Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts

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Laura B. Bartell*

The goal of Article Nine of the Uniform Commercial Code is to promote credit transactions by making secured financing operate within a simple, unified structure that would be less costly and more certain than the panoply of prior security devices. The Code has been wildly successful in achieving that objective. As the United States economy has become more service-oriented and less centered on the production and distribution of "hard goods," the credit markets have also moved towards creative financing techniques that rely on the valuation and securitization of intangible assets, frequently those represented by contractual rights.

When beneficiaries of those contractual rights suffer financial reverses and seek protection of the Bankruptcy Code, it provides

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* Associate Professor of Law at Wayne State University Law School. I would like to extend my thanks to my colleagues John F. Dolan and Charles W. Mooney, Jr., who provided critical comments on drafts of this article.

1. U.C.C. § 9-101, Official cmt.; see also Grant Gilmore, The Secured Transactions Article of the Commercial Code, 16 LAW & CONTEMP. PROBS. 27, 36 (1951) ("The proposal is to make the taking of security easy, cheap, and certain.").

2. One commentator has estimated that approximately two trillion dollars in secured debts was held by domestic lenders by the mid-1990s. See Ronald J. Mann, Explaining the Pattern of Secured Credit, 110 HARV. L. REV. 625, 627 (1997).


them the legal option of assuming the contract, thereby receiving the benefits of its provisions at the cost of meeting its obligations on a priority basis, or rejecting the contract, thereby foregoing all benefits but absolving themselves of further obligations and relegating the other party to the status of pre-petition creditor for unsatisfied liabilities.\(^5\) To illustrate this in simple terms, suppose a company is a party to two agreements; one is a lease with a third party under which the company is the lessee, and the other is a contract to purchase goods at a fixed price. When the company files for protection under the Bankruptcy Code, section 365 of the Code allows the company to reassess the benefits and detriments of each of these agreements. With respect to the lease, if comparable property is currently available to the debtor for a lower cost than the rent established by the third party lease, the debtor may choose to reject the lease and vacate the premises in favor of a more advantageous arrangements elsewhere. A rejection results in a deemed "breach" of the lease as of the time immediately prior to the filing of the petition under section 365(g) of the Code, and the lessor will have a claim in respect of such breach under section 502(g). Similarly, if the goods subject to the contract are now available at a lower cost than the fixed price established in the contract, the company will reject the contract and obtain the goods elsewhere on better terms, and the other party to the contract will receive a pre-petition claim in respect of the breach of contract. Alternatively, if the rent under the lease is at or below market, or if the goods under the contract would now cost the company more than the contract price, the company may assume the lease or the contract, securing for itself the ongoing benefits of those agreements.

Assumption of executory contracts and leases poses few conceptual problems. The pre-bankruptcy obligations of the debtor under those agreements become obligations of the bankrupt estate and remain enforceable against the estate after assumption (as

\section*{\textsuperscript{5} Section 365(a) of the Code provides as follows:}

Except as provided in sections 765 and 766 of this title [dealing with commodity broker liquidations] and in subsections (b) [limiting ability to assume where there has been a default], (c) [prohibiting assumption under certain circumstances] and (d) [providing time period during which assumption must occur, if at all] of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

\textsuperscript{11} U.S.C. \S 365(a) (1994).
administrative claims) and against the debtor after it emerges from bankruptcy.\(^6\)

By contrast, the impact of rejection on the non-debtor party to an executory contract or lease has been a source of some confusion to courts and commentators. Many courts have concluded that rejection of a contract or lease results in its termination.\(^7\)

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6. See id. §§ 365(g)(2)(A) (rejection of contract or lease previously assumed is deemed breach as of time of rejection); 503(b)(1)(A) (defining administrative expenses); 1142(a) (requiring debtor to carry out plan of reorganization); 1141(b) (property of estate vests in debtor free and clear of all claims except as otherwise provided in plan).

Recent seminal articles by Michael T. Andrew and Jay Lawrence Westbrook have contested this conclusion, suggesting that rejection of a contract or lease by the debtor does not affect the enforceability of property rights in the other party created thereby. Their analysis has proven convincing to many courts. To use the phrase a claim for damages for breach); Mayfield Smithson Enterprises v. Com-Quip, Inc., 896 P.2d 1156, 1162 (N.M. 1995) ("[R]ejection terminates the lease . . ."); Giddings Petroleum Corp. v. Peterson Food Mart, Inc., 859 S.W.2d 89, 93 (Tex. App. 1993) ("The weight of federal authority holds that the trustee's rejection of an executory contract or lease effectively terminates the contract or lease."); Cf. In re Cochise College Park, Inc., 703 F.2d 1339, 1352 (9th Cir. 1983) ("Until rejection . . . the executory contract continues in effect . . ."); Federal's, Inc. v. Edmonton Investment Co., 555 F.2d 577, 579 (6th Cir. 1977) (holding that executory contracts "remain in effect unless rejected"); Smith v. Hill, 317 F.2d 539, 542 n. 6 (9th Cir. 1963) (noting that executory contracts continue in effect unless rejected); Consolidated Gas Elec. Light & Power Co. v. United Rys. Co., 85 F.2d 799 (4th Cir. 1936) (holding that executory contract "remains in force until it is rejected"); In re Continental Country Club, Inc., 114 B.R. 763, 767 (Bankr. M.D. Fla. 1990) (finding debtor failed to satisfy requirements for rejection and thus executory contract "was not the subject of termination under 11 U.S.C. § 365").


employed by these commentators—and that was adopted by the National Bankruptcy Review Commission and was included in its suggested revisions to section 365 of the Code—rejection is not an “avoiding power”.

It is the thesis of this Article that, although rejection is not an “avoiding power” in the traditional sense, section 365 was intended to allow a debtor the opportunity to “undo” an executory contract or lease at the price of creating a bankruptcy claim for breach. A rejected contract, through the operation of the bankruptcy process, becomes unenforceable and thus is in fact terminated both in fact and at law. I will argue that treating rejection as analogous to an avoiding power is not only mandated by application of traditional common law contract doctrine, but is also the only result that is consistent with the theoretical underpinnings of bankruptcy law—the much vaunted “fresh start” policy.

However, this Article goes one step further, examining the rights of the third party who may be involved in the contractual relationship between debtor and non-debtor—the secured creditor with an interest in the rights of the debtor or non-debtor party to the rejected agreement. I will suggest that in those situations of most concern to Messrs. Westbrook and Andrew—when there is a property right created pursuant to the rejected contract or lease—if a secured creditor has taken a security interest in that property right and/or the personal property created by the rejected contract or lease itself, its security interest should not be destroyed merely because the contract or lease terminates. Rather, if the secured creditor has a security interest in property that existed prior to the lease or contract, that security interest should “ride through” the rejection with the collateral into the hands of the ultimate beneficiary of the rejection. If, instead, the secured

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11. See Andrew, Executory Contracts, supra note 8, at 901-931; Andrew, Reply, supra note 8, at 17; Westbrook, Functional Analysis, supra note 8, at 270-75.

12. Professor Westbrook eschews the term “property right,” preferring the term “Interest in the Thing Itself” or “ITI” to avoid any need to wrestle with “that ubiquitous concept, ‘property’.” Westbrook, Functional Analysis, supra note 8, at 258. Mr. Andrew and I, perhaps less intimidated by our inability to define the concept, are comfortable with the terminology. See Andrew, Reply, supra note 8, at 9.
creditor's security interest attaches only to property *created by* the lease or contract, that security interest extends to the proceeds of that property upon rejection, which should include the property underlying the contract or lease.\(^{13}\)

For purposes of this Article, I will be using two simple models of executory contracts pursuant to which a property interest is transferred to illustrate my thesis, one involving a lease, and one involving a license.\(^{14}\) Because leases of real property are subject to the vagaries of state real property law (and because the impact of rejection has been addressed in part by Congress in section 365(h)\(^{15}\)), the lease will involve personal property, equipment. This equipment is owned in the state property law sense by the lessor. When the lessor enters into the lease, the lessor continues to "own" the equipment as against the world, but it has limited its ownership to the extent and for the period provided in the lease as against the other party to the lease, the lessee. To that extent, the lessee can be seen as having obtained property rights in the equipment, representing a subset of the property rights originally held by the lessor (which can be called P1). A diagram of this transaction, which I will call "Lease Model," using the terminology I will be employing in this Article, would look as follows:

<table>
<thead>
<tr>
<th>OWNER</th>
<th>UNDERLYING PROPERTY</th>
<th>OTHER PARTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>LESSOR</td>
<td>EQUIPMENT</td>
<td>LEESEE</td>
</tr>
</tbody>
</table>

**LEASE**

LESSOR ———> LEESEE

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13. If we were to use Professor Westbrook's terminology, the proceeds should include the "Thing Itself" in which the "ITI" was created. See supra note 12.

14. My examples are limited to contracts or leases in which a property right to some underlying property is conveyed. In a normal supply contract—such as the contract for the sale or purchase of onions used by Professor Westbrook to illustrate the economic consequences of assumption and rejection, see Westbrook, *supra* note 8, at XXX, there is no property right in any underlying property created. Rather, the onions belong to one party to the contract or the other (ignoring for purposes of this overbroad assertion the "special property and [ ] insurable interest in goods [acquired by the buyer] by identification of existing goods as goods to which the contract refers" under § 2-501 of the U.C.C.).

15. See infra notes 93-96 and accompanying text.
When a Licensor enters into a license, it conveys to the Licensee the right to exploit the intellectual property in the area and for the period specified. The Licensor continues to "own" the intellectual property, but subject to the limitations on that ownership provided in the license. The rights of the Licensee (P1) can be seen as a subset of the ownership rights of the Licensor in the intellectual property. A diagram of this transaction, which I will call "License Model," using similar terminology would be as follows:

<table>
<thead>
<tr>
<th>OWNER</th>
<th>UNDERLYING PROPERTY</th>
<th>OTHER PARTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>LICENSOR</td>
<td>INTELLECTUAL PROPERTY</td>
<td>LICENSEE</td>
</tr>
</tbody>
</table>

**LICENSE**

LICENSOR → LICENSEE

Part I of this Article takes the terms used by the Bankruptcy Code with respect to executory contracts and leases and applies state law concepts to provide definitional context. Part II analyzes the impact of bankruptcy on the relationships created by a lease or
executory contract. Part III looks at the impact of rejection on the lease or contract, analogizing rejection and discharge to common law concepts of voidability for incapacity or impossibility, and concludes that, contrary to the views of Messrs. Andrew and Westbrook, the result must be complete termination of the lease or contract, including all conveyances of interests in property effected thereby. Part IV focuses on the property rights of a secured creditor holding an interest in property rights of a party to a rejected lease or contract that conveyed an interest in pre-existing property. The final section of the Article provides some conclusions.

I. Definition of Terms

The Code itself provides no definition of "unexpired lease" or "executory contract." The legislative history of section 365 suggests that Congress intended the provision to apply to "contracts on which performance remains due to some extent on both sides." In so stating Congress was undoubtedly influenced by the standard formulation enunciated by Professor Vern Countryman five years earlier: an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Considered under this formulation, "unexpired leases," which are also subject to rejection or assumption under section 365 of the Code, are simply one category of executory contracts, in that the lessor will necessarily have a continuing (unperformed) obligation to provide the leased goods or premises for the remaining term, and the lessee will have a continuing (unperformed) obligation to make payment for those goods or premises, and a default by either party in performing those obligations would excuse the other party from performance.

18. I believe that Professor Westbrook would disagree with my assertion that an unexpired lease is necessarily executory. Professor Westbrook would likely conclude that the initial transfer of possession of the leased property completes the performance of the obligations of the lessor, and absent ancillary obligations imposed on the lessor under the...
The Countryman formulation has garnered some criticism when applied to rejection of leases and executory contracts. Some argue that it appears to create a pre-condition to rejection that is unwarranted, because rejection is the equivalent of a breach of the contract (a decision by the estate not to perform) that would be permitted to any contract party willing to suffer the consequences under non-bankruptcy law. Others contend that the entire concept of "executoriness" as a condition to operation of section 365 of the Code is itself wrong-headed, and that the ability of the trustee to assume or reject contracts should turn on whether the estate will benefit from assumption or rejection rather than on whether the contract or lease is "executory."

For purposes of the analysis in this Article, the "executoriness" of the contract or lease is not of any significance. In reaching lease are unperformed, the lease, although unexpired, is not "executory." See Westbrook, Functional Analysis, supra note 8, at 238.

19. See THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 108 (1986). Professor Jackson argues that a party in possession of property pursuant to a rejected contract would not be dispossessed by a breach of contract by the owner of that property outside of bankruptcy and therefore should not be so dispossessed upon rejection in bankruptcy. See id. at 110. Although I agree with Professor Jackson that under non-bankruptcy law the non-breaching property possessor would not be involuntarily dispossessed, I believe that he gives insufficient weight to the fact that the decision of the possessor outside of bankruptcy to retain the property is the functional equivalent of partial specific performance of the rejected contract and is precluded by the bankruptcy policy of equality of treatment. See infra notes 129-132.


21. I have much sympathy for the criticisms of Messrs. Westbrook and Andrew and the National Bankruptcy Review Commission with respect to the executoriness precondition to assumption or rejection, but my own perspective is slightly different. I believe that the "material breach" test proposed by Professor Countryman should be seen simply as an effort to distinguish between a contract that is so far performed that the bankruptcy goals furthered by a trustee's option to reexamine the wisdom of honoring it do not outweigh the need for finality in commercial transactions, and a contract that is sufficiently unperformed to conclude that commercial finality would not be violated by providing the trustee a "second look" at the benefits and detriments of performance pursuant to Section 365. See Vern Countryman, supra note 17, at 457 (1973) (suggesting that a contract between a debtor and a building contractor under which the contractor has performed all tasks other than proper connection of the water should not be deemed executory and subject to assumption or
my conclusions, I have assumed that the contract or lease at issue is subject to rejection by the debtor under whatever definition the court chooses to employ. Rather than seeing the definition of "executory" as key, I see the impact of that rejection on the party to that contract other than the debtor (who will hereinafter be referred to as the "non-debtor party" or "NDP"), and on any third party holding a security interest or lien on the contractual interests of either the debtor or the NDP (who will hereinafter be referred to as the "secured third party" or "STP"), as turning on an earlier analytical phase, the identification of what a contract or lease is and the property rights involved. These definitions and their consequences are a matter of state law, and we are aided in our definitional search by recourse to the Uniform Commercial Code ("U.C.C.").

Contracts have been viewed as "nothing more than mixed assets and liabilities arising out of the same transaction." However useful this conceptualization, its terminology matches accounting better than bankruptcy. Bankruptcy law is aimed at the protection and allocation of property of the debtor, and the discharge of "debts." Therefore, a contract for purposes of a bankruptcy case can be described better as a legal obligation that creates property interests and debts. The impact of bankruptcy and rejection on executory contracts and leases can then be analyzed by focusing on the property rights and debts of the debtor, rather than on the debtor's assets or liabilities. To understand that impact, the property rights involved in a contract or lease involving the transfer of an interest in property must be analyzed.

As a preliminary matter, before any contract or lease is entered into by the parties, one of the parties (who will be hereinafter referred to as the "Owner") has an interest in some underlying property (UP)—personal or real property—of which the other party or parties (who will be called the "OP") wishes to obtain all or part. Unless the contractual arrangement reached by

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rejection). I do not, however, as Professor Westbrook seems to do, equate "finality" in this context with the transfer of a property right by the debtor to the other party to the contract. See Westbrook, Functional Analysis, supra note 8, at 238.

22. JACKSON, supra note 19, at 106; see also Andrew, Executory Contracts, supra note 8, at 855.


24. See, e.g., id. §§ 727(b), 1141(d)(1)(A), 1228(c), 1328(c). A "debt" is defined as "liability on a claim" in section 101(12).
the parties is a contract of sale; the existence of a contract or lease with respect to the UP will not affect title to the UP. The Owner to whom the UP originally "belongs" will continue to "own" the UP. As to the Owner, the contract or lease does not create any new property rights in the UP; it merely carves out from those existing rights a subset of rights in the UP and confers that subset to the OP.

In the hands of the OP, the "contract" or "lease agreement" itself is not property but instead transfers property interests in the UP, representing that subset of the Owner's property rights conferred on the OP by enforceable agreement. Section 1-201(11) of the U.C.C. defines "contract" as "the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." That "contract" is likely to be embodied in an "agreement" of the parties, meaning their bargain in fact.

25. In most jurisdictions, under the theory of "equitable conversion" the execution of the contract of sale relating to real property gives the buyer an ownership interest in the property itself and then transforms the seller's interest therein to personal property (the right to receive payment from the buyer). See generally 3 AMERICAN LAW OF PROPERTY §§ 11.22-.35 (1952); ARTHUR LINTON CORBIN, 3A CORBIN ON CONTRACTS § 667 (2d ed. 1962).

26. As a matter of pure feudal theory, occupancy by a tenant did not affect seisin in the landlord. The landlord's present estate in the land was merely burdened by the term of years in the tenant. See 1 AMERICAN LAW OF PROPERTY, supra note 25, § 3.1, at 176-177. Although it has become common to refer to the creation of a leasehold as transferring to the lessee a present interest (an estate for years) constituting a non-freehold estate in land with the lessor retaining a reversion (or transferring a remainder to a third party), the fee simple ownership of the property remains in the lessor. See generally THOMAS F. BERGIN & PAUL G. HASKELL, PREFACE TO ESTATES IN LAND AND FUTURE INTERESTS 38-42 (2d ed. 1984). Technically speaking, therefore, the creation of a lease was merely a matter of contract, not conveyance of property. See generally William M. McGovern, The Historical Conception of a Lease for Years, 23 UCLA L. REV. 501 (1976). Consistent with feudal treatment, it is the person in whose name title to real property is recorded (as between the lessor and lessee, generally the lessor) who is considered the owner thereof for property tax purposes; 49 AM. JUR. 2d Landlord and Tenant § 446 (1995). The tension between property and contract theories of leases has been a rich source of scholarly writing. See, e.g., Edward Chase, The Property-Contract Theme in Landlord and Tenant Law: A Critical Commentary of Schoshinski's American Law of Landlord and Tenant, 13 RUTGERS L.J. 189 (1982); John Forrester Hicks, The Contractual Nature of Real Property Leases, 24 BAYLOR L. REV. 443 (1972); John A. Humbach, The Common-Law Conception of Leasing: Mitigation, Habitability, and Dependence of Covenants, 60 WASH. U. L.Q. 1213 (1983). Although concepts of seisin have no impact on title to personal property, there is no reason to treat leasehold interests in personal property differently from those in real property insofar as they affect ownership.

27. The U.C.C. defines "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance . . . ." U.C.C. § 1-201(3) (1977).
that agreement has legal consequences is governed by the U.C.C. when applicable provisions exist, but is otherwise determined by the law of contracts pursuant to section 1-103 of the U.C.C., which provides for the supplementation of the U.C.C. by principles of law and equity.\textsuperscript{28}

Similar to a “contract,” a “lease contract” is defined under the U.C.C. as: “the total legal obligation that results from the lease agreement as affected by this Article and any other applicable rules of law.”\textsuperscript{29} A “lease agreement” is the bargain of the lessor and lessee with respect to a “lease,”\textsuperscript{30} and a “lease” is defined as “a transfer of the right to possession and use of goods for a term in return for consideration . . . .”\textsuperscript{31}

The contract or lease has a significant impact on property rights. A lease affects the rights of both Lessee (OP) and Lessor (Owner). With respect to the Lessee, the lease creates a new property interest, characterized as a “leasehold interest,”\textsuperscript{32} which is personal property.\textsuperscript{33} In the Lease Model described earlier, the leasehold interest would be P1. If the leased property is goods, the leasehold interest will be classified by the nature of the leased goods in the hands of the lessee, for example, equipment, inventory, consumer goods, or farm products.\textsuperscript{34} This leasehold interest of

\begin{itemize}
  \item \textsuperscript{28} Section 1-201(3) concludes: “Whether an agreement has legal consequences is determined by the provisions of this Act, if applicable; otherwise by the law of contracts (Section 1-105) . . . .” The U.C.C. further provides:
    
    Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.
    
    \textit{Id.} § 1-103.
  
  \item \textsuperscript{29} U.C.C. § 2A-103(1)(d) (1987).
  
  \item \textsuperscript{30} \textit{Id.} § 2A-103(1)(k).
  
  \item \textsuperscript{31} \textit{Id.} § 2A-103(1)(j).
  
  \item \textsuperscript{32} The U.C.C. characterizes a “leasehold interest” as “the interest of the lessor or the lessee under a lease contract.” U.C.C. § 2A-103(1)(m).
  
  \item \textsuperscript{33} Even if the leased property is real estate and the leasehold is an interest in land, for historical reasons leasehold interests have always been categorized as personal property (“chattels real”). See 1 \textsc{American Law of Property} \textit{supra} note 25 § 3.12, at 205; \textsc{Restatement of Property} § 8 cmt. c (1936).
  
  \item \textsuperscript{34} Section 9-109 of the U.C.C. provides:
    
    Goods are
    
    (1) “consumer goods” if they are used or bought for use primarily for personal, family or household purposes;
    
    (2) “equipment” if they are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization
  
\end{itemize}
the Lessee represents "the right to possession and use" of the leased premises or goods,\textsuperscript{35} for the term of the lease. Absent the lease, the Lessee had no property interest in the UP (the equipment in the Lease Model), and apart from the leasehold interest, the lease gives the Lessee no other property rights.

In the case of the Lessor or Owner, that is, the "person who transfers the right to possession and use of goods under a lease,"\textsuperscript{36} the "leasehold interest" under the lease consists of two property rights, only one of which is newly-created. The first is the right to consideration from the Lessee paid for the Lessee's leasehold interest (often colloquially labeled "rent"). Absent the lease, this property right would not exist. If the Lessor uses this newly-created personal property as collateral, it is classified as "chattel paper" under the U.C.C.\textsuperscript{37} The second is what has been labeled

\begin{itemize}
  \item or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods;
  \item (3) "farm products" if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory;
  \item (4) "inventory" if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business. Inventory of a person is not to be classified as his equipment.
\end{itemize}

35. The definition of "lessee" in Section 2A-103(1)(n) of the U.C.C. provides that it is "a person who acquires the right to possession and use of goods under a lease . . . ."

36. \textit{Id.} \textsection \textsuperscript{2A-103}(1)(p).

37. "Chattel paper" is "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods . . . ." \textit{Id.} \textsection \textsuperscript{9-105}(1)(b). The monetary obligation satisfying the definitional requirement is the consideration the lessee agrees to pay for the possession and use of the goods.

Any rights of the lessor created by the lease other than the right to receive payment are also characterized as part of the "chattel paper" even though they do not fit neatly into the definition. The draftsmen of the U.C.C. wished to avoid bifurcating the payment rights and other rights inhering in a lease, and specified that all lease rights were to be treated as chattel paper. \textit{See Id.} \textsection \textsuperscript{9-106} Official Cmt.

A security interest in chattel paper may be perfected either by filing a financing statement, \textit{see id.} \textsection \textsuperscript{9-304}(1), or by the secured party's taking possession of the collateral, \textit{see id.} \textsection \textsuperscript{9-305}. To perfect by possession of a lease constituting chattel paper, the secured party must hold the "original counterpart" of the lease. \textit{Compare In re} LCS Cybernetics, Inc., 123 B.R. 467 (Bankr. N.D.N.Y. 1989), \textit{aff'd}, 123 B.R. 480 (N.D.N.Y.1990) (holding that the lender perfected by holding original counterpart of equipment schedule) \textit{with In re} Funding Systems Asset Management Corp., 111 B.R. 500 (Bankr. W.D. Pa. 1990) (holding that the lender not perfected by possession of one of three original equipment schedules). If the lender fails to perfect by possession, a purchaser of the lease, which may be another secured
the "lessee's residual interest," which represents the interest of the Lessor in the UP after the lease contract expires, terminates, or is cancelled. This interest is not a new property interest; rather, it represents the original property interest held by the Lessor in the UP reduced by the subset of rights, which is the "leasehold interest" or P1 under my model, conferred on the Lessee. If the Lessor uses this property interest as collateral, it will be classified as inventory because the goods have been furnished under a lease pursuant to section 9-109(4). Thus, in the Lease Model, the Lessor has a residual interest in the equipment, which constitutes inventory in its hands.

In the case of contracts other than lease contracts that transfer an interest in property, typically the Owner agrees to provide property to another (the OP) in exchange for money. In the License Model, the Licensor (Owner) agrees to transfer an interest in the intellectual property (the underlying property or UC) to the Licensee (OP) for an agreed compensation. The property interest of the owner of the UC in payment pursuant to the contract, labeled under the 1962 official version of the U.C.C. as a "contract right," now falls under the rubric of "account." This account is a newly-created personal property interest. Any interest of a party to a contract that does not represent a right to payment would be characterized as a "general intangible," which is defined to include any personal property not otherwise categorized. The party, see id. § 1-201(32)-(33), who gives new value and takes possession of it in the ordinary course of his business can obtain priority even over a lender who properly perfected by filing. See id. § 9-308.

38. Id. § 2A-103(1)(q).

39. A security interest in the lessor's interest in leased goods will, as a practical matter, have to be perfected by filing a financing statement under section 9-304(1). Although security interests in goods can be perfected by possession, see id. § 9-305, because a lease transfers possession of the goods to the lessee, the secured party will not be able to perfect by possession. Possession of the lease constituting chattel paper does not perfect a security interest in the leased goods. See, e.g., In re Commercial Management Serv., Inc., 127 B.R. 296 (Bankr. D. Mass. 1991).

40. Section 9-106 of the 1962 version of the U.C.C. defined "contract right" as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper."

41. Article Nine of the U.C.C. includes within the definition of "account": "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106 (1977).

42. "General intangibles" is defined as "any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, investment
interest of the Licensee to the intellectual property, which would not exist in the absence of the contract, would be characterized as a general intangible, as would any rights of the Licensor against the licensee other than the right to receive payment. Note again that the contract creates new property rights that did not exist before, but does not affect the owner's pre-existing property rights in the UP, except to the extent a subset of property rights in the UP (P1 in the License Model) has been defined and conveyed to the other party by enforceable provisions of the contract.

II. Effect of Bankruptcy and Pre-action Status of Lease or Executory Contract

What happens to these property rights when the Owner or OP files for protection under the Bankruptcy Code? For purposes of this discussion, the party so seeking protection will be referred to as the "Debtor," and the party not seeking protection will be called the "non-debtor party" or "NDP." The Debtor could be the Owner, in which case the NDP is the OP, or the Debtor may be the OP, in which case the NDP is the Owner. The Bankruptcy Code purports to affect only the property of the Debtor, and does not distinguish between the pre-bankruptcy status of the contracting party as Owner or OP.

A. Owner as Debtor

The commencement of the bankruptcy case under the Code results in the creation of an "estate," comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."\(^43\) The universe of property interests belonging to the Debtor for purposes of the Code is defined by reference to state property law, both real and personal.\(^44\) Therefore, in applying the operative provisions of section 541 to a lease or executory contract existing at the time of the commencement of the bankruptcy case, we must again look at the property interests related to them.


First, as previously discussed, the Owner has a property interest in the UP that constitutes his “ownership” or “title” or “legal interest” to that UP. This property interest in the UP existed before there was any lease or contract, and will immediately become an asset of the estate pursuant to section 541. In the Lease Model, this means that the equipment itself becomes an asset of the estate. In the License Model, the intellectual property becomes estate property.

Second, the Owner has property interests created by the lease or executory contract itself. In the case of a lease (as in the Lease Model), this property interest (the lessor’s “leasehold interest”) includes the right to consideration for providing possession and use of premises or goods. In the case of an executory contract (like the license in the License Model), this property interest (“account” and “general intangibles”) represents the package of benefits accruing to the Owner as a result of the contract, usually consisting primarily of the right to receive payment. These property interests immediately become part of the bankrupt estate under section 541.

45. Unlike Michael T. Andrew, I do not believe that the Owner's interest in the UP that becomes part of the estate is properly characterized as merely a “residual” or “reversionary” interest. See Andrew, Executory Contracts, supra note 8, at 904-05; Andrew, Reply, supra note 8, at 10. Until the debtor's decision to assume or reject is made, the estate's legal interest in the UP is limited by the equitable interest of the OP. However, the estate is comprised not only of the Debtor's equitable interest in the UP, but also the Debtor's legal interest, which is its title to or ownership of the UP. This legal interest may be subject to limitations at the moment of filing (representing the property interest of the OP in the UP, or P1 in my two models), but is fully included in the estate.

46. Michael T. Andrew would argue that the property interests created by leases or contracts do not become part of the estate pursuant to section 541 unless and until assumed pursuant to section 365. In his seminal article, Executory Contracts in Bankruptcy, 59 U. COLO. L. REV. 845 (1988), he traced the historical antecedents of the concept of assumption and rejection, and concluded that courts were unwilling to impose on a bankrupt party the administrative liabilities believed to accompany the inclusion of the asset represented by a lease or contract in the bankrupt estate. See id. at 856-861; see also Douglas Bordewieck & Vern Countryman, The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors,” 57 AM. BANKR. L.J. 293, 303 (1983). Bordewick and Countryman state:

"Were it not for section 365, all contracts and leases in which the debtor had a legal or equitable prepetition interest would become property of the estate under section 541(a)(1). Perhaps section 365 should be viewed as a limitation on section 541(a)(1) giving the debtor... an option to decide whether executory contracts and unexpired leases should become property of the estate." Id. at 303. In re Tleel, 876 F.2d 769, 770 (9th Cir. 1989); In re Lovitt, 757 F.2d 1035, 1041 (9th Cir.), cert. denied sub nom. Cheadle v. Appleatchee Riders Ass'n, 474 U.S. 849 (1985); In re Tonry, 724 F.2d 467, 469 (5th Cir. 1984); In re Cochise College Park, Inc., 703 F.2d 1339, 1351 n.10 (9th Cir. 1983); Fletcher v. Surprise (In re Northern Indiana Oil Co.), 180 F.2d 669, 676 (7th Cir.), cert. denied, 340 U.S. 824 (1950); Green v. Finnigan Realty Co., 70
Note that the lease or contract is not affected by section 541 of the Code. Despite its significant impact on pre-existing property interests and creation of new property interests, the lease or contract is not itself property because it never becomes a part of the bankruptcy estate. Nor is the contract immediately enforceable against the Debtor, although it remains enforceable against the OP. The thrust of section 365 after the commencement of the case will be to determine whether the provisions of the lease or contract, which create new property interests and limit existing property interests in the UP, will again become enforceable against the Debtor or become permanently unenforceable, through the operation of Debtor’s election to assume or reject.

B. OP as Debtor

When the OP is the Debtor, there are no property interests in UP other than those created by the lease or executory contract (P1 in the two models). Those interests (“leasehold interests” and “general intangibles”) automatically become part of the bankrupt estate by operation of Section 541. Again, the contract or executory contract, not being property itself, does not become part of the estate, but remains enforceable against the Owner/NDP by the OP/Debtor despite the inability of the Owner/NDP to enforce

F.2d 465, 466 (5th Cir. 1934); Cobabe v. Stanger, 844 P.2d 298, 301 (Utah 1992).

However interesting and even persuasive Andrew's historical analysis may be, section 541 makes no distinction between property of the estate created by lease or executory contract and other property of the estate. The necessary conclusion, as noted by Professor Westbrook, is that all property interests (“rights”) created by leases or executory contracts are affected by section 541 and become part of the bankrupt estate. See Westbrook, Functional Analysis, supra note 8, at 250 & 325; see also In re Taylor, 198 B.R. 142, 159-60 (Bankr. D.S.C. 1996); In re Matta, No. 95-10315, 1995 WL 664765, at *3 (Bankr. D. Vt. Nov. 7, 1995); In re The Leslie Fay Companies, Inc., 166 B.R. 802 (Bankr. S.D.N.Y. 1994); In re Seymour, 144 B.R. 524, 528 n.2 (Bankr. D. Kan. 1992); In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687, 702 (Bankr. S.D.N.Y. 1992).


48. See, e.g., In re Shoppers Paradise, Inc., 8 B.R. 271 (Bankr. S.D.N.Y. 1980); see generally Howard C. Buschman III, Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts, 5 BANKR. DEV. J. 341, 345-49 (1988); Bordewieck, supra note 47, at 200. Of course, if the Debtor receives benefits from the OP prior to the time a decision is made on rejection or assumption, the Debtor must pay for the reasonable value of the benefits. See, e.g., Bildisco, 465 U.S. at 531; Philadelphia Co. v. Dipple, 312 U.S. 168, 174 (1941).
its provisions against the OP/Debtor. The decision to assume or reject the contract will determine whether the contractual provisions creating these new property interests will be enforceable against the OP/Debtor by virtue of the OP/Debtor's decision to assume the contract, or will be rendered permanently unenforceable by rejection and therefore ineffective to create the property interests.

III. Effect of Rejection

When the Debtor elects to reject a lease or executory contract, the Code does not fully articulates the consequences of that decision. Congress simply provided that rejection of an executory contract or unexpired lease "constitutes a breach of such contract or lease" as of the specified time.\footnote{11 U.S.C. § 365(g)(1) (1994).} Because a breach of contract gives rise to a right to payment at law or in equity under state law, such breach gives rise to a "claim" under section 101(5) of the Code\footnote{Section 101(5) of the Bankruptcy Code defines "claim" very broadly to include: (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.} and the OP may file a proof of claim and obtain a distribution in respect thereof with all other unsecured claimants.\footnote{Pre-petition claims not listed by the debtor in its schedule of liabilities filed with the court under section 521(1) of the Code may be filed by a creditor pursuant to section 501(a) of the Code. Such claims are deemed allowed, unless a party in interest objects. See id. § 502(a). Under section 502(g), "A claim arising from the rejection, under section 365 of this title . . . of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed . . . or disallowed . . . the same as if such claim had arisen before the date of the filing of the petition." Allowed claims obtain the priority in distribution specified in section 507 of the Code. Damages suffered by the OP as a result of the rejection of a lease or executory contract are afforded the same treatment. See generally Bildisco, 465 U.S. at 531 (1984) ("Damages on the contract that result from the rejection of an executory contract, as noted, must be administered through bankruptcy and receive the priority provided general unsecured creditors.")}
After the claim is satisfied (either through distribution of property of the estate pursuant to section 726 of the Code, or pursuant to a plan of reorganization under section 1141, 1228, or 1328), the Debtor will, through the bankruptcy discharge granted under section 727, 1141, 1228 or 1328 of the Code, be relieved of its obligations under the lease or contract and the NDP will be permanently enjoined from seeking enforcement of that lease or contract under section 524 of the Code. In sum, the contract has, by operation of the Code, been rendered unenforceable against Debtor.

But what happens to the contract or lease? Except in limited circumstances in which Congress has chosen to provide a NDP continuing property rights under rejected contracts or leases, the Code says nothing about the status of these rejected agreements. Examining precisely this issue, Michael T. Andrew reached the conclusion that rejection of the lease or contract does not result in termination or cancellation thereof and does not affect the rights of the NDP to the UP. Professor Jay Lawrence Westbrook has endorsed a similar theory, seeing rejection of executory contracts and leases alone as having no effect on what he calls an “ITI,” or “interest in the thing itself” (in my terminology, property rights of

52. A discharge granted pursuant to section 727(a) “discharges the debtor from all debts that arose before the date of the order for relief under this chapter, and any liability on a claim that is determined under section 502 of this title as if such claim had arisen before the commencement of the case . . . .” 11 U.S.C. § 727(a). Confirmation of a plan of reorganization under section 1141 “discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g) [describing claims arising from rejection of an executory contract or unexpired lease] . . . .” Id. § 1141(d)-(1)(A). Other sections provide that a discharge “discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title . . . .” Id. §§ 1228(c), 1328(c). A non-individual debtor is not entitled to a discharge in Chapter 7, see id. § 727(a)(1), but because such a debtor is unlikely to continue to conduct business in its current legal form after emerging from bankruptcy, the absence of a discharge in most cases does not render pre-petition obligations enforceable as a practical matter.

53. The Bankruptcy Code lists certain claims that are not subject to discharge pursuant to section 727, 1141, 1228(a), 1228(b) or 1328(b). See 11 U.S.C. § 523.

54. A discharge under title 11 “operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such [discharged] debt as a personal liability of the debtor, whether or not discharge of such debt is waived . . . .” Id. § 524(a)(2).

55. See infra notes 93-100 and accompanying text.

56. Andrew, Executory Contracts, supra note 8, at 921.

57. Westbrook, Functional Analysis, supra note 8, at 257-263.
the NDP in the UP). With due respect, I must take another view. I believe their assertion that rejected leases and contracts remain intact for some purposes after rejection and discharge is unsupported either by the language of the Code or by bankruptcy policy. In reaching that conclusion, I will begin by looking at situations in which contracts become void under state law and the consequences of that avoidance. I will then look at the language of the Code, which indirectly supports the conclusion that a rejected lease or contract terminates. Finally, I will argue that the “fresh start” policy underlying the Code requires the same conclusion.

A. Voidable Contracts at State Law

Bankruptcy is, of course, a statutory construct. However, the common law provides analogies to which we can look to discern the consequences of bankruptcy on a rejected lease or contract. By operation of the Code, a contract or lease that was initially enforceable against both parties has become unenforceable against one of those parties, that is, one party has been discharged of its obligations on the contract or lease. The most obvious analogy outside the bankruptcy context is the discharge of one party to a valid contract or lease based on impossibility of performance.

The common law doctrine of excuse is far more limited than bankruptcy discharge. Early nineteenth century contract theorists

58. The Andrew/Westbrook thesis has also convinced Professor Lawrence P. King, who endorsed it in the most recent edition of COLLIER ON BANKRUPTCY when discussing section 365. See 3 COLLIER ON BANKRUPTCY ¶ 365.09[3], at 365-73 (Lawrence P. King ed., 15th ed. rev. 1998) [hereinafter COLLIER ON BANKRUPTCY]. However, in discussing section 502(b)(6), Professor King states, “The rejection of a lease under section 365 is equivalent to a termination by breach.” 4 id. ¶ 502.03[7][b], at 502-46. See generally infra notes 103-04 and accompanying text. A number of courts have also been persuaded by the Andrew/Westbrook analysis. See supra note 9.

One court has taken the Andrew/Westbrook view to the ultimate conclusion that an executory contract that could be specifically enforced in the absence of bankruptcy remains specifically enforceable against a rejecting debtor because it is not “terminated.” See In re Walnut Associates, 145 B.R. 489, 494 (Bankr. E. D. Pa. 1992). One could characterize that conclusion as rejecting rejection.

59. Of course, if the lease or contract remained in effect after rejection and discharge, any STP with a security interest in the rights of either the Owner or the OP continues to hold that security interest after rejection. Therefore, my ultimate conclusion that an STP “rides through” the rejection process would be the same even if I agreed with Messrs. Andrew and Westbrook. See, e.g., In re Austin Development Co. 19 F.3d 1077, 1084 (5th Cir. 1994) (holding that rights of secured party in debtor/tenant’s leasehold interest did not terminate with rejection of lease).
embraced what has been described as "a theory of absolute contractual liability,"[60] under which parties would be held to the letter of their bargain notwithstanding subsequent "accident or inevitable necessity."[61] Impossibility of performance theoretically failed to supply a defense to contractual liability because the parties had the ability from the inception of the contractual relationship to specify the risks they were unwilling to assume and thus protect themselves from burdensome obligations.[62]

However, the practical injustice of holding parties to contractual obligations in the face of extreme changes in circumstances that the parties themselves had not foreseen (and thus had not reached an objectively discernible meeting of the minds expressed in the contract as to allocation of risk for non-performance in that situation) impelled courts to develop safety valves to the absolute liability theory. As ultimately reflected in the section 457 of the Restatement of Contracts, "where, after the formation of a contract facts that a promisor had no reason to anticipate, and for the occurrence of which he is not in contributing fault, render perfor-

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60. GRANT GILMORE, THE DEATH OF CONTRACT 49 (2d ed. 1995).
61. Adams v. Nichols, 19 Mass. Pick. 275, 276 (1837). This nineteenth century theory was heavily influenced by dictum from a seventeenth century English case, Paradine v. Jane, Aley 26, 82 Eng. Rep. 897, Style 47, 82 Eng. Rep. 519 (K.B. 1647). In that case, the lessee sought to be excused from paying rent when he was ousted from the leased premises by royalist forces led by Prince Rupert, nephew of Charles I of England, during the English Civil War. In refusing to discharge the lessee, according to the report in Aley the court noted:

"[W]hen the party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract."

Aley at 27. The report of the case in Style has no such language, and it is likely that the result in Paradine turned less on a theory of absolute contract than on the court's view of leasehold interests. See generally GILMORE, supra note 57, at 51. It certainly did not deal with a situation in which performance (the performance at issue in Paradine was payment of rent) had been rendered "impossible." See generally John D. Wladis, Common Law and Uncommon Events: The Development of the Doctrine of Impossibility of Performance in English Contract Law, 75 GEO. L.J. 1575, 1585 (1987).
62. See, e.g., Wills v. Shockley, 157 A.2d 252, 253 (Del. 1960) ("At the time of entering the contract, [salvager] did not see fit to relieve himself from liability for his failure to perform by reason of any subsequent difficulty . . . . Not having done so, he is now obligated to perform the contract according to its terms . . . ."); Beatty v. Oakland Sheet Metal Supply Co., 244 P.2d 25, 33 (Cal. App. 1952) ("If a party desires to be free from his obligation to deliver a commodity in the event of nonproduction by a particular concern, it is incumbent upon him to make clear provision to that effect in his contract."); quoting S. L. Jones & Co. v. Bond, 217 P. 725, 727 (Cal. 1923); Leavitt v. Dover, 32 A. 156, 156 (N.H. 1891) ("Having voluntarily entered into an absolute contract, without any qualification or exception . . . he must abide by his contract . . . .")
mance of the promise impossible, the duty of the promisor is discharged." The doctrine, later reflected in sections 2-615 and 2A-405 of the U.C.C. and in the Restatement (Second) of Contracts section 261, embraces not only performance that is physically impossible but also performance that may be rendered impracticable because of "extreme and unreasonable difficulty, expense, injury, or loss to one of the parties will be involved."

Two central limitations are inherent in the common law impossibility/impracticability doctrine. First, the anticipated non-occurrence of the supervening event must have been central to the willingness of the parties to enter into the contract. This concept certainly includes events that were not reasonably foreseeable by the contracting parties. However, although traditionally phrased in terms of "foreseeability," as recognized by Restatement (Second) of Contracts section 261, parties may share a central expectation that certain occurrences that may be foreseeable will not occur, and may decline expressly to allocate risk for those occurrences for reasons of negotiating dynamics, cost, or complexity.

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63. Restatement of Contracts § 457 (1932).
64. Section 2-615 of the U.C.C. provides:
   "Except so far as a seller may have assumed a greater obligation . . .:
   (a) Delay in delivery or non-delivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order . . . ."


The parallel provision under Article 2A for excused performance under a lease provides:

(a) Delay in delivery or nondelivery in whole or in part by a lessor or a supplier . . . is not a default under the lease contract if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the lease contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order . . . ."

Id. § 2A-405(a) (1987).

65. "Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged . . . ."

66. Restatement (Second) of Contracts § 261 cmt. d (1981); see also Restatement of Contracts § 454 (1932).

67. See Restatement (Second) of Contracts § 261 cmt. c ("Factors such as the practical difficulty of reaching agreement on the myriad of conceivable terms of a complex agreement may excuse a failure to deal with improbable contingencies."). See, e.g.,
The second limitation on the “impossibility” doctrine at common law was the reluctance to relieve one party of its obligations if the event were occasioned by acts or omissions of the party seeking such relief. This limitation may have grown up from the general notion that parties to a contract have an implied obligation of good faith and fair dealing, which would be inconsistent with affirmatively causing or failing to take steps to prevent an intervening event that prevents performance. In any event, courts consistently required parties seeking to benefit from the impossibility doctrine to come into court with “clean hands” in the sense of being the innocent victim of circumstances rather than an active manipulator of events.

The consequences of impossibility of performance of a contract by one party are well-established: when the limitations of the doctrine are satisfied, the party is “discharged” from liability on the contract. The consequences of the excused party’s failure to perform for the other party are the same as those in the case of a breach of contract; if performance is a material term, the other party can also decline to perform and terminate the contract. If the performance is permanently excused, the contract terminates.

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69. See, e.g., Taylor-Edwards Warehouse & Transfer Co. v. Burlington Northern, Inc., 715 F.2d 1330 (9th Cir. 1983) (increased expense attributable to railroad’s own decision to abandon main rail line); Neal-Cooper Grain Co. v. Texas Gulf Sulphur Co., 508 F.2d 283 (7th Cir. 1974) (increased expense of performance attributable to seller’s decision to switch to Canadian mine); Handicapped Children’s Educ. Bd. v. Lukaszewski, 332 N.W.2d 774 (Wis. 1983) (health danger associated with performance attributable to teacher rather than school board).

70. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981); RESTATEMENT OF CONTRACTS § 457 (1932).

71. See E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 9.9, at 572 (1990); see, e.g., Stewart & Stevenson Services, Inc. v. Superior Boatworks, Inc., Civ. A. Nos. 94-2332, 94-2693 1995 WL 608494 (E.D. La. Oct. 11, 1995) (allowing termination of subcontract when performance became impossible due to non-assumption of prime contract upon bankruptcy of third party). When dealing with executory contracts in bankruptcy, we are by definition necessarily discussing contracts in which the nonperformance of the remaining obligations of one party are sufficiently material as to excuse the complete nonperformance of the remaining obligations of the other party. See supra note 16 and accompanying text.

To the extent that the contract conveyed property interests, "courts attempt to return the parties to their status quo ante, unless to do so would work an injustice on third parties." Thus, for example, when consideration for the conveyance of a railroad right-of-way could no longer legally be provided in the form previously agreed (a lifetime pass), one court concluded that the "contract is at an end" and "[t]he party obtaining the property . . . should be required to restore it, or to pay for it upon equitable terms."

But is the rejection of a lease or executory contract sufficiently analogous to contractual impossibility to argue that the consequences of discharge in both situations should be identical? Initially, one could argue that each party to a lease or contract certainly is able to foresee the potential lack of continued financial viability of the other party, and that the necessary pre-condition to operation of the impossibility doctrine therefore does not exist. However, the parties to the contract certainly share a "basic assumption" that both parties will remain willing and able to perform the contract during its term, within the meaning of Restatement (Second) of Contracts section 261. Even if a party insisted on an absence of "foreseeability" as a precondition to excuse for nonperformance, if one views bankruptcy as analogous to death or illness of an individual contracting party (albeit a financial rather than a physical affliction), its occurrence should not be seen as "foreseeable" in a way that precludes invocation of the impossibility doctrine.

Schaub v. Wright, 130 N.E. 143 (Ind. App. 1921); Stratford, Inc. v. Seattle Brewing & Malting Co., 162 P. 31 (Wash. 1916); cf. Transatlantic Financing Corp. v. United States, 363 F.2d 312, 320 (D.C. Cir. 1966) ("When performance of a contract is deemed impossible it is a nullity.").

73. HOWARD O. HUNTER, MODERN LAW OF CONTRACTS ¶ 19.01, at 19-3 (rev. ed. 1993).
74. Louisville & N.R. Co. v. Crowe, 160 S.W. 759, 760 (Ky. 1913) (ordering payment rather than restitution of the property because "the rights of the public hav[e] intervened").
75. Indeed, parties are often sufficiently concerned about the possibility of bankruptcy that they bargain for credit support in the form of guarantees, letters of credit, and security interests to protect themselves from financial peradventure.
76. As explained by one author:
"Any one who contracts to render a personal service within a year knows that death or illness may occur; but under ordinary circumstances he does not foresee that it will occur during the year of performance and his duty is terminated if he still could and would have performed as agreed but for the unforeseen event."

Moreover, if financial collapse was viewed as "foreseeable," when the ability to foresee potential events is not coupled with an ability to allocate the risk of those events through contractual negotiation, it would be meaningless to designate such events as "foreseeable." The Code prevents the parties from specifying the consequences of financial collapse of one or the other by contract. Instead, the legislative provisions preclude the NDP from enforcing any provisions of the contract against the debtor,\textsuperscript{77} in particular those that permit termination or modification of the contract conditioned on financial condition or insolvency of the debtor or the commencement of a bankruptcy case.\textsuperscript{78}

Similarly, one could argue that the Debtor has "caused" the event that precipitated the impossibility of performance, in two ways. First, the Debtor has pursued a course of action that had led inexorably to its financial difficulties. But the same could be argued of an individual whose careless or intentional acts result in his death or disability, and courts have nevertheless suggested that the conclusion of those acts provides an excuse to performance by landlord excused under the impossibility doctrine from compliance with use restriction contained in second tenant's lease because the risks associated with bankruptcy were not contemplated or allocated by the parties).

\textsuperscript{77} See 11 U.S.C. § 362 (1994). That section states:

1. the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

2. any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

3. any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

\textsuperscript{78} See id. § 365(e)(1). That section reads:

(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

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

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

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.
reason of impossibility. Second, the Debtor (or the trustee on its behalf) has taken a more direct action to preclude performance, by electing to reject the contract and relieve itself from its liabilities thereunder. While this is certainly true, the right of the Debtor to make such an election is statutory in nature, and represents a Congressional judgment that the public interest is best served by affording troubled debtors the ability to reassess certain contractual obligations (a "second look" policy) and to elect to return to the pre-contractual state at the cost of providing for the damages occasioned by that decision in connection with the bankruptcy proceeding. Indeed, if the parties were to attempt to provide contractually for a waiver of the Debtor's ability to reject a contract, such a provision would undoubtedly be unenforceable as contrary to public policy.

This discussion is not intended to suggest that the rejection of executory contracts and leases is simply an application of the doctrine of impossibility of performance. Indeed, in the absence of the legislative provisions permitting the discharge of the Debtor, common law principles would hold the Debtor to the contract notwithstanding the fact that the promised performance is financially difficult or even impossible. The two concepts also differ

79. See, e.g., Hughes v. Wamsutta Mills, 93 Mass. (11 Allen) 201 (1865) (rejecting the suggestion that an employee's arrest was due to his "voluntary act" and allowing him to invoke the impossibility defense when unable to perform) cf. Joseph Constantine S.S. Line, Ltd. v. Imperial Smelting Corp., [1942] A.C. 154, 166 ("Some day it may have to be determined whether a prima donna is excused by complete loss of voice from an executory contract to sing if it is proved that her condition was caused by her carelessness in not changing her wet clothes after being out in the rain. The implied term may turn out to be that the fact of supervening physical incapacity dissolves the contract without inquiring further into its cause, provided, of course, that it has not been deliberately induced in order to get out of the engagement.").


notably in their consequences on the NDP. Whereas impossibility of performance completely discharges the party precluded from performance from damages for the breach of contract occasioned by that nonperformance, rejection of a contract or lease gives rise to a claim against the nonperforming party, explicitly recognized by the Code, for damages caused by the breach. Yet, despite its differences from rejection, the impossibility doctrine provides the most apt analogy outside of bankruptcy in which a contract, initially enforceable against both parties, becomes completely unenforceable against one because of subsequent events, whether natural or legal. When a rejected contract or lease has become unenforceable as a matter of law because of the differences between contract excuse and bankruptcy discharge and suggesting that radically different approaches to the two concepts are not warranted); John C. Weistart, The Costs of Bankruptcy, 41 LAW & CONTEMP. PROB. 107, 112 (1977) (suggesting that any distinction between insolventy and other types of impracticability is not "inevitable").


83. See 11 U.S.C. §§ 365(g)(1), 502(g) (1994). The fact that the Bankruptcy Code provides such a remedy has been cited by some courts as evidence that rejection of the lease or contract does not result in its termination; if the lease or contract terminated, these courts reason, there would be no binding obligations to breach and no claim against the Debtor (or any guarantor of the Debtor) on account of such breach. See, e.g., In re Continental Airlines, 981 F.2d 1450, 1459 (5th Cir. 1993); In re Modern Textile, Inc., 900 F.2d 1184, 1191 (8th Cir. 1990); In re Kilpatrick, 160 B.R. 560, 563 (Bankr. E.D. Mich. 1993); Societe Nationale Algerienne v. Distrigas Corp., 80 B.R. 606, 608 (D. Mass. 1987). In reaching this conclusion, courts are adhering too literally to the term "termination." Rejection should be viewed resulting in "cancellation" of the lease or contract within the meaning of section 2-106(4) of the U.C.C. rather than "termination" within the meaning of section 2-106(3). The effect is the same (all obligations that are executory on both sides are discharged), but upon "cancellation" the cancelling party "retains any remedy for breach of the whole contract or any unperformed balance." Id. § 2-106(4); see In re Child World, Inc., 147 B.R. 847, 852 (Bankr. S.D.N.Y. 1992) ("[R]ejection of the... contracts does not mean that the obligations thereunder will evaporate. Rejection is not the equivalent of rescission... ").
operation of the provisions of the Code, it must be found to come to an end as does any other contract rendered completely impossible of performance, and thus unenforceable, by superseding event.

Another analogy one might make to state contract law would be to the contract that is voidable by reason of minority. Now codified in most states, at common law a contract entered into by a minor is voidable (subject to "disaffirmance") at the instance of the minor at any time prior to a reasonable period after the minor attains majority. Alternatively, the minor can "ratify" the contract upon reaching the age of majority, thereby affirmatively relinquishing the right to disaffirm. Although the Code uses the term "rejection" instead of "disaffirmance," and "assumption" instead of "ratification," the decision given the trustee in bankruptcy is very much the same. As under section 365 of the Code, the contract must be disaffirmed or ratified in whole; minors cannot select which provisions are binding. The consequence of the doctrine is to "allow the minor to enforce transactions that have proved advantageous while avoiding those that have proved disadvantageous," which is precisely the objective behind the power to assume or reject executory contracts and unexpired leases given a trustee under section 365 of the Code.

Unlike under the Code, the power of a minor to disaffirm applies even to fully performed contracts, including those in which goods or real property were sold to or by the minor. Upon disaffirmance, "the transaction is treated for many purposes as if it were void from the beginning." The minor returns anything received under the contract (traditionally without responsibility for any damage or depreciation), and the other contractual party also returns what it received, whether cash or property. In the case of real property, the obligation to return applies even if the other party has sold what was received from the minor to a bona fide

85. See Restatement (Second) of Contracts § 14 (1981); John D. Calamari & Joseph M. Perillo, Contracts, § 8-2 (3d ed. 1987); Farnsworth, supra note 71, § 4.4.
86. See, e.g., Putman v. Deinhamer, 70 N.W.2d 652, 655-56 (Wis. 1955) (holding that a minor may not repudiate cancellation provisions of automobile insurance policy while retaining remainder of policy).
87. Farnsworth, supra note 71, § 4.4, at 380.
88. Calamari & Perillo, supra note 85, § 8-2, at 308.
purchaser for value. The common law rule is thus to return to the "status quo ante regardless of the effect on the other party." The harsh effect of the common law rule has been ameliorated in the case of contracts for "necessaries," and in some jurisdictions (notably New Hampshire) in other situations as well, by providing the other party a claim against the minor for the value of what the minor received and did not return. But in all situations the contract is terminated and becomes void, even if the other party is given an extra-contractual remedy.

A bankrupt is not a minor, of course, and the doctrine embodied in section 365 of the Code is not premised on any notion of incapacity to contract. However, in both situations the law recognizes the ability of a contractual party to take a "second look" at its obligations under its contracts and decide whether it will continue to honor them. Although the drafters of the Code have chosen to provide the OP a remedy for rejection not generally available to those dealing with minors, there is no reason that the effect of that choice to disaffirm or reject on the contract itself and property rights received thereunder should be any different in the two contexts; the rejected contract, like one subject to disaffirmance, is terminated and void.

B. Interpreting the Code

Although statutory support for this conclusion is indirect, some provisions of the Code suggest that Congress recognized that rejected leases and contracts ceased to exist. First, in special circumstances, Congress has chosen to ameliorate the effects of termination of rejected leases or executory contracts in the interest of preserving property rights of the NDP. In the case of an unexpired lease of real property under which the Debtor is the lessor, Congress provided in section 365 that a lessee who does not

89. See Ware v. Mobley, 9 S.E.2d 67 (Ga. 1940) (citing cases). With respect to personal property, section 2-403(1) of the U.C.C. modifies this rule and grants protection to the good faith purchaser for value. See CALAMARI & PERILLO, supra note 85, § 8-2, at 308.

90. HUNTER, supra note 73, § 2.01[4], at 2-7.

91. FARNSWORTH, supra note 82, § 4.5, at 385; CALAMARI & PERILLO, supra note 85, § 8-8.

wish to treat the rejection as terminating the lease\textsuperscript{93} may retain the right to remain in possession of the leased property, notwithstanding the rejection of the lease.\textsuperscript{94} Congress expanded those

\textsuperscript{93} Section 365(h)(1)(A)(i) states:
If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection . . .

In \textit{In re Austin Development Co.}, 19 F.3d 1077, (5th Cir.), cert. denied, 513 U.S. 874 (1994), the court relied on the existence of section 365(h)(1)(A)(i), and the comparable provisions in sections 365(i) and 365(n) dealing with timeshare interests and licenses of intellectual property, to support its conclusion that Congress did not make rejection of a lease or contract result in termination thereof under other circumstances. \textit{See id.} at 1082-83. I agree with the Fifth Circuit in its conclusion that Congress did not attempt to provide for termination of rejected leases and executory contracts as a matter of federal law. However, I believe that under state law—to which Congress properly deferred on matters of property rights—a lease or contract that becomes totally unenforceable against one of the parties must terminate. The inclusion of the “savings” provisions in sections 365(h), 365(i), and 365(n) were therefore intended not to give the OP an “option to terminate,” as the Fifth Circuit characterizes it. \textit{See id.} at 1083. Indeed, the legislative history of section 365(n)(1) recognizes that the ability of the OP to treat a rejected license as terminated “would be available to the licensee without this bill.” S. REP. No. 100-505, at XX (19XX), \textit{reprinted in} 1988 U.S.C.C.A.N. 3200, 3201. Rather, these provisions were included by Congress to provide the OP an option it would not have under state law, an option to retain its rights under the lease, timeshare plan, or license agreement notwithstanding its rejection. In essence, the provisions of the Code in these three situations preempt state law and allow OPs to elect to keep in effect leases and executory contracts that would otherwise automatically terminate under state law. \textit{Cf. In re O.P.M. Leasing Services, Inc.}, 23 B.R. 104, 118 (Bankr. S.D.N.Y. 1982) (holding that a lessee under an equipment lease is not protected by section 365(h), and that the equipment returns to lessor upon rejection of lease).

\textsuperscript{94} \textit{See} 11 U.S.C. § 365(h)(1)(A)(ii). As originally enacted, section 365(h)(1) read as follows:

(h)(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law.

This provision was consistent with section 70b of the Bankruptcy Act of 1898. \textit{See Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended,} 11 U.S.C. § 110b (repealed, Section 401 of the Bankruptcy Reform Act of 1978, P.L. No. 95-598) Section 706 provided in part as follows:

Unless a lease of real property shall expressly otherwise provide, a rejection of such lease or any covenant therein by the trustee of the lessor shall not deprive the lessee of his estate.

It has been suggested that the language of section 70b protecting lessees from the consequences of lease rejection by a landlord was merely a reflection of the common law principle that a landlord's creation of a leasehold estate in the lessee was an executed conveyance of a property interest and was not itself subject to rejection. \textit{See} John J.
protections in the Bankruptcy Reform Act of 1994,\textsuperscript{95} preserving in the NDP/Lessee after rejection by the Debtor/lessor other rights under the lease that are "in or appurtenant to the real property" to the extent enforceable under nonbankruptcy law.\textsuperscript{96}

\textsuperscript{95} Pub. L. No. 103-394 (effective Oct. 22, 1994).

\textsuperscript{96} See 11 U.S.C. § 365(h)(1)(A)(ii). That section reads:

\[(h)(1)(A)\] If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—

\[\ldots\]

\[(ii)\] if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.
The same treatment is afforded purchasers of timeshare interests from a Debtor/Seller, as well as purchasers of real property from a Debtor/Owner who rejects the sale contract as executory. Similarly, on the theory that, as is true for real property leases and timeshare interests, the property underlying an intellectual property license is “unique,” Congress adopted a new section 365(n) that allows a NDP licensee of intellectual property to retain use of the intellectual property covered by the license and exercise its rights thereunder to exclusive use, notwithstanding the rejection of the license by the trustee.

These provisions of the Code are specifically limited to the types of leases or executory contracts described therein, and could be seen as carefully tailored legislative reactions to interpretations of the Code that adversely affected important segments of the economy. Nevertheless, had the operation of section 365 of the

The purpose of the amendment was to reject those cases that had narrowly interpreted the term “possession” in the prior version of section 365(h)(1), see supra note 94 and to allow a lessee under a rejected lease to retain such rights under the lease as “the amount and timing of payment of rent or other amounts payable by the lessee, the right to use, possess, quiet enjoyment, sublet, or assign.” 140 CONG. REC. H10,752-01, H10,767 (daily ed. Oct. 4, 1994).

See 11 U.S.C. § 365(h)(2)(A)(ii). Under section 365(h)(2)(A)(ii), if the purchaser does not wish to treat the timeshare plan as terminated, the purchaser may “retain its rights in such timeshare interest for the balance of such term and for any term of renewal or extension of such timeshare interest to the extent that such rights are enforceable under applicable nonbankruptcy law.”

Section 365(i)(1) provides:

If the trustee rejects an executory contract of the debtor for the sale of real property or for the sale of a timeshare interest under a timeshare plan, under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property or timeshare interest.


See 11 U.S.C. § 365(n)(1). That section provides:

(n)(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property . . . .
Code not resulted in the termination of the rejected contract or lease in these contexts, there would have been no need for palliative measures.

When it is the trustee for a lessee under a lease of nonresidential real property who is deemed to have rejected a lease by failure to assume or reject it within 60 days after the date of the order for relief, section 365(d)(4) of the Code directs the trustee to "immediately surrender such nonresidential real property to the lessor." If the rejected lease remained effective, surrender to the lessor would be inappropriate, as noted by several of the courts that have concluded that this type of rejection results in termination of a lease. There is no reason to believe that rejection of other types of unexpired leases or executory contracts have a different legal consequence.

Additional support can be drawn from the language of section 502 dealing with allowance of claims. Although claims resulting from the deemed breach of a rejected contract or lease are generally not described specifically, certain types of such claims are treated in detail and are described in terms that support the conclusions that the contract has terminated. In section 502(b)(6), the Code imposes an upward limit (a "cap") on the claim that can be asserted against a Debtor/lessee by an OP/lessor for damages "resulting from the termination of a lease of real property." The "termination" to which section 502(b)(6) refers includes the termination resulting from rejection of a lease.


102. See 11 U.S.C. § 502(b)(6). That section provides that a "claim of a lessor for damages resulting from the termination of a lease of real property" is to be disallowed to the extent that it exceeds:

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates . . .

103. See id. Section 502(b)(6) was originally enacted as Section 502(b)(7) as part of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, and was redesignated by the Bankruptcy Amendments and Federal Judgeship Act of 1987, Pub. L. No. 98-353. However,
The same terminology is used in section 502(b)(7) with respect to employment contracts; any claim "resulting from the termination" of such a contract, which includes terminations resulting from rejection of the contract as executory,\textsuperscript{104} is statutorily limited.\textsuperscript{105}

it derives from long-standing provisions in the Bankruptcy Act of 1898, as amended, in particular section 63a(9), which specified, as a provable debt which could be allowed against the bankrupt estate:

(9) claims for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property: Provided, however, that the claim of a landlord for damages or injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding [the prescribed amount].

Similar caps on the damage claim allowable to a landlord in the case of rejection of an unexpired lease were included in sections 202, 353 and 458 of the Act for cases under chapters X, XI and XII. The justification for such provisions was the recognition that the claim of a landlord under a rejected lease could be disproportionate to the damage actually suffered by the landlord, and could deplete the estate. See generally Oldden v. Tonto Realty Corp., 143 F.2d 916 (2d Cir. 1944); 4 COLLIER ON BANKRUPTCY, supra note 58, ¶ 502.03[7][a], at 502-45.

Although it has been successfully argued that the different language in section 502(b)(6) (referring to damages from "termination" of a lease rather than from "rejection") indicated that the statutory cap does not apply to damages caused by breach of lease covenants as opposed to failure to continue to occupy and pay rent for the leasehold, see, e.g., In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231 (Bankr. D.N.D. 1992); In re Atlantic Container Corp., 133 B.R. 980 (Bankr. N.D. Ill. 1991), most courts have concluded that section 502(b)(6), like its predecessor section 63a(9), is intended to capture all claims occasioned by rejection. See In re McSheridan, 184 B.R. 91, 101 (B.A.P. 9th Cir. 1995); In re Mr. Gatti's, Inc., 162 B.R. 1004, 1013 (Bankr. W.D. Tex. 1994); In re Emple Knitting Mills, Inc., 123 B.R. 688, 691 (Bankr. D. Me. 1991).


The natural conclusion to be drawn from Congressional amendments protecting a NDP in certain discrete situations, and the use of language limiting claims for “termination” of leases or executory contracts that are applicable when such leases or contracts are rejected pursuant to section 365, is that rejection ordinarily results in termination of the rejected contract or lease. A NDP who is a party to a lease or executory contract not addressed by the protective provisions of section 365(h) or (n) has no such benefit, and its right to possess or use property of the estate or enjoy services provided by the Debtor terminate absolutely when the lease or contract is rejected.

Although they seldom provide any discussion of the issue, the overwhelming majority of cases dealing with rejected leases and contracts not subject to the specific statutory protections just discussed treat such contracts as terminated or cancelled. The Supreme Court, in its most recent decision addressing section 365 provided oblique support for this conclusion. The majority concluded that “from the filing of a petition in bankruptcy until formal acceptance [i.e., assumption], the collective-bargaining


106. See supra note 7. One class of cases that comes to the contrary conclusion deal with non-compete clauses. See, e.g., in re Printronics, Inc. 189 B.R. 995, 100 (Bankr. N.D. Fla. 1995) (holding that the rejection by a franchisee of a franchise agreement did not terminate obligations under agreement, including non-compete clause); in re Hirschhorn, 156 B.R. 379, 388 (Bankr. E.D.N.Y. 1993) (holding that the rejection of sublease did not render a noncompete clause unenforceable); in re Udell, 149 B.R. 908, 911-913 (N.D. Ind. 1993), rev’d on other grounds, 18 F.3d 403 (7th Cir. 1994) (holding that the rejection of an employment agreement did not terminate a non-compete clause); in re Don & Lin Trucking Co., 110 B.R. 562, 567 (Bankr. N.D. Ala. 1990) (rejection terminates all mutual performance obligations but does not affect provisions dealing with effect of termination). But see In re Register, 95 B.R. 73, 74 (Bankr.), aff’d, 100 B.R. 360 (M.D. Tenn. 1989); In re Rovine Corp., 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980) (holding that because the noncompete covenant was part of rejected executory contract it was rejected).

Because leases or executory contracts that include such clauses contemplate that the clauses will be operational only upon termination of the lease or contract, the conclusion that the non-compete clause is enforceable after rejection of the lease or contract is not in itself inconsistent with the proposition that the underlying lease or contract is terminated by rejection. As Professor Westbrook suggested, “[T]he right to discharge is the correct place to tussle over [the issue of enforceability of a non-compete clause after rejection of a contract], rather than it being the offshoot of some special rule about bankruptcy contracts.” Westbrook, supra note 8, at 277-78.

agreement is not an enforceable contract within the meaning of NLRA § 8(d).” 108 Although four Justices dissented from this conclusion, contending that the collective-bargaining agreement remained “in effect” within the meaning of section 8(d) notwithstanding the filing of a bankruptcy petition, even they assumed that the beleaguered employer could make section 8(d) inapplicable by rejecting the collective-bargaining contract. 109 The necessary premise for this conclusion is that a rejected collective-bargaining contract is no longer “in effect,” that is, it has ceased to exist.

C. Termination and Property Rights

The Code explicitly discharges the Debtor under the rejected lease or executory contract, and by analogy to the common law contract theories previously discussed, the impact of that rejection and discharge should be the termination of the contract. But as previously discussed, the central feature of a contract or lease for bankruptcy purposes is its impact on property rights of both Debtor and OP. How does termination of the lease or executory contract affect those property rights?

As we saw, the property interests of the Debtor created by the lease or contract and, in the case of an Owner/Debtor, in the UP, became property of the estate pursuant to section 541 of the Code. 110 When the contract or lease is rejected and thus terminated, two different property rights are affected. Those property rights that are created by the contract or lease (accounts, general intangibles, leasehold interests) exist in the holders thereof only by virtue of the contract or lease, and disappear with its termination. 111 The Owner’s property rights in the UP, which existed

108. Bildisco, 465 U.S. at 532 (finding section 8(d) of the NLRA inapplicable to a collective bargaining agreement even prior to rejection).
109. See id. at 551. (Brennan, J., dissenting).
110. See supra notes 45-46 and accompanying text.
111. Certain commentators argue that property interests created by leases or contracts continue to exist independent of rejection of those leases or contracts because the contract is not terminated, but merely “breached.” See articles cited supra note 8. As previously discussed, I believe that common law principles of contract jurisprudence lead to the conclusion that the rejected contract or lease must terminate when it becomes permanently unenforceable against the Debtor. Although the plight of the innocent NDP/OP afflicted by the Debtor/Owner’s bankruptcy is certainly appealing, if one responds by preserving the OP’s property interests in the UP in this case, does one also allow a Debtor/OP to reject a lease or contract while still obtaining the benefit of property rights in a NDP/Owner’s UP created thereby? Cf. Fletcher v. Surprise (In re Northern Indiana Oil Co.), 180 F.2d 669, 676 (7th Cir.), cert. denied, 340 U.S. 824 (1950) (rejecting the contention that the “savings clause” of
prior to the contract or lease but were limited by its provisions (through the creation of interests in the OP, labelled P1 in the models), continue to exist after the termination of the lease or contract, free of the now-unenforceable limitations. Viewed another way, the property interests of the OP in the UP, created by the executory contract or lease (P1), revest in the Owner upon rejection; there, joined to the retained property interest of the Owner in the UP, they create an unencumbered fee simple absolute ownership. When the Owner is the Debtor, this expanded interest in the UP acquired from the OP/NDP after the commencement of the bankruptcy case becomes property of the estate under section 541(a)(7). When the OP is the Debtor, the effect of rejection is to remove from the bankruptcy estate and transfer to the Owner/NDP any property interest created by the rejected contract or lease.

The Code specifies the impact of the conclusion of a bankruptcy case on property of the estate. Property of the estate is either distributed to creditors in liquidation, or vests in the Debtor upon confirmation of a plan of reorganization. Whether in the hands of the Debtor or a third party, such property is "free and clear" of any claim or interest of any creditor, and the NDP will be permanently enjoined from seeking redress for its claim against the property.

If the OP is the Debtor, there is no property of the estate relating to the rejected contract or lease existing at the conclusion of the case because rejection resulted in the transfer of the subset of property interests in the UP created by the lease or contract back to the Owner/NDP. If the Owner is the Debtor, however, the entire interest in the UP, including that portion of the interest representing the property interest of the OP/NDP that transferred back to the Owner upon rejection, is included in the estate. Given the broad definition of "claim" in section 101(5) of the Code, one must conclude that the property rights of the OP/NDP under the section 70b of the Bankruptcy Act protects a debtor/lessee from loss of the leasehold estate upon its own rejection of the lease). The essence of rejection is that the Debtor must forego the benefits of a contract or lease as the price of obtaining discharge from claims in respect of the contract or lease. The mirror image of that principle is that the NDP cannot enjoy the benefits of a contract or lease when, by virtue of rejection, the Debtor has chosen to be relieved of the obligation to provide them.

113. See id. §§ 1141(b), 1227(b), 1327(b).
114. See id. §§ 1141(c), 1227(c), 1327(c).
115. See id. § 524(a)(2).
rejected lease or contract are precisely the types of "claims" of which the UP in the hands of the Debtor or a third party is "free and clear."\textsuperscript{116}

Professor Westbrook maintains that, while rejection terminates rights and obligations under the rejected contract or lease, it does not affect the Other Party's "Interest in the Thing Itself." He views this as a consequence of the "property principle" under which "bankruptcy will enforce nonbankruptcy remedies on behalf of an Other Party if they are remedies entitling the Other Party to dominion over a specific asset, unless the Other Party's interest is subject to avoidance under the bankruptcy avoiding powers."\textsuperscript{117} To illustrate this principle he points to the Code's respect of security interests and argues that the same principle operates with respect to bankruptcy contracts.\textsuperscript{118} Thus, rejection therefore does not affect the Other Party's ITI.

The fallacy of this analogy is that a security interest is created and exists as a matter of state law by reason of a security agreement that is not an executory contract and thus is not subject to assumption or rejection under federal bankruptcy law. Because the security agreement remains valid in bankruptcy, it is quite obvious that the rights of the secured party in the underlying collateral created by that agreement are also respected by the Code. The property rights (ITIs, in Westbrook's terminology) held by Other Parties to rejected executory contracts and leases are created by, and exist as valid rights only pursuant to, the very contract or lease that is being rejected. When the contract or lease becomes unenforceable as a matter of bankruptcy law, there is no independent basis for asserting that the Other Party has a property right at all. In that sense, section 365 does create an "avoiding power"—it allows a debtor to render unenforceable against the estate and ultimately against the debtor a document by which an interest in property is conveyed to another, thus making the conveyance (and every other provision of that document) unenforceable and (as I have argued) void.

\textsuperscript{116} Cf. 2 COLLIER ON BANKRUPTCY, supra note 58, § 365.03, at 365-30 - 31 (distinguishing the situation in which an executory contract is neither rejected nor assumed during the bankruptcy case, noting that "[t]he discharge of Section 1141(c) will not assist the debtor since, absent rejection, the other party to the contract will not be a creditor.").

\textsuperscript{117} Westbrook, supra note 8, at 257 (footnote omitted).

\textsuperscript{118} Id. at XXX.
D. Bankruptcy Policy

The conclusion that leases and executory contracts terminate upon rejection and discharge, and that any property rights created by those rejected agreements also terminate and are transformed into “claims,” is also compelling as a matter of bankruptcy policy. A review of certain agreed upon premises of the goals of a federal bankruptcy system leads to a better understanding of this conclusion. Outside of bankruptcy, state law enables individual creditors to strike advantageous deals with the debtor and, in the event of default, enforce them through self-help or legal proceedings to the detriment of the debtor’s other creditors, and even in circumstances in which honoring the obligation means financial ruin to the debtor. The bankruptcy system alters state law both substantively and remedially. As a substantive matter, for example, bankruptcy law establishes that certain obligations undertaken by the debtor will not be enforceable at all.\(^1\) Some creditors are provided recompense who would not be entitled to anything outside of bankruptcy, either because the debtor’s obligations are contingent or because they are not yet quantifiable.\(^2\) On the remedy side, the Code stays all traditional methods of enforcing private obligations\(^3\) and funnels claims into an unified forum. The claimant is then limited to a single remedy—the assertion of a “claim,” representing a right to payment, even when state law would provide other alternatives, such as specific performance. The Code also provides its own priority scheme that in many respects differs from that prevailing under state law.\(^4\)

Various provisions in the Code can be explained as intended to further certain policy objectives.\(^5\) For example, certain

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119. Ipso facto clauses and no-assignment clauses are good examples of agreements rendered unenforceable by bankruptcy. See 11 U.S.C. §§ 365(b)(2), 365(c)(1).

120. See id. § 101(5). Section 101(5) includes within the definition of “claim” obligations that are “unliquidated,” “contingent,” “unmatured,” and “disputed”.

121. See id. § 362.

122. See id. § 507 (setting forth certain “priority” claims and expenses).

priorities and exceptions from discharge can be seen as motivated by Congressional concern for creditors who are least able to bear the loss on their claim against the debtor. Therefore, their claims are satisfied early in the distributive order, and/or are not discharged at all through the bankruptcy process. The avoiding powers of sections 547 and 548 can be seen as intended to further two goals: (1) discouraging antisocial behavior towards a financially troubled debtor, and (2) requiring that similarly-situated creditors should be treated the same, the so-called equality principle. The bankruptcy discharge and permanent injunction are intended to ensure that an individual or reorganized entity will have a “fresh start,” free from pre-bankruptcy claims against future property and income.

How do we interpret section 365 of the Code in this light? I agree with Professor Westbrook that, except to the extent that there is an overriding bankruptcy policy such as those described above mandating a different conclusion, the Code should be interpreted to effectuate state law rules and remedies. However, as applied to section 365, I must differ with him on the proper analogies to be drawn from state law. This is understandable because, as Professor Westbrook acknowledges, “[T]he state law questions are sometimes quite difficult because some circumstances that arise in bankruptcy are not likely to have arisen under state law, and therefore there may be few precedents.”

Take as an example the simple contract for the purchase of onions used by Professor Westbrook for illustrative purposes in his article. If the Debtor is the seller of the onions and has failed to perform, regardless of whether the Other Party has made


124. See 11 U.S.C. §§ 507(a)(3) - (4) (giving preferential treatment to certain employee claims), 507(a)(6) (giving preferential treatment to certain consumer debts) 507(a)(7) (giving preferential treatment to claims for alimony, maintenance and support), 523(a)(5) (excluding alimony, maintenance, and support debts from discharge).

125. See id. §§ 727, 1141, 1228(a), 1328(b) (dealing with discharge), 524(a)(2) (permanent injunction).

126. Westbrook, supra note 8, at 285 n. 248. Although his comments were made in the context of arguing against any requirement of “executoriness” as a condition for assumption or rejection of contracts in bankruptcy, they are equally apt in considering the impact of rejection on such a contract.

127. See id. at 247-48.
payment, outside of bankruptcy the Other Party afflicted by the breach has the option of suing for damages or seeking specific performance of the contract. If the onions are unique in nature, a court may order specific performance; otherwise, the Other Party is relegated to a damage remedy. Once the Other Party has received a judgment entitling it to damages in lieu of performance, it can no longer enforce the contract against the Debtor and the contract terminates, having been transformed by virtue of the judgment into money damages. If the Other Party instead obtains specific performance, the court has determined that the contract will be enforced against the Debtor and thus remains in effect as a consequence of that judicial determination.

Now suppose the contract at issue is one that creates property rights in the Other Party, such as in the Lease Model. If the Debtor is the Lessor and has failed to perform some aspect of the lease prior to delivery of the leased property, the analysis is exactly the same as for the onion contract. The Other Party/Lessee may seek money damages for breach, and if they are awarded the lease becomes a nullity. Alternatively, the Lessee/Other Party may seek specific performance of the lease, including delivery of the underlying property, in which case the lease remains effective and enforceable against the Lessor/Debtor.

If the breach of the lease occurs after the underlying property has been delivered, the analysis is slightly different. The Other Party/Lessee is not required by state law to make an "either/or" choice between treating the lease as terminated and seeking damages or alternatively trying to hold the lessor to the lease.

Instead, the Other Party may keep the property (enforcing the lease to that extent) and still seek monetary compensation for the other damages caused by breach. Alternatively, the Other Party may seek to enforce the unperformed obligations through specific performance.

How does bankruptcy change this analysis? In bankruptcy, as Professor Westbrook points out, the principle that requires similarly situated creditors to be treated in a similar fashion (the equality principle) precludes the Other Party from seeking specific performance of a rejected (and thus “breached”) contract or lease, because specific performance is the equivalent of receiving 100 cents on the dollar of claim. The only remedy available to the purchaser of onions or Lessee in the examples above is to assert a claim for damages.

But what about the Lessee who has already received the leased property? At state law, the Lessee may retain the property while seeking compensatory damages. But bankruptcy policy relegates the Lessee to a single remedy—asserting a claim for deemed breach. To allow the Lessee to retain the property would be the equivalent of bifurcating the lease for purposes of rejection into the portion that was already performed (delivery of the leased property) and the portion that is truly executory (the obligations that have been breached) and limiting rejection to the latter. Perhaps that would be a good idea. Indeed, Westbrook believes that when “certain aspects of performance are final under state law” those aspects should not be affected by rejection. But it is clear that rejection is an all-or-nothing proposition; an executory contract or lease must be assumed in whole or rejected in whole. In most cases, this protects the Other Party by prevent-

130. Id. at 333.
131. See, e.g., Stewart Title Guaranty Co. v. Old Republic National Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996); Department of Air Force v. Carolina Parachute Corp., 907 F.2d 1469, 1472 (4th Cir. 1990); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985); Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984).
ing a debtor from picking those aspects of a contract that benefit the debtor and assuming those, while rejecting the *quid pro quo* originally negotiated to obtain those benefits. But this doctrine is equally applicable to the Other Party, who can not seek to limit the impact of rejection to those parts of the contract or lease it chooses. Once a lease is rejected, the rights of the Other Party/Lessee to retain property of the estate which were created by that lease are no longer enforceable. Pursuant to section 542, the Lessee has an obligation to turn over the property to the trustee. Any damages caused by the loss of the property are also included in the Lessee’s claim, which is treated on a parity basis with the claims of all other unsecured creditors. Enforcement of the lessee’s contractual right to retain the leased property would result in nothing more than partial specific performance of the rejected lease, which is an unjustifiable violation of the equality principle.

Professor Westbrook argues that no bankruptcy rule or policy justifies a result that strips the Other Party of its property rights (ITIs) in the face of a breach by the Debtor. He states that the “contract doctrine would not permit the breacher *to benefit from its own breach*” by recovering the conveyed property, and bankruptcy should treat the parties in the same way. But that statement has a strong moral component that illustrates the same confusion Westbrook attributes to others between the “breacher” and the “beneficiary” of rejection. Rejection by the trustee is treated as a pre-petition breach *by the debtor* under section 502(g) of the Code. The beneficiary of this decision is not the debtor, but the unsecured creditors who will share in the estate property as augmented (or not diminished) by reason of the rejected lease or contract. Yes, the Other Party suffers a detriment, and one who loses a property interest suffers more detriment than others, but that detriment is compensable through the claim process. Outside of bankruptcy, every creditor can recover the full value of its damages for breach by the debtor, whether through money or retention of property or some combination thereof. Bankruptcy policy requires that remedies be limited to assertion of a claim; enforcement of property rights created by rejected contracts or leases is inconsistent with the equality principle.

The “fresh start” policy underlying bankruptcy law also requires that we treat rejection and discharge as rendering property

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rights conveyed by a rejected contract or lease unenforceable. As Professor Margaret Howard has noted, "Discharge of legal obligations is an extraordinary exception to the usual obligation orientation of the law and it must have equally extraordinary justification."\textsuperscript{133} The most important role of discharge can be seen as promoting the return of the debtor to productive activity. In other words, discharge is economically efficient. When the benefit of one's labors it appropriated by another, the laborer has no incentive to produce or innovate. Free from the constraints of debt, a laborer has greater motivation to produce more and develop new products that will stimulate more demand.

In the context of section 365, rejection of executory contracts and unexpired leases, coupled with discharge from continuing liability thereunder, is an obvious illustration of this principle. Indeed, many bankruptcies have taken place in part, if not in whole, in an effort to relieve the Debtor from contractual responsibilities.\textsuperscript{134} A Debtor can be as improvident in entering into a contract for the purchase or provision of goods or services or real property as it can with respect to borrowing money. Just as we accept the premise that a lender should have no further claim on the Debtor or its property after discharge of its debt, we should equally accept that the Other Party to rejected executory contracts or leases should have no further claim on the Debtor or its property with respect to the obligations created by those contracts or leases. If the Debtor was unable to "undo" the property conveyance made pursuant to a rejected contract or lease, the benefits of rejection may become illusory. This is especially true in this Article's models.

Take the Lease Model. Assume that the Debtor as Lessor has entered into a lease with NDP/Lessee for a twenty year lease of its principal asset, heavy equipment, at a rent that failed to reflect the true market value. Two months later, the Debtor files for bankruptcy protection. The Debtor's trustee clearly wishes to reject the lease because it is disadvantageous to the estate. If the consequences of rejection are that the NDP/Lessee keeps the equipment for the next twenty years at the contractual rate, the


benefits of rejection are completely illusory. The Debtor will be unable to use its property in the future free of the claims of the NDP consistent with the goal of rehabilitation and economic productivity. Congress could not have included "unexpired leases" in section 365 with the expectation that the principal obligation under such a lease—the obligation to lease the underlying property—was immune from rejection and discharge.

There is certainly no moral reason why a party to an executory contract or unexpired lease is entitled to more protection from a Debtor's bankruptcy than any other creditor. Indeed, Congress has, through its system of priorities and exceptions from discharge, specified those situations in which certain creditors are entitled to preferential treatment. It has done the same with respect to certain executory contracts and unexpired leases.

One of those situations benefits the NDP/Licensee in the License Model. Even if the Debtor/Licensor has entered into an unfavorable license of technology and economic efficiency and rehabilitation both would suggest that the underlying technology should return to the Debtor free of the claims of the NDP/Licensee, Congress has conclude that the equities compel protection of the NDP/Licensee, even if that protection dooms Debtor's rehabilitation efforts. Congress is free to make that judgment. However, in the absence of an explicit thumb on the scales, the rehabilitation policy requires that claims subject to discharge be interpreted broadly, and that Debtor's property interests, limited by the now-unenforceable rejected contracts or leases, be held free and clear of all claims asserted thereunder.

136. See supra notes 93-100 and accompanying text.
138. The legislative history of the definition of "claim" suggests that "[b]y this broadest possible definition . . . the bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court." H.R. REP. NO. 95-595, at 309 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6266; see also S. REP. NO. XX-989, at 21-22 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5807-08.
139. Professor Thomas E. Plank has argued that an interpretation of section 365 that would permit the trustee to "defeat a non-creditor's property interest" exceeds the constitutional scope of the bankruptcy power because clause 4 of Section 8 of Article 1 of the United States Constitution allows Congress to enact laws only if they bear on rights between a debtor and its creditors. See Thomas E. Plank, The Constitutional Limits of Bankruptcy, 63 TENN. L. REV. 487, 576 (1996). While his argument would support my analysis in Part IV with respect to the impact of rejection on third-party secured creditors,
In sum, I believe that the ability to reject executory contracts furthers two basic goals of bankruptcy: (1) it facilitates the rehabilitation of debtors (the “fresh start”) by allowing them to be discharged from burdensome obligations, including the obligation to continue to convey property interests under the rejected contract or lease, and (2) it promotes the equal treatment of similarly-situated creditors by declining to provide contract creditors full compensation for their claims against the debtor in the form of specific performance of the contract or lease. To the extent that a NDP retains the ability to enforce provisions of rejected contracts or retain property rights that would otherwise revert to the debtor, the purpose behind section 365 is thwarted on both sides. While Congress can (and does) decide that in certain cases broader public interests outweigh the rehabilitative concerns of individual debtors, to extend that protective philosophy to all leases and executory contracts would essentially construe the ability to reject under section 365 so narrowly as to render it illusory in many cases. This is not only inconsistent with more than fifty years of legislative treatment of leases and executory contracts, but would also provide an unwarranted benefit to contract claimants over

I see no basis for his assertion that a lessee under a rejected lease (who is explicitly given a “claim” in the bankruptcy case) is not a “creditor” of the debtor.

140. See, e.g., Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986) (“Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a).”); cf. NLRB v. Bildisco, 465 U.S. 513, 527-528 (1984) (“Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection should not be permitted without a finding that policy would be served by such action . . . . Thus, the authority to reject an executory contract is vital to the basic purpose to a Chapter 11 reorganization, because rejection can release the debtor’s estate from burdensome obligations that can impede a successful reorganization.”).

141. See, e.g., In re Freeman, 49 F. Supp. 163, 167-68 (S.D. Ga. 1943) (holding that rejection of a lease by a debtor/lessor deprived lessee of any right to possession). The court noted:

The equities also preponderate in favor of the removal of the tenant. When removed he may suffer injury, he and his family. As indicated, however, he is not remediless. If injury is done that can be measured in dollars he becomes a creditor of the debtor and may assert his rights and share with other creditors of the same class in the arrangement proceedings. On the other hand, if he does not yield immediate possession of the premises, the debtor and his family are injured because they lose the small equity now but not later or otherwise realizable, above the mortgage on the home. And the creditors of the debtor, of whom there are twenty, and who are equally as innocent as the tenant insofar as the proceedings in bankruptcy are concerned, will be also injured. If this home were the only asset of the debtor, they might lose their debts entirely.

Id.
others in the debtor’s bankruptcy case, consequently undermining the general principle of equality of treatment of unsecured creditors.

IV. Property Rights and the Secured Party

Leases and executory contracts of the sort discussed above both create property rights and limit pre-existing property rights in the UP. If the lease or executory contract is rejected, any property rights created by the lease or contract, either in the Owner or the OP, disappear. If the UP “belonged” to the NDP prior to the contractual arrangement, any property right in the UP created by the lease or contract in favor of the Debtor, be it a leasehold interest or stream of payments or license to use intellectual property, will, in the absence of specific statutory provision to the contrary, no longer exist and the unfettered property right in the UP will remain in the NDP. On the other hand, if the UP “belonged” to the Debtor prior to the contract or lease, any limitations on the property interest of the Debtor in the UP created by the rejected lease or contract become unenforceable and the property interest of the NDP carved out of the absolute fee simple interest of the Debtor (P1 in the Lease Model and License Model) revests in the Debtor and reunites with the interest in the UP previously retained by the Debtor. Rejection can therefore be seen as a means of eliminating personal property interests created by lease or contract, and of transferring—whether voluntarily (in the case of the Debtor) or involuntarily (in the case of the NDP)—property interests in UP created by an unexpired lease or executory contract from an OP to an Owner through termination of enforceable limitations on fee simple absolute ownership of the UP.

So far the discussion assumes that the repercussions of rejection redound to the benefit or detriment of only two parties, the Debtor and the NDP. Given the two alternative identities of the Debtor (either Owner or OP), the consequences of rejection can be diagramed as follows:
Thus, in the Lease Model, if the Debtor is the Owner of the leased equipment, upon rejection of the Lease the Debtor owns the equipment free and clear of any property rights of the NDP/OP. If the Debtor is the OP, upon rejection of the Lease the Debtor relinquishes all property rights to the equipment, and it reverts to the NDP/Owner. Similarly, in the License Model, if the Debtor is the Owner of the intellectual property, when the license is rejected the property rights in the UP originally conveyed to the NDP/OP revert to the Debtor, who then owns the intellectual property free and clear. If the Debtor is the OP, rejection of the license terminates any interest the Debtor had in the UP under the license, and complete ownership of the intellectual property vests in the NDP/Owner.

Assume, however, that the property interests of Owner or OP created or limited by the lease or executory contract were not retained by the Owner or OP, respectively, but instead were transferred to a third party as security for an obligation. How does rejection of the contract or lease, and the previously discussed consequences of that termination, affect the property rights of the STP?

To analyze this issue, the model must be complicated further, because either party to a contractual arrangement (Owner or OP) may convey its rights to an STP, and either Owner or OP may become the Debtor. The possible permutations have expanded from two to four, as follows:

<table>
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<tr>
<th>IMPACT OF REJECTION ON:</th>
<th>DEBTOR:</th>
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<tbody>
<tr>
<td></td>
<td>OWNER</td>
</tr>
<tr>
<td>DEBTOR</td>
<td>bold unencumbered interest in UP</td>
</tr>
<tr>
<td>NDP</td>
<td>no property interests remain; has claim in bankruptcy</td>
</tr>
</tbody>
</table>
A Debtor can be either Owner or OP; the NDP can also have either of these two statuses. The STP can take a security interest in the rights of either Debtor or NDP, in each case in either of its two possible roles. Looking at each of these potential scenarios, and applying established principles of state property law, it becomes clear that the rejection of an executory contract or unexpired lease, with the consequences previously discussed on the property interests of the Owner and OP, should have the same consequences on the STP in all four situations: the STP should retain a valid security interest either in the UP or the proceeds thereof which is valid against all parties.

A. Case One: STP with security interest in rights of Debtor/Owner

As previously discussed, the property interests of an Owner relating to an executory contract or lease fall into two categories. First, there is the property interest of the Owner in the UP, a pre-existing property interest out of which a subset of rights is created and transferred to the OP by the enforceable provisions of the lease or contract. In the Lease Model, the UP is the equipment. In the License Model, the UP is the intellectual property. If the UP is real property, the STP may obtain an interest in it under
state real property law in the form of a mortgage or deed of trust.\textsuperscript{142} If the UP is personal property (as in the Models), the STP may take a security interest in the Owner’s rights thereto under the Uniform Commercial Code or (if the property is not within the scope of the U.C.C.) under non-U.C.C. state or federal law.\textsuperscript{143}

Second, there is the property interest of the Owner created by the lease or contract itself. This property interest will be characterized as a “leasehold interest” (in the case of a lease as is the Lease Model), primarily representing the right to compensation for possession and use of the property leased,\textsuperscript{144} or an “account” or “general intangible” in the case of a right arising under an executory contract not constituting a lease (such as the license in the License Model).\textsuperscript{145} All of these property interests should be characterized as personal property for state law purposes.\textsuperscript{146} The

\textsuperscript{142}All states recognize a security interest in real property. See, e.g., ARK. CODE ANN. § 18-40-101 (Michie 1987); CAL. CIV. CODE § 2920 (West 1993); CONN. GEN. STAT. ANN. § 49-1 (West 1994); 25 DEL. CODE ANN. tit. 25, § 2101 (1989); FLA. STAT. ANN. § 695.01 (West 1994); GA. CODE ANN. § 44-14-30 (1994); HAW. REV. STAT. § 506-1 (Michie 1993); IDAHO CODE § 45-901 (1997); IND. CODE ANN. § 32-8-11-1 (Michie 1995); KAN. STAT. ANN. § 58-2301 (1994); MONT. CODE ANN. § 71-1-201 (19XX); NEV. REV. STAT. § 107.015 (19XX); N.J. STAT. ANN. § 46-17-1 (West 1989); N.D CENT. CODE § 35-03-01.2 (1987); ORE. REV. STAT. § 86.010 (1997).

\textsuperscript{143}Section 9-104 of the Uniform Commercial Code sets forth exclusions from the scope of Article Nine, including interests in real property other than fixtures, see U.C.C. § 9-104(j) (1977), security interests subject to a federal statute, id. § 9-104(a), and statutory liens for services or materials, id. § 9-104(c), among others.

\textsuperscript{144}See id. § 2A-103(m) (definition of “leasehold interest”), (p) (definition of “lessor”).

\textsuperscript{145}See id. § 9-106; see also discussion in text at supra notes 40-42.

\textsuperscript{146}The U.C.C. is inherently ambiguous about the treatment of the Owner’s leasehold interest if the UP is real property. Compare section 9-102(3) and comment 4 thereto with Section 9-104(j) and comment 2 thereto. Compare also Frearson v. Wingold (In re Equitable Development Corp.), 617 F.2d 1152 (5th Cir. 1980) (holding that the assignment for security of interest of real estate developer in contracts for the sale of property with home site buyers held subject to Article Nine filing requirements); Southwest Nat’l Bank v. Southworth (In re Southworth), 22 B.R. 376 (Bankr. D. Kan. 1982) (holding that the assignment of vendor’s right to receive payment under contract of deed for real property is governed by Article Nine); First Nat’l Bank of Boston v. Larson, 17 B.R. 957 (Bankr. D.N.J. 1982) (holding that the security interest granted by first lender to second lender in promissory notes secured by mortgages on real estate was perfected by possession of notes under Article Nine) with Shuster v. Doane (In re Shuster), 784 F.2d 883 (8th Cir. 1986) (holding that the assignment for security of vendor’s interest in contract for deed not governed by Article Nine); In re Bristol Associates, Inc., 505 F.2d 1056 (3d Cir. 1974) (holding that the assignment by lessor to lender of lease as collateral was excluded from Article Nine); Swanson v. Union State Bank (In re Hoeppner), 49 B.R. 124 (Bankr. E.D. Wis. 1985) (holding that the assignment of a vendor’s interest under land sale contract for security is not subject to Article Nine). See generally Robert H. Bowmar, Real Estate Interests as Security Under the UCC: The
security interest of the STP will attach when the requirements of section 9-203 of the U.C.C. are satisfied, at which point the interest becomes enforceable against the Owner.\textsuperscript{147}

When the Owner as Debtor rejects the lease or executory contract, a STP with a security interest in Owner's property interest in the UP is unharmed. The property interest in the UP held by the Owner before rejection remains with Owner after rejection. Indeed, except to the extent that the OP is protected by specific statutory savings clauses,\textsuperscript{148} the property interest in the UP held by the Owner has now expanded from one circumscribed by enforceable provisions of the lease or contract to one free from those limitations. Does the STP get the benefit of this increased collateralization? If the security agreement/mortgage was properly drafted, outside of bankruptcy the answer would certainly be yes. For example, assume the security agreement granted the STP a security interest in "all of Debtor's right, title and interest in and to the equipment listed on Schedule A," and the equipment so listed was leased to OP prior to the time the STP took the security interest. Under section 2A-307(2) of the U.C.C., the STP would take its security interest subject to the lease contract.\textsuperscript{149} However,
er, once the lease terminates, the STP would continue to have a security interest in the equipment, free of the leasehold interest of lessee.\textsuperscript{150}

Does the Bankruptcy Code affect this analysis? Under section 552(a) of the Code, property acquired by the estate after the commencement of a bankruptcy case is not subject to a pre-bankruptcy security interest, except as provided in section 552(b) with respect to proceeds and related concepts.\textsuperscript{151} One could argue that the lessee's leasehold interest in the equipment acquired by the Debtor during the bankruptcy case should be characterized as property acquired by the estate after commencement of the case and thus should not be seen as subject to the STP's security interest under section 552(a). However, that argument is flawed. Again, assuming the security agreement so provided, the property in which the STP had a security interest was all of Debtor's interest in the specified equipment (the UP in our example). That interest was an absolute ownership interest. While the lease is in effect, it is worth less than it would be without the lease, but the nature of the interest is identical; no new property is created by the rejection and termination of the lease.\textsuperscript{152} Therefore, the full value of the interest; or

(c) the creditor holds a security interest in the goods which was perfected \ldots before the lease contract became enforceable.

\textsuperscript{150} See id. § 2A-307. This section is merely a rule of priority; when a prior interest to the collateral terminates, the previously subordinated interest will prevail.

\textsuperscript{151} See 11 U.S.C. § 552(a) (1994). The section provides:

\begin{enumerate}
  \item Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
  \item Section 552(b)(1) validates security interests in, among other things, proceeds of property acquired by the estate after the commencement of the case “if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds \ldots of such property.” \textit{Id}. However, the section allows “the court, after notice and a hearing and based on the equities of the case, [to] order[ ] otherwise.” \textit{Id}. Section 552(b)(2) gives real estate lenders holding a valid pre-petition assignment of rents or hotel revenues a security interest in post-petition rents and hotel revenues, comparable to that provided other secured creditors in post-petition proceeds under section 552(b)(1).
  \item One could also argue that, even were a court to characterize the termination of the lease as having the effect of transferring a “new” property interest to the Debtor (that being the leasehold interest of the OP in the leased equipment), that property interest should properly be characterized as proceeds of the Debtor's prior residual interest in the leased equipment, which has been disposed of by rejection of the lease. There are two problems
Debtor/Owner's interest in the UP should become subject to the security interest of the STP after rejection of the lease or executory contract, and the claim of the STP should be treated as secured to that extent under section 506.153

If the STP has a security interest in the UP, even if it also has a security interest in the Debtor/Owner's interests in the lease or executory contract as well, its position upon rejection will be protected. As an economic matter, its interests with respect to the UP and its earning power represented by the lease or executory contract should be identical to that of the Debtor/Owner. Absent differences in business judgment between the Debtor and the STP, if the lease or contract is a "bad" deal from the standpoint of the Debtor/Owner (in the sense that superior benefits could be derived were the Debtor/Owner free to redeploy the UP with another OP), it is also a "bad" deal from the standpoint of the STP who obtains the diminished collateral value represented by the existing arrangement. Any advantages accruing to the Debtor/Owner when the lease or contract is rejected and a new lease or contract obtained will also redound to the benefit of the STP, as any new interest in the UP will be subordinate to that of the STP.154

What if the STP does not have a security interest in the Debtor/Owner's interests in the UP, but solely in the Debtor/Owner's interests created by the lease or executory contract itself, that is, the leasehold interests, accounts, or general intangibles? In that situation, again unless the result has been modified by statutory savings clauses (in which event not only the OP but

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153. See 11 U.S.C. § 506. Section 506 allows a claim to be treated as a "secured claim" "to the extent of the value of such creditor's interest in the estate's interest in such property." Id. If the security agreement is drafted to create a security interest in "all" of the Debtor's interest in the collateral, as that interest expands, so does the security interest. See id.

154. If the UP is subsequently leased, under U.C.C. § 2A-307(2)(a) of the UCC the previously attached lien has priority. A subsequent licensee would not be entitled to any of the special priority rules for certain buyers and purchasers under sections 9-307 through 9-309, and thus would take subject to the perfected security interest of the STP.
also the STP will be protected from the premature termination of its property rights), the rejection of the lease or executory contract terminates the personal property rights created thereby and in which the STP had its interest.

Deferring until our discussion in part IV.C the issue of whether the Bankruptcy Code protects the STP from rejection of the lease or contract in these circumstances, the STP should nevertheless be protected as a matter of state property law. At first blush, one might assume that, if the Debtor/Owner’s property interest has disappeared with rejection, the STP’s security interest has also evaporated. But in this situation, the STP should be able to claim a right to the Debtor/Owner’s rights in the UP as proceeds of the contractual rights in which it previously had a security interest.

“Proceeds” include anything “received upon . . . disposition of collateral.” When the Debtor/Owner rejects a lease or executory contract, it specifically decides as a matter of its business judgment to dispose of the benefits afforded by that contract in order to obtain a discharge of its obligations thereunder. That disposition of personal property collateral, unless authorized by the STP, results in the security interest of the STP continuing in the collateral in the hands of a transferee, and in any identifiable proceeds of the collateral. Here the collateral (the leasehold interest, account and/or general intangible) is not transferred to anyone; it simply ceases to exist. Therefore, the STP cannot follow the collateral into other hands. However, there are identifiable proceeds of that collateral in the form of the former interest of the NDP/OP in the UP, now revested in the Debtor/Owner. The security interest of the STP automatically attaches to this property interest pursuant to the provisions of section 9-306(2) of the U.C.C.

155. See infra notes 177-179 and accompanying text.
156. U.C.C. § 9-306(1).
157. See id. § 9-306(2). That section provides:

(2) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

The reference to an “authorized” disposition has been interpreted by the Permanent Editorial Board for the Uniform Commercial Code to mean a situation in which the secured party has authorized disposition free and clear of the security interest. See PEB Commentary No. 3, sections 9-306(2), 9-402(7) (March 10, 1990). Unless the secured party has obtained replacement collateral, it is unlikely to have authorized the rejection of a lease or executory contract that create the rights constituting its collateral.
This result can be analogized to the position of a chattel paper or accounts receivable financer under section 9-306(5) of the U.C.C. when goods the sale of which gave rise to the chattel paper or account are returned or repossessed. Under section 9-306(5)(b) and (c), the unpaid transferee of chattel paper or an account resulting from the original sale of the returned goods "has a security interest in the goods against the transferor."\textsuperscript{158} Essentially, in making the decision under section 365 of the Code to reject a lease or executory contract, the Debtor/Owner has decided to repossess the property interest conveyed to the NDP/OP pursuant to that lease or executory contract. The original conveyance gave rise to an interest, analogous to the chattel paper or account in section 9-306(5), a security interest in which was granted to the STP, an unpaid transferee. If, under section 9-306(5), an unpaid financer of chattel paper or accounts receivable in this situation would have a security interest in the returned goods, then under section 9-306(2) the STP should have a security interest in the repossessed property interest as against the transferor (the Debtor/Owner) after rejection pursuant to section 365.

Applying this analysis to the Models, the result is that if the STP has a security interest in Debtor/Owner's leasehold interest and Debtor rejects the Lease, Debtor thereby "disposes" of the leasehold interest and in exchange recaptures the property interest of the NDP created by the rejected Lease (P1 in the Model). That property interest should be seen as the proceeds of the leasehold interest for purposes of the U.C.C., and the security interest of the STP should attach to the UP in Debtor's hands.\textsuperscript{159}

Of course, as in the case of all security interests in proceeds, the bankruptcy court retains the power, applying principles of equity, to capture the benefit of the property interest represented by proceeds for the benefit of creditors other than the STP.\textsuperscript{160}

\textsuperscript{158} We do not need to deal here with the priority of that security interest as against a secured party secured by the UP. \textit{Compare} U.C.C. § 9-306(5) \textit{with} U.C.C. § 9-308.

\textsuperscript{159} Although one may feel a frisson of discomfort at the thought that the STP, which formerly had a security interest only in a leasehold interest in the UP, now should have an interest in the UP itself, the structure of section 9-306(2) of the U.C.C. is intended to provide a secured creditor more collateral upon an unauthorized disposition of its collateral (in the form of the original collateral in the hands of the transferee, as well as the proceeds of the disposition in the hands of the transferor) than it had previously.

\textsuperscript{160} See 11 U.S.C. § 552(b)(1) (1994). Section 552(b)(1) of the Code extends the security interest to after-acquired proceeds "except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." \textit{Id.} The equitable power
However, absent any contrary determination by the bankruptcy court, the STP with a security interest in the property of a Debtor/Owner should retain a security interest in property of the Debtor/Owner notwithstanding the rejection of the lease or executory contract creating, or limiting the rights of the Debtor/Owner in, such property.

B. Case Two: STP with security interest in rights of NDP/OP

The property rights of the NDP/OP available to a secured creditor are limited to those interests ("leasehold interests" or "general intangibles") created by the contract or lease itself. The OP has no pre-existing interest in the UP, and any interest created by the contract or lease disappears with its rejection. That is, the interest is taken back by the Owner/Debtor.

Outside of bankruptcy, if a STP has a security interest in property of a debtor and that property is transferred to a third party, whether voluntarily by the debtor or involuntarily through writ of execution or foreclosure, the security interest of the STP continues unless the STP authorizes the transfer free and clear of the security interest.\(^1\) This principle applies even when the third party into whose hands the collateral is transferred is the original owner from whom the STP's debtor obtained it.\(^2\) Although no examples have been found in which the return of the property to the original owner from the STP's debtor was occasioned by the termination of the contract between them, there is no reason to distinguish this type of transfer from any other.

The Bankruptcy Code complicates the analysis slightly. When the Debtor/Owner makes the determination that rejection of a

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of the court was intended to be invoked in circumstances in which the secured creditor has been benefitted by the dedication of estate funds to the collateral in transforming it into proceeds. See, e.g., Delbridge v. Production Credit Ass'n & Fed. Land Bank, 104 B.R. 824, 826 (E.D. Mich. 1989) (citing S. Rep. No. XX-989, reprinted in 1978 U.S.C.C.A.N. 5787, 5877).

161. See U.C.C. § 9-306(2); see also supra note 157.

162. An example of the circumstances in which this is most likely to occur is when a seller of collateral retains a purchase money security interest in the collateral in the hands of the purchaser/debtor, who then obtains additional financing on the same collateral on a subordinated basis. If the purchaser/debtor defaults on its obligations to the seller, the seller may repossess the collateral, but it remains subject to the security interest of the second financer. Of course, the seller may then dispose of the collateral, thereby discharging not only its own security interest but also that of the subordinated second financer, who will receive any proceeds of disposition in excess of the expenses of sale and satisfaction of the priority indebtedness. See U.C.C. § 9-504.
lease or contract is in the best interests of the Debtor, central to its decision is the belief that the estate should be able to benefit from the property interests in the UP without the limitations created by the lease or contract. In other words, the Debtor wishes to take back from the OP the property interests in the UP conveyed by the rejected contract or lease, and redeploy those property interests for a higher consideration. We have already seen that, absent specific statutory provisions to the contrary, the OP has no right to retain the benefits of the property interests conveyed because the lease or contract that gave the OP that right becomes unenforceable in whole with its rejection. One could argue that the bankruptcy policy underlying rejection—that of permitting the Debtor to recapture the benefit of the property interests in the UP conveyed by the lease or contract—would be undermined if the OP’s conveyance of an interest in those same property rights to an STP could not be defeated by the Debtor/Owner. Why should the

163. This was precisely the rationale given by the court in In re Bernard, 69 B.R. 13 (Bankr. D. Haw. 1986), for concluding that the rejected lease under which the lessee had conveyed a leasehold mortgage was terminated. The court noted:

If it is determined that a lease is still in existence and subject to the leasehold mortgage even after the lease is deemed rejected, the lessor will continue to be frustrated in obtaining income from his commercial property . . . . This means that the lessor will be further frustrated and the purpose of Section 365(d)(4) will not be achieved.


However, there is nothing in the language of section 365(d)(4), which establishes a period during which the lessee of nonresidential real property must assume or reject the lease or it will be deemed rejected and directs that the trustee “immediately surrender” the property subject to the rejected lease to the lessor, or in its legislative history that suggests that anything more was intended than to limit to 60 days the period of uncertainty inflicted on a lessor and its other tenants as to whether the lease in question would be assumed to rejected. See 130 Cong. Rec. S 8891 (daily ed. June 29, 1984) (statement of Senator Hatch), reprinted in 1984 U.S.C.C.A.N. 590, 598 (“The first problem which this bill would remedy is the long-term vacancy or partial operation of space by a bankrupt tenant”). See generally In re Moreggia & Sons, Inc., 852 F.2d 1179, 1185 (9th Cir. 1988) (“[T]he purpose of Section 365(d)(4) is to protect lessors from delay and uncertainty by forcing the trustee or debtor-in-possession to act quickly to assume unexpired leases.”).

I believe that the motivating force behind many of those decisions concluding that rejection does not result in termination of an executory contract or lease was the desire
STP be allowed to cloud the Debtor's interest in the UP and impede its ability to rehabilitate itself?

The short answer is that the Code respects property rights created by state law. Rejection of the contract or lease terminates the property rights of the OP as a matter of state law because the contract between the Debtor/Owner and the NDP/OP becomes unenforceable. Whether rejection of the contract or lease terminates the property rights of the STP should also be determined by state law, and as a matter of state law this retaking of the property rights of the OP to the Debtor/Owner without fault by the OP should not affect the property rights of third parties, such as the STP, in the retaken property.

Take the case of an executory contract between Debtor/Owner and OP dealing with UP constituting personal property. While that contract is in effect, the position of the OP can be seen as one with voidable title to the property, who has the power to transfer good title (that is, a valid security interest) to a good faith purchaser for value.\textsuperscript{164} Despite the rejection of the contract rendering OP's courts to protect the secured party from what they assumed would be the consequences of such termination—elimination of the security interest. \textit{See, e.g., In re Austin Development Co., 19 F.3d 1077 (5th Cir.), cert. denied, 513 U.S. 874 (1994)} (protecting holder of deed of trust on debtor/lessee's leasehold interest upon rejection); \textit{Leasing Service Corp. v. First Tenn. Bank Nat'l Ass'n.}, 826 F.2d 434 (6th Cir. 1987) (protecting assignee of equipment lease with security interest in equipment upon rejection of lease by debtor/lessee); \textit{In re Garfinkle}, 577 F.2d 901 (5th Cir. 1978) (protecting holder of leasehold mortgage on debtor/lessee's interest upon rejection); \textit{In re Argonaut Financial Services, Inc.}, 164 B.R. 107 (N.D. Cal. 1994) (holding that a 60-day period for assumption or rejection cannot run against alleged holders of security interest in leasehold who did not receive notice as a matter of due process because their security interest would be adversely affected by deemed rejection); \textit{see also In re H.B. Leasing Co.}, 188 B. R. 810, 815 (Bankr. E. D. Tex. 1995) (dictum) (noting that even if assignment from lessee to debtor had been effective, rejection could not be interpreted to forfeit security interest of creditor in leasehold); \textit{In re Locke}, 180 B.R. 245, 261 (termination of debtor/lessee's right to possession under rejected lease did not terminate judgment creditor's lien on interest in lease); \textit{cf. In re Elephant Bar Restaurant, Inc.}, 195 B.R. 353, 356 (Bankr. W.D. Pa. 1996) (finding the lease was terminated "with respect to the debtor," but "may exist" with respect to nondebtor sublessee "to the extent recognized under pertinent nonbankruptcy law"); \textit{In re Ames Dep't. Stores, Inc.}, 148 B.R. 756, 758 (Bankr. S.D.N.Y. 1993) (holding that rejection of lease by debtor/lessee did not terminate lease so as to relieve prior lessee who assigned lease to debtor of responsibility for performance after assignment as provided in lease).

\textsuperscript{164. See U.C.C. § 2-403(1). Section 2-403(1) states that "[a] person with voidable title has power to transfer a good title to a good faith purchaser for value."} \textit{Id.} "Voidable title" is not defined in section 2-403(1), but four examples are given:

\begin{itemize}
  \item[(a)] the transferor was deceived as to the identity of the purchaser, or
  \item[(b)] the delivery was in exchange for a check which is later dishonored, or
  \item[(c)] it was agreed that the transaction was to be a "cash sale", or
\end{itemize}
property interests void, as a matter of state law the STP should retain good title (a valid security interest) in the OP's property, albeit in the hands of another party (the Owner).

Consider instead the situation in which the UP is subject to a lease to the OP and the Debtor/Owner rejects the lease. In the case of leases of real property, section 365(h)(1)(A) of the Code prevents the termination of the OP/lessee’s leasehold interest without the OP/lessee’s election to treat it as terminated, an election that cannot be made if precluded by any agreement made with the lessee.165 Assuming the STP has inserted an appropriate limitation on the ability of the OP as lessee to treat the lease as terminated, the interest of the STP in the property of the OP will continue with the continued interest of the OP notwithstanding rejection.

If the STP has not contractually precluded the lessee election under section 365(h)(1)(A), or if the UP is not real property so that section 365(h)(1)(A) is not applicable, rejection of the lease terminates the interest of the OP thereunder. Were that termination occasioned by the default of the OP under the lease, the interest of the STP (like that of a sublessee) would be deemed subordinate to the interest of the Debtor/Owner (lessor) of the property and the termination of the lease by rejection would result in termination of the mortgage or security interest as a matter of state law.166 However, the termination of the leasehold interest

(d) the delivery was procured through fraud punishable as larcenous under the criminal law.

A “purchaser” is a person who takes by “purchase,” U.C.C. § 1-201(33), including “taking by mortgage, pledge, lien . . . or any other voluntary transaction creating an interest in property.” Id.

165. See supra note 93. The language limiting the lessee’s ability to elect termination of a lease after rejection by the lessor was added by the 1984 amendments to the Bankruptcy Code, and protects leasehold mortgagees and subtenants by permitting them to obtain contractual agreements by the lessee not to make such an election.

as a result of rejection of the lease by the Debtor/Owner is not based on any fault of the OP/lessee but on the business judgment of the trustee for the Debtor/Owner that the lease is not in the best interests of the estate. Under these circumstances, the leasehold returned to the Debtor/Owner should be encumbered by the interest of the STP, by analogy to the state law concept of "surrender."

Outside of bankruptcy, surrender of a lease is a consensual act by which the tenant offers the leasehold to the landlord, and the landlord may elect to accept it at the cost of relieving the tenant of obligations accruing under the lease after the surrender. Although surrender frequently occurs when the tenant is in default of the lease,\textsuperscript{167} it may occur under other circumstances as well.\textsuperscript{168} If surrender occurs, the rights of third parties in the surrendered leasehold (such as sublessees or secured parties) are unaffected; the lessee can surrender only those rights it has and the landlord can not abrogate the rights of third parties absent default.\textsuperscript{169}

The return of the leasehold interest of the NDP/OP to the Debtor/Owner is not consensual on the part of the NDP/OP in the sense of a non-bankruptcy "surrender," but it should not be

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Of course, a secured creditor obtaining an interest in a leasehold may obtain an agreement from the lessor to subordinate its interest to the interest of the secured creditor, in which event the security interest would survive even foreclosure for default of the lessee. See, e.g., In re JAS Enterprises, Inc., 180 B.R. 210 (Bankr. D. Neb. 1995) (holding that rejection did not affect holder of leasehold interest when lessor had subordinated its interest to lienholder).

\textsuperscript{167} See, e.g., Warnert v. MGM Properties, 362 N.W.2d 364 (Minn. 1985).

\textsuperscript{168} See, e.g., Parris-West Maytag Hotel Corp. v. Continental Amusement Co., 168 N.W.2d 735 (Iowa 1969) (lease surrendered in connection with sale of property).

\textsuperscript{169} As stated in 49 AM. JUR. 2D Landlord and Tenant § 263 (1995):

Although a surrender operates between the parties as an extinguishment of the interest which is surrendered, it does not do so as to third persons who at the time of the surrender had rights which such an extinguishment would destroy; as to them, the surrender operates only as a grant subject to their right, and the interest surrendered still lies for its preservation, that is, interests in the leasehold acquired by third parties prior to the surrender will not be defeated by operation of the surrender. See also, e.g., Goldberg v. Tri-States Theatre Corp., 126 F.2d 26, 28 (8th Cir. 1942); Warnert, 362 N.W.2d at 368; Futterman v. South African Airways, 481 N.Y.S.2d 283, 286 (N.Y. Sup. Ct. 1984); Parris-West Maytag Hotel, 168 N.W.2d at 738-39; Louis Schlesinger Co. v. Rice, 72 A.2d 197, 199-200 (N.J. 1950); Shaw v. Creedon, 32 A.2d 721, 723 (N.J. Sup. Ct. Ch. Div. 1943); cf. National Shawmut Bank of Boston v. Correale Mining Corp., 140 F. Supp. 180, 184 (D. W. Va. 1956) (holding that when a lease was subject to forfeiture because of lessee default and lessor demanded that lessee surrender the lease instead and lessee agreed, sublease terminated).
analogized to a forfeiture of the leasehold for default by the lessee. The consequences to the third party of the transfer of the leasehold interest should turn not on voluntariness but on whether the transfer occurs because of the default of the lessee, a risk the third party assumed when taking a legally subordinated interest in a leasehold. Thus, even if the transfer is involuntary, if it does not occur because of a default by the lessee entitling the lessor to claim forfeiture of the leasehold, the leasehold should transfer to the Debtor/Owner encumbered by the STP's security interest.

The Debtor's need to make productive use of the property in its rehabilitation is protected under the Code against the claims of the STP, as it is against all creditor claims. Although the STP's security interest in the property created by the contract or lease should continue in such property when it is repatriated by the Debtor, by virtue of the rejection the STP has been transformed from a stranger to the bankruptcy case with a recourse claim against the NDP/OP into a non-recourse creditor of the Owner/Debtor.\textsuperscript{170} The claim of the STP to Debtor's property is thus subject to all provisions of the Code, including the automatic stay,\textsuperscript{171} the obligation to file a proof of claim,\textsuperscript{172} and discharge of its claim upon liquidation or confirmation of a plan of reorganization.\textsuperscript{173}

In the Lease Model, if the STP has a security interest in the NDP/OP/Lessee's leasehold interest in the equipment, upon rejection of the lease by the Debtor/Owner/Lessor, the property interest previously held by Lessee (P1) reverts to Debtor. To the extent of the value of that property interest, the STP becomes a secured creditor of Debtor, secured by a security interest in the

\textsuperscript{170} One who holds a claim against property of a debtor is treated by the Bankruptcy Code as holding a claim against the debtor, see 11 U.S.C. § 102(2) (1994), and thus constitutes a "creditor" under section 101(10). See Johnson v. Home State Bank, 501 U.S. 78 (1991) (holding that a mortgage lien securing obligation on which debtor's personal liability was previously discharged in Chapter 7 case was a "claim" subject to rescheduling under Chapter 13). Under section 1111(b) of the Code, such claim is allowed to the same extent as any secured claim under section 502 under most circumstances, but the claim will be secured only "to the extent of the value of such creditor's interest in the estate's interest in such property" under Section 506(a). Id. § 502. Thus, if the leasehold interest of the NDP/OP in which the STP had a security interest was valued at $1 million, the claim against the Debtor/Owner is a secured claim (secured by the UP) to the extent of $1 million, even if the UP is worth several times that.


\textsuperscript{172} See id. § 501.

\textsuperscript{173} See id. §§ 727, 1141, 1228, 1328.
equipment. In the License Model, when the license is rejected by Debtor/Owner/Licensor, absent protective legislation, the Licensee's interest in the intellectual property returns to Debtor, but the STP becomes a creditor of Debtor with a secured claim limited in value to the value of the property interest (P1) so returned. Affording the STP this protection is not inequitable. The only reason the Debtor/Owner is able to eradicate the NDP/OP's property interest is because the Code, in section 365, has decided that state law rights must give way to the important bankruptcy policies of equality of treatment of similarly-situated creditors, and the Debtor's need for a fresh start though a second look at its executory contractual obligations. No such policies require elimination of the STP's interest. The STP was never a creditor of the Debtor prior to bankruptcy, and when it becomes one through the operation of rejection of the lease or contract, it is treated in exactly the same way as all other secured creditors of the Debtor. The equality policy is fully honored. With respect to the fresh start policy, the Debtor should not be better off with respect to an STP with a secured claim against an interest in the Debtor's property in the hands of an OP than it would be had the secured claim been created by the Debtor itself. Absent exercise of an avoiding power, the Debtor could not render unenforceable a security interest in its property while such property was in its own hands, and the Code provides no basis for doing so when the property is in the hands of another. If the Debtor wishes to protect itself against the possibility of such secured claims created by third parties, it can always require the OP to agree in the lease or contract by which the property rights are created not to create security interests in those property rights.

C. Case Three: STP with security interest in rights of Debtor/OP

When the STP has a security interest in property interests of a Debtor/OP created by a lease or contract, the STP is a secured

174. The avoiding powers include, among others, the "strong-arm power" under section 544(a) that allows the trustee to avoid an unperfected security interest, the power to avoid preferential transfers under section 544(b) and section 547 of the Code, and the power to avoid fraudulent conveyances under section 548.

175. These so-called "negative pledge" clauses (precluding the creation of security interests in assets of the covenanting party) are quite common in debtor/creditor contracts. For examples, see AMERICAN JURISPRUDENCE LEGAL FORMS, Banks §§ 38.271 (2d ed. 1996).
creditor of the Debtor/OP and entitled to the protections afforded all secured creditors with respect to their collateral. Rejection of a lease or contract does not affect the STP's status (that is, it does not constitute rejection of the security agreement itself). 176

Rejection does, however, have a significant impact upon the collateral subject to the STP's security interest. Can the Debtor/Owner reject under these circumstances? Rejection here can be seen as the functional equivalent of a disposition of the STP's collateral. 177 Under section 363(e) of the Code, upon request of the STP, the court is required to prohibit or condition such disposition of the property subject to an unexpired lease or contract as necessary to provide the STP "adequate protection" of its security interest. 178 Generally when collateral is disposed of, providing the secured creditor the proceeds of the disposition would be seen as adequate protection of its interest. 179 However, when the property is held pursuant to a rejected lease or contract, no consideration is received for the disposition. Of course, the property may be valueless. In such a case, the STP should be

176. See, e.g., Leasing Service Corp. v. First Tenn. Bank Nat'l Ass'n, 826 F.2d 434, 437 (6th Cir. 1987) (holding that the rejection of lease by debtor/lessee simply determines whether claim is entitled to pre-petition or administrative priority, but does not affect security interest because security interest was "non-executory"). A security agreement is not an executory contract subject to rejection or assumption. See, e.g., In re Pacific Express, Inc., 780 F.2d 1482, 1487 (9th Cir. 1986); Jenson v. Continental Financial Corp., 591 F.2d 477, 482 (8th Cir. 1979); In re Hotel Syracuse, Inc., 155 B.R. 824, 843 (Bankr. N.D.N.Y. 1993).

177. Although some courts have concluded that section 365 of the Bankruptcy Code is the exclusive remedy available to a debtor party to an executory contract or lease and that the debtor cannot use section 363 to circumvent the protections afforded the OP pursuant to section 365, see, e.g., In re Taylor, 198 B.R. 142, 164-65 (Bankr. D.S.C. 1996); In re Owen-Johnson, 118 B.R. 780, 783 (Bankr. S.D. Cal. 1990); In re Robinson Truck Line, Inc. 47 B.R. 631 (Bankr. N.D. Miss. 1985), there is no reason to deny secured creditors the protections afforded by section 363 when section 365 is utilized by a debtor to dispose of the secured creditor's collateral.

178. See 11 U.S.C. § 363(e). Under Section 363(e), "[A]t any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court . . . shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest." Id. Section 363(e) was amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, by the addition of the last sentence that states that the subsection "also applies to property that is subject to any unexpired lease of personal property" insofar as such property is not subject to an order granting relief from the stay under section 362 of the Code.

179. Adequate protection may be provided by "providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property." 11 U.S.C. § 361; see, e.g., In re Collins, 180 B.R. 447, 452 (Bankr. E.D. Va. 1995); In re Williamson, 43 B.R. 813, 820 n.4 (Bankr. D. Utah 1984) (adequate protection provided by lien on proceeds of sale).
indifferent to the decision to reject and would not challenge it. But more likely the value of the lease or contract to the debtor given the security interest (the debtor's equity in the property) is insufficient to justify its retention.

When the Debtor/OP rejects the lease or executory contract, under the same principles applicable to Case Two, impact of that rejection upon the security interest of the STP in the leasehold interest or general intangibles of the Debtor/OP should be determined by state law. If the STP has not consented to the disposition of its collateral and its security interest is subject to the U.C.C., that security interest should continue in that collateral even as the collateral migrates back to the NDP/Owner. 180 Similarly, if the STP has a leasehold mortgage or security interest, the interest of the STP in what was formerly property of the Debtor/OP should remain valid when the property is effectively surrendered to the Owner. 181 The analogy to surrender is even stronger here than in Case Two because the decision to relinquish the leasehold interest is voluntary on the part of the Debtor/OP, even if the consent of the Owner to the surrender is inferred as a matter of law under the Code.

Thus, in the Lease Model, if the STP has a security interest in the Debtor/OP's leasehold interest and the Debtor rejects the Lease, the property interest of the Debtor in the equipment (P1) should migrate back to the NDP/Owner encumbered by the security interest of the STP. Similarly, for the License Model, the intellectual property interest of the Debtor/OP that was the collateral for the STP remains its collateral even after its disposition by the Debtor to the NDP/Owner through rejection of the license.

One could argue that the transfer of the leasehold or property rights under an executory contract by a Debtor/OP should not be treated as would a "surrender" because the STP took the risk of being subordinated to the NDP/Owner in the event of the Debtor/OP's rejection. But more likely the value of the lease or contract to the debtor given the security interest (the debtor's equity in the property) is insufficient to justify its retention.

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180. See U.C.C. § 9-306(2); supra note 155.
181. Cf. In re Garfinkle, 577 F.2d 901, 904 (5th Cir. 1978) (concluding that rejection of lease by trustee for Debtor/lessee did not terminate leasehold estate which was encumbered by mortgage in favor of third party, but merely "placed the leasehold outside of the bankruptcy administration" in the hands of the Debtor/lessee). Although I believe the Fifth Circuit correctly concluded that the mortgagee's interest in the leasehold estate is preserved, I disagree with the court in its conclusion that the estate (subject to the mortgage) migrates to the Debtor/lessee rather than to the NDP/lessor.
or/OP's default, and bankruptcy is certainly a default. Indeed, in most of those cases involving third party interests in property rights of a Debtor/OP under a rejected lease or executory contract in which the court has concluded that the rejection results in termination of the lease or contract, the court has also concluded or assumed that the third party interests disappear with rejection.  

However, although the Debtor is in bankruptcy, rejection of a lease or executory contract may occur even though the Debtor is completely current on its payments and has complied with all other obligations under the contract or lease. In other words, rejection is not a substituted form of remedy for the NDP/Owner; rather, it is a decision made by the trustee for the Debtor/OP with respect to its property interests and future obligations. As such, rejection could be seen as equivalent to abandonment of the property interests created by the executory contract or lease and should have consequences similar to those resulting from abandonment of property under section 554 of the Code. The security interest of the secured creditor in the abandoned property is unaffected by the abandonment, and remains effective in the hands of the debtor to whom the property is abandoned by the estate.
Debtor/OP (the value of the collateral for purposes of section 506 of the Code having been reduced to zero) and a nonrecourse security interest in property of the NDP/Owner. The STP’s property interests created by state law are thus respected, the Debtor has the benefit of rejection, and the NDP/Owner has both its claim in the bankruptcy case of the Debtor and its property rights in the UP, encumbered only by the interest of the STP rather than by the interest of the OP and the STP.

D. Case Four: STP with security interest in rights of NDP/Owner

The fourth scenario is similar to the first. The property interests of the NDP/Owner (in which the STP may have a security interest) are of two types: (1) the interest in the UP and the (2) interest created by the lease or contract. With respect to the first type of property interest, the rejection of the contract or lease by the Debtor/OP results in the elimination of any restrictions created by the lease or contract on the property interest of the NDP/Owner in the UP in which the STP has a security interest. As in Case One, if the security agreement describes the collateral in general terms (as would ordinarily be the case), the fact that the debtor’s rights in the collateral have expanded by rejection of the lease or contract imposes limitations on those rights would simply increase the value of the collateral covered by the security interest. But here, unlike Case No. 1, the STP remains a stranger to the bankruptcy case, and the increased collateralization of the STP occasioned by the rejection does not have any implications for creditors of a bankrupt. Although the NDP/Owner may wish to realize upon the returned value in a way other than providing increased collateralization to the STP, and other creditors of the NDP/Owner may wish to reach that property interest to satisfy other debts, those conflicting goals have no bankruptcy policy implications until and unless the Owner seeks protection from its creditors. Resolution of these objectives will be resolved by private contract and negotiation, not by statute. The property interests of the STP will be respected. Thus, if the STP has a security interest in the equipment leased in the Lease Model by the NDP/Owner to the Debtor/OP, when the Debtor rejects the lease, the STP continues to have a security interest in the equipment, free of any

185. See supra notes 151-153 and accompanying text.
claim by the Debtor. The STP with a security interest in the intellectual property of the NDP/Owner underlying a rejected license retains its security interest in that property after such rejection.

If the security interest of the STP is not in the NDP/Owner's interests in the UP, but is limited to the NDP/Owner's personal property interest created by the lease or contract itself (the "account" or "general intangibles" representing the rights afforded the NDP/Owner under the lease or contract), the rejection of the lease or contract has the same result as in Case One. When the Debtor/OP rejects the lease or contract, resulting in its termination, the collateral itself is involuntarily disposed of by the NDP/Owner, but the NDP/Owner is provided two things in exchange. First, pursuant to section 502(g) of the Code, the NDP/Owner is given a claim in the bankruptcy case of the Debtor/OP for damages occasioned by the deemed "breach" of the contract or lease. Second, the NDP/Owner receives the property interest in the UP carved out by the rejected lease or contract and previously held by the Debtor/OP which has now effectively been conveyed back to the NDP/Owner. Both of these property interests should be considered "proceeds" of the original collateral of the STP and, as in Case One, its security interest should continue in them without further action pursuant to section 9-306(2) of the U.C.C.

V. Conclusion

When an Owner enters into a contract or lease with respect to UP, it provides the OP property rights to the UP created by the contract or lease. It agrees to do so only because the OP provides the Owner a corresponding package of benefits from the lease or contract, principally a right to payments in respect of the new property right. These benefits are mutually sustaining. The Owner would never transfer an interest in the UP to the OP without the right to a stream of payments; the OP would never agree to make payment without a property right in the UP.

When the lease or contract is rejected by the Debtor, whether Owner or OP, that party has made the determination that the package of benefits created by the lease or contract is not sufficiently beneficial to justify the continuing claims on the bankrupt estate, either in the form of payments (OP) or loss of property rights to the UP (Owner). Rejection has the consequence of voiding the contract, by rendering every one of its provisions
permanently unenforceable against the Debtor, including those provisions creating property rights in the UP in favor of the OP. Rejection thereby effectively returns those property rights to the Owner, whether Debtor or NDP.

When the Owner is the NDP, the Owner loses the benefit of the payment stream in respect of those property rights, but has a claim for breach that can be filed in the bankruptcy case of the Debtor/OP and for which compensation will be provided commensurate with that provided other unsecured creditors of the Debtor/OP. The Debtor/OP is generally discharged from its payment obligations under the lease or contract, but also loses the property rights in the UP created thereby.

When the Owner is the Debtor, the NDP/OP loses the future benefit of the property rights in the UP created by the contract or lease, but is relieved of its obligations to make payment for those property rights. In addition, the NDP/OP will have a claim for breach of the contract or lease, and will receive compensation in respect of its lost property interests.

When one of the parties has conveyed its property rights in the UP to the STP, a new property interest has come into existence, one that attaches to an interest in real or personal property and that constitutes “collateral” under state law. Because the Bankruptcy Code makes no provision for avoiding or rejecting the interest of the STP, termination of the lease or contract upon rejection in the bankruptcy case affects the existence of that collateral only to the extent state law provides. By removing limitations on the collateral imposed by the lease or contract, rejection may change the value of the collateral, may change its ownership by transferring limited interests in the UP from an OP back to an Owner, or may even change its nature by transforming it from one type of collateral into proceeds of that collateral. But as a matter of statutory interpretation, bankruptcy policy, and most importantly state property law, in any situation, the security interest of the STP should remain valid—ride through—despite rejection of an executory contract or unexpired lease.