted Price rule, judicial valuation may be necessary in the event of rejection, breach, or performance.

However, it is not possible to determine whether the frequency of valuation decisions is higher or lower than under the RD/Adjusted Price rule. The reason for this is as follows: The Modified Price/ED rule will in certain cases turn a contract that is originally profitable for the nonbankrupt party into one that is not profitable; it will also turn a contract that is originally unprofitable for the bankrupt firm into one that is profitable. As a result, there may be fewer instances of mutual abandonment under the Modified Price/ED rule -- that is, fewer cases in which both parties would be made worse off by performance.[100] Both rules provide incentives to perform if and only if the contract is value-creating. Thus the frequency of performance should be the same under both rules. It follows that the combined frequency of breach and rejection may be higher under the Modified Price/ED rule than under the RD/Adjusted Price rule. Thus, while there are no performance valuation decisions under the Modified Price/ED rule, there may be more breach and rejection valuation decisions under that rule than under the RD/Adjusted Price rule. As a result, it is not possible to rank the two rules according to relative information requirements.

Let us now consider the distributional consequences of the Modified Price/ED rule relative to the other rules. The distributional effect of the Modified Price/ED rule relative to that of the other rules will of course depend on the price adjustment factor; the larger is the factor, the more the rule favors the debtor. However, two features of the rule are worth noting: First, in any given case, the Modified Price/ED rule might make the bankruptcy estate better off or worse off than any of the other rules (including the RD rule).[101] Second, the Modified

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[100] Under the RD/Adjusted Price rule and ND/Adjusted Price rule, mutual abandonment will occur under the same conditions as under the ED rule.

[101] To illustrate, suppose that the contract price is $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 is 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 makes the estate worse off than under the RD/Adjusted Price rule.

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

Price/ED rule benefits the estate (relative to the ED rule) in a wider variety of circumstances than any other rule. The RD/Adjusted Price and ND/Adjusted Price rules benefit the estate only when the other party would gain from performance under the original terms of the contract. By contrast, the estate is better off under the Modified Price/ED rule (relative to the ED rule) whenever there is performance, rejection, or unilateral breach by the other party, as well as in certain cases when the parties mutually abandon the contract.[102]

3. Another Note on Fairness

The RD/Adjusted Price and ND/Adjusted Price rules at most deprive the nonbankrupt party of its profits under the contract.[103] In contrast, the Modified Price/ED rule may turn a contract under which the nonbankrupt party expected to make a profit into a contract under which it suffers a loss. Thus the Modified Price/ED rule might appear even more vulnerable to a fairness objection than the other two rules. As we will see later in the paper, 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.[104] 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

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[102] For example, suppose that the original price is $100 and Builder's cost of construction is $120. Under the RD/Adjusted Price rule Builder does not suffer damages from rejection by Buyer's bankruptcy estate. Thus the adjustment to the performance price under the RD/Adjusted Price rule is zero. As a result, the RD/Adjusted Price rule does not make the estate better off than the ED 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 (relative to the ED rule) if performance occurs or if Buyer's estate sues Builder for breach.

[103] *See supra* Subsection V.C.4.

[104] *See infra* Section VI.

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 cost is generally still 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. In contrast, a party that has been promised $100 for a performance costing it $60 will recover 60 cents on the dollar if the estate pays its costs. The only difference between this party and a builder 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 to be paid at least 60 cents on the dollar while the party that has already performed is paid only 5 cents on the dollar.

F. Comparing the Alternative Arrangements

The aim of this Part has been to conduct a preliminary investigation of various alternatives to the RD rule. As we have seen, there are a number of different dimensions along which these alternatives can be compared.

First, each of the three price adjustment rules provides the trustee with desirable performance incentives. The fourth alternative, the "balancing test" approach, also yields desirable results when courts are able to measure the benefit to the estate and the harm to the other party from rejection. All four of the arrangements could -- in principle -- eliminate the distortion problem that this paper set out to address. (The Appendix provides a chart that uses numerical examples to compare the effect of each approach on the trustee's reject/performance decision.)

Second, the rules differ in the frequency with which courts might be called on to make valuation decisions. Under the RD rule, courts might be called on to make such determinations whenever the estate rejects or the nonbankrupt party breaches. The "balancing test" approach similarly might require such involvement whenever the estate seeks to reject or the other party breaches.[105] Under the RD/Adjusted Price rule, valuation decisions might be required when there is performance, rejection, or breach. The ND/Adjusted Price rule might require court valuation when there is performance or breach. The Modified Price/ED rule might require valuation when there is rejection or breach. The RD/Adjusted Price rule thus is likely to require more frequent court valuation decisions than the ND/Adjusted Price rule, the "balancing test" approach, or the RD rule. However, it is not possible to rank the Modified Price/ED rule against the other rules.[106]

Third, the arrangements differ in the amount of information that a court would require to make a valuation decision. The three price adjustment rules might require that a court determine only one of two disputable amounts (seller's cost, or the value placed on performance by the buyer). The "balancing test," however, requires that the court determine both amounts.

Fourth, the arrangements vary in the extent to which they transfer value to the bankruptcy estate. Without further assumptions it is not possible to determine how the Modified

[105] Note that under the "balancing test" approach the trustee may not seek rejection if it believes that the estate will ultimately be required to perform. Thus the frequency of court involvement may be somewhat lower under the "balancing test" rule than under the RD rule.

[106] *See supra* Subsection V.E.2.

Price/ED rule compares with the other arrangements. However, the distributional effects of the other arrangements can be ranked as follows, from most to least distributive: (1) the ND/Adjusted Price rule, (2) the RD/Adjusted Price rule, (3) the RD rule, and (4) the "balancing test" approach. The foregoing is summarized in Table A below, which assumes that the bankruptcy estate is contracted to receive performance from the other party.

Thus far, the evaluation of the rules -- and, indeed, the entire analysis that preceded it -- has focused on the effects of these rule on behavior after the bankruptcy filing. However, the treatment of executory contracts in bankruptcy will also affect the parties' decisions prior to bankruptcy. I consider some of these *ex ante* effects in the next Part.

TABLE A

vs.	Rule	Performance Efficiency [107]	Judicial Valuation May be Required	Info Required	Transfer to Debtor vs. RD Rule
A.	RD	Ineff. Rejection	Rejection	Cost	
B.	Balancing Test	Eff.	Debtor seeks Rejection	Cost and Value	Less
C.	RD/Adjusted Price	Eff.	Performance and Rejection	Cost	More
D.	ND/Adjusted Price	Eff.	Performance	Cost	More
E.	Modified Price/ED	Eff.	Rejection[108]	Cost	More or Less

[107] Assuming parties have good information.

[108] The total combined incidence of rejection and breach may be greater under the Modified Price/ED Rule than any of the other three alternative arrangements. *See supra* Subsection V.E.2.

VI. The Ex Ante Effects of the Treatment of Contracts in Bankruptcy

Until now we have focused on the effects *in* bankruptcy of different rules for governing the treatment executory contracts. The paper first showed that the currently-used RD rule gives the bankruptcy trustee an incentive to reject value-creating contracts. It then presented a number of alternative rule that would correct this distortion, considering the effect of each rule on the value of the bankruptcy estate and the information that would be required to implement each rule.

This Part now considers the effect of the treatment of executory contracts in bankruptcy on the parties' behavior *before* bankruptcy. I first look at the effect of the perform/reject rule on a party's incentive to enter bankruptcy (Section A). I also consider the effect of the bankruptcy rule on performance decisions in anticipation of bankruptcy (Section B). Next, I examine how the perform/reject rule in bankruptcy affects the initial price of the contract and consider the efficiency and fairness implications of this price effect (Section C). This Part concludes by considering two approaches for reducing the *ex ante* effects of changing the treatment of executory contracts in bankruptcy (in the event that such a reduction is deemed to be desirable).

It should be emphasized that this Part does not attempt to identify all of the possible *ex ante* effects of the perform/reject rule in bankruptcy. Nor does it aim to resolve fully the issues that are raised. Rather, this Part -- like the preceding Part -- seeks to identify and briefly explore some of the issues that must be considered in selecting the appropriate reject/perform rule.

A. The Incentive to File for Bankruptcy

In this section I consider the extent to which the reject/perform rule in effect is likely to affect a firm's decision to file for bankruptcy.

The frequency and strength of the incentive to file for bankruptcy will vary from rule to rule. For example, the RD rule gives a firm an incentive to file for bankruptcy only when it prefers not to perform a contract.[109] The RD/Adjusted Price creates the same incentives for filing as the RD rule when the firm would reject the contract. In addition, the RD/Adjusted Price rule provides an incentive for filing when the firm would prefer to perform the contract and the other party would profit from performance. The ND/Adjusted Price rule provides an incentive to file for bankruptcy in the same cases as the RD/Adjusted Price rule -- but the incentive is stronger.[110]

However, there are two reasons to believe that the reject/perform rule in effect is unlikely to significantly affect a firm's decision to file for bankruptcy. First, in order to transfer value from contracting parties, the firm entering bankruptcy must be considered insolvent by the court

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[109] If the firm would prefer performance over nonperformance in bankruptcy, the RD rule does not give the firm an incentive to enter bankruptcy.

[110] Under the "balancing test," a firm has the same incentive to file for bankruptcy as under the RD rule when rejection would be permitted (i.e., rejection is value-increasing). But relative to the RD rule the "balancing test" reduces a firm's incentive to enter bankruptcy in those cases where the "balancing test" would require the firm to perform an unfavorable but value-creating contract that the firm would be better off rejecting under the RD rule.

The Modified Price/ED rule provides an incentive to file for bankruptcy whenever there would be performance, breach, or rejection under the rule. It would also provide an incentive to file for bankruptcy when there would be mutual abandonment of the contract under the rule in bankruptcy, and the debtor would be forced to pay damages for breach outside of bankruptcy under the ED rule. The strength of the incentive would depend on the magnitude of the adjustment percentage.

when claims are paid at the end of the proceeding. Otherwise, the payout rate for unsecured claims will be 100% and the other party's damage claim will be paid in full. Thus any firm that is bankruptcy-solvent will not be able to take advantage of a price adjustment rule in bankruptcy.

Second, those who determine whether the firm files for bankruptcy -- the managers or owner-managers of the firm -- might not find it in their interest to have the firm file for bankruptcy. Bankruptcy proceedings increase the likelihood that these parties will lose control (and ownership) of the business. Those who must make the decision to file for bankruptcy will often be reluctant to do so (even when filing for bankruptcy would be in the best interest of the firm as a whole).[111] That is, the reject/perform rule will not cause a firm to file for bankruptcy unless these parties believe that they can benefit from filing and taking advantage of the rule (*e.g.*, when the reject/perform rule increases the chance of the business surviving so that those controlling can retain their jobs or some of their equity interest).

B. The Timing and Nature of Performance Decisions Before Bankruptcy

Until now we have considered the effect of the various reject/perform rules on performance decisions once the debtor has entered bankruptcy. But the treatment of executory contracts in bankruptcy will also affect performance decisions prior to bankruptcy, a point that has also been overlooked in the bankruptcy literature. This Section considers the effect of these rules on the following types of prebankruptcy performance decisions: (1) performance decisions that must be made prior to bankruptcy; (2) performance decisions that may be postponed until

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[111] *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 794-795 (1987); Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT. REV. L. & ECON. 223, 230-31 (1991).

bankruptcy; (3) and performance decisions that are made on the eve of bankruptcy with the intent of circumventing the rule in bankruptcy. These prebankruptcy performance effects must also be taken into account in choosing the optimal treatment of executory contracts in bankruptcy.

The focus of this Section will be on two issues: (1) the effect of each rule on the timing of the prebankruptcy decision; and (2) whether the rule distorts the choice between breach and performance outside of bankruptcy. To simplify the analysis, I assume that the managers of the firm making the performance decisions are interested in maximizing the assets of the firm and that performance and payment are exchanged in full simultaneously.

1. Performance Decisions that Must be Made Prior to Bankruptcy

Let us first examine the case in which payment or performance must be rendered at a time when both parties are outside of bankruptcy. Consider the choice facing a financially distressed firm that anticipates entering bankruptcy. If it renders payment or performance, it must be rendered in full.[112] But 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 does inside bankruptcy under the RD rule. But this problem arises under any regime where unsecured claims that arise *prebankruptcy* need not be paid in full --

[112] Recall that I am assuming that performance and payment are exchanged in full simultaneously.

that is, under *any* bankruptcy system. When performance decisions must be made prior to bankruptcy (and performance and payment are made in full simultaneously), none of the alternatives performs any better than the RD rule.[113]

2. Performance Decisions that May be Deferred Until Bankruptcy

Now let us consider a different situation: that in which the performance decision can be postponed to a point in time when the financially distressed firm is likely to be in bankruptcy. In these circumstances, the treatment of executory contracts in bankruptcy may have both delay and performance distortion effects. Consider the following three cases.

First, suppose that performance is value-wasting and makes the other party better off.[114] In that case, the financially distressed firm will breach or reject under any of the rules. However, the financially distressed firm will have an incentive to delay announcing its nonperformance decision when rejection costs less than breach. Rejection costs less than breach under the ND/Adjusted Price rule (and perhaps under the Modified Price/ED rule). Thus when performance is value-wasting the performance/nonperformance decision is not distorted under any of the considered rules. However, the ND/Adjusted Price rule (and perhaps the Modified Price/ED rule) provides the financially distressed with an incentive to delay the announcement

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[113] The other party's decisions will not be distorted under any of the considered rules.

[114] If performance is value-wasting and makes the other party *worse* off, performance may make the financially distressed firm either better or worse off. If performance makes the financially distressed Firm better off, the other party will breach the contract; otherwise both parties will abandon it. In the first case the other party will have no incentive to delay its breach decision (but may have an incentive to accelerate it under the Modified Price/ED rule) in order to have damages calculated at the original price, rather than at a price that is adjusted in favor of the financially distressed firm.

until bankruptcy.

In the second case, suppose that performance is value-creating and the financially distressed firm is better off performing than rejecting under the RD rule (and thus under all of the other rules as well). In that case, the financially distressed firm will perform under all of the rules -- the desirable result. However, the firm will have an incentive to delay performance until bankruptcy if the reject/perform rule in bankruptcy adjusts the price of performance in its favor. The Modified Price/ED rule always creates such an adjustment and the RD/Adjusted Price and ND/Adjusted Price rules sometimes do so (when performance under the original contract price benefits the other party). Thus when performance is value-creating and the financially distressed firm would perform rather reject under the RD rule, it has an incentive to delay performance until bankruptcy under the Modified Price/ED rule and perhaps under the RD/Adjusted Price and ND/Adjusted Price rules.

In the third case, suppose that performance is value-creating but that the financially distressed firm would be better off rejecting than performing under the RD rule. Under the RD rule, the firm will have no incentive to delay the performance decision until bankruptcy because the choice it faces in bankruptcy is the same it faces outside bankruptcy. Under the "balancing test" rule, the firm will not have an incentive to delay the performance decision, because it faces worse treatment in bankruptcy. Thus in the third case the RD and "balancing test" rules do not affect the timing or nature of the performance decision: the financially distressed firm breach outside of bankruptcy. Now consider the remaining three rules. Under the RD/Adjusted Price and ND/Adjusted Price rules, the financially distressed firm will be better off performing under those rules than rejecting under the RD rule. Thus under these two rules the firm will have an incentive to delay the performance decision until bankruptcy and then choose the value-maximizing course of action. The consequences of the Modified Price/ED rule here depend on the adjustment factor. If the adjustment factor is large enough, the Modified Price/ED rule will have the same effect as the RD/Adjusted Price and ND/Adjusted Price rules. Otherwise, the financially distressed firm will not delay the performance decision and breach outside bankruptcy.[115]

3. Performance Decisions on the Eve of Bankruptcy

The third effect of perform/reject rules to consider is that of the eve-of-bankruptcy behavior by the parties. As we will see, some of the rules may cause one party or the other to accelerate a performance decision that would otherwise be made after bankruptcy (and perhaps thereby prevent a value-creating contract from being performed). For this discussion, I assume that a party cannot unilaterally choose that performance occur on the eve of bankruptcy. Thus, I assume all such decisions are unilateral decisions to breach.

Under the RD, RD/Adjusted Price, and ND/Adjusted Price rules, neither the financially distressed firm nor the other party has an incentive to breach on the eve of bankruptcy to circumvent the bankruptcy rule. Under the "balancing test" rule, the financially distressed firm will have an incentive to breach before bankruptcy when performance is value-creating. Under the Modified Price/ED rule, one party or the other may benefit from breaching right before bankruptcy. A contract breached on the eve-of-bankruptcy breach by either party may or may

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[115] The other party will never have an incentive to postpone its performance decision until the distressed firm's bankruptcy.

not be value-creating.

4. Comparing the Alternative Arrangements

We have seen that when performance decisions are made when both parties are outside of bankruptcy, the RD rule creates the same incentives as all of the other rules. Thus for purposes of comparison we need to look at, with respect to each rule, (1) whether the rule gives the financially distressed firm an incentive to delay the performance decision until bankruptcy; (2) whether the rule thereby reduces the prebankruptcy breach of value-creating contracts; (3) whether the rule gives either party an incentive to breach before bankruptcy; and (4) whether the rule thereby may increase the prebankruptcy breach of value-creating contracts.

The baseline for comparison will be the RD rule. The RD rule provides neither an incentive to delay the performance decision until bankruptcy, nor an incentive to accelerate breach prior to bankruptcy.

The "balancing test" rule does not provide an incentive to delay the performance decision until bankruptcy. But it does provide an incentive to accelerate inefficient breaches prior to bankruptcy. If a financially distressed firm can accelerate all of its value-wasting breaches prior to bankruptcy, the total level of inefficient breach/rejection under the "balancing test" rule will be the same as under the RD rule.

The RD/Adjusted Price rule gives an incentive to delay the performance decision until bankruptcy when the other party would profit from performance under the original terms of the contract. The delay may or may not improve the quality of the performance decision.

The ND/Adjusted Price rule provides incentives to delay in the same circumstances as the RD/Adjusted Price rule, and, as with the RD/Adjusted Price rule, delay in those cases may or may not improve the quality of the performance decision. In addition, the ND/Adjusted Price rule gives the financially distressed firm an incentive to delay rejection until bankruptcy (with no effect on the quality of the decision).

The Modified Price/ED rule will delay a decision to perform until bankruptcy in the case where the financially distressed firm would have performed under the RD rule (in this case the rule has no effect on the quality of the decision). The Modified Price/ED rule may delay a decision to reject until bankruptcy (with no effect on the quality of the decision). The Modified Price/ED rule also may delay a performance decision until bankruptcy when the firm would have rejected a value-increasing contract outside bankruptcy (thereby improving the performance decision). Finally, the rule may also cause either party to accelerate a breach decision prior to bankruptcy (with or without affecting the breach/performance decision).

These results are summarized in Table C below.

TABLE C

Rule	Incentive to Delay Until Bankruptcy	Improve Perform. Decision As Result of Delay (vs RD Rule)	Incentive to Accelerate to Eve of Bankr.	Worsen Perform. Decision As Result of Accel. (vs. RD Rule)
RD	No	-	No	-
Balancing	No	Same as RD Rule	Yes	Debtor may breach inefficiently (but would breach same contracts in bankruptcy under RD rule)
RD/Adjusted Price	Yes	Sometimes	No	-
ND/Adjusted Price	More than RD/Adjusted Price rule	Same as RD /Adjusted Price rule	No	-
Modified Price/ED	Yes	Sometimes	Yes (Either party)	Sometimes

C. *Ex Ante* Contract Price Adjustment

We have seen that the various perform reject/rules have different effects on the distribution of value in bankruptcy, performance decisions prior to bankruptcy, and the incentive of parties to file for bankruptcy in the first instance. When the contracting parties are relatively sophisticated -- as is the usually the case when the contract is between two firms -- the risk that one party will not have its expectation met if the other party enters bankruptcy will be priced into the initial contract; that is, if one party anticipates that the other party may enter bankruptcy, it will compensate itself for this risk of loss by insisting that the price be adjusted in its favor.

This Section briefly considers (1) the extent by which the initial contract price is likely to increase if the RD/Adjusted Price rule were substituted for the RD rule and (2) the effect of such a price adjustment on the ability of firms to enter into value-increasing contracts. This Section also considers how the ability of certain parties to adjust prices *ex ante* to compensate themselves for the risk of loss in bankruptcy *ex post* affects the distribution of value under (and the fairness of) the various rules.

1. The Magnitude of Ex Ante Price Adjustment

To the extent the reject/perform rule in bankruptcy favors the bankruptcy estate, a party will demand to be compensated through a better price for the increased risk of loss associated with the other party's bankruptcy. The adjustment the other party will demand should equal the expected loss under the rule.

For simplicity, we can use as a baseline for comparison the ED rule. Under the ED rule (i.e., parties always either perform or pay damages in full, whether or not they are in bankruptcy), neither Builder (nor Firm) would face any risk from the other's bankruptcy. Thus under the ED rule the parties would not adjust the terms of their contract to reflect such a risk.

Under the RD rule, there is a risk that Builder will not be paid in full if Firm enters bankruptcy. The expected loss connected to this risk is (1) the probability that Firm will go bankrupt while the contract is executory, multiplied by (2) the probability that Firm is better off not performing than performing under the RD rule, multiplied by (3) the probability that Builder would profit from performance under the original terms of the contract, multiplied by (4) the profits that are lost from application of the rule.

Let us compare the expected loss to Builder under the RD rule to that under the RD/Adjusted Price rule. Under that rule, Builder's expected loss is the same whether Firm performs or rejects. Thus the expected loss to Builder under the RD/Adjusted Price rule is the expected loss to Builder under the RD rule multiplied by 1/x, where x is the probability that Firm is better off not performing than performing. Consequently, the increase in the expected loss to Builder from moving from the RD rule to the RD/Adjusted Price rule is (1/x - 1) multiplied by the expected loss under the RD rule.

To make this comparison more concrete, let us consider the case in which under the RD rule (1) there is a 50% likelihood that Firm's estate will be better off rejecting than performing; (2) the expected payout for unsecured claims is 30%; and (3) Builder expects to make a $40 profit. Thus in the event of rejection Builder would lose $28 (70% of $40) of profit. Since there is a 50% chance of rejection if Firm enters bankruptcy, the expected loss to Builder once Firm enters bankruptcy is therefore $14 (50% of $28).

First let us consider the case of a typical firm that is not financially distressed. Although the likelihood that such a firm will become insolvent while any particular contract is still executory is likely to be much less than 1%, let us assume that the probability is 1%. Thus in the case of a typical firm the expected loss to Builder under the RD rule would be 14 cents, or 0.35% of Builder's expected profit under the contract. Suppose, as in the example that has been used throughout the paper, the $40 profit represents 40% of the contract price. In that case the RD rule would add approximately 0.14% to the contract price -- a negligible amount. It follows from the analysis above that moving to the RD/Adjusted Price rule, in this example, would double the risk premium that would be added to the contract price -- to 28 cents (approximately 0.28% of the contract price). Thus for a typical firm moving from the RD to the RD/Adjusted Price rule is unlikely to increase by much the cost of entering into contracts.

Now let us consider the case of a firm that is financially distressed. Suppose that firm is 30 times more likely to enter bankruptcy than the typical firm, so that there is a 30% likelihood that the firm will enter bankruptcy. In the above example, the expected loss to Builder under the RD rule would be $4.20, requiring that a premium of 4% of the contract price be paid by the Firm. Under the RD/Adjusted Price, the premium under the RD/Adjusted Price would be approximately 8% in the above example.

Of course, the premium under the ND/Adjusted Price rule will be greater than that under the RD/Adjusted Price rule.[116] And the premium might be more or less under the Modified Price/ED rule, depending on the adjustment percentage. The point is that even in the case

[116] In the above examples--which assume a 30% payout for unsecured claims--the premium would be approximately 40% larger under the ND/Adjusted Price rule than under the RD/Adjusted Price rule.

where a firm is financially distressed the premium it must pay to enter contracts under any of these rules need not be substantial.

2. The Economic Consequences of *Ex Ante* Price Adjustment

Now let us consider the economic consequences of the change in *ex ante* price adjustment when the RD rule is replaced by the RD/Adjusted Price rule. In particular, let us consider how such price adjustments are likely to affect the ability of those controlling firms to enter into various types of contracts. As we will see, the economic consequences of the *ex ante* price adjustments likely to occur if the RD rule were replaced by the RD/Adjusted Price rule might be either desirable or undesirable.

Before beginning such an analysis, it will be useful to examine why a contract might have a different effect on the owners of the firm than on the creditors of the firm. Suppose that by entering into a particular contract the firm is able to pursue a high risk strategy that increases the likelihood that the firm will fail but promises a large payoff in the event of success. In that case the contract might make creditors worse off (by increasing the probability of default) but make shareholders better off (because they capture most of the large payoff in the event of success). Conversely, a contract may allow a firm to pursue a lower-risk project that makes creditors better off and shareholders worse off than the project the firm would otherwise undertake.

To the extent a contract increases the size of the pie available to shareholders and creditors, it is value-creating. But to the extent the contract reduces the size of the pie, it is value-wasting. However, in deciding whether to enter into the contract the owners of the firm will consider only how the contract affects them, and not whether the contract is value-creating or value-wasting. Thus the owners of a firm will find it in their interest to enter into contracts that are value-wasting if they are made better off as a result.

Having seen that a contract may have affect shareholders and creditors differently, let us now consider the consequences of the change in *ex ante* price adjustment from moving to the RD/Adjusted Price rule. To focus on the consequences of *ex ante* price adjustment, let us assume that the only differences between the RD rule and the RD/Adjusted Price rule are (1) the size of the *ex ante* price adjustment and (2) that the RD rule causes the trustee to reject certain value-creating contracts while the RD/Adjusted Price rule does not (and that when performance occurs under the RD/Adjusted Price rule there may be a reduction in price).[117] Let us consider two cases.

The first case to consider is that in which all of the firm's creditors are "adjusting:" that is, they adjust the interest rate they charge the firm to reflect the effect on them of the executory contract rule in place.[118] Under the RD/Adjusted Price rule, the firm's other creditors will be better off than under the RD rule since both the size of the bankruptcy pie and their relative share of that pie will be larger than under the RD rule. Thus, if the firm's others 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 must pay a higher price to enter into contracts under the RD/Adjusted Price rule than under the RD rule, its creditors, which are assumed to

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[117] I thus abstract from the effects of these rules on the parties' behavior from the time the contract is signed until the perform/reject decision is made.

[118] Lucian Bebchuk and I have used 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 and Fried, *supra* note 57, at 864.

be adjusting, will charge less interest. In fact, since the RD/Adjusted Price rule enlarges the size of the bankruptcy pie -- and thus increases 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 will be greater than the increase in the price the firm must pay to enter contracts. Thus in a world with perfectly adjusting creditors, the RD/Adjusted Price rule will on balance reduce the costs faced by the firm and allow it to enter into *more* value-creating contracts.

However, as I have argued elsewhere, not all of a debtor's creditors are "adjusting."[119] In fact, many of a debtor's creditors will be nonadjusting. Thus the more realistic case to consider is that in which a substantial number of creditors will not set their interest rates to reflect the expected effect of the particular executory contract rule in effect on the debtor's executory contracts. Such nonadjusting creditors would include tort creditors and the government, which under any regime will not charge interest to reflect their expected loss from the debtor's default. These creditors will be better off in bankruptcy under the RD/Adjusted Price rule than under the RD rule. However, the interest charged by these creditors will be the same under both rules: zero.

When certain creditors of the firm are nonadjusting, the effect of moving from the RD to the RD/Adjusted Price rule can have different effects on the firm's contracting. Again, let us consider two cases.

In the first case, suppose that a particular contract that the firm would undertake under the RD rule is value-wasting: it makes creditors worse off by more than it makes shareholders better off. In that case moving to the RD/Adjusted Price rule makes shareholders (who, I am

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[119] *See* Bebchuk and Fried, *supra* note 57, at 864.

assuming for simplicity, bear fully the *ex ante* price adjustment) worse off and nonadjusting creditors better off. If the RD/Adjusted Price rule eliminates the gain to shareholders from undertaking the rule, then moving to the RD/Adjusting Price rule will prevent the shareholders from undertaking the project. Otherwise, the RD/Adjusted Price rule will have the effect of making the nonadjusting creditors better off than under the RD rule and shareholders worse off but will not block the value-wasting contract. Thus in the case where the contract is value-wasting, the RD/Adjusted Price rule leads to at least as good an outcome (and perhaps a better one) than the RD rule.

In the second case, suppose that the contract is value-creating. In that case, moving from the RD rule to the RD/Adjusted Price rule may, as above, either prevent the transaction or simply transfer value to the nonadjusting creditors from the shareholders. However, the most value that can be transferred to the nonadjusting creditors is that which is necessary to pay 100% of their claims. Thus in order for the RD/Adjusted Price rule to transfer so much of the gain from shareholders that it is not worth undertaking a value-creating contract, the nonadjusting creditors must have only a relatively small piece of the pie to begin with. In other words, this situation arises only when the firm is so financially distressed that the value of the nonadjusting creditors' claims is very low. In those cases the presence of nonadjusting creditors might prevent some value-creating contracting that would take place under the RD rule.

3. The Distributional/Fairness Consequences of *Ex Ante* Price Adjustment

Having seen that parties can sometimes adjust the terms of their agreements with the debtor to reflect the effect on them of the debtor's contracts with other parties, we can now consider the distributional and fairness issues in a slightly different light. While the RD/Adjusted Price rule favors other creditors at the expense of the contract creditor more than the RD rule *in* bankruptcy, if the contract and other creditors are adjusting the overall distributional effect is the same under both rules. As explained, however, certain parties are not adjusting. Thus let us compare the distributional effects of the RD and RD/Adjusted Price rules under different assumptions about the ability of various parties to adjust. Consider four cases.

First, consider the simple case in which all parties are adjusting. In that case, the contract and other creditors adjust the terms of their bargains with the debtor so that they are equally well off under both the RD and RD/Adjusted Price rules. The extra pie created under the RD/Adjusted Price rule is thus enjoyed by the shareholders.

Second, consider the case in which the contract creditor is adjusting but the debtor's other creditors are not all adjusting. In that case, the contract creditor is equally well off under both the RD and RD/Adjusted Price rule. The nonadjusting creditors are better off under the RD/Adjusted Price rule. Shareholders are worse off under the RD/Adjusted Price rule than under the RD rule.

Third, consider the case in which the contract creditor is nonadjusting and the other creditors are. In that case, the contract creditor will be worse off under the RD/Adjusted Price rule, the other creditors will be equally well off, and the shareholders will be better off. They will also be better off than in the first case, where all parties are adjusting.

Fourth and finally, suppose that none of the parties are adjusting. In that case the contract creditor will be worse off under the RD/Adjusted Price rule, the other creditors will be better off, and the shareholders will be equally well off under the RD and RD/Adjusted Price rules.

D. Mitigating the *Ex Ante* Effects of Bankruptcy Contract Rules

Although the preliminary analysis suggests that the prebankruptcy effects of adjusting contract prices in bankruptcy may not be substantial, it may be the case that such an adjustment does create significant distortions outside of bankruptcy. Thus it is worth briefly considering how these distortions could be reduced while retaining the proper performance incentives in bankruptcy. Below I consider two approaches to reducing the *ex ante* consequences of adjusting the terms of performance in favor of the bankruptcy estate.

The first approach is to adopt a reject/perform rule that does not transfer as much value ex post to the bankruptcy estate as the RD/Adjusted Price or the ND/Adjusted Price rules. There are three types of rules that could be used to achieve such a result. First, one could adopt the "balancing test" rule. Second, one could adopt a Modified Price/ED rule that -- on average -- transfers less value to the bankruptcy estate than the RD/Adjusted Price rule. The adoption of such a rule rather than the RD/Adjusted Price rule would, for example, on average provide less of an incentive to file for bankruptcy. The other type of rule that could be used for this purpose would be a "Fractional Damages/Adjusted Price" ("FD/Adjusted Price") rule that provides the nonbankrupt party with a fixed fraction of its damages and adjusts the price accordingly. For example, one could adopt a 60% FD/Adjusted Price rule that requires the bankruptcy estate to pay 60% of any rejection damage claim and adjusts the cost of performance by 40% of the damage claim.

A second approach would be to adopt a rule such as the RD/Adjusted Price rule, but apply it only in particular types of bankruptcy cases. For example, one could limit its use to Chapter 7 proceedings. Limiting the use of the rule to liquidations, for example, would reduce managers and shareholders' incentives to use the rule to transfer value from other parties when they could otherwise avoid bankruptcy. Alternatively, one could limit the rule to the less often used Chapter 11, on the theory that the ex post distributive effect of the rule is most desired in the case of reorganizations.

VII. CONCLUSION

This paper has carried out an economic analysis of the treatment of executory contracts in bankruptcy. The analysis shows that the longstanding 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 resulting damages -- provides the trustee with the incentive to reject value-creating contracts. This problem has so far been overlooked by both traditional bankruptcy scholars as well as commentators taking an economic approach.

The same analytical framework was also used to examine the current controversy over the proper interpretation and application of Section 365, the provision of the Bankruptcy Code that embodies the "ratable damages" rule. This examination revealed that the manner in which courts apply Section 365 further reduces the number of desirable contracts that are performed in bankruptcy.

The paper then offered a preliminary analysis of four alternative arrangements that could, in principle, eliminate the problem of excessive rejection under the ratable damages rule. One of the arrangements -- which builds on an existing but rarely-used "balancing test" doctrine -- would bar the trustee from rejecting contracts when the harm to the other party is greater than the benefit to the estate. Each of the other three arrangements gives the trustee full discretion whether to perform or reject an executory contract, but adjusts the terms of performance in favor of the bankruptcy estate in order to eliminate the distortion identified in the paper. These arrangements were then compared along a number of different dimensions -- including the information that would be required to implement them properly as well as their distributional effects.

Finally, the paper showed that the treatment of executory contracts in bankruptcy has effects on many of the parties' decisions prior to bankruptcy, a point that has largely been overlooked by bankruptcy commentators. The paper identified and considered a number of such *ex ante* effects: the effects of the perform/reject rule on various types of performance decisions prior to bankruptcy, the incentive to file for bankruptcy, and the initial pricing of contracts. The paper also suggested two approaches for reducing the *ex ante* consequences of the rules that adjust the price in favor of the bankruptcy estate (in case that is thought to be desirable).

The analysis in this paper is in many respects preliminary. My aim has been to identify a problem with the current treatment of executory contracts and to put forward for consideration various approaches for remedying the problem. Much work remains to be done before a determination can be made that the treatment of executory contracts in bankruptcy should be modified. It is my hope that this paper will contribute to this effort.

APPENDIX

Contract Price: $100
Value to Firm: $80
Cost to Builder: $60

RULE	PAYOUT RATE	COST OF NONPERFORM.	PERFORM. PRICE	COST OF PERFORM
Expect. Damage	**100%**	**$40**	**$100**	**$20** [$100-$80]
Ratable Damages	**30%**	**$12**	**$100**	**$20**
No Damages	**0**	**0**	**$100**	**$20**
Balanc. Test	**30%**	**$12 (if permitted)**	**$100**	**$20**
Ratable Damages/ Adjusted Price	**30%**	**$12**	**$72** [$100-($40-$12)]	**($8)** [$80-$72]
No Dam. Adjusted Price	**0**	**0**	**$60** [$100-$40]	**($20)** [$80-$60]
Modified Price/ Expect. Damages (assuming 25% adjustment)	**100%**	**$15** [$75-$60]	**$75** [$100-25%($100)]	**($5)** [$80-$75]