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Emory Bankruptcy Developments Journal

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Volume 38 | Issue 1

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2022

## Bankruptcy and the Anti-Assignment Acts: A New Approach to the Issue of Assumption and Assignability of Government Contracts

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### Recommended Citation

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# **BANKRUPTCY AND THE ANTI-ASSIGNMENT ACTS: A NEW APPROACH TO THE ISSUE OF ASSUMPTION AND ASSIGNABILITY OF GOVERNMENT CONTRACTS**

## **ABSTRACT**

*One of the most important and valuable tools that a business debtor has for reorganization under the bankruptcy proceedings is assuming and assigning executory contracts. However, circuit courts are divided on the issue of whether the Anti-Assignment Act, in conjunction with Section 365(c)(1)(A) of the Bankruptcy Code, prohibits the assumption of an executory government contract over the objection of the government where the contract is to be performed by the debtor-in-possession. Some circuit courts apply the “Hypothetical Test” which restricts a debtor-in-possession from assuming an executory contract over an objection if applicable law would bar assignment to a hypothetical third party, even if the debtor-in-possession has no intention of assigning the contract to a third party, and the contract is to be performed by the same performing party (i.e., debtor-in-possession or reorganized debtor). Others adopt the “Actual Test,” which holds that laws, such as the AAA, only prohibit assumption where the debtor-in-possession actually intends to subsequently assign the assumed contract to an unrelated third party.*

*In the case of a government contract, courts have to balance between protecting government interests and the debtor’s interest in reorganization. While government interests can have underlying considerations (such as national security concerns) that are crucial for the success of the U.S., the debtor’s interest in reorganization is also crucial in helping the economy to weather a crisis. However, both the Hypothetical Test and the Actual Test mechanically favor one side over the other, putting either the country’s national security or its economy at risk. Therefore, this Comment proposes that courts use a four-pronged analysis that examines each case in light of the totality of the circumstances.*

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## INTRODUCTION

In the years following the 2008 financial crisis, many U.S. companies—including those whose business depends primarily on government contracts—struggled to stay afloat.<sup>1</sup> Today, many of those businesses face the same economic issues in the wake of the COVID-19 pandemic.<sup>2</sup> Faced with the alternative of a buyout or ceasing operations altogether, many of these companies now recognize the need to seek a “fresh start” by reorganizing or restructuring under chapter 11 of the Bankruptcy Code (the “Code”).<sup>3</sup>

One key benefit of the bankruptcy reorganization process is that it enables a debtor to assume and assign executory contracts. However, the term “executory contract” is not clearly defined in the Code. Both the case law and legislative history surrounding Section 365 of the Code suggest that a contract *is* “executory” when both parties have “substantially underperformed” their obligations under the contract.<sup>4</sup> Further, this body of case law and the legislative history of the Code indicate that a contract *is not* executory when one party has no post-petition obligations to fulfil, other than monetary payments.<sup>5</sup>

The Code does provide some special rules for executory contracts.<sup>6</sup> In particular, the Code allows a debtor to be released from its contracts if the debtor

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<sup>1</sup> See Turna Ray, *Perlegen Defunct: PGx Firm Shuttters Doors After R&D Disappointment, Mounting Losses*, GENOMEWEB, Jan. 13, 2010, <https://www.genomeweb.com/diagnostics/perlegen-defunct-pgx-firm-shuttters-doors-after-rd-disappointments-mounting-losses#.X38R0GhKg2w>; see, e.g., Patrick Fitzgerald, *BearingPoint Requests Bankruptcy Protection*, WALL ST. J., Feb. 19, 2009, <https://www.wsj.com/articles/SB123496681501311401>.

<sup>2</sup> See Ben Winck, *U.S. Companies Tumble into Bankruptcy at a Fastest Pace Since 2013 Under Coronavirus Stress*, BUS. INSIDER, Jun. 30, 2020, <https://markets.businessinsider.com/news/stocks/us-companies-file-bankruptcy-fastest-rate-coronavirus-fallout-economy-recession-2020-6-1029356044#>.

<sup>3</sup> *Id.*

<sup>4</sup> S. REP. NO. 95-989, at 58 (1978) (“Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.”); *In re C & S Grain Co.*, 47 F.3d 233, 237 (7th Cir. 1995) (“For purposes of the Bankruptcy Code, an executory contract is one in which the obligations of each party remain substantially unperformed. Consequently, when the debtor has breached the contract pre-petition with the result that the other party has no further duty to perform, . . . the contract is no longer executory.” (quoting *In re Murtishi*, 55 Bankr. 564, 567 (N.D. Ill. 1985))) (internal marks and citation omitted).

<sup>5</sup> See *In re Munple, Ltd.*, 868 F.2d 1129, 1131 (9th Cir. 1989) (holding that a real estate brokerage commission agreement is not an executory contract even though payment of fee was conditioned upon closing of sale); see also *In re Spectrum Information Technologies, Inc.*, 190 B.R. 741, 748 (Bankr. E.D.N.Y. 1996) (“[W]here the only performance that remains is the payment of money, the contract will not be found to be executory”).

<sup>6</sup> See, e.g., FED. R. BANKR. P. 1007(b) (requiring a debtor to provide, among other things, a schedule of executory contracts); 11 U.S.C. § 365(a) (2018) (allowing a trustee to assume or reject any of the debtor’s executory contracts subject to the approval of the court).

decides that doing so is in its best interests.<sup>7</sup> Thus, when undergoing the bankruptcy process, the debtor must decide whether it wants to “assume” or reject their contracts.

In chapter 11 bankruptcies, the ability to assume and assign executory contracts and unexpired leases is one of the most important tools available to a debtor seeking a second chance.<sup>8</sup> Under the Code, “assumption” means “the mechanism by which a debtor, upon notice to creditors, seeks authorization from a bankruptcy court to reaffirm its obligations under an agreement.”<sup>9</sup> Additionally, an assumption also requires the debtor to cure existing defaults.<sup>10</sup> From the debtor’s perspective, undergoing this assumption process during a bankruptcy proceeding is akin to entering into a new contract after the initial bankruptcy filing.

If a trustee or a debtor assumes a lease or contract, then the debtor may either: (1) elect to retain its performance obligations under the contract, or (2) “assign,” that contract to a third party.<sup>11</sup> When the debtor or trustee assigns a contract to a third party, the assigned party acquires the debtor’s contractual rights and the duties, and, in return, “the bankruptcy estate has no liability for the subsequent performance.”<sup>12</sup>

Although the Code does not require a chapter 11 debtor to formally assume or reject an executory contract, there is a general presumption that “the only way a reorganized debtor can retain an executory contract through a chapter 11 proceeding is to formally assume it under [Section] 365.”<sup>13</sup> Further, by assuming an executory contract, the reorganized debtor retains the contract’s benefits, without additional change to the parties’ original obligations—with the

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<sup>7</sup> See *In re Health Science Products, Inc.*, 191 B.R. 895, 909 n.15 (Bankr. N.D. Ala. 1995) (noting that a bankruptcy court must approve a debtor’s decision to assume or reject an executory contract “unless there is bad faith or gross abuse of discretion” and “the decision of the debtor is so manifestly unreasonable that it could not be based on sound business judgment”).

<sup>8</sup> Michelle Morgan Harmer et al., *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 187 (2005).

<sup>9</sup> Steven S. Diamond & Thomas Pettit, *Considerations for Gov’t Contractors in Bankruptcy: Part 1*, ARNOLD & PORTER (May 15, 2020), <https://www.arnoldporter.com/en/perspectives/publications/2020/05/considerations-govt-contractors-bankruptcy-part-1>.

<sup>10</sup> 11 U.S.C. § 365(b)(1).

<sup>11</sup> *Executory Contracts Under 365*, AM. BANKR. INST. J. (2004), <https://www.abi.org/abi-journal/executory-contracts-under-365>.

<sup>12</sup> See 11 U.S.C. § 365(k) (providing that the trustee and the bankruptcy estate are not liable for any breach of the contract that occurs after the assignment of an executory contract assumed under Section 365).

<sup>13</sup> Mark R. Campbell & Robert Haste, *Executory Contracts: Retention without Assumption in Chapter 11—“Ride-Through” Revisited*, AM. BANKR. INST. J. (2000), <https://www.abi.org/abi-journal/executory-contracts-retention-without-assumption-in-chapter-11ride-through-revisited>.

exception of any changes that the Code explicitly requires.<sup>14</sup> Thus, the ability to assume and assign a contract allows the debtor to retain favorable contracts and compel continued performance by a non-debtor party, while simultaneously abandoning burdensome contracts and their associated future performance obligations.<sup>15</sup> In many cases, the debtor may assume and then assign an executory contract or unexpired lease to a third party without obtaining the consent of the non-debtor party, even if an applicable law or contractual provision “prohibits, restricts, or conditions the assignment of such contract or lease.”<sup>16</sup>

However, this authority to assume and assign executory contracts and unexpired leases raises many issues in bankruptcy proceedings. One such issue is whether a trustee—an entity appointed by the bankruptcy court to manage the affairs of the debtor and exercise its rights and responsibilities as a debtor—can force a non-debtor party to accept performance from a third party with which it did not contract by assigning or assuming a contract or lease.

Section 365(c)(1) of the Code attempts to resolve this issue, providing that “a trustee may not assume or assign any executory contract or unexpired lease” without the consent of the non-debtor party if “applicable law excuses [the non-debtor party] . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession.”<sup>17</sup> As a result of Section 365(c), government contractors, in particular, have limited ability to assume and assign their executory contracts with the government to a third party. The federal Anti-Assignment Act (the “AAA”)—a statute that courts deem “applicable law” under Section 365(c)(1)(A)<sup>18</sup>—“generally prohibit[s] the

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<sup>14</sup> See *In re Wash. Cap. Aviation & Leasing*, 156 B.R. 167, 173 (Bankr. E.D. Va. 1993). The Code permits the debtor to cure defaults, ignore *ipso facto* clauses, and resume its contractual obligations if the statutory tests are met. *Id.*

<sup>15</sup> See Harner, *supra* note 8, at 193.

The purpose of section 365 of the Bankruptcy Code is to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.

*Id.* (internal quotation marks omitted). Generally, a non-debtor party is the other party to the original pre-petition contract that did not file for bankruptcy and is not seeking a “fresh start” under the Code. In the case of a government contractor seeking to assume an executory contract under the Code, the non-debtor party is the government.

<sup>16</sup> 11 U.S.C. § 365(f)(1).

<sup>17</sup> *Id.* § 365(c)(1)(A).

<sup>18</sup> See Tanya M. Kiatkulpiboone, *Keeping Score When Bankruptcy Principles and the Federal Anti-Assignment Act Collide: Government Contractors’ Options Concerning Executory Contracts*, 3 J. BUS. ENTREPRENEURSHIP & L. 281, 289 (2010).

transfer of government contracts and the assignment of claims against the government.”<sup>19</sup>

However, circuit courts are divided on whether the AAA prohibits the assumption of a government contract where: (1) the non-debtor party objects to the assumption; and (2) the contract, if assumed, will be performed by the debtor-in-possession.<sup>20</sup> Without a definitive judicial or legislative mandate, debtors and legal practitioners face substantial uncertainty in determining whether to file for bankruptcy under chapter 11. This issue is especially acute for businesses that regularly contract with the government. Specifically, the inability to selectively assume favorable contracts prevents these businesses from maximizing the value of their remaining assets in reorganization and restructuring.

This Comment argues that courts should allow certain government contractors to assume their government contracts and conditionally continue performance under these contracts throughout the reorganization process. To determine whether a government contractor may assume its government contracts, this Comment proposes applying a new test that: (1) examines each situation on a case-by-case basis; (2) emphasizes the totality of the circumstances; (3) and considers the nature of the contract in question. Part I of this Comment will explain the interplay between the Code, Section 365’s “applicable law” exception, and the AAA—an interplay that created the existing circuit split over how the AAA affects the ability of a debtor-in-possession to assume a contract. In Part II, this Comment demonstrates why the current tests for determining the AAA’s effect on a debtor-in-possession’s ability to assume a government contract are insufficient. Part II will examine the Code’s favoritism toward debtors and their reorganization, the statutory language of Section 365(c)(1), the legislative intent behind the AAA, and available case precedent. Finally, this Comment proposes a four-factor test to guide judicial interpretation of executory government contracts within chapter 11 reorganization.

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<sup>19</sup> *Westinghouse Elec. Co. v. United States*, 56 Fed. Cl. 564, 569 (2003).

<sup>20</sup> *See Kiatkulpiboone, supra* note 18, at 290–91 (2010). A debtor-in-possession is “a post-petition debtor who is authorized by the court to continue [the debtor’s] business.” *Id.*

## I. BACKGROUND

### A. *A Debtor Has Rights through Reorganization Procedure*

This section will explain the options generally afforded to a debtor in cases involving pre-petition executory contracts and explore why assumption is the best available option for a business debtor wanting to retain favorable contracts.

In a chapter 11 reorganization proceeding, a debtor must identify executory contracts, determine the contracts' status, and evaluate whether the debtor should preserve each contract for the survival of its business.<sup>21</sup> A debtor-in-possession<sup>22</sup>—or the chapter 11 “trustee”<sup>23</sup>—may take any of the following post-petition actions concerning an executory contract: “(1) reject the contract; (2) assume the contract; (3) assume and assign the contract...; or (4) do nothing and let the contract ‘ride through’ the bankruptcy.”<sup>24</sup> An executory contract that “rides-through” the bankruptcy process remains in full force and effect against the reorganized debtor upon the debtor’s emergence from chapter 11.<sup>25</sup> Although court approval is necessary for the assumption, assignment, or rejection of an executory contract, a “ride-through” does not require this formal authorization.<sup>26</sup> Ride-through is only available when the debtor’s chapter 11 reorganization plan is silent on the assumption and rejecting the contract would leave all claims under it unaffected by the debtor’s bankruptcy.<sup>27</sup>

Retaining a contract through ride-through creates several potential pitfalls for the debtor.<sup>28</sup> Normally, if the debtor formally assumes a contract under bankruptcy law, then the *ipso facto* clause is unenforceable.<sup>29</sup> An *ipso facto*

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<sup>21</sup> *Id.* at 285 (2010).

<sup>22</sup> See discussion *infra* Part I.B.

<sup>23</sup> See 11 U.S.C. §§ 1107, 1108.

<sup>24</sup> Kristin S. Simpson, *Fifth Circuit’s Executory Contract Standards Deconstructed: The Mirant Lessons*, 26 MISS. COLL. L. REV. 225, 226 (2007).

<sup>25</sup> Compare *In re Hernandez*, 287 B.R. 795, 799 (Bankr. D. Ariz. 2002) (holding that the debtor’s patent licensing agreement could ride through the debtor’s Chapter 11 case as it was without being affected by the bankruptcy), with *In re O’Connor*, 258 F.3d 392, 404 (5th Cir. 2001) (“There appears to be general agreement that the ‘pass-through’ theory continues to apply in Chapter 11 cases . . . where an assumable executory contract is neither assumed nor rejected, and the Reorganized Debtor continues to operate the debtor’s pre-bankruptcy business.”).

<sup>26</sup> See Simpson, *supra* note 24.

<sup>27</sup> Mette H. Kurth & Joel Ohlgren, *Ride-Through Revisited (Again): The Strategic Use of the Ride-Through Doctrine in the Post-Catapult Era*, AM. BANKR. INST. J. (2005), <https://www.abi.org/abi-journal/ride-through-revisited-again-the-strategic-use-of-the-ride-through-doctrine-in-the-post#6>.

<sup>28</sup> See generally *id.*

<sup>29</sup> Robbin L. Itkin & Katherine C. Piper, *The Metamorphosis of Assignment Clauses in Bankruptcy*, LAW J. NEWSLS. (2005), <https://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2005/05/24/the->

clause is a contract provision that “automatically triggers a default or termination upon a bankruptcy filing.”<sup>30</sup> However, if the debtor chooses the ride-through option in lieu of assumption, then the *ipso facto* clause remains in full effect, and the non-debtor party to the contract may terminate the contract as soon as the reorganized debtor exits the bankruptcy proceeding.<sup>31</sup> Therefore, the general presumption is that the debtor should formally assume an executory contract in order to retain that contract.<sup>32</sup>

*B. 11 U.S.C. § 365 Creates an “Applicable Law” Exception to the Debtor’s Ability to Assume and Assign an Executory Contract*

The debtor’s right to assume and assign an executory contract plays an important role in a business debtor’s successful reorganization in a chapter 11 proceeding. However, Section 365 places two important limitations on their ability to assume or assign an executory contract. Section 365(a) enables the debtor to assume or reject an executory contract, and Section 365(c) creates the “applicable law” exception to this right. This Section of the Comment examines Section 365(a) in the broader context of a chapter 11 bankruptcy proceeding.

Section 365(a) plays an important role in chapter 11 cases because it gives “a trustee the general right to assume or reject any executory contract or unexpired lease of the debtor.”<sup>33</sup>

Although the language of the Code uses the term “trustee,” a trustee is rarely appointed in chapter 11 cases.<sup>34</sup> When a trustee is appointed in chapter 11, they gain control of the day-to-day operations of the business.<sup>35</sup> Instead, courts usually leave the existing management intact because they typically have a better understanding of their own business.<sup>36</sup> Additionally, appointing a chapter 11 trustee may harm the business’ reorganization plan if the appointed trustee: (1) fires the company’s management; or (2) converts the business to a Chapter 7

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[metamorphosis-of-assignment-clauses-in-bankruptcy/?slreturn=20210722204103](#).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Haste, *supra* note 13.

<sup>33</sup> Kiatkulpiboone, *supra* note 18, at 288; 11 U.S.C. § 365(a) (2018).

<sup>34</sup> John D. Ayer et al., *An Overview of the Automatic Stay*, 22 AM. BANKR. INST. J. 16 (2004) (noting that there is a strong presumption against appointing a trustee because: 1) a debtor-in-possession has “a fiduciary duty to act in the best interest of creditors and other stakeholders, are typically motivated to maximize value and usually don’t engage in significant wrongdoing”, and 2) the debtor-in-possession is usually more familiar with the business it had been managing pre-petition than the appointed trustee).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

liquidation, effectively shutting down the business.<sup>37</sup> Therefore, the U.S. Trustee rarely appoints a trustee to represent the debtor's estate in chapter 11 bankruptcies, and courts generally interpret "trustee" as the debtor or the debtor-in-possession.

Section 365(a) essentially gives a debtor-in-possession the right to assume an executory contract because the term "trustee" refers to a debtor-in-possession. However, Section 365(a) also limits this right such that the debtor-in-possession may only assume or reject an executory contract absent a pre-petition default.<sup>38</sup> Alternatively, if a pre-petition default arises, under Section 365(b)(1)(A), the debtor-in-possession can either: (1) cure the default when it assumes the contract; or (2) provide the court with "adequate assurance that [it] will promptly cure [the default]."<sup>39</sup>

If the debtor rejects an executory contract, then they must also obtain court approval.<sup>40</sup> However, the court may withhold approval if the debtor filed their bankruptcy petition in bad faith.<sup>41</sup> A court may find that the debtor filed a petition in bad faith if it the debtor's "rejection of an important executory contract [was] essentially the sole motive for filing the Chapter 11 case."<sup>42</sup>

Importantly, a debtor's rejection of an executory contract does not relieve them from the contract's obligations altogether.<sup>43</sup> Instead, courts will treat the debtor's rejection as a pre-petition breach, giving the non-debtor party an unsecured claim.<sup>44</sup> The bankruptcy estate will distribute to unsecured claims on

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<sup>37</sup> Lynn Wartchow, *The Role of the "Trustee" in Chapter 11*, WARTCHOW L. OFFICE (Apr. 16, 2012), <http://wartchowlaw.com/2012/04/16/the-role-of-the-trustee-in-chapter-11/>.

<sup>38</sup> See 11 U.S.C. § 365(a) (2018) ("Except as provided in...subsection[] (b)...of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"); see also *id.* § 365(b) (providing that a trustee cannot assume an executory contract if the debtor previously defaults under the contract unless the trustee meets certain criteria).

<sup>39</sup> *Id.* § 365(b)(1)(A).

<sup>40</sup> *Id.* § 365(a) ("Except as provided in...subsection[] (b)...of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor").

<sup>41</sup> *In re Health Science Products, Inc.*, 191 B.R. 895, 909 n.15 (Bankr. N.D. Ala. 1995) (providing that courts may not reject a debtor's choice "unless there is bad faith or a gross abuse of discretion").

<sup>42</sup> DANIEL J. FLANIGAN, UNDERSTANDING THE LEGAL ISSUES BEHIND EXECUTORY CONTRACTS IN BANKRUPTCY: LEADING LAWYERS ON STRATEGIES FOR THE STRUCTURING, DRAFTING AND EXECUTION OF EXECUTORY CONTRACTS 6 (Aspatore, Inc. 2006).

<sup>43</sup> *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1659 ("A rejection convert[s] a debtor's unfulfilled obligation to a pre-petition damages claim.") (quoting *In re Tempnology, LLC*, 559 B. R. 809, 820–23 (B.A.P. 1st Cir. 2016)) (alteration in original, internal quotation marks omitted).

<sup>44</sup> Victoria Vron, *Rejection of an Executory Contract Does Not Relieve a Debtor of Assumed Liabilities*, WEIL RESTRUCTURING (2010), <https://restructuring.weil.com/executory-contracts/rejection-of-an-executory-contract-does-not-relieve-a-debtor-of-assumed-liabilities/>.

a *pro rata* basis, which enables secured creditors to collect some damages and entitles unsecured creditors to monetary recovery.<sup>45</sup>

If the debtor decides to assume an executory contract after obtaining approval from the court, then they must assume the contract in its entirety.<sup>46</sup> Courts treat this as a new contract, the breach of which gives rise to damages that must be paid out of the estate as “priority administrative expenses.”<sup>47</sup> To determine whether the debtor is worthy of assuming a contract, the court applies a “business judgment” standard, which requires the debtor to assert that assuming the contract is a smart business decision.<sup>48</sup> If the debtor’s assertion satisfies this standard, and there is no evidence of bad faith or abuse of discretion by the debtor, then the court will approve the assumption.<sup>49</sup> Some scholars argue that courts should not preclude a debtor-in-possession from assuming and continuing its performance under their contract.<sup>50</sup> However, Section 365(b)(1) limits this assumption of an executory contract by requiring a debtor-in-possession to either cure a contractual default or provide adequate assurance to the court that it will promptly cure the default.<sup>51</sup>

More importantly, Section 365(c) restricts a trustee’s ability to assume or assign the executory contracts or unexpired leases of a debtor. Section 365(c)(1) provides:

- (c) The *trustee* may not assume *or* assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegations of duties, if—
  - (1)
    - (A) *applicable law* excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

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<sup>45</sup> Simpson, *supra* note 24, at 227.

<sup>46</sup> *Id.* at 226.

<sup>47</sup> *Id.* at 230. The Code has a priority scheme which provides the order in which claims are paid. For claims that are unsecured by collaterals, administrative expenses are given first priority. 11 U.S.C. § 507(a)(1). The Code defines administrative expenses as “the actual, necessary costs and expenses of preserving the [bankruptcy] estate.” 11 U.S.C. § 503(b)(1)(A).

<sup>48</sup> Harner, *supra* note 8, at 194.

<sup>49</sup> *Id.* at 194–95.

<sup>50</sup> See Jay R. Indyke et al., *Ending the “Hypothetical” vs. “Actual” Test Debate: A New Way to Read Section 365(c)(1)*, 16 J. BANKR. L. & PRAC. 2 Art. 2 (2007).

<sup>51</sup> 11 U.S.C. § 365(b)(1).

(B) such party does not consent to such assumption or assignment.<sup>52</sup>

In essence, Section 365(c)(1) “excuses the non-debtor from accepting or rendering performance in accordance with the terms of [their] contract with the debtor or [debtor-in-possession]” if there is “applicable law” that allows the non-debtor to do so.<sup>53</sup> Some non-bankruptcy laws that courts have previously found to be “applicable law” include patent law, copyright law, and the AAA.<sup>54</sup> Broadening this interpretation, some courts have read Section 365(c)(1)’s use of the word *applicable* to include personal service contracts and contracts of public importance, such as government contracts.<sup>55</sup>

Whether applicable non-bankruptcy law restricts a debtor-in-possession from assuming a contract is a critical determination in chapter 11 bankruptcies because a trustee or a debtor must assume a contract before assigning its obligations to a third party. The debtor’s estate may “sell the contracts to generate capital for a reorganization or cash for distribution to creditors” if it is authorized to assign the contract.<sup>56</sup>

For some business debtors, a successful reorganization is not feasible without the ability to assume and assign their executory contracts.<sup>57</sup> Consequently, some legal analysts argue that the bankruptcy principle of “free assignability”—derived from Section 365(f) of the Code—preempts state law that restricts assignability.<sup>58</sup> However, if the principle of free assignability overrides state non-bankruptcy laws, then a new question arises: *whether the free-assignability principle also overrides federal non-bankruptcy laws that*

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<sup>52</sup> *Id.* § 365(c)(1) (emphasis added).

<sup>53</sup> Kiatkulpiboone, *supra* note 18; 11 U.S.C. § 365(c)(1).

<sup>54</sup> See *In re Alltech Plastics, Inc.*, 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987) (finding that the patent law rule against the assignability of patent licenses is applicable law within the meaning of Section 365); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 242 (finding that federal policy concerning copyright law constitutes applicable non-bankruptcy law); *In re W. Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988) (finding that the federal AAA is applicable law within the meaning of Section 365(c)).

<sup>55</sup> Harner, *supra* note 8, at 188.

<sup>56</sup> David R. Kuney, *Restructuring Dilemmas for the High Technology Licensee: Will “Plain Meaning” Bring Order to the Chaotic Bankruptcy Law for Assumption and Assignment of Technology License?*, 44 GONZ. L. REV. 123, 135 (2008) (internal marks omitted).

<sup>57</sup> *E.g.*, U.S. Dep’t of Air Force v. Carolina Parachute Corp. (*In re Carolina Parachute Corp.*), 108 B.R. 100, 102 (M.D.N.C. 1989).

<sup>58</sup> Kuney, *supra* note 56, at 136–37. As a general rule, bankruptcy courts view executory contracts that a debtor has prior to its filing for bankruptcy as “assets of the bankruptcy estate.” *Id.* Because the assignment of prepetition contracts “provides value to the estate and a *raison d’être* for the bankruptcy filing,” this right generally trumps laws that restrict assignability in most cases. *Id.* at 136.

restricts a debtor's ability to assume and assign executory contracts, such as the AAA.

*C. Federal Anti-Assignment Act Is An Applicable Non-Bankruptcy Law under Section 365(c)(1)(A)*

Under Section 365(c)(1)(A), a trustee cannot assume or assign an executory contract if there is an “applicable law” that allows the non-debtor party to the executory contract to refuse performance by a third party other than the debtor.<sup>59</sup> Over the last few decades, courts have ruled that the federal AAA is an applicable law under Section 365(c)(1)(A).<sup>60</sup> Thus, because the AAA is an applicable law, Section 365(c)(1)(A) automatically prevents a trustee from assuming or assigning an executory government contract.<sup>61</sup> However, because chapter 11 cases often involve a debtor-in-possession instead of a trustee, the question becomes whether the AAA automatically prohibits a debtor-in-possession from assuming a government contract even if it does not intend to assign it.

The AAA “generally prohibit[s] the transfer of government contracts and the assignment of claims against the government.”<sup>62</sup> The general purpose of the AAA is to prevent fraud in government contracting.<sup>63</sup> Generally, a contractor may borrow from a lender via accounts receivable lending in which a lender will give the contractor a loan in exchange for a claim payable “after the contractor finishes a project or reaches certain payment milestones.”<sup>64</sup> Similarly, the lender—who is now the contractor’s creditor—“may assign that claim to a third-party in exchange for something of value.”<sup>65</sup> This unregulated transfer of claims raises a significant issue regarding government contractors and claims against the government.<sup>66</sup>

In 1853, Congress passed An Act to Prevent Frauds Upon the Treasury of the United States, which became the AAA, to prevent third parties from obtaining claims against the federal government and using these claims as a

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<sup>59</sup> 11 U.S.C. § 365(c)(1)(A).

<sup>60</sup> See, e.g., *In re W. Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988) (finding that the AAA is applicable law within the meaning of Section 365(c)).

<sup>61</sup> See, e.g., *id.* (finding that the AAA is applicable law within the meaning of Section 365(c)).

<sup>62</sup> *Westinghouse Elec. Co. v. United States*, 56 Fed. Cl. 564, 569 (2003).

<sup>63</sup> Chung Kun Kevin Park, *Removing Uncertainty for the Most Uncertain Times: The Need for Amending the Anti-Assignment Acts to Better Prepare for a Financial Crisis*, 47 PUB. CONT. L.J. 307, 316 (2010).

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

means to influence government officials.<sup>67</sup> Over time, the courts have discerned a three-pronged intent underlying the AAA: (1) “to prevent the trafficking of claims to improperly influence the U.S. government;” (2) “to prevent multiple payments on the same claim and allow the government to deal solely with one claimant;” and (3) “to preserve the government’s defense against the transferee.”<sup>68</sup> The Supreme Court inferred the first legislative intent in *Spofford v. Kirk*.

In *Spofford v. Kirk*, the Supreme Court inferred that Congress passed the AAA “to prevent a single claim from being brought by multiple claimants” and to prevent a single claimant from accruing multiple substantial claims against the government, limiting the individual leverage to influence government officials.<sup>69</sup> By generally prohibiting a party from assigning a claim against the federal government to a third party, the AAA essentially ensures that the government only has to deal with one single claimant that is the original claimant.<sup>70</sup> This fact also means that the government will not have to: 1) evaluate whether a transfer/assignment of the claim is valid, 2) go through multiple litigations brought by different claimants regarding the same claim, 3) potentially be held legally liable to multiple claimants for the same claim, and 4) potentially pay multiple claimants for the same claim.<sup>71</sup> After *Spofford*, courts inferred a third congressional purpose of the AAA—“to preserve the government’s defense against the transferee.”<sup>72</sup>

In short, the fact that courts typically find the AAA to be an applicable law under Code Section 365(c)(1)(A) effectively prohibits trustees from assuming or assigning executory government contracts. However, the outcome is less clear when the party seeking to assume the contract is the debtor-in-possession. This ambiguity arises from the uncertainty surrounding whether restricting a debtor-in-possession’s ability to assume a contract serves the purpose of the AAA. Because the intent of the AAA is to protect government interests and prevent fraud,<sup>73</sup> the assumption of a government contract does not necessarily serve these objectives. In cases involving a debtor-in-possession, the party rendering the services remains unchanged when the debtor-in-possession assumes the

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<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 319 (2010) (citing *Anchor Sav. Bank, FSB v. United States*, 121 Fed. Cl. 296, 324 (2015)) (internal quotation removed).

<sup>69</sup> *Id.* at 316–17 (2010).

<sup>70</sup> *Patterson v. United States*, 173 Ct. Cl. 819, 823 (1965).

<sup>71</sup> *Id.*

<sup>72</sup> *Park*, *supra* note 63, at 324 (internal quotation removed).

<sup>73</sup> *Id.* at 316–17.

contract without assigning it to a third party. Therefore, harm to the government's contractual rights and interests is not likely to occur. As a result, while courts have generally accepted that the AAA is an applicable non-bankruptcy law under Section 365(c)(1)(A), courts remain divided about how the AAA affects a debtor-in-possession's ability to assume an executory government contract.<sup>74</sup>

*D. Circuit Courts Disagree on Whether the AAA Has the Effect of Preventing a Debtor-in-Possession from Assuming an Executory Government Contract*

To determine how the AAA affects the ability of a debtor-in-possession to assume an executory government contract, circuit courts employ two competing approaches—the hypothetical test<sup>75</sup> (“Hypothetical Test”) and the actual test<sup>76</sup> (“Actual Test”). Four circuits—the Third, Fourth, Ninth, and Eleventh<sup>77</sup>—have adopted the Hypothetical Test and applied it in cases that involve technology companies. Alternatively, the First Circuit, along with most bankruptcy courts, utilize the Actual Test.<sup>78</sup> Other circuit courts—the Second, Fifth<sup>79</sup>, Sixth, Seventh, Eighth, Tenth, and District of Columbia—do not apply either test and, instead, focus on whether there is an applicable law that automatically prohibits the assignment or assumption of the contract in question.<sup>80</sup>

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<sup>74</sup> Compare *In re W. Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988) (prohibiting the debtor-in-possession from assuming an executory government contract for production of military equipment without governmental consent), with *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) (holding that common law and contractual restrictions against assignment of patents did not preclude assignment of patents to the debtor-in-possession).

<sup>75</sup> The Hypothetical Test restricts a debtor-in-possession from assuming an executory contract over a governmental objection if applicable law would bar assignment of the contract to a *hypothetical third party*, even if: (1) the debtor-in-possession has no intention to assign the contract to a third party; and (2) the contract is to be performed by the same party (i.e., the debtor-in-possession or the reorganized debtor). See *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partner)*, 27 F.3d 534, 537 (11th Cir. 1994).

<sup>76</sup> The Actual Test holds that laws, such as the AAA, only prohibit assumption where the debtor-in-possession *intends* to subsequently assign the assumed contract to an unrelated third party. See *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 613–14 (1st Cir. 1995); *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 247–51 (5th Cir. 2006).

<sup>77</sup> *In re W. Elecs., Inc.*, 852 F.2d at 83; *Perlman v. Catapult Ent., Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747, 750 (9th Cir. 1999); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *In re James Cable Partner*, 27 F.3d at 537 n.6. The Eleventh Circuit appeared to adopt the Hypothetical Test in *In re James Cable Partner*, but ultimately did not reach the issue because no “applicable law” excused the city from accepting performance from a party that is not the debtor.

<sup>78</sup> See *Summit Inv. & Dev. Corp.*, 69 F.3d at 613–14.

<sup>79</sup> While the Fifth Circuit has not adopted either test in interpreting Section 365(c), it adopted the Actual Test in interpreting Section 365(e)(2). See *In re Mirant Corp.*, 440 F.3d 238.

<sup>80</sup> See Heather Hili, *Seventh Circuit Holds Trademark License Not Assignable in Bankruptcy Case*, AM. BANKR. INST., <https://www.abi.org/member-resources/blog/seventh-circuit-holds-trademark-license-not-assignable-in-bankruptcy-case>. See, e.g., *In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011) (finding that U.S.

The Hypothetical Test notes that Section 365(c) stipulates that “[t]he trustee may not assume or assign any executory contract . . . if applicable law excuses a [non-debtor] party.”<sup>81</sup> In other words, if applicable law prevents the debtor from assigning an executory contract pre-petition, then the debtor also cannot assume the contract post-petition. Based on this line of reasoning, the AAA, as an “applicable law,” makes assignment impermissible. Because assignment required assumption and the trustee, debtor, or debtor-in-possession cannot “assume or assign,”<sup>82</sup> assumption is also impermissible.

Nearly ten years after the creation of the Hypothetical Test, the First Circuit adopted the Actual Test in *Summit v. Leroux*.<sup>83</sup> The First Circuit concluded that Section 365(c) did not prohibit assumption when the debtor-in-possession did not intend to assign an executory contract to a third party.<sup>84</sup> The court also noted that the legislative intent behind Section 365(c) provided a good counterbalance to the strong support for a debtor’s fresh start by “provid[ing] the counter-party with the benefit of its bargain.”<sup>85</sup>

In short, because circuit courts value different interests in chapter 11 cases, they cannot agree on a uniform approach for determining whether a debtor-in-possession may assume an executory government contract. Courts that apply the Hypothetical Test emphasize the interests of the non-debtor and look strictly to the statutory language of the statute.<sup>86</sup> On the other hand, courts that apply the Actual Test are more concerned with the overall objective of the Code, which favors the debtor’s reorganization, and look to the actual intent of the debtor-in-possession seeking to assume the contract.<sup>87</sup> The question remains, which test, if any, should be applied.

## II. DISCUSSION AND ANALYSIS

Based on Sections 365(a) to 365(f), “a debtor may assume a pre-petition executory contract as long as the debtor did not default or if the debtor took steps to cure the default.”<sup>88</sup> However, “if ‘applicable law’ excuses a non-debtor party

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trademark law was an applicable law that automatically prohibits the trustee/debtor from assigning the executory contract without the consent of the non-debtor party).

<sup>81</sup> 11 U.S.C. § 365(c)(1)(A).

<sup>82</sup> *Id.* § 1107 (2018).

<sup>83</sup> *Summit Inv. & Dev. Corp.*, 69 F.3d at 613–14.

<sup>84</sup> *Id.* at 613.

<sup>85</sup> *Kuney*, *supra* note 56, at 150 (citing *Summit Inv. & Dev. Corp.*, 69 F.3d at 612–13).

<sup>86</sup> *See, e.g., In re W. Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988).

<sup>87</sup> *See, e.g., Summit Inv. & Dev. Corp.*, 69 F.3d at 613–14.

<sup>88</sup> *Kiatkulpiboone*, *supra* note 18, at 291.

from recognizing the performance terms of a contract, it is only the non-debtor's authorization that will allow a [debtor-in-possession] to assume the executory contract."<sup>89</sup> In other words, if the non-debtor party to the contract explicitly permits the assignment, waives its right to object to the assignment, or remains inactive, then the debtor-in-possession's assignment of the contract may be valid—provided that the assignment “is subject to notice of assurance on future performance.”<sup>90</sup>

A debtor or debtor-in-possession can guarantee that it will be able to assume and assign an executory contract to a third party only if the non-debtor consents to such assumption and assignment. However, bankruptcy cases concerning the issue of whether a debtor-in-possession may assume or assign an executory contract often arise when the non-debtor seeks to lift the automatic stay to terminate the contract.<sup>91</sup> This means that, in most cases, the non-debtor party does not consent to the debtor-in-possession's assumption or assignment of the contract. Consequently, courts must decide whether a debtor-in-possession can assume or assign an executory contract without the permission of the non-debtor. To determine which test is appropriate in this context, the court looked at the overall objectives and principles of the Code, the applicable law exception that contradicts the Code's objective, the statutory language of Section 365(c), and the legislative intent behind the AAA.

*A. The Bankruptcy Code Generally Favors Debtors through Its Objectives and the Application of the Automatic Stay*

As previously described, circuit courts disagree on how the AAA affects the ability of a debtor-in-possession to assume an executory government contract under Section 365(c)(1)(A). When interpreting an ambiguous statute, such as Section 365(c)(1)(A),<sup>92</sup> courts may look to the rest of the statute to effect legislative intent under the doctrine of *in pari materia*<sup>93</sup> Because Section 365(c)(1)(A) is part of the Code, other sections of the Code—such as Section 362(a)—may shed light on the legislative intent behind the Code and its overall objectives.

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<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at 291–92.

<sup>91</sup> *See, e.g., In re W. Elecs., Inc.*, 852 F.2d 79.

<sup>92</sup> The language of a statute is ambiguous if it has more than one meaning. As discussed later in this Comment, circuit courts have devised two competing interpretations of the words “trustee” and “or,” as used in Section 365(c)(1)(A). *See* discussion *infra* Part II.C. The existence of these competing interpretations suggests that the language of the statute is ambiguous.

<sup>93</sup> *See generally*, Stephen Adams, *Listing the Canons of Construction*, IDAHO STATE BAR, [https://isb.idaho.gov/wp-content/uploads/canons\\_w\\_commentary.pdf](https://isb.idaho.gov/wp-content/uploads/canons_w_commentary.pdf).

One of the best ways to understand the primary objectives of chapter 11 and the legislative intent behind the Code, is to look at the automatic stay, which is one of the most powerful tools that the Code provides a debtor. Pursuant to Section 362(a) of the Code, the automatic stay is a protection mechanism, triggered immediately upon a debtor's filing of a bankruptcy petition, that stops the creditors from taking different kinds of actions against the debtor or debtor's property—including but not limited to, filing or continuing to litigate against the debtor to recover on claims that arose before the petition date.<sup>94</sup> In a chapter 11 proceeding, a debtor's pre-petition property and possessions are entrusted to an estate that will hold them until the court confirms debtor's reorganization plan and solution that adequately protects the property interest of third parties, such as secured creditors.<sup>95</sup> While a creditor can obtain relief from the stay "for cause,"<sup>96</sup> from a debtor's standpoint, the filing of the bankruptcy petition is akin to "asking the a referee to call time."<sup>97</sup>

The automatic stay serves two primary functions. First, the automatic stay preserves the business debtor's going-concern value by preventing creditors from picking apart the debtor one asset at a time, which can convert an operating business into "a pile of spare parts."<sup>98</sup> Second, the stay helps to assure the equality of distribution amongst creditors by preventing creditors from racing to the courthouse to obtain judgments and record liens in order to assure that they get paid first.<sup>99</sup> The functions of the automatic stay indicates that "the two primary objectives of chapter 11 are to maximize the going-concern value of the bankruptcy estate and to assure equality of distribution among similarly situated creditors."<sup>100</sup>

However, a closer look at the actual application of the automatic stay suggests that the Code generally favors debtors and their ability to reorganize their businesses. While the automatic stay may benefit creditors by preventing the race to the courthouse, the stay also adversely affects the creditors by putting

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<sup>94</sup> 11 U.S.C. § 362(a).

<sup>95</sup> See DAVID G. EPSTEIN ET AL., *BANKRUPTCY: DEALING WITH FINANCIAL FAILURE FOR INDIVIDUALS AND BUSINESSES* 124 (4th ed. West Academic 2015).

<sup>96</sup> The Code does not define "cause," but provide that adequate protection for property constitutes a cause warranting relief from the automatic stay. See 11 U.S.C. § 362(d)(1). However, courts have found the following situations to constitute "cause": "failure to maintain and preserve collateral, waste or mismanagement, failure to pay taxes, and undue delay by the debtor in proposing a reorganization plan." John D. Ayer et al., *Chapter 11—"101": An Overview of the Automatic Stay*, 22 AM. BANKR. INST. J. 16 (2004).

<sup>97</sup> Kiatkulpiboone, *supra* note 18, at 283.

<sup>98</sup> John D. Ayer et al., *Chapter 11—"101": An Overview of the Automatic Stay*, 22 AM. BANKR. INST. J. 16 (2004).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

some of their property interests at risk. Because “[c]reditors in a chapter 11 case often have to wait several years for the automatic stay to terminate automatically,”<sup>101</sup> the collateral value may begin to decline during that period of time.<sup>102</sup> Therefore, courts must balance creditors’ interests in getting adequate protection of its property interest and debtors’ interest in having reasonable time to plan and reorganize successfully.<sup>103</sup> In the context of ensuring a successful reorganization for a government contractor, the automatic stay prevents the non-debtor party from unilaterally terminating an executory contract,<sup>104</sup> ensuring that the filing of a bankruptcy petition does not constitute a material breach of a contract. Moreover, although the automatic stay is not fatal to non-debtors, courts have “recognized the automatic stay’s broad application and noted that such breadth reflects a congressional intent that courts will presume protection of [debtor’s] property when faced with uncertainty and ambiguity.”<sup>105</sup>

Thus, while the objectives of chapter 11 show concern for both the debtor’s interests and the creditors’ interests, the actual application of the automatic stay—and its subsequent effects on both the creditors and debtor—favors the interests of the debtor. Although this fact suggests that the Code generally favors a debtor’s interests in reorganization, the Code’s many inconsistencies contradict this overall objective.<sup>106</sup>

### *B. The “Applicable Law” Exception That Seemingly Contradicts Overall the Objective of the Bankruptcy Code*

While the Code generally favors the interests of the debtor, some inconsistencies in the Code run contrary to its general objectives. For example, Section 365(c)(1) excuses the non-debtor from accepting or rendering performance in accordance with the terms of their contract with the debtor or debtor-in-possession if there is an “applicable law” that allows the non-debtor to do so.<sup>107</sup> The term “applicable law” re-appears in Section 365(f), which stipulates that, regardless of provisions in the contract or an “applicable law” that hinder assignment of an executory contract, the trustee may assign the contract as long as (1) the trustee assumes the contract and (2) provides adequate

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<sup>101</sup> DAVID G. EPSTEIN ET AL., *BANKRUPTCY: DEALING WITH FINANCIAL FAILURE FOR INDIVIDUALS AND BUSINESSES* 121 (4th ed. West Academic 2015).

<sup>102</sup> Ayer, *supra* note 98, at 70.

<sup>103</sup> See Epstein, *supra* note 101, at 125.

<sup>104</sup> See U.S. Dep’t of Just., *Just. Manual, Civ. Res. Manual* § 4-61 (2018).

<sup>105</sup> Simpson, *supra* note 24, at 250–51 (citing *Bonneville Power Admin. v. Mirant Corp.* (*In re Mirant Corp.*), 440 F3d 238, 251 (5th Cir. 2006)).

<sup>106</sup> See, e.g., 11 U.S.C. §§ 365(c), (f) (2018).

<sup>107</sup> *Id.* § 365(c)(1) (2012).

assurance of an assignee's future performance.<sup>108</sup> In other words, on its face, Section 365(f) seems to allow a debtor to assume and assign an executory contract even if: (1) the contract includes a provision that “prohibits, restricts, or conditions the assignment of [the] contract”; or (2) applicable law “prohibits, restricts, or conditions the assignment of [the] contract”.<sup>109</sup> Because the general principle of Section 365(c) is to prohibit a trustee from assuming or assigning an executory contract if dictated by “applicable law,” Section 365(f) appears to render the “applicable law” exception superfluous. Many courts have noted this apparent contradiction between the two sections.<sup>110</sup> However, while some courts conclude that Section 365(f) states a broad rule of free assignability to which Section 365(c)(1) proposes an exception,<sup>111</sup> others maintain that the contradictory language cannot be reconciled.<sup>112</sup>

Case precedent reveals that the AAA—which is considered an “applicable law”—tends to trump bankruptcy principles because “[e]xecutory contracts and unexpired leases to which the federal government is a party may not be assigned outside of bankruptcy.”<sup>113</sup> Courts have found that the prohibition on assigning government contracts outside of bankruptcy continues to apply in bankruptcy under Section 365(c)(1).<sup>114</sup> However, if the AAA's prohibition on assigning government contracts applies to debtors-in-possession under Section 365(c)(1)'s applicable law exception, then there is an apparent contradiction between the applicable law exception and the Code's goal of promoting a debtor's reorganization by allowing them to freely assume and assign executory contracts. Ultimately, this apparent contradiction in the Code leads to a circuit split on how to interpret the effect of applicable non-bankruptcy law, such as the AAA, on a debtor-in-possession's ability to assume its executory government contracts.<sup>115</sup>

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<sup>108</sup> *Id.* § 365(f)(1) (2018).

<sup>109</sup> *Id.* § 365(f)(1).

<sup>110</sup> *See e.g., In re Mirant Corp.*, 440 F.3d at 247–51.

<sup>111</sup> *Perlman v. Catapult Ent., Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999).

<sup>112</sup> *Breedon v. Catron (In re Catron)*, 158 B.R. 629, 637 (E.D. Va. 1993).

<sup>113</sup> *Harner, supra* note 8, at 223.

<sup>114</sup> *Id.* at 223–24.

<sup>115</sup> *Compare In re W. Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988) (holding that if the applicable law requires the consent of the non-debtor party for assignment to a third party, then the debtor-in-possession could not assume the contract), *with Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (holding that while federal patent law was the applicable law, it did not prevent the debtor from assuming the patent license because the non-debtor was not actually forced to accept performance from someone other than the debtor party with whom it originally contracted), *cert. denied*, 521 U.S. 1120 (1997).

C. *The Statutory Language of Section 365(c)(1) Does Not Support an Automatic Prohibition of a Debtor-in-Possession's Assumption of Its Executory Government Contracts*

The circuit split arose largely because the statutory language of Section 365(c)(1) lends itself to multiple interpretations. Section 365(c)(1) states:

- (c) The *trustee* may not assume *or* assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegations of duties, if—
- (1)
    - (A) *applicable law* excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
    - (B) such party does not consent to such assumption or assignment.<sup>116</sup>

In particular, courts cannot agree on a uniform interpretation of “trustee” and “or.”

1. *The Term “Trustee” Is Not a Synonym for the Term “Debtor-in-Possession”*

A source of tension between the Hypothetical Test and the Actual Test is the interpretation of the word “trustee” in Section 365(c)(1)—namely, with respect to whether the term constitutes a synonym for debtor-in-possession.<sup>117</sup> While courts applying the Actual Test argue that “trustee” *should* be read as having a different meaning from debtor-in-possession, courts following the Hypothetical Test maintain that “trustee” should be read as synonymous with debtor-in-possession. Reading “trustee” to be synonymous with debtor-in-possession overlooks both the legislative history of the statute and the overall objective of the Code.

Courts applying the Hypothetical Test treat the two words “trustee” and “debtor-in-possession” as synonymous.<sup>118</sup> If the two terms are treated synonymously, Section 365(c)(1) will apply, regardless of whether the trustee or the debtor-in-possession wants to assume the contract. To support their

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<sup>116</sup> 11 U.S.C. § 365(c)(1) (emphasis added).

<sup>117</sup> *In re Footstar, Inc.*, 323 B.R. 566, 570–71 (S.D.N.Y. 2005).

<sup>118</sup> *See, e.g., In re W. Elecs., Inc.*, 852 F.2d at 83.

position, courts applying the Hypothetical Test look toward Section 1107(a) of the Code, which provides that “a debtor-in-possession shall have all the rights . . . and powers, and shall perform all the functions and duties, . . . of a trustee serving in a case.”<sup>119</sup> For instance, in *In re West Electronics, Inc.* (“*West*”), the Third Circuit substituted the term “debtor-in-possession” for “trustee.” More specifically, the Third Circuit found that if an “applicable law” required the non-debtor party to consent to assignment to a third party, then the debtor-in-possession could not assume the contract.<sup>120</sup>

Similarly, in *In re James Cable Partner* (“*James Cable*”) where the party that sought to assume the contract was a debtor-in-possession, the Eleventh Circuit treated the two terms as synonymous and substituted “debtor-in-possession” for “trustee” in applying the Hypothetical Test.<sup>121</sup> The Eleventh Circuit further explained that, because a debtor-in-possession and a trustee generally had all the same rights, powers, and duties,<sup>122</sup> the court could substitute “debtor-in-possession” for the term “trustee.” This substitution, thus, made Section 365(c)(1) applicable to *James Cable*.<sup>123</sup>

The Fourth Circuit affirmed an opinion in which the District Court for the Eastern District of Virginia discussed the substitution of “debtor-in-possession” for “trustee.”<sup>124</sup> Like the cases from the Third and Eleventh Circuit, mentioned above, the court in *In re Catron*, relied on Section 1107(a) of the Code in determining that the two terms are synonymous.<sup>125</sup> The court went on to decide that the debtor had legally obtained the status of a debtor-in-possession.<sup>126</sup> Applying the Hypothetical Test, the court ruled that this debtor-in-possession was barred from assuming the contract at issue.<sup>127</sup> The Ninth Circuit in *In re Catapult* cited *West*, *In re James Cable Partner*, and *In re Catron* in forming a similar opinion.<sup>128</sup>

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<sup>119</sup> 11 U.S.C. § 1107(a); *In re W. Elecs., Inc.*, 852 F.2d at 82–83 (citing 11 U.S.C. § 1107(a); *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 28 (1st Cir. 1984)); *see also* *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partner*), 27 F.3d 534, 537 (11th Cir. 1994) (using Section 1106 for support).

<sup>120</sup> *In re W. Elecs., Inc.*, 852 F.2d at 82–83.

<sup>121</sup> *In re James Cable Partner*, 27 F.3d at 537.

<sup>122</sup> *Id.*

<sup>123</sup> *See id.*

<sup>124</sup> *Breeden v. Catron* (*In re Catron*), 158 B.R. 629, 632–33 (E.D. Va. 1993), *aff’d*, 35 F.3d 1038 (4th Cir. 1994).

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 633.

<sup>127</sup> *Id.* at 638.

<sup>128</sup> *Perlman v. Catapult* (*In re Catapult Ent., Inc.*), 165 F.3d 747, 749–50 (9th Cir. 1999).

However, this interpretation of the word “trustee” as synonymous with “debtor-in-possession” lacks support from legislative history, particularly that of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the “BAFJA”).<sup>129</sup> The BAFJA “amended 11 U.S.C. § 365(c)(1)(A) by substituting the phrase ‘an entity other than the debtor or the debtor-in-possession’ for the words ‘the trustee.’”<sup>130</sup> The legislative intent behind this substitution was to resolve:

[T]he prohibition against a trustee’s power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal service nature of the contract.<sup>131</sup>

This legislative comment distinguishes a debtor-in-possession from a trustee by clarifying that a debtor-in-possession is *always* the debtor party to an original executory contract, while a trustee can generally be *either* a debtor-in-possession or a third party that is a non-party. Therefore, because a “trustee” encompasses more than just a “debtor-in-possession,” the terms should not be treated as a synonym.<sup>132</sup>

The Bankruptcy Court for the Northern District of Mississippi applied this distinction in *In re Jacobsen*, by holding that “trustee” does not mean “debtor-in-possession.”<sup>133</sup> In addition, the court cited to Collier on Bankruptcy to support its decision to apply the Actual Test.<sup>134</sup> Collier described the *West* decision as “troubling” and approved of the First Circuit’s decision in *Institut Pasteur*.<sup>135</sup> The court also noted that it found itself convinced by “the reasoning expressed in Collier, as well as, in the overwhelming majority of cases that have addressed this issue” that the Hypothetical Test was “erroneous.”<sup>136</sup>

Moreover, treating the two terms as synonymous does not align with the legislative intent behind Section 365(c)(1)(A). The legislative comment to the Bankruptcy Amendments Act suggests that Congress designed the prohibition against a debtor’s power to assume an executory contract to protect non-debtor parties. In other words, the goal of the prohibition is to avoid forcing a non-

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<sup>129</sup> See *In re Cardinal Indus.*, 116 B.R. 964, 979 (S.D. Ohio 1990).

<sup>130</sup> *Id.* at 978 (citing 11 U.S.C. § 365(c)(1)(A)).

<sup>131</sup> H.R. REP. NO. 96-1195, 2d Sess. § 27(b) (1980).

<sup>132</sup> See *In re Cardinal Indus.*, 116 B.R. at 979.

<sup>133</sup> *In re Jacobsen*, 465 B.R. 102, 107 (N.D. Miss. 2011).

<sup>134</sup> *Id.* (citing 3 COLLIER ON BANKRUPTCY, § 365.07[1][d]).

<sup>135</sup> 3 COLLIER ON BANKRUPTCY, § 365.07[1][d]).

<sup>136</sup> *In re Jacobsen*, 465 B.R. at 107.

debtor party into a contract with a third party with whom it did not bargain. This objective further implies that the legislature generally favors allowing a debtor to assume an executory contract to reorganize and will allow a debtor to do so if assuming the contract will not hurt the rights of a non-debtor party.

Consequently, when the person who assumes the contract is a debtor-in-possession (a party to the original contract), and not a trustee (a non-party to the contract), the rights of the non-debtor party remain unharmed. Therefore, the debtor's power to assume the contract should prevail considering the overall objective favoring the debtor's reorganization under the Code. If a court interprets the two terms as synonymous, then a debtor-in-possession cannot assume an executory contract with the government under the AAA—even though the parties in the contract remain the same parties. This is an absurd outcome that prevents a debtor from maximizing its value in reorganization. Thus, interpreting the two terms as synonymous produces a result that is inconsistent with legislative intent.

## 2. *The Conjunction “or” Should Be Read Conjunctively*

Another source of tension between the Hypothetical Test and the Actual Test is the interpretation of the conjunction “or” in Section 365(c)(1).<sup>137</sup> While courts applying the Actual Test argue that “or” should be read conjunctively, courts following the Hypothetical Test argue that “or” should be read disjunctively (or “literally”).<sup>138</sup> This “literal” reading of “or” as disjunctive ignores the conjunction's ambiguous nature and produces an absurd result that frustrates the intention of the legislature that drafted the Code.

Proponents for the Hypothetical Test that read “or” disjunctively argue that the language is clear and unambiguous.<sup>139</sup> Their position stems from the assumption that the conjunction “or” is always disjunctive, and thus, establishes alternatives between two or more things.<sup>140</sup> However, both the legal court system and legal practitioners acknowledge that “or” is ambiguous and may be used as an inclusive conjunction.<sup>141</sup> Thus, the use of the conjunction “or” signals that seemingly exclusive alternatives can exist concurrently to either: (1) create a

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<sup>137</sup> *In re Footstar, Inc.*, 323 B.R. 566, 569 (S.D.N.Y. 2005).

<sup>138</sup> See Heather Hili, *Assumption Under Section 365(c)(1) Creates Uncertainty for Debtors*, 4 ST. JOHN'S BANKR. RSCH. LIBR. No. 14, 2–3 (2012).

<sup>139</sup> See, e.g., Jennifer Ying, *The Plain Meaning of Section 365(c): The Tension Between Bankruptcy and Patent Law in Patent Licensing*, 158 U. PENN. L. REV. 1225, 1271 (2010).

<sup>140</sup> See Hili, *supra* note 138.

<sup>141</sup> TINA L. STARK, *DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO* 297 (2d ed. 2014).

third alternative; or (2) change an existing standard to a single cumulative standard.<sup>142</sup>

Tina L. Stark, author and contract drafting expert, offers the following example of this principle: “If the Landlord makes a misrepresentation or breaches a covenant, then the Tenant may pursue all remedies to which it is entitled under the law.”<sup>143</sup> “If ‘or’ is only disjunctive here, then this provision permits the Tenant to sue for damages if the Landlord makes a misrepresentation or breaches a covenant—but not if the Landlord does both.”<sup>144</sup> This interpretation produces an absurd result; if the Landlord both misrepresents and breaches, then the Tenant loses all remedies. More likely, the parties intended that, if the Landlord both misrepresented and breached, then the Tenant could pursue causes of action for both misrepresentation and breach of warranty.<sup>145</sup> In other words, there are, not two, but three alternatives here that gives rise to remedies: 1) a misrepresentation, 2) a breach of covenant, and 3) a misrepresentation and a breach of covenant.<sup>146</sup>

Reading “or” literally as being purely disjunctive goes against the legislative intent of the Code. When applying the Hypothetical Test, a court that reads the conjunction “or” literally essentially concludes that a trustee cannot assume the contract unless applicable law permits assignment to a third party.<sup>147</sup> This outcome occurred in *In re Catapult* when the Ninth Circuit had to determine whether a Chapter 11 debtor-in-possession could assume a patent license as part of its reorganization plan.<sup>148</sup> Applying the Hypothetical Test, the court held that the debtor could not assume the license because an “applicable law” (federal patent law) would excuse the licensor from accepting performance by a third party—even though a third party was not involved in the dispute.<sup>149</sup>

However, this “literal” reading creates an absurd result where a debtor-in-possession “would be deprived of its valuable but unassignable contract solely by reason of having sought the protection of the Bankruptcy Court, even though it did not intend to assign it.”<sup>150</sup> In *Institut Pasteur*, the First Circuit adopted the

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<sup>142</sup> *See id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *See, e.g.,* Perlman v. Catapult (*In re Catapult Ent., Inc.*), 165 F.3d 747, 751 (9th Cir. 1999).

<sup>148</sup> *See id.* at 748–49.

<sup>149</sup> *Id.* at 750–51.

<sup>150</sup> *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997).

Actual Test to prevent these “anomalous” results.<sup>151</sup> More specifically, the First Circuit held that federal patent law—the “applicable law” in this case—did not prevent the debtor from assuming the patent license because the licensor was not actually “forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.”<sup>152</sup>

The Code generally favors debtors (or in this case, debtors-in-possession) and their interest in reorganizing their business.<sup>153</sup> In fact, “[t]he purpose of Section 365 of the Code is to permit the trustee to retain or assign valuable contracts and to abandon burdensome contracts.”<sup>154</sup> The Bankruptcy system “seeks to maximize the value of the remaining assets and capacities of the troubled [debtor]” by “afford[ing] trustees and debtors substantial leeway to rescind contracts and reorder the affairs of the entity.”<sup>155</sup>

However, when a debtor-in-possession cannot assume its executory contracts with the government, the debtor-in-possession loses the power to pick which contracts it wants to retain to help reorganize the business. As a result, the debtor-in-possession finds itself at the mercy of the government—which may choose to terminate the contract, even though the assumption will make no substantive changes to the contract and the debtor-in-possession remains the performing party. This situation is detrimental to a debtor-in-possession who seeks to reorganize through bankruptcy proceedings, because the debtor-in-possession is not able to “maximiz[e] its value under reorganization.”<sup>156</sup> This fact is especially true for a debtor whose business relies heavily on contracting with the government. Because the Code generally favors the debtors and their interest in reorganizing their business,<sup>157</sup> this kind of literal reading will likely frustrate the congressional intent behind the Code.

By reading “or” as a conjunction operating cumulatively as opposed to disjunctively, courts can review cases on a case-by-case basis by looking at whether: (1) the debtor-in-possession will assign the non-debtor’s contract; or (2) the non-debtor will have to accept performance from a third party other than

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<sup>151</sup> *Id.*

<sup>152</sup> *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995) (internal marks omitted).

<sup>153</sup> *See In re Footstar*, 323 B.R. 566, 571 (S.D.N.Y. 2005).

<sup>154</sup> Madlyn Gleich Primoff & Erica G. Weinberger, *E-Commerce and Dot-com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including Intellectual Property Greements, and Related Issues Under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code*, 8 AM. BANKR. INST. L. REV. 307, 314 (2000).

<sup>155</sup> Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 737 (2007).

<sup>156</sup> Ying, *supra* note 139, at 1234.

<sup>157</sup> *See In re Footstar*, 323 B.R. at 571.

the debtor-in-possession. Although courts should stick to a literal reading of the statute, courts may examine other sources—including legislative history—and deviate from a literal reading of the statute if the outcome is “demonstrably at odds” with clearly expressed congressional intent or results in an absurd outcome that “shock[s] the general moral or common sense.”<sup>158</sup> When one considers the overall objectives of chapter 11—which Congress designed to foster, not frustrate, the reorganization and the economic well-being of the debtor-in-possession<sup>159</sup>—a reading of “or” as a conjunction operating cumulatively in Section 365(c)(1) better reflects the intention of the legislature.

*D. Legislative Intent for the AAA Is Not Violated by Allowing a Debtor-in-Possession to Assume Its Executory Government Contracts*

While it is important to look at the statutory language of Section 365(c)(1)(A) and the legislative intent behind the statute, the legislative intent behind the AAA also plays a crucial role in determining whether the AAA prohibits a debtor-in-possession’s assumption of executory contracts with the government under bankruptcy proceedings. Gaining an understanding of the legislative intent behind the AAA can help understand the evil that the AAA is intended to prevent, whether that kind of evil is present in cases of debtors-in-possession seeking to assume their executory contracts with the government, and whether the legislative intent behind the AAA can be reconciled with the overall objective of the Code.

The AAA provides, *inter alia*, that “[n]o contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned.”<sup>160</sup> With government contractors and other persons with claims against the government, Congress became concerned that allowing unregulated transfers of claims may lead to deception.<sup>161</sup> Specifically, the legislature was wary of fraud against the government, where both the seller and the acquirer of a claim may demand payment from the government, without the government fully knowing who owns the rights under the contract.<sup>162</sup> In addition, there is also the possibility of

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<sup>158</sup> *Crooks v. Harrelson*, 282 U.S. 55, 59–60 (1930); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989).

<sup>159</sup> *In re Footstar*, 323 B.R. at 570.

<sup>160</sup> 41 U.S.C. § 6305 (2018).

<sup>161</sup> *See* An Act to Prevent Frauds Upon the Treasury of the United States, ch. 81, 10 Stat. 170 (1853).

<sup>162</sup> Williams Mullen, *When Deal Making and Government Consent Merge: The Who, What, When, Where, and Why of Novation Agreements*, JDSUPRA (Feb. 22, 2018), <https://www.jdsupra.com/legalnews/when-deal->

corrupted persons “buying up claims against the United States” and later using those claims to exert improper influence upon government officials.<sup>163</sup> However, when dealing with only one claimant, the government can avoid (1) multiple payments, (2) the investigation of assignments, and (3) multiple successive litigation upon the same claim.<sup>164</sup> Therefore, Congress passed the AAA in 1853 to address the growing concern of multiple claimants and ensure that the government only has to deal with a single claimant.<sup>165</sup>

Additionally, some courts suggest that one of the AAA’s primary purposes was “to ameliorate inconveniences to the government if the potential exists for contractual obligations to be modified.”<sup>166</sup> Under this line of reasoning the government has carefully chosen the contractor when awarding a contract. Accordingly, the contract terms are so specific and narrowly tailored to the original contractor and the government that any substitute in who performs the contract may change the intended terms of the contract.<sup>167</sup> Additionally, in choosing the contractor, the government tends to rely on the contractor’s skills and reputation. Assigning a government contract to a third party who may or may not have the same qualities as the original contractor violates the government’s contractual rights and puts the government at risk of not getting the benefits of its bargain. Courts have shown concerns over letting the government get the full benefit of its bargain because whether the government gets that benefit can affect national interests in some cases. For instance, if a government contract involves the production of military equipment, then the legislative intent supports maintaining “a policy of non-assignability in the interest of national security.”<sup>168</sup>

Here, when the debtor-in-possession is the party assuming the contract and such debtor has no intention of assigning the contract to a third party, there is no change in the party performing the contract.<sup>169</sup> Because there is no change in the performing party, the government is dealing with only one claimant and, therefore, not obligated to contract with a third party with whom it did not desire to contract. Because the government is dealing with only one claimant, there is

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<sup>163</sup> See *Tuftco Corp. v. United States*, 614 F.2d 740, 744 (Ct. Cl. 1980).

<sup>164</sup> See *id.*

<sup>165</sup> See An Act to Prevent Frauds Upon the Treasury of the United States, ch. 81, 10 Stat. 170 (1853).

<sup>166</sup> *Kiatkulpiboone*, *supra* note 18, at 292.

<sup>167</sup> *Id.* at 288.

<sup>168</sup> *Id.* at 293.

<sup>169</sup> *In re Footstar*, 323 B.R. 566, 573–74 (S.D.N.Y. 2005).

no risk that multiple parties will demand payment from the government for the same claim or that a third party will buy up multiple claims against the government to exert improper influence. In short, the risk of fraud is minimized when the debtor-in-possession assumes the contract without assigning it to another party because the government is still dealing with the same single claimant.

More importantly, because there is no change in the performing party, the government still receives the benefits of the bargain. Some may argue that the government's interests experience some degree of harm when the debtor-in-possession assumes the contract, because the debtor-in-possession may be unable to perform the contract. The argument follows that a debtor presumably had decided to go bankrupt because it was in a precarious financial condition and may not have the ability or resources to continue performing its obligations under the government contract. This argument is unpersuasive because Section 365(b)(1)(C) requires a debtor to, *inter alia*, provide adequate assurance that it will be able to perform under the contract post-assumption.<sup>170</sup> Moreover, the debtor-in-possession must obtain the court's approval in order to assume an executory contract under bankruptcy proceedings.

In short, allowing a debtor-in-possession to assume executory government contracts in the process of reorganization does not go against the legislative intent of the AAA. Assumption without assignment means that the government is only dealing with one claimant; the government is not at risk of frauds, multiple payments, or not receiving the benefits of its bargain. When viewed in light of the bankruptcy objective favoring debtors and debtors-in-possession's successful reorganization, the scale tips towards allowing a debtor-in-possession to assume an executory government contract. The modern trend of courts has been to embrace this conclusion.

*E. Current Trend in Case Precedent Favors Allowing Debtors-in-Possession to Assume Executory Government Contracts*

Early caselaw indicates that courts favor the government applying the AAA broadly to prohibit a debtor-in-possession from assuming its executory government contracts, regardless of the types of contracts and the circumstances. Recently, however, some courts changed course by utilizing a case-by-case analysis to reach more nuanced results than a blanket approach provided by the Hypothetical Test and the Actual Test. In a bankruptcy case involving an

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<sup>170</sup> 11 U.S.C. § 365(b)(1)(C) (2018).

executory government contract, the underlying dilemma that courts must consider is: *Whether protecting and encouraging debtors' reorganization plans is more beneficial to the interests of the U.S. economy than supporting the government's discretion in exercising common law contractual rights?*

On one hand, perhaps the government should facilitate commerce by bailing out businesses that rely heavily on government contracts. On the other hand, however, there may be important considerations, other than protecting the government from frauds, behind protecting the government's right to deny the assumption and assignment of contracts—especially in cases involving military contracts or healthcare contracts that can affect national interests. Looking at how courts have balanced different interests and considerations in determining whether a debtor-in-possession can assume and assign an executory government contract can help understand how much the considerations weigh.

### 1. *Early Cases Favor the Government*

Cases concerning a debtor-in-possession's ability to assume an executory government contract date back to the 1980s.<sup>171</sup> More specifically, while the courts generally favor the government to the detriment of the debtor-in-possession, they also suggest an underlying rationale beyond the mechanical application of the statutory provisions.<sup>172</sup> For example, in *West Electronics* (“*West*”)—one of the most monumental executory government contract cases to date—the government contractor filed for bankruptcy under Chapter 11, and the United States government moved to lift an automatic stay in order to terminate a defense contract with the government contractor.<sup>173</sup> The bankruptcy judge denied the government's motion, finding that “there were no exigent circumstances arising from national defense considerations requiring lifting of the stay.”<sup>174</sup>

The district court's decision to affirm the lower court's ruling relied on the idea that the automatic stay's protection should remain in force so long as the debtor (i.e., the government contractor) showed that it “had the capacity and intention to cure the default.”<sup>175</sup> However, the Third Circuit did not share this view, noting that the debtor's capacity or intent to cure the default were not

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<sup>171</sup> See generally *Tuftco Corp. v. United States*, 614 F.2d 740, 744 (Ct. Cl. 1980); *In re W. Elecs., Inc.*, 852 F.2d 79, 80–81 (3d Cir. 1988); *U.S. Dep't of Air Force v. Carolina Parachute Corp.* (*In re Carolina Parachute Corp.*), 108 B.R. 100, 102 (M.D.N.C. 1989).

<sup>172</sup> See, e.g., *In re W. Elecs., Inc.*, 852 F.2d at 80–81.

<sup>173</sup> *Id.*

<sup>174</sup> *Id.* at 81.

<sup>175</sup> *Id.*

relevant to the case.<sup>176</sup> The court held that the AAA was “applicable law” under Section 365(c), which allowed “the government to annul a contract for missile supply from a [debtor-in-possession]”.<sup>177</sup>

According to many courts, Section 365(c)(1)’s limitation on a debtor’s ability to assume or assign “applies to a debtor who seeks either: (i) to assume and render performance under the agreement; or (ii) to assume the agreement and assign it to a third party.”<sup>178</sup> Under this interpretation, a court applying the Hypothetical Test will pose a hypothetical question: “[c]ould the debtor assign the contract to a third party under applicable non-bankruptcy law?”<sup>179</sup> If the debtor cannot, then they may not assume the contract.<sup>180</sup> In the case of *West*, the circuit court found that because the AAA foreclosed an assignment by the debtor to a third party, *West* was also prohibited from assuming the contract.

Further, the circuit court in *West* was particularly concerned with the important safety considerations associated with protecting the government’s contractual rights. The court pointed out that the government contract in question involved the production of military equipment, which implicated national security. Specifically, the court explained that the debtor “could not force the government to accept the personal attention and services of a third party without its consent” as that was exactly what Congress had in mind when it passed the AAA.<sup>181</sup>

Similarly, in *In re TechDYN Systems* (“*TechDYN*”), the Alexandria Division of the Bankruptcy Court for the Eastern District of Virginia concluded that the debtor could not assume or assign its pre-petition executory government

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<sup>176</sup> *Id.* at 82.

<sup>177</sup> Kiatkulpiboone, *supra* note 18, at 294 (citing *In re W. Elecs., Inc.*, 852 F.2d at 82–83).

<sup>178</sup> Mark G. Douglas, *IP Perspective: Actual Test and Footstar Approach Govern DIP’s Ability to Assume Patent and Technology License*, JONES DAY: INSIGHTS (Nov. 2007), <https://www.jonesday.com/en/insights/2007/12/ip-perspective-actual-test-and-footstar-approach-govern-dips-ability-to-assume-patent-and-technology-license>. See generally, *In re W. Elecs., Inc.*, 852 F.2d 79 (finding that the section also applies to a debtor who seeks to assume and performs under the agreement); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) (finding that the section applies only to a debtor who seeks to assume and assign the contract to a third party).

<sup>179</sup> Mark G. Douglas, *IP Perspective: Actual Test and Footstar Approach Govern DIP’s Ability to Assume Patent and Technology License*, JONES DAY: INSIGHTS (Nov. 2007), <https://www.jonesday.com/en/insights/2007/12/ip-perspective-actual-test-and-footstar-approach-govern-dips-ability-to-assume-patent-and-technology-license>; see *In re W. Elecs., Inc.*, 852 F.2d 79.

<sup>180</sup> Mark G. Douglas, *IP Perspective: Actual Test and Footstar Approach Govern DIP’s Ability to Assume Patent and Technology License*, JONES DAY: INSIGHTS (Nov. 2007), <https://www.jonesday.com/en/insights/2007/12/ip-perspective-actual-test-and-footstar-approach-govern-dips-ability-to-assume-patent-and-technology-license>.

<sup>181</sup> *In re W. Elecs., Inc.*, 852 F.2d at 83 (internal marks and citation omitted).

contracts based on the plain language of the AAA.<sup>182</sup> In that case, a chapter 11 debtor had six pre-petition executory contracts with the government to equip military bases with telephone systems.<sup>183</sup> The government filed for relief from the automatic stay, arguing that “the national security interests at stake outweigh[ed] any benefit to the debtor and its estate from assumption of the contracts.”<sup>184</sup> The court ultimately ruled in favor of the government, noting that the issue of whether the debtor intended to assign its contract was not relevant.<sup>185</sup> The Court agreed with the United States’ assertion that maintaining “reliable, long-term telecommunication capabilities at each installation affected by the debtor’s bankruptcy is vital to the completion of ongoing military missions.”<sup>186</sup> Rather than mechanically applying the statutory provisions to favor the government’s position, the *TechDYN* court examined the reasons why the government sought relief from the stay and ultimately found its identified national security concerns to be persuasive.

However, not all courts followed this more nuanced approach to determining whether the AAA, in conjunction with Section 365(c), prohibited a debtor-in-possession from assuming its executory government contract. In *In re Pennsylvania Peer Review* (“*Peer Review*”), the court took a more simplistic approach to the issue than that of the *TechDYN* court. In *Peer Review*, the debtor entered into a contract with the Health Care Financing Administration (the “HCFA”), a federal agency, to “review . . . health care services furnished under the Medicare program in Pennsylvania.”<sup>187</sup> After two months, the HCFA allegedly withheld further payments to the debtor and then wrongfully terminated the contract.<sup>188</sup> Seven months after entering into the contract with the HCFA, the debtor filed for chapter 11 bankruptcy and sought to enjoin the termination of its contract with the government in an adversarial proceeding.<sup>189</sup>

The government argued that contract’s non-assignability under applicable bankruptcy law barred the debtor from assuming the contract.<sup>190</sup> The *Peer Review* court agreed with the government, finding that “the [S]ection 365(c)

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<sup>182</sup> United States v. TechDyn Sys. Corp. (*In re TechDYN Sys. Corp.*), 235 B.R. 857, 863 (Bankr. E.D. Va. 1999).

<sup>183</sup> *Id.* at 858.

<sup>184</sup> *Id.* at 859–60.

<sup>185</sup> *Id.* at 863.

<sup>186</sup> *Id.*

<sup>187</sup> Pa. Peer Rev. Org., Inc. v. United States (*In re Pa. Peer Rev. Org., Inc.*), 50 B.R. 640, 642 (Bankr. M.D. Pa. 1985).

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 645.

<sup>190</sup> *Id.* at 642.

requirement of a general nontransferability statute is satisfied and the Code itself precludes any assumption of the contract” because the applicable statute (the AAA) prohibits the transfer of a government contract to any other party.<sup>191</sup> The court also noted that “the meaning of § 365(c) [was] clear on its face and [the court] lack[ed] the power to look behind the language of the statute in order to disregard its clear and unambiguous meaning.”<sup>192</sup>

Similar to *Peer Review*, the district court in *In re Carolina Parachute Corp.* (“*Carolina Parachute*”) reversed the bankruptcy court’s decision and granted the United States Army relief from the automatic stay, allowing the Army to terminate its contract with the debtor.<sup>193</sup> The debtor in *Carolina Parachute* was a business that “manufactured parachutes and related items for the United States government under fixed price defense contracts since 1979.”<sup>194</sup> However, in 1987, “the government suspended progress payments under the debtor’s contracts” with the Army and the Air Force due to the lack of outside working capital.<sup>195</sup> As a result, the debtor filed for chapter 11 bankruptcy, and continued to operate its business as a debtor-in-possession throughout the reorganization process.<sup>196</sup> The government motioned for the modification of the automatic stay, because the debtor was forty percent delinquent in performing under its modified delivery schedules and, as a result, paralyzed the parachute training program at the Seymour-Johnson Air Force Base.<sup>197</sup>

The *Carolina Parachute* court held that the debtor could not assume the contract because the AAA barred the assignment of the parties’ contract without the consent of the government.<sup>198</sup> The court noted that “defense contracts with the government constitute[d] [the] debtor’s primary, if not only, source of revenue,” but also stated that “the specific facts and equities of [the] case ha[d] no relevance.”<sup>199</sup> As a result, the court’s opinion ultimately made no mention of whether: (1) the contracts were of a personal service nature; or (2) the identity of the debtor party was material to the executory contract, despite the availability of the facts required to weigh those considerations.<sup>200</sup>

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<sup>191</sup> *Id.* at 645.

<sup>192</sup> *Id.* at 646.

<sup>193</sup> U.S. Dep’t of Air Force v. Carolina Parachute Corp. (*In re Carolina Parachute Corp.*), 108 B.R. 100, 101 (Bankr. M.D.N.C. 1989).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 102.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

*Carolina Parachute* was not the only case that gave blanket effect to the treatment of executory government contracts under the AAA and Section 365(c).<sup>201</sup> The bankruptcy court in *In re Plum Run Service Corp.* (“*Plum Run*”) also held that the debtor-in-possession could not assume the debtor’s executory contract with the Navy because the AAA “gave the Navy the unilateral right to reject further performance by the debtor”.<sup>202</sup> In *Plum Run*, the debtor entered into an executory contract with the Navy to “provide[] base maintenance services for the U.S. Naval base in Guantanamo Bay, Cuba.”<sup>203</sup> The solicitation for bids for the contract stated that “[o]ffers shall be submitted for the performance of work for a period of one year [from October 1, 1992 to September 30, 1993] plus four option years.”<sup>204</sup> In January 1993, the debtor filed for bankruptcy under Chapter 11, and the Navy refused to exercise the option after the base period of one year.<sup>205</sup>

The debtor sought to assume the contract, stating that: (1) it relied on the assumption that the Navy would exercise the four option years when it decided to bid; (2) “with the exception of the housing maintenance portion of the BOS contract, Plum Run performed satisfactorily under the BOS contract,” even after filing for bankruptcy; and (3) “the Navy refused to exercise the option,” due primarily to the debtor’s filing for bankruptcy.<sup>206</sup> The Navy argued that “it had the unilateral right to decide whether option would be exercised, and chose not to exercise the option” because the debtor “had not performed well under the BOS contract” from the beginning.<sup>207</sup> The evidence suggested that debtor defaulted with respect to the housing maintenance portion of the government contract because it underperformed.<sup>208</sup> This default led to the termination of this part of the contract, making it “a default incapable of a cure”.<sup>209</sup>

Ultimately, the court agreed with the government’s stand, finding that there was a “distinction between a pre-petition debtor and the debtor-in-possession.”<sup>210</sup> The court also noted that, “[t]o allow a debtor-in-possession to assume a

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<sup>201</sup> See, e.g., *In re Plum Run Serv. Corp.*, 159 B.R. 496, 497 (Bankr. S.D. Ohio 1993).

<sup>202</sup> *Kiatkulpiboone*, *supra* note 18, at 299 (citing *In re Plum Run Serv. Corp.*, 159 B.R. 496, 497 (Bankr. S.D. Ohio 1993)).

<sup>203</sup> *In re Plum Run Serv. Corp.*, 159 B.R. at 497.

<sup>204</sup> *Id.* at 497–98.

<sup>205</sup> *Id.* at 498.

<sup>206</sup> *Id.* at 497–98.

<sup>207</sup> *Id.* at 498.

<sup>208</sup> See *id.* (“[W]ith the exception of the housing maintenance portion of the BOS contract, Plum Run performed satisfactorily under the BOS contract”).

<sup>209</sup> *Id.* at 500.

<sup>210</sup> *Id.* at 501.

contract, in essence, create[d] an assignment of the contract from the prepetition debtor to the debtor-in-possession.”<sup>211</sup> Under Section 365(c), a trustee or debtor cannot assume or assign if there is an applicable law that permits the non-debtor to refuse performance from an entity other than the debtor or the debtor-in-possession.<sup>212</sup> Consequently, the debtor would violate Section 365(c) if the debtor either assumed or assigned an executory contract, because the government could refuse performance by any third-party contractor under the applicable law. Because the AAA barred the assignment of an executory government contract to any other contractor (and thus, allowed the government to refuse performance by any other contractor), that debtor-in-possession could not assume the unassignable contract pursuant to Section 365(c).<sup>213</sup> Similar to the *Carolina Parachute* court, the *Plum Run* court believed that the performance of the debtor or the debtor’s financial status were not relevant considerations.<sup>214</sup>

Past case history demonstrates that courts are particularly concerned about the legislative intent behind the AAA and the safety considerations behind protecting the government’s contractual rights. In both *West* and *TechDYN*, for example, the courts addressed contracts involving the production or supply of military equipment. This leaves room for the consideration of a corollary question: *What if the assignments at issue involve government contracts unrelated to military supply and national security?*

## 2. Current Trend Favors the Debtors

Although several circuits have adopted the Hypothetical Test, favoring the government over the debtors, most bankruptcy courts, as well as the First Circuit and Fifth Circuit, have expressly rejected it and adopted the “Actual Test”—often favoring the debtors over the government.<sup>215</sup> In recent years, some lower courts have departed from the two traditional tests and followed the reasoning of *In re Footstar*.<sup>216</sup> However, these courts reached the same outcome as if they

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<sup>211</sup> *Id.*

<sup>212</sup> 11 U.S.C. § 365(c) (2018).

<sup>213</sup> *In re Plum Run Serv. Corp.*, 159 B.R. at 501.

<sup>214</sup> *Id.*

<sup>215</sup> See *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 611–14 (1st Cir. 1995) (developing the Actual Test); see also *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (applying the Actual Test); cf. *United States v. TechDyn Sys. Corp.* (*In re TechDYN Sys. Corp.*), 235 B.R. 857, 861 (Bankr. E.D. Va. 1999) (adopting the Hypothetical Test but noting that “[the actual] test . . . has been adopted by a clear majority of lower courts”).

<sup>216</sup> The court in *In re Footstar, Inc.* adopted a new literal reading of § 365(c)(1), noting that the word “trustee” does not include the debtor or the debtor-in-possession, and therefore, the right of the non-debtor party to object to assignment does not by itself affect the right of the debtor-in-possession to assume an executory contract. *In re Footstar*, 323 B.R. 566, 570 (S.D.N.Y. 2005).

had applied the Actual Test, allowing debtors-in-possession to assume executory contracts with the government.<sup>217</sup>

For instance, in *Hartec Enterprises, Inc.* (“*Hartec*”), a debtor that heavily contracted with the federal government filed a chapter 11 bankruptcy petition.<sup>218</sup> The government gave the debtor a deadline to assume the executory contracts post-petition.<sup>219</sup> The parties resolved all dispositions of the contracts, except for a contract involving the Department of the Navy.<sup>220</sup> While the debtor wanted to assume the contract, the government refused to grant consent for the assumption, asserting its discretion to do so under both Section 365(c)(1) and the AAA.<sup>221</sup> The court in *Hartec* ultimately held that, even without the government’s consent to the assumption, “a debtor in possession is not prohibited by 11 U.S.C. § 365(c)(1) from assuming an executory contract with the United States.”<sup>222</sup> The court adopted the Actual Test for three reasons.<sup>223</sup> First, it found that the Hypothetical Test overburdened a debtor who has well intent.<sup>224</sup> Second, it noted that the Hypothetical Test also “create[d] inherent inconsistencies” within the Code.<sup>225</sup> Lastly, the Hypothetical Test, according to the court, “d[id] not fulfil the purposes of the non-assignment statutes it s[ought] to enforce.”<sup>226</sup>

Similarly, the court in *In re Ontario Locomotive* rejected the United States Navy’s assertion that the AAA permits the government to terminate any contract—including its present executory contract with the debtor—for “convenience” reasons assignm.<sup>227</sup> The court pointed to the government’s own supporting papers, which correctly required a showing of “cause” to terminate the contract, but ultimately rejected the proposal that Section 365(c) and the AAA automatically barred a debtor from assuming its government contracts.<sup>228</sup> In other words, the convenience of the government did not constitute sufficient cause for termination. The judge also reaffirmed that the AAA only governs transfers to an entirely “new entity,” and that Section

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<sup>217</sup> Ying, *supra* note 139, at 1281.

<sup>218</sup> *In re Hartec Enters., Inc.*, 117 B.R. 865, 866 (Bankr. W.D. Tex. 1990).

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 866–67.

<sup>222</sup> *Id.* at 873.

<sup>223</sup> *Id.* at 871.

<sup>224</sup> *Id.*

<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *In re Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc.*, 126 B.R. 146, 146 (Bankr. W.D.N.Y. 1990).

<sup>228</sup> *Id.* at 148–49.

365(c) only prohibits a debtor/trustee from assuming or assigning a personal-service executory contract.<sup>229</sup>

Three years later, the Navy again asserted that Section 365(c)(1)(A) and the AAA automatically barred a debtor-in-possession from assuming an executory government contract in *In re American Ship Building Co., Inc.*<sup>230</sup> The federal department claimed that the Hypothetical Test applied whenever “every party entering into a lease or executory contract that subsequently files bankruptcy would be precluded from assuming its own contract under Section 365(c)(1)(A) because bankruptcy created a third party in the form of a debtor-in-possession as distinguished from the original contracting party.”<sup>231</sup> However, the court ultimately rejected the Navy’s claim and allowed the debtor-in-possession to assume a pre-petition executory contract to build ships with the United States Navy despite the AAA.<sup>232</sup>

Similarly, in *In re Mirant Corp.*, the Fifth Circuit held that the Actual Test was a better approach for determining whether the AAA was “applicable law” for the purposes of Section 365(c) that would have enabled the Bonneville Power Administration (“BPA”) to terminate its existing executory contract with debtor.<sup>233</sup> In this case, the debtor filed for bankruptcy under Chapter 11, which triggered the automatic stay, and the BPA terminated the executory contract shortly thereafter.<sup>234</sup> The court reasoned that the Actual Test was a better approach than the Hypothetical Test because the debtor never made an attempt to assign or transfer the contract to a third party.<sup>235</sup> The court held that the BPA violated the automatic stay when it terminated the contract because: (1) the debtor cured the default by paying the agency “a monetary sum ‘as adequate assurance of its ability to perform;’”; (2) the government did not qualify as a forward contract merchant under Code [S]ection 362(b)(6), which would have entitled it to an exception from the imposition of the automatic stay; and (3) the government presented no basis for relief from stay.”<sup>236</sup>

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<sup>229</sup> *Id.* at 147–48 (defining a personal services contract as a contract “which call[s] for the performance of non-delegable duties”).

<sup>230</sup> *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 362 (Bankr. M.D. Fla. 1994).

<sup>231</sup> *Id.*

<sup>232</sup> *Id.* at 362–63.

<sup>233</sup> *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 240–41, 251 (5th Cir. 2006).

<sup>234</sup> *Id.* at 243.

<sup>235</sup> *Id.* at 251.

<sup>236</sup> *Kiatkulpiboone, supra* note 18, at 302 (citing *In re Mirant Corp.*, 440 F.3d at 242–45).

The court also revisited the “cause” requirement, which provided that creditor must show cause to obtain relief from the automatic stay.<sup>237</sup> It noted that the non-debtor (i.e., the government agency) “failed to demonstrate cause for relief where [it] would suffer no harm by the continued enforcement of the stay” when the executory contract concerned the future purchase of electricity.<sup>238</sup> In addition to the reasons above, the court also held that the agency had no ground to terminate the contract because: (1) a valid *ipso facto* clause was unenforceable against executory contracts; and (2) the AAA did not preclude contract assumption when there was no transfer.<sup>239</sup> The court clarified the logistics of the AAA, stating:

[T]he Act does not provide for automatic rescission of the public contract upon transfer; annulment of the contract at issue requires a response by the United States . . . and its effect on a given executory contract, may be raised by the government after the entry of a bankruptcy court’s automatic stay under . . . the provision for stay modification.<sup>240</sup>

Therefore, the court concluded that the BPA “could not declare the debtor in default and demand a termination payment simply because the debtor filed for bankruptcy.”<sup>241</sup> This conclusion was favorable to the debtor.

Following *In re Mirant Corp.*, the court in *United International Investigative Services v. United States* “rejected the government’s argument that the corporation to which the contract had been transferred could not be the successor-in-interest to the original contractor because the original contractor continued to exist after the transfer.”<sup>242</sup> This action suggests that, the court will not treat the transfer of a contract as an assignment to a distinctly separate entity that the AAA may bar, provided that the assignee (i.e., the successor corporation) maintains the same operations as its predecessor.

The statutory language, the legislative history of Section 365(c), the legislative intent behind the AAA, and the overall objectives of Code all seem to suggest that the Actual Test is a better approach than the Hypothetical Test. Although most circuit courts still favor the government and its interests, in recent

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<sup>237</sup> See *In re Mirant Corp.*, 440 F.3d at 245.

<sup>238</sup> *Id.*

<sup>239</sup> *Id.* at 245, 247.

<sup>240</sup> *Id.* at 252.

<sup>241</sup> Kiatkulpiboone, *supra* note 18, at 303 (citing *In re Mirant Corp.*, 440 F.3d at 240–41).

<sup>242</sup> Peter Cockerell & Robert A. Bartlett, *A Government Contract and Bankruptcy Law Conundrum: Interpretation of the Anti-Assignment Act and Related Matters*, 43 PROCUREMENT L. 1, 19 (2007); see *United Int’l Investigative Servs. v. United States*, 26 Cl. Ct. 892, 897 (1992).

years, lower-level bankruptcy courts began to favor the debtor and its successful reorganization. This trend suggests that contemporary courts find the Actual Test to be more persuasive than the Hypothetical Test. However, the question remaining is whether the Actual Test is the best solution.

#### *F. A Holistic Test Is the Best Solution*

##### *1. Both Hypothetical Test and Actual Test Are Insufficient*

When looking at the issue of debtor versus government, the main question is: *Which legal analytical approach is most beneficial to the prosperity of the United States as a country?* An automatic application of the AAA would bar a debtor-in-possession from assuming its executory government contract, preventing the debtor-in-possession from maximizing its value for a successful reorganization of its business. This sacrifices the debtor-in-possession's reorganization, without actually serving the purposes of the AAA, which are to protect the government from fraud and to ensure the government gets the benefits of its bargain. Thus, courts should not automatically enforce the AAA whenever they face a case involving the debtor-in-possession that is seeking to assume or assign a government contract.

One commentator, Patrick Jackson, examines what factors courts should consider when determining the permissibility of an executory contract modification—focusing on the “material and economically significant” standard utilized in *In re Joshua Slocum, Ltd.*<sup>243</sup> Jackson gave credit to the standard for attempting to balance the interests of the parties in a bankruptcy proceeding, thereby: “preventing substantial economic detriment to the non-debtor contracting party and permitting the bankruptcy estate’s realization of the intrinsic value of its assets.”<sup>244</sup> Therefore, Jackson suggests that, in considering whether a contract term can be modified, the *In re Joshua Slocum* court was correct.

More specifically, the court in *In re Joshua Slocum* evaluated the materiality of each contract term and determined whether a breach of the term would cause economic detriment to any of the parties.<sup>245</sup> The court’s approach supports the

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<sup>243</sup> See *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1092 (3rd Cir. 1990). See generally Patrick A. Jackson, *Third Circuit Confirms Court’s Power to Modify Executory Contracts: Clarifies Joshua Slocum Material and Economically Significant Standard*, 26 AM. BANKR. INST. J. 32, 33 (2007).

<sup>244</sup> See generally Patrick A. Jackson, *Third Circuit Confirms Court’s Power to Modify Executory Contracts: Clarifies Joshua Slocum Material and Economically Significant Standard*, 26 AM. BANKR. INST. J. 32, 74 (2007).

<sup>245</sup> See *In re Joshua Slocum Ltd.*, 922 F.2d at 1092. See generally Jackson, *supra* note 244.

idea that courts should give more weight to Code provisions than non-bankruptcy laws in chapter 11 proceedings. Although applicable law like the AAA exist to protect non-debtor's contractual interests, courts should consider the nature and purpose of the contract at issue. prior to applying the applicable law to bar the debtor-in-possession's assumption or assignment of the contract

Therefore, this Comment argues that, in each case, the court should conduct a nuanced analysis of the facts that carefully considers the totality of the circumstances. In the case of a government contract, courts must balance the protection of government interests against the reorganization interests of the debtor—both of which are equally important to the success of a nation. On the one hand, there are government interests, such as an interest in protecting national security, that courts have to protect without any compromise, because it can bring harm to the country. On the other hand, a debtor's interest in being able to reorganize their business through bankruptcy proceedings is crucial to the success of the U.S. because reorganization helps companies preserve jobs and operations while weathering a crisis, and thus, helps the economy of the country stay afloat during a crisis.<sup>246</sup> Because both sides play an important role in contributing to the stability and success of a country, mechanically favoring one side over the other will put either the country's national security or its economy at risk. Therefore, courts should consider taking a holistic approach that takes into account the totality of the circumstances to these cases as a holistic approach is more valuable to the success of the U.S. as a country than the existing approaches that tend to favor one party at the expense of the other party

An examination of recent case precedents suggests that the lower courts are becoming disenchanted by the Hypothetical Test. These lower courts have given more equal weights to the legislative intents behind both the AAA and the Code. In addition, they also re-considered the long-standing interpretation of Section 365(c)'s "applicable law" exception extending beyond personal service contracts. However, recent cases, such as *In re Footstar*, suggest that courts may also steer away from the current Actual Test.<sup>247</sup> This outcome is probable because the current Actual Test, like the Hypothetical Test, tends to give more weight to one side than the other. Moreover, the Actual Test often overlooks the purpose and nature of the contracts in question. As a result of this oversight, the

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<sup>246</sup> See generally Tom Califano et al., *COVID-19: The Benefits of US Chapter 11 Relief in a Time of Economic Crisis*, DLA PIPER (Mar. 19, 2020), available at <https://www.dlapiper.com/en/us/insights/publications/2020/03/benefits-of-chapter-11-to-companies-in-crisis/>.

<sup>247</sup> See, e.g., *In re Footstar*, 323 B.R. 566, 570–71 (S.D.N.Y. 2005).

Actual Test often results in a favoritism towards the debtors, sacrificing the non-debtor party's rights and interests. In the case of government contracts, a blinded favoritism towards the debtors without regard to the nature of the contract in question can lead to damages to national interests, where continuing to contract with the debtor would put national security concerns at risk.

Going forward, courts should consider the totality of the circumstances when faced with legal battles involving the assumption and assignment of executory government contracts. Although many court opinions support this holistic view, their holdings reflect a mechanical application of legal principles, ignoring the factual considerations mentioned. Therefore, this Comment proposes that court uses a holistic approach (hereafter referred to as the "Holistic Test").

2. *The Holistic Test Considers Four Factors to Give Equal Weights to the Interests of Both the Debtor-in-Possession and the Government*

In determining the effect of the AAA on a debtor-in-possession's ability to assume or assign an executory government contract, courts should consider the following prongs in the listed order: (1) whether the debtor-in-possession has the actual intent to assign the contract; (2) if it does have the intent to assign, whether the assignment constitutes a transfer involving the assignment of rights or delegation of duties to a wholly distinct third party; (3) the pertinent pre-petition facts that may indicate the government's risk of losing its benefits of the bargain; and (4) why the government should be entitled to a relief from the automatic stay. Although there is no single factor that should be considered determinative, some factors of the Holistic Test in *In re Joshua Slocum* may be given more weight than others.

Several courts have shown support for the notion that Congress designed the AAA to protect the government from dealing with strangers. Therefore, the first two prongs address this concern. The first prong makes sure that the government faces an actual risk of having to deal with strangers. Because an assumption of a contract does not mean that there will be a subsequent assignment of the contract to a third party, there exists only a possibility that the government may have to deal with a party it did not contract with. Because this is a mere possibility, the government should not have the ability to seek relief from the automatic stay or termination of the contract, as allowing a relief from the stay or the termination of the contract can have a major negative impact of the debtor's reorganization. Instead, the government must present evidence of an actual assignment or an attempt of an assignment. Absent this evidence, the analysis should move to prong four, putting the burden on the government to

show why the debtor-in-possession may not assume the contract. . On the other hand, in cases where the debtor-in-possession attempts to assign the contract to a third party—particularly one that is unqualified, the government may have a ground to seek the aforementioned remedies. *In re Braniff Airways, Inc.* (“*Braniff*”) provides a clear example of this scenario. In *Braniff*, the debtor-in-possession tried to assign its contract to a party that did not meet the federal requirements.<sup>248</sup> Because the government would have to deal with an unqualified assignee, this evidence of an actual attempt of assignment should weigh in favor of the government.

If the government succeeds in establishing the debtor’s intent to assign, the focus will shift onto the second prong, in which the debtor must show that the assignee is not wholly distinct from the debtor. Similar to the first prong, the second prong focuses on whether the government is actually going to deal with a stranger (i.e., a third party with whom it did not contract). However, the second prong dives deeper into the issue by examining whether the party to whom the debtor-in-possession intends to assign the contract is wholly distinct from the pre-petition debtor. If the intended assignee is not a wholly distinct third party and that assignee have virtually the same or substantially similar qualifications as the original contractor, then the government retains its benefits. However, if the debtor-in-possession struggles to maintain its current operations after it filed for bankruptcy protections, courts should distinguish the debtor-in-possession from the pre-petition debtor and view the debtor-in-possession as a wholly distinct party. In this case, the government may justify a relief from the stay or termination of the contract on the basis that it is not at risk of losing the benefit of its original bargain (the fourth prong).

In assessing the authenticity of the government’s risk of losing the benefits of the original bargain, courts should also take into account the pre-petition facts under the third prong. Some of the important pre-petition facts include but not limited to: 1) the financial status of the debtor, 2) any prior default/underperformance, and 3) any cure or adequate assurance of future performance. For example, in *Carolina Parachute*, the government’s “lack of outside working capital” forced the company to file bankruptcy to reorganize.<sup>249</sup> This pre-petition circumstance was material and relevant because it could have been an indicator of subsequent default/underperformance under

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<sup>248</sup> Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (*In re Braniff Airways, Inc.*), 700 F.2d 935, 943 (5th Cir. 1983).

<sup>249</sup> U.S. Dep’t of Air Force v. Carolina Parachute Corp. (*In re Carolina Parachute Corp.*), 108 B.R. 100, 101 (M.D.N.C. 1989).

the contract. The company subsequently recommenced work on the contract.<sup>250</sup> Unfortunately, after a nine-month period of consistent performance, the company failed to continue to meet its obligation, causing the government to assert that the company lost its benefit of the bargain.<sup>251</sup> However, the court in *Carolina Parachute* only noted that the AAA allowed the government to terminate the contract, without giving any consideration to the “debtor’s performance under its contracts with the government, and the financial status of the debtor.”<sup>252</sup>

Similarly, the court in *Plum Run* gave no weight to the pre-petition circumstances. In *Plum Run*, the debtor underperformed its contractual obligations, which led to a default that could not be cured.<sup>253</sup> Like *Carolina Parachute*, the pre-petition circumstances in this case contributed to the government’s decision to seek termination of the contract by filing for a relief from the automatic stay. However, the judicial determination did not take into account the pre-petition circumstances, and instead found its authority solely in the AAA and the application of the misconstrued Hypothetical Test.<sup>254</sup> By ignoring the pre-petition circumstances and only focusing on the mechanical application of the AAA and Section 365(c), both courts created a blanket effect. The AAA—in conjunction with Section 365(c)—automatically bars a debtor-in-possession from assuming an executory contract. This is so even when the debtor-in-possession cures pre-petition default, provides adequate assurance for future performance, and continues to perform satisfactorily under the contract up to that point.

Instead of disregarding pre-petition circumstances that could inform courts of the debtor’s risk of default and the likelihood of the government getting the benefits of its bargain, courts should follow the example set by the *Mirant* case when applying the third prong. In *Mirant*, the court did not allow the government to terminate or modify the contract in part because the debtor had given the government adequate assurance of its ability to continue to perform as required under Section 365(b).<sup>255</sup>

Finally, under the fourth prong, the government must provide legitimate reasons to justify its rejection of a debtor-in-possession’s assumption or

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<sup>250</sup> *See id.*

<sup>251</sup> *Id.* at 102.

<sup>252</sup> *Id.*

<sup>253</sup> *See In re Plum Run Serv. Corp.*, 159 B.R. 496, 500 (Bankr. S.D. Ohio 1993).

<sup>254</sup> *See id.* at 501.

<sup>255</sup> *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 242 (5th Cir. 2006).

assignment of an executory contract. One of the possible justifications that a government party may raise is the nature and purpose of the contract at issue. Some scholars, in referring to *West*, insist that Congress intended to protect national security by avoiding assignment of military equipment contracts when it passed the AAA. However, as illustrated in the previously covered cases, the executory contracts at issue have involved contracts for other things that did not raise national security concerns, including but not limited to, telephone services and review of healthcare services.

Where the non-government contracting party must have meet certain requirements/qualifications (e.g., having a license or security clearance) to perform its obligations under the contract, courts may use the AAA to protect the country from the assumption or assignment of military contracts. However, the concerns about the non-government contracting party having the special required licenses or qualifications are similar to the concerns that make certain personal service contracts unassignable. Courts have generally deemed personal service contracts unassignable because they involve the performance of non-delegable duties that require special judgment, taste, skill, or ability.<sup>256</sup> However, where a third party could easily perform a service or duty under the agreement, as in the case where the performance involves reviewing health care services,<sup>257</sup> a government will not have a strong argument that it is not receiving the benefit of the bargain. Assuming that the government chose the original contractor based on thorough examination and trust, the original contractor, with its expertise and understanding of its own business and the qualifications required to perform the contract, would be in the best position to determine whether it could assume the contract or whether it should assign its obligations to a third party of its choice.

As a whole, the four prongs of the Holistic Test help to determine whether allowing a debtor-in-possession to assume or assign a pre-petition executory government contract will cause the government to lose the benefits of its original bargain. This is also the main concern in chapter 11 proceedings between a debtor-in-possession and a government. If the government still gets the benefits that it has bargained for and there exists no risk to the government's resources or national security, a debtor-in-possession should have the choice to assume or

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<sup>256</sup> See generally AM. BANKR. INST., ASSUMPTION OF PROVIDER AGREEMENTS AND PERSONAL SERVICE CONTRACTS (ABI, May 1, 2002) <https://www.abi.org/abi-journal/assumption-of-provider-agreements-and-personal-service-contracts>.

<sup>257</sup> See generally Pa. Peer Rev. Org., Inc. v. United States (*In re* Pa. Peer Rev. Org., Inc.), 50 B.R. 640, 642 (Bankr. M.D. Pa. 1985).

assign the contract, unless the government can justify extreme measures such as lifting the automatic stay to terminate a pre-existing contract.

### CONCLUSION

At first glance, there seems to be an inherent tension between the AAA and the authorization for assumption of executory contracts codified in Section 365 of the Code. Because the AAA protects the non-debtor government from having to accept performance from, or render performance to, an entity other than that with which it originally contracted, the AAA falls within the scope of the “applicable law” mentioned in Section 365(c). This has led to the current state of uncertainty where courts struggle to reconcile the bankruptcy principles that generally favor debtor’s reorganization and the AAA’s principles that seek to protect the government. Courts have developed two main tests in applying these provisions: 1) the Hypothetical Test, which emphasizes a literal reading of the statute over the legislative intent behind it, and 2) the Actual Test, which defers more to the overall goals of bankruptcy policy.

Although Congress could have addressed this issue of which test to apply via amendments in 2005, that never happened.<sup>258</sup> Similarly, the U.S. Supreme Court declined the opportunity to resolve the circuit split over the Hypothetical Test versus the Actual Test in 2009, when it denied certiorari in *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*<sup>259</sup> As a result, the circuit split has only worsened over the years, creating uncertainty for government contractors that are considering filing for bankruptcy in the United States.

In examining the two traditional tests, one can see that the Actual Test is a better approach to the issue because it avoids giving a blanket treatment to executory government contracts that is often seen in courts applying the Hypothetical Test. An examination of the language of the statute, the legislative intents behind the AAA and Code, and applicable caselaw clearly indicates that the Actual Test is a more rational approach, even if it is not as favorable to the government. Furthermore, the legislative history of Section 365(c), the overall objectives of Chapter 11 of the Code, and the legislative intent behind the AAA suggest both statutes share the same concern of protecting the government’s contractual rights, which will not be harmed by allowing a debtor-in-possession to assume its executory government contracts. However, because the Actual Test

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<sup>258</sup> *Supra* note 180.

<sup>259</sup> *See* *N.C.P. Mktg. Group, Inc. v. BG Star Prods., Inc.*, 556 U.S. 1145, 1146 (2009) (concluding that the division in the courts over the interpretation of section 365(c)(1) is “an important one to resolve” but that the case in question was “not the most suitable case for our resolution of the conflict”).

fails to consider the nature of the contracts in question, the Actual Test overlooks the importance of the government's contractual rights and the important welfare and security considerations behind that.

In fact, some courts have recognized that neither the Actual Test nor the Hypothetical Test may be the appropriate approach to the issue. Notably, the court in *In re Footstar* actually adopted an entirely different approach. Under this *Footstar* approach, a debtor-in-possession can assume the executory contract because the word "trustee" is not synonymous with the word "debtor-in-possession."<sup>260</sup> However, as is the case with the Actual Test, the *Footstar* approach results in the same outcome where the debtor is favored over the non-debtor party. This tendency to favor one side over the other is not conducive to the prosperity of the United States as a country because it fails to provide some protection to the interests of the government. Therefore, the best compromise between bankruptcy principles and the antithetical federal AAA is one where the courts make a case-by-case examination, maintaining a debtor-in-possession's right to assume or assign its contracts while allowing the government to object based on legitimate and important safety and welfare concerns.

It is crucial to resolve the existing circuit split because the assumption and assignment of a business's contracts play a vital role in the business' reorganization under bankruptcy proceedings. Without a definitive judicial or legislative mandate, this circuit split will continue to worsen, leading to the ongoing problems of forum shopping by debtors and uncertainty on the part of practitioners and debtors, all of which can create an inherently unfair bankruptcy process.

This Comment proposes that courts use the Holistic Test, examining each case in light of the totality of the circumstances. Under the four-pronged Holistic Test, courts will consider: (1) whether the debtor-in-possession has the actual intent to assign the contract; (2) if it does have the intent to assign, whether the assigning constitutes a transfer involving the assignment of rights or delegation of duties to a wholly distinct third party; (3) what pre-petition circumstances are pertinent; and (4) why the government should be entitled to a relief from the automatic stay. The first prong and the second prong address the primary issue of the Hypothetical Test: should a debtor-in-possession be prevented from assuming a contract even when it does not intend to assign the contract and there will be no change in the contracting party. The first and second

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<sup>260</sup> *In re Footstar*, 323 B.R. 566, 570 (S.D.N.Y. 2005).

prongs shift the burden onto the government to justify its desire to terminate the contract when there is no change in the identity of the contracting party. Both of these prongs take into account the legislative intent behind both the AAA and the Code, by ensuring that the government only has to deal with one claimant, thus avoiding some frauds, and that the government receives the same quality of goods and services for which it contracted. Furthermore, the debtor-in-possession can assume executory contracts to maximize its value in reorganization as long as the assumption does not harm the government. A potential drawback of the proposed Holistic Test involves the issue of judicial efficiency. The courts that adopted the Hypothetical Test must engage in “a difficult, and sometimes complicated, abstract analysis of what the debtor hypothetically could or could not do,” while the courts that adopted the Actual Test typically go through “an expensive, expertise-requiring case-by-case analysis.”<sup>261</sup> Adopting the proposed Holistic Test will require courts to do a fact-specific case-by-case analysis that is potentially more costly and time-consuming than what is required under both the Hypothetical Test and Actual Test. However, such case-by-case approach is necessary and arguably better than adopting the existing tests because it ensures the protections of the interests of both the debtor and the non-debtor.

While the first two prongs consider factors that weigh in favor of the debtors, the last two prongs balance it out by considering factors that weigh in favor of the government. The third prong ensures that courts consider pre-petition circumstances, including the debtor’s prior default, financial status, and performance. By considering pre-petition circumstances, courts can objectively determine whether the debtor could become delinquent in performance after assumption, and thus, harm the government. Similarly, the fourth prong gives the government the power to object and bring its concerns up to the court for consideration. By having the government give justifications for its objection, courts can balance those concerns against the interests of the debtor, which, when viewed in light of the circumstances presented in the third prong, will help courts come to a decision that properly balance the interests of both parties. Because the government and business debtors are both crucial to the success of

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<sup>261</sup> Saul Ehrenpreis, *Trademark Licenses: Even in a Hypothetical or Actual World, Footstar Got it Right*, AM. BANKR. INST. J. (2011), [https://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1021&context=student\\_pubs](https://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1021&context=student_pubs).

the country, the Holistic Test is the correct approach to the issue of determining whether a debtor-in-possession should be allowed to assume its executory government contracts under Section 365(c)(1) and the AAA.

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