

AMERICAN BANKRUPTCY INSTITUTE

MID-ATLANTIC BANKRUPTCY WORKSHOP

AUGUST 3-5, 2006

Inconsistent or Reconcilable?: The Mixed Blessings of
Circuit Splits

CIRCUIT SPLITS CHOICE OF LAW DETERMINATIONS IN BANKRUPTCY COURT

Honorable Judith Wizmur
United States Bankruptcy Court; New Jersey

Bankruptcy courts often address causes of action and claims arising under or governed by state law. Often presented is the question of which state's laws to apply. To be discussed here is the further question raised: how does a bankruptcy court make a choice of law determination?

In answering this question, the circuits have split. Some circuit courts have viewed choice of law determinations for a federal court having bankruptcy jurisdiction as a matter of substantive state law. In such instances, those courts have held that the federal court must employ the choice of law rule of the applicable forum state ("state rule"). Other courts have held that federal courts sitting in bankruptcy have the independent discretion to make choice of law determinations ("federal rule"). A third group of courts have sidestepped the issue by deciding either that the substantive choice of law outcome in each case would be the same under either the state or federal rule, or that the contractual choice of law provisions chosen by the parties must be honored.

A. State Rule

1. Sources

Courts following the "state rule" base their authority on the landmark U.S. Supreme Court opinions of Erie and Klaxon. Under Erie, federal courts sitting in diversity must apply the substantive law of the forum state. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938). Several years after Erie, the Supreme Court in Klaxon construed the

choice of law determination as a matter of substantive law, thus requiring the application of the choice of law rule of the forum state in diversity cases. Klaxon Co. v. Stentor Elec. Mfgr. Co., 313 U.S. 487, 61 S.Ct.1020 (1941).

2. Rationale

In the most influential of the circuit court opinions following the "state" approach, In re Merritt Dredging Co., Inc., 839 F.2d 203 (4th Cir), cert. denied sub nom., Compliance Marine, Inc. v. Campbell, 487 U.S. 1236, 108 S.Ct. 2904, 101 L.Ed.2d 936 (1988), the Fourth Circuit followed the perceived mandate of Erie and Klaxon:

We believe ... that in the absence of a compelling federal interest which dictates otherwise, the Klaxon rule should prevail where a federal bankruptcy court seeks to determine the extent of a debtor's property interest.... A uniform rule under which federal bankruptcy courts apply their forum states' choice of law principles will enhance predictability in an area where predictability is critical. Most important, such a rule would accord with the model established by Erie and Klaxon. Both those cases make clear that federal law may not be applied to questions which arise in federal court but whose determination is not a matter of federal law.... Such is the case with questions regarding the extent of a bankruptcy debtor's property interests.... It would be anomalous to have the same property interest governed by the laws of one state in federal diversity proceedings and by the laws of another state where a federal court is sitting in bankruptcy. Id. at 206 (internal citations omitted); see also In re Nantahala Village, Inc., 976 F.2d 876, 880-81 (4th Cir. 1992) (mechanical application of Klaxon without citation to Merritt Dredging).

3. Circuit and Lower Federal Court Opinions Applying State Rule

a. Second Circuit:

In re Gaston & Snow, 243 F.3d 599 (2d Cir.), cert. denied sub nom., Erkins v. Bianco, 543 U.S. 1042, 122 S.Ct. 618, 151 L.Ed.2d 540 (2001) (rejected the creation of a bankruptcy choice of law rule as an unnecessary creation of federal common law).

b. Third Circuit:

(1) Mechanical Application of Klaxon without Recognizing Circuit Split

Robeson Indus. Corp. v. Hartford Acc. & Indem. Co., 178 F.3d 160, 164-65 (3d Cir. 1999).

(2) "Not Precedential" Opinion following Merritt

Dredging

In re PHP Healthcare Corp., 128 Fed. Appx. 839 (3d Cir. 2005) (per curiam) (adopted choice of law rule of "the state in which the Bankruptcy Court resides.")

(3) Third Circuit Lower Federal Court Decisions Applying State Rule:

In re B.S. Livingston & Co., Inc., 186 B.R. 841, 863 (D.N.J. 1995) (parties agreed, under Klaxon, "that a federal court must look to the forum state's choice of law principles to determine the appropriate state law to be employed."); In re Presque Isle Apartments, L.P., 118 B.R. 332, 334 & n.1 (Bankr. W.D. Pa. 1990); In re Groggel, 333 B.R. 261, 276 (Bankr. W.D. Pa. 2005). But see In re Route One West Windsor Ltd. P'ship, 225 B.R. 76, 86 (Bankr. D.N.J. 1998) (federal substantive law controlled post-petition interest issue, court honored contractual choice-of-law provision).

c. Fifth Circuit:

Askanase v. Fatjo, 130 F.3d 657, 670-71 (5th Cir. 1997) (mechanically applying Texas choice of law principles without mentioning circuit split, Klaxon or Woods-Tucker, see infra).

d. Seventh Circuit:

Matter of Iowa RR. Co., 840 F.2d 535, 542-43 (7th Cir.), cert. denied sub nom., Union Pacific R.R. Co. v. Moritz, 488 U.S. 899, 109 S.Ct. 244, 102 L.Ed.2d 233 (1988).

e. Eighth Circuit:

In re NWFx, Inc., 881 F.2d 530, 535 (8th Cir. 1989), aff'd on reh'g by an equally divided court, 904 F.2d 469, 470 (8th Cir.) (en banc) (per curiam), cert. denied sub nom., Pyburn Enterprises, Inc. v. Bird, 498 U.S. 941, 111 S.Ct. 349, 112 L.Ed.2d 313 (1990) (citing Union Nat'l Bank v. Fed. Nat'l Mortg. Ass'n, 860 F.2d 847, 853 n. 13 (8th Cir.1988)) (when deciding the choice of applicable state law district courts are obligated to apply the choice of law principles of the state in which they sit).

f. Tenth Circuit:

Cascade Energy & Metals Corp. v. Banks, No. 95-4045, 1996 WL 124757 (10th Cir. Mar. 21, 1996) (mechanical application of Klaxon in unpublished non-precedential case).

g. District of Columbia Circuit:

Goldstein v. Madison Nat. Bank of Washington, D.C., 807 F.2d 1070, 1072 (D.C. Cir. 1986) (mechanical application of Klaxon).

h. Selected Lower Court Decisions from Other Circuits Applying State Rule:

(1) From First Circuit:

In re Forbes, 191 B.R. 510, 513-14 (Bankr. D.R.I. 1996), reversed on other grounds sub

nom., Forbes v. Four Queen Enterprises, Inc., 210 B.R. 905 (D.R.I. 1997) (adopting Merritt Dredging approach); In re Medico Assocs., 23 B.R. 295, 301-02 (Bankr. D. Mass. 1980); In re Maplewood Poultry Co., 2 B.R. 550, 553 (Bankr. D. Me 1980).

(2) From Fifth Circuit:

In re Hill Petroleum Co., 95 B.R. 404, 407 (Bankr. W.D. La. 1988).

(3) From Sixth Circuit:

In re Southwest Equip. Rental, Inc., Nos. 88-33, 89-33, 90-62, 1992 WL 684872, *9 & n.48 (E.D. Tenn. Jul 09, 1992). (Albeit in a footnote, the court comprehensively reviewed the then-existing authorities, and followed Merritt Dredging, id. at *9 n.48, to employ Tennessee's choice of law rules in a bankruptcy case.) See also In re Dynamic Enters., Inc., 32 B.R. 509, 514 n.2 (Bankr. M.D. Tenn. 1983); In re Wallace's Bookstores, Inc., 317 B.R. 709, 712-13 & n.3 (Bankr. E.D.Ky. 2004).

(4) From Tenth Circuit:

In re Powell, 29 B.R. 346, 349 (Bankr. D. Colo. 1983); In re Integra Realty Resources, Inc., 198 B.R. 352, 361 (Bankr. D. Colo. 1996).

(5) From Eleventh Circuit:

In re Bagley, 6 B.R. 387, 389 (Bankr. N.D. Ga. 1980); In re Shepard, 29 B.R. 928, 931 (Bankr. M.D. Fla. 1983); In re High-Line Aviation, Inc., 149 B.R. 730, 733 (Bankr. N.D. Ga. 1992).

(6) From District of Columbia Circuit:

In re Int'l Loan Network, Inc., 160 B.R. 1, 17 (Bankr. D. Dist. Col. 1993) (citing Merritt Dredging, 839 F.2d at 205).

B. Federal Rule

1. Sources

Courts following the "independent" or "federal" rule base their authority on certain dicta from the less well-known case of Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 67 S.Ct. 237 (1946). Vanston was a bankruptcy case addressing the substantive issue of post-petition interest under the Bankruptcy Act of 1898, which the Court held was to be addressed under federal law. In passing, the court commented on choice of law principles for federal courts exercising their bankruptcy jurisdiction over state-based claims and causes of action.

Justice Black observed that, within the bankruptcy context, choice of law determinations "requires the exercise of an informed judgment in the balancing of all the interests of the states with the most significant contacts in order best to accommodate the equities among the parties to the policies of those states." Id. at 162. He distinguished Erie, observing that its holding for federal courts exercising diversity jurisdiction would not necessarily apply where federal courts sit in bankruptcy, as the "bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles." Id. at 163.

Courts following the "federal rule" articulated in Vanston require a federal bankruptcy court to exercise its "independent" judgment in balancing the equities to determine which state's underlying substantive law should apply.

2. Rationale

To followers of the "federal rule," the creation of a federal common law for choice of law determinations enhances the predictability of such decisions in the bankruptcy courts, and reduces "forum shopping" by the parties. Judge Wiseman of the Middle District of Tennessee set forth the policies behind this approach in In re SMEC, Inc., 160 B.R. 86, 90

(M.D. Tenn. 1993), reconsideration denied, 161 B.R. 953 (M.D. Tenn. 1993). After predicting that the U.S. Supreme Court would follow its dicta in Vanston if presented again with the issue of choice of law determinations by bankruptcy courts, Judge Wiseman observed that:

the logic of Vanston is compelling. In a diversity case, it is presumed that the forum state has the greatest interest in seeing its laws applied. In a federal bankruptcy case incorporating state law, this presumption is untenable. There is no necessary reason to believe that the forum state is the state with the greatest interest in a bankruptcy proceeding. In fact, in today's business world, the location of a debtor may bear little relation to the location of his or her property interests or to the corpus of his or her business dealings. A choice of law rule that looks to the state with the greatest interests in the proceeding acknowledges the complex nature of property and transactions and thereby protects state interests. Oftentimes the forum state will be the state with the greatest interests, but there is no need for such a presumption.

This rule also helps prevent forum shopping by debtors. Rather than allow debtors in the shadow of bankruptcy to restructure or relocate their business dealings in such a way as to gain the benefit of a certain forum's laws, this rule imposes on debtors the laws under which they primarily acted. Likewise, creditors and other parties are not subjected to, or given the benefit of, an unjustified quirk of legal procedure that imposes on them laws under which they rarely or never transacted.

It is true that a bright line rule, such as the forum state rule, has its benefits, most notably its ease of application. But these benefits are bought at the cost of particularity. The special

circumstances of a case that may argue against application of the forum state's laws are not given consideration. Preserving particularity, and protecting states' interests and fairness thereby, is ample justification for imposing on courts the possibly more difficult choice of law that may accompany the most significant contacts test. Id. at 90-91.

3. Circuit and Lower Federal Court Opinions Applying Federal Rule

a. Ninth Circuit:

In re Lindsay, 59 F.3d 942 (9th Cir. 1995), cert. denied sub nom., Lindsay v. Beneficial Reins. Co., 516 U.S. 1074, 116 S.Ct. 778, 133 L.Ed.2d 730 (1996). A bankruptcy judge in the Northern District of California, in following Lindsay, had described the Ninth Circuit as following the "minority rule" from Vanston. In re Gibson, 234 B.R. 776, 779 (Bankr. N.D. Cal. 1999). The Ninth Circuit has recently mechanically applied the rule from Lindsay in stating, without mentioning the circuit split, that "[i]n a bankruptcy case, the court must apply federal choice of law rules." In re Vortex Fishing Systems, Inc., 277 F.3d 1057, 1069 (9th Cir. 2002). Citing Vortex Fishing, Lindsay and Gibson, the Ninth Circuit's Bankruptcy Appellate Panel has also stated that "[i]n the Ninth Circuit, federal common law choice of law rules apply in bankruptcy cases." In re Miller, 292 B.R. 409, 413 (B.A.P. 9th Cir. 2003).

b. Lower Court Decisions from Other Circuits Applying Federal Rule:

(1) From the Second Circuit, pre-Gaston & Snow:

In re McCorhill Publ'g, Inc., 86 B.R. 783, 792-93 (Bankr. S.D.N.Y. 1988); In re Perret, 67 B.R. 757, 772 (Bankr. N.D.N.Y. 1986); In re Barney Schogel Inc., 12 B.R. 697, 699-700 (Bankr. S.D.N.Y. 1981). But see In re O.P.M. Leasing Servs., 28 B.R. 740, 747-48 (Bankr. S.D.N.Y. 1983) (following Erie and Klaxon).

(2) From the Sixth Circuit:

In re SMEC, see supra; In re Elder-Beerman Stores Corp., 221 B.R. 404 (Bankr. S.D. Ohio 1998).

(3) From the Tenth Circuit:

The Bankruptcy Court for the Northern District of Oklahoma opined that it was not bound to "automatically apply Oklahoma's choice of law rules" as this was "not a diversity case." In re Otasco, Inc., 111 B.R. 976, 980 (Bankr. N.D. Okla. 1990), rev'd on other grounds, 196 B.R. 554, (N.D. Okla. 1991). The choice of law issue was not critical, however, to the outcome because that court also saw "no particular reason why the parties' choice of law should not govern." Id. at 980-81.

(2) From the Eleventh Circuit:

Matter of Ovetsky, 100 B.R. 115, 117 (Bankr. N.D. Ga. 1989); In re L.M.S. Assocs., Inc., 18 B.R. 425, 428 (Bankr. M.D. Fla. 1982).

C. AVOID THE ISSUE AND/OR HONOR CONTRACTUAL CHOICE

Courts have side-stepped the issue of whether to follow Klaxton or the Vanston dicta where either approach would result in the application of the same state substantive law, or where contractual choice of law provisions are honored. In many instances the applicable underlying substantive state law will be identical, or nearly so, because many states have adopted the Restatement (Second) of Conflict of Laws, various Model Acts, and the Uniform Commercial Code. As well, where the parties to the litigation have agreed to choice-of-law clauses in their contracts, such clauses will customarily be enforced by the courts.

An early and influential decision which avoided the choice between the "state rule" and the "federal rule" is Woods-Tucker Leasing Corp. of Georgia v. Hutcheson-Ingram

Dev. Co., 642 F.2d 744 (5th Cir. 1981).

To the extent we are faced with this threshold question of whether a federal or a forum (Texas) choice of law rule applies, we see no need to resolve it. For reasons to be elaborated, we find that Texas, by its adoption of the [Uniform Commercial Code], has provided a choice of law rule specifically directed to contractual choice of law provisions by parties to transactions regulated by the UCC. Texas UCC § 1.105(a). If we were required to exercise independent federal judgment in choosing whether to apply Texas or Mississippi law to this UCC-regulated transaction involving significant contacts with both Texas and Mississippi, we would likewise look to UCC § 1-105(1), adopted in identical versions in both Texas and Mississippi as part of a national effort to establish a nationally uniform law to govern the validity and effect of commercial transactions. Texas UCC § 1.102(b)(3); Mississippi UCC § 75-1-102(2)(c). As stated in In Re King-Porter Company, 446 F.2d 722, 732 (5th Cir. 1971), although in the context of a different issue arising in a bankruptcy proceeding: "The Uniform Commercial Code has been adopted in all but one state. It should generally be considered as the federal law of commerce including secured transactions." Id. at 748-49; see also In re Professional Investors Ins. Group, Inc., 232 B.R. 870, 885 (Bankr. N.D.Tex. 1999) (apparently applying a Vanston style analysis, but concluding that, because of pre-petition state litigation in Texas, "even if this court looks beyond Erie to the choice of law approach of Vanston, the court would apply Texas procedural law."); In re Consol. Capital Equities Corp., 143 B.R. 80 (Bankr. N.D. Tex. 1992).

On the issue of contractual conflict-of-law clauses, the Sixth Circuit recently reflected as follows:

[t]hough there is a circuit split over what

choice-of-law provisions a federal court exercising bankruptcy jurisdiction should apply, both Michigan choice-of-law rules and general equitable choice-of-law policies support enforcing parties' agreed-upon choice-of-law clauses absent any strong public policy concerns to the contrary.

In re Dow Corning Corp., 419 F.3d 543, 548 (6th Cir. 2005).

Other courts around the country have expressed similar views.

1. First Circuit:

In re Morse Tool, Inc., 108 B.R. 384, 385 (Bankr. D. Mass. 1989) (avoids issue as both federal common law and Massachusetts law would use the Restatement); see also In re O'Day Corp., 126 B.R. 370 (Bankr. D. Mass. 1991); In re Engage, Inc., 330 B.R. 5, 9-10 (D. Mass. 2005) (addresses circuit split but avoids issue, as "[t]he choice of law question, whether as a matter of federal common law or Massachusetts, is resolved under the 'most significant relationship,' test set forth in the Restatement (Second) of Conflict of Laws § 188(1).").

2. Third Circuit:

In re Kaplan, 143 F.3d 807, 812 n.7 & 814-15 (3d Cir. 1998) (respecting parties' contractual choice of law provision and also holding that federal preclusion principles applied to the effect of prior federal judgment); In re Global Indus. Techs., Inc., 333 B.R. 251, 256-57 (Bankr. W.D. Pa. 2005) (despite long discussion of circuit split, avoided issue because "[i]n the instant case there is no difference in the outcome whether the court applies federal common law or Pennsylvania conflict of laws principles because both cite to the Restatement (Second) Conflict of Laws."); In re Am. Metrocomm Corp., 274 B.R. 641, 659 n.3 (Bankr. D.Del. 2002) ("However, in the instant action it is does not matter which choice-of-law rule the Court applies because both Delaware and the federal common law apply the Restatement's 'most significant relationship test' to decide choice of law

issues."); In re Halpert & Co., Inc., 254 B.R. 104, 123-24 (Bankr. D.N.J. 1999) (no "actual conflict" between states' underlying substantive law).

3. Seventh Circuit:

Despite its earlier mechanical application of Klaxon in Iowa R.R. Co., see supra, the Seventh Circuit sidestepped the circuit split when it addressed the issue more fully. See Matter of Morris, 30 F.3d 1578, 1582 (7th Cir. 1994). ("This controversy need not be resolved here, however, since under either [the Klaxon or independent] approach Iowa's substantive law would be applied"); In re Stoecker, 5 F.3d 1022 (7th Cir. 1993); see also In re Allied Prods. Corp., 288 B.R. 533, (Bankr. N.D. Ill. 2003), aff'd, No. 03-1361, 2004 WL 635212 (N.D. Ill. Mar. 31, 2004) (citing Morris, 30 F.3d at 1581-82) ("The Seventh Circuit has not determined whether the choice of law rules of the forum state are binding in bankruptcy cases, or whether a bankruptcy court may exercise independent judgment as to the appropriate source of substantive law.").

4. Tenth Circuit:

In re Kaiser Steel Corp., 87 B.R. 154, 157-58 (Bankr. D. Colo. 1988). The Kaiser Steel opinion was one of the first to recognize the "clear split of authority whether federal courts sitting pursuant to the special grant of bankruptcy jurisdiction are bound to mechanically apply the Klaxon choice of law rule." The opinion contained a thorough, if now dated, review of the conflicting authorities.

5. Eleventh Circuit:

Two more recent bankruptcy court decisions from the Eleventh Circuit take a nuanced approach, i.e., generally applying Klaxon, but doing so in light of either the nature of the action brought in bankruptcy or any relevant contractual choice-of-law provisions. In re Simpson, 319 B.R. 256, 262-64 (Bankr. M.D. Fla. 2003); In re New Power Co., 313 B.R. 496, 513-14 (Bankr. N.D. Ga. 2004).

D. CONCLUDING REMARKS

A commentator has noted the irony in that, in attempting to bring uniformity to choice of law in the bankruptcy context, courts following the two main approaches have made choice of law rule determinations by bankruptcy courts unpredictable and non-uniform:

The application of federal choice-of-law rules has, in principle, the added virtue of bringing national uniformity to conflicts questions in the bankruptcy context. Of course, the goal of national uniformity can be achieved only when all federal courts apply federal choice-of-law rules. Many continue to apply state rules, however, making uniformity impossible. While courts applying the federal choice-of-law rules stress the virtue of uniformity that their approach would bring (if applied everywhere), courts applying the state choice-of-law rules cite the virtue of predictability that their approach would bring (if applied everywhere). Ironically, the very existence of a split of authority on this question makes the current treatment of choice-of-law in bankruptcy both unpredictable and nonuniform.

J. C. Rozendaal, *Choice of Law in Distinguishing Leases from Security Interests under the Uniform Commercial Code*, 75 TEX. L. REV. 375, 386-87 (footnotes omitted) (1996).

E. ADDITIONAL REFERENCES

Richard E. Coulson, *Choice of Law in United States Cross-Border Insolvencies*, 59 CONSUMER FIN. L.Q. REP. 67 (2005).

Paul R. Glassman, *Choice of State Law in Bankruptcy Cases, Part I*, 24-SEP AM. BANKR. INST. J. 32 (Sep. 2005).

Paul R. Glassman, *Choice of State Law in Bankruptcy Cases, Part II*, 24-OCT AM. BANKR. INST. J. 20 (Oct. 2005).

Conflict of Laws in Bankruptcy: Choosing Applicable State Law and the Appropriate (State or Federal?) Choice-of-Law Rule, BANKR. LAW LETTER (2001).

James T. Markus & Don J. Quigley, *Conflict of Laws-Which State Rules Govern?* 18-NOV AM. BANKR. INST. J. 18 (Nov. 1999).

J. C. Rozendaal, *Choice of Law in Distinguishing Leases from Security Interests under the Uniform Commercial Code*, 75 TEX. L. REV. 375 (1996).

AMERICAN BANKRUPTCY INSTITUTE
MID-ATLANTIC BANKRUPTCY WORKSHOP
AUGUST 3-5, 2006

**Inconsistent or Reconcilable?: The Mixed Blessings of
Circuit Splits**

REJECTION DAMAGES: WHEN IS THE CLAIM CALCULATED?

Honorable Kay Woods
United States Bankruptcy Court; Ohio

On the Petition Date, many debtors are parties to executory contracts and/or unexpired leases. The Code permits the debtor, the debtor-in-possession, or the trustee to assume or reject such contracts at any time prior to confirmation under chapter 9, 11, 12, 13 (with the exception of non-residential real estate leases in section 365(d)(4)). Pursuant to the Code, contracts and leases assumed by the debtor, the debtor-in-possession, or the trustee are treated as administrative expenses, while contract and lease rejection damages are treated as pre-petition unsecured claims.

Although statutory law clearly identifies the nature of rejection claims as pre-petition claims, the date upon which the amount of damages is calculated has led to a split among the circuits. Relying on the plain language in 11 U.S.C. § 502(g), most circuit courts have concluded that rejection damages are calculated based upon the market conditions existing on the day before the petition is filed. The First Circuit, on the other hand, has held that rejection damages should be calculated based upon the market conditions as they existed on the date that the contract was actually rejected.

I. RELEVANT STATUTES

A. 11 U.S.C. §365(g)(1)

1. Text:
“Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease– (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, 13 of this title, immediately before the date of filing the petition. . .”

2. Legislative history:
The legal fiction which undergirds section 365(g)(1) was first articulated in ***Central Trust Co. of Ill. v. Chicago Auditorium Ass'n***, 240 U.S. 581 (1916), where the Supreme Court held that the filing of the petition in bankruptcy court is the equivalent of repudiation of the contract.

This fictional relation back was codified in 1938 in section 36c of the Chandler Act, which read, “the rejection of an executory contract or unexpired lease, as provided in this Act, shall constitute a breach of such contract or lease as of the date of the filing of the petition. . .”

In enacting section 63c, Congress recognized that the fiction was a necessary mechanical device to ensure that the breach claim shares in the debtor’s estate, along with pre-petition creditors, and that the debtor is discharged from liability under the contract, as with pre-petition debts. S. Rep. No 75-1916 at 6 (1938).

B. 11 U.S.C. § 502(g)

1. Text:
“A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.”

II. CIRCUIT SPLIT:

- A. Damages resulting from the rejection of a contract are calculated based upon market conditions as they existed on the date which the contract was actually rejected (minority view— First Circuit).

1. ***In re Good Hope Chemical Corporation***
747 F.2d 806 (1st Cir. 1984)

- a. Relevant statute(s):
section 63c, 11 U.S.C. § 103(c) and section 64(a)(1), 11 U.S.C. § 104(a)(1)
- b. Facts:
Texas corporation, Good Hope, contracts with West German

corporation, K&L, for the manufacture and sale of two heat exchangers. Good Hope agrees to pay the contract price for the heat exchangers in German marks.

Prior to the first payment installment, but after K&L substantially completes the heat exchangers, Good Hope files Chapter 11 petition.

The First Circuit concludes that K&L's cause of action arose under American law, and, therefore, the exchange rate on the breach day prevails. *Id.* at 812.

The exchange rate prevailing on the date of confirmation (the date the contract was actually and finally rejected) results in a larger dollar amount than the exchange rate on the date the petition was filed. *Id.* at 808.

K&L asserts that "fictional breach" on petition date did not give rise to an obligation enforceable against Good Hope on that date. *Id.* at 812.

- c. Ruling:
First Circuit cites ***Hicks v. Guinness***, 269 U.S. 71(1927)¹, for its definition of "breach date"(upon breach "the event has come to pass upon which your liability becomes absolute as fixed by law."). *Id.* at 812. First Circuit further

¹In *Hicks*, a German firm was indebted to an American firm under an account in the amount of 1,079.35 marks, subject to a set off of \$35.35. The debt was outstanding when the war between the United States and Germany began in 1917. The Alien Property Custodian had taken property of the German firm of a value greater than the debt and the American firm brought a suit in equity to recover on the account pursuant to the Trading With the Enemy Act of October 6, 1917. Two issues were raised before the Supreme Court: whether interest accrued during the war and on what date the value of the mark was to be estimated in dollars in order to fix the amount of the decree.

The Supreme Court concluded that the American firm was to recover the value of the account in the dollar value that the marks had on the date when the account was stated. "The loss for which the plaintiff is entitled to be indemnified is the loss of what the contractor would have had if the contract had been performed. . .It happens at the moment when the contract is broken, just as it does when a tort is committed, and the plaintiff's claim is for the amount of that loss valued in money at that time." *Hicks*, 269 U.S. at 80.

cites *Hicks* for the proposition that “the fixation of liability is important because the plaintiff’s loss, its expectancy from the contract, ‘happens when the contract is broken. . .and the plaintiff’s claim is for the amount of loss valued in money at that time.’” *Id.* at 812.

First Circuit concludes that: (1) the “relation back” rule “would disrupt the *Hicks* Court’s attempt to give the plaintiff his expectancy as of the date his loss became definite” *Id.* at 812; and (2) “[R]elation back rule is necessary in bankruptcy because without it a Chapter 11 debtor would be required to reject an executory immediately upon filing or have its obligation for damages upon rejection treated as a administrative expense entitled to priority under section 64(a)(1).” *Id.* at 812-813.

2. ***In re James R. Corbitt Co.***

48 B.R. 937 (Bankr. E.D. Va. 1985)

a. Relevant Statute(s):
11 U.S.C. §365(g), 11 U.S.C. §348(c) (deemed rejection 60 days after conversion)

b. Facts:
Three claims were filed based upon the failure of debtor, a residential builder, to construct and convey houses to purchasers.

Chapter 11 petition was filed on March 19, 1981. The case was converted to a Chapter 7 on January 19, 1983.

Construction costs damages were calculated based upon appraisals made on July 1, 1981 and September 21, 1981.

c. Ruling:
Although the Eastern District of Virginia applied the fictional relation back rule with respect to the damage computation for evidentiary reasons, the Court acknowledges that, “in proper circumstances,” another date may be used. *Id.* at 942, note 7 (*citing with favor In re Good Hope, supra.*):

“For purposes of determining the status of these claims, the breach date of these contracts relates back and becomes

effective March 18, 1981, pursuant to the provisions of Section 365(g)(1). The claims thus become pre-petition claims rather than administrative ones. In proper circumstances, however, another date may be used for purposes of computing the amount of damages. In a case in which fluctuating foreign currency exchange rates materially affected the amount that would be due, the First Circuit considered and rejected the “judgment date” rule applicable in certain non-bankruptcy currency exchange cases. However, the court then declined to follow the relation back provisions of section 365(g)(1) because the purpose of relation back would not have been served in the particular circumstances. The court held the breach date to be the date the contract actually was rejected by the debtor and fixed the damages as of the actual rejection date. *In re Good Hope Chemical Corp.*, 747 F.2d 806 (1st Cir.1984). Using the date of rejection in the case sub judice, however, would interject more time between the dates of the appraisals, summer 1981, and the date of actual rejection, March 20, 1983, and thus would diminish, rather than enhance, the probative value of claimant’s evidence.”

B. Damages resulting from the rejection of a contract are calculated based upon market conditions as they existed on the day before the petition was filed (majority view— (Second, Third, Fourth, Fifth, Sixth, Eighth, Ninth)

1. ***In re American HomePatient, Inc.***
414 F.3d 614 (6th Cir.2005)

a. Relevant statute(s):
11 U.S.C. §§365(g)(1) and 502(g)

b. Facts:
AHP entered into a warrant agreement which allowed warrant holders to purchase shares of AHP common stock at an exercise price of \$.01 per share.

AHP filed a voluntary Chapter 11 petition prior to the holders’ exercise of their rights.

Following confirmation, AHP rejected the warrant agreement.

Expert testimony set the price per warrant at \$.02692 on the day before the petition was filed, resulting in a damage

amount of \$846,369.85. Warrant holder argued that the damage amount was \$6,987,774.10 based upon the stock price on the rejection date.

- C. Ruling:
Sixth Circuit relies upon the rules of statutory construction, as well as the use of the terms “determined” and “allowed” and the definition of those words (determine-”to fix the boundaries of”; allow-”to permit”) to conclude that damages are fixed on the day before the petition is filed.

In response to the argument the contract rejection damages are to be determined by state law, the Sixth Circuit wrote that bankruptcy courts have the power to supercede state law where it conflicts with federal bankruptcy law, and that resort to state law is appropriate and/or necessary only when a gap exists in federal bankruptcy law. Because the Bankruptcy Code specifically fixes the date of breach in section 365(g)(1) and provides that a claim arising from rejection is “determined” as if the claim has arisen before the date of the filing in section 502(g), the Court concluded that no such gap exists.

III. CRITICISM OF THE MAJORITY VIEW

- A. Creditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating debtor’s obligation, subject to any qualifying or contrary provision in the Bankruptcy Code. ***Butner v. United States***, 440 U.S. 48, 55 (1979). The “basic federal rule” in bankruptcy is that state law governs the substance of claims, Congress having “generally left the determination of property rights in the assets of a bankrupt’s estate to state law.” ***Raleigh v. Illinois Dept. Of Revenue***, 530 U.S. 15, 20 (2000).
- B. State law (more specifically U.C.C. §2-713(1)) sets the measure of damages for repudiation by the seller as “the difference between the market price at the time the buyer learned of the breach and the contract price. . .” In other words, the amount of damages should be determined by reference to the prevailing market price “at the time when the buyer learned of the breach.”
- C. The AHP rule prevents the non-debtor party from arranging a substitute transaction on the petition date, because the non-debtor party is still obligated as a party to the contract until the debtor repudiates the contract. ***Rejection of Executory Contracts and the Nondebtor***

Party's Resulting Breach Claim: Exploring the Limits of the Code's Fictional Prepetition Breach, 25 No. 12 Bankruptcy Law Letter 1, 5 (December 2005).

IV. COUNTER MEASURES IN THE CODE

A. Relevant statute(s):

11 U.S.C. 365(d)(2)

1. Text: "In a case under chapter 9, 11, 12, or 13 of the title, the trustee may assume or reject an executory contract or an unexpired lease of residential real property or of personal property of the debtor at any time before confirmation of a plan, but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specific period of time whether to assume or reject such contract or lease."

B. ***In re Enron Corp.***, 330 B.R. 387, 393 (Bankr. S.D.N.Y. 2005):

"While the provisions of the Bankruptcy Code preclude the Claimant from terminating the Power Contract unilaterally, the Bankruptcy Code provides a mechanism for an entity to seek a determination concerning an executory contract. Although a debtor in a chapter 11 case is afforded an opportunity to make a determination concerning assumption or rejection of an executory contract until confirmation of a plan of reorganization, the non-debtor party may seek to reduce the time within which the debtor must make such election by filing a motion seeking to compel the debtor to make a determination concerning assumption or rejection of the contract within a specified period of time."

C. The *Enron* Court recognized the following test for the application of section 365(d)(2):

In fixing the time for a debtor to assume or reject a contract, the standard applied by the court is whether a debtor has been afforded a reasonable time within which to make its determination on assumption or rejection of the contract. The decision as to whether a reasonable time has been afforded is within the court's discretion as considered under the facts of the particular case. The factors considered by a court in reaching its conclusion include (1) the damage the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (2) the importance of the contract to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan; and (4) whether exclusivity has terminated.. In addition, a court must consider the complexity of the case, including the number of contracts to

be evaluated, and the need for a court to determine the validity of the contract.

Regarding factor (1), the difference in the damages calculation resulting from its being determined at the deemed rejection date, instead of the actual rejection, is the type of non-debtor damages that arguably would be considered as not compensated by the bankruptcy code in determining whether such factor, in conjunction with the other factors, may warrant setting a specific time within which the debtor would have to assume or reject a particular executory contract. While consideration of factor (1) may be outweighed by some or all of the other factors, especially at the early stages of a complex case; seeking to compel an election by a debtor as to its intent concerning assumption or rejection of a contract is the only remedy available to a non-debtor, counter-party to an executory contract that is not otherwise protected by another section of the Bankruptcy Code. Congress chose to otherwise protect certain parties, including forward contract merchants, in the “safe harbor” provisions but did not include a party such as the Claimant within the ambit of the protection afforded there. It is not the role of this Court to expand those provisions to include such non-covered parties.

In re Enron Corp., 330 B.R. 387,393 n. 10.

- D. At least one commentator has criticized the characterization of section 365(d)(1) as a counter-balance to 365(g). “Compelling early assumption/rejection is not the norm, and, thus, will seldom (if ever) provide nondebtor parties an effective remedy. . .The desire to give the debtor sufficient time to assess the potential value of its assets in formulating a plan. . .will always [discourage early assumption/rejection] and will likely swamp any concern for the nondebtor.” 25 No. 12 Bankruptcy Law Letter 1, 10.

V. ADDITIONAL SUPPORT FOR THE MAJORITY VIEW

- A. Textual: BAPCPA amendment carves out specific types of executory contracts from the general rule in section 365(g)that damages resulting from the breach of such contracts are calculated as of the day before the petition is filed.
1. Relevant statute:
11 U.S.C. § 562
 2. Text:
“If a trustee rejects a

swap agreement,

securities contract (section 741),
forward contract,
commodity contract (section 761),
repurchase agreement, or
master netting agreement

pursuant to section 365(a), or if a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of--

- (1) the date of such rejection; or
- (2) the date or dates of such liquidation, termination, or acceleration.

B. Policy

1. The majority view, although detrimental to the individual creditor, increases the estate and, therefore, benefits creditors as a whole by preventing the enrichment of one creditor based upon post-petition events. The individual creditor, to protect its rights, is entitled to bring a motion to assume or reject.

AMERICAN BANKRUPTCY INSTITUTE

MID-ATLANTIC BANKRUPTCY WORKSHOP

AUGUST 3-5, 2006

**Inconsistent or Reconcilable?: The Mixed Blessings of
Circuit Splits**

DIFFERENT STANDARDS FOR APPROVAL OF BREAK UP FEES

Bonnie Glantz Fatell, Chair
Business Restructuring and Bankruptcy Group
Blank Rome LLP

I. STANDARDS

- "Business Judgment Rule" - Two prime cases: (i) *In re 995 Fifth Avenue Associates, L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989) and (ii) *Official Committee of Subordinated Bondholders v. Integrated Resources, Inc.* (In re *Integrated Resources, Inc.*) 147 B.R. 650 (S.D.N.Y. 1992). The breakup fee is presumptively valid, as long as it can withstand the following three questions asked by the court in applying the business judgment rule to breakup fees: (a) is the relationship of the parties who negotiated the breakup fee tainted by self-dealing or manipulation; (b) does the fee hamper, rather than encourage, bidding; and (c) is the amount of the fee unreasonable relative to the proposed purchase price?

- "Best Interests of the Estate" test - Two prime cases, both found in the Sixth Circuit: (i) *In re Hupp Industries, Inc.*, 140 B.R. 191 (Bankr. N.D. Ohio 1992) and (ii) *In re S.N.A. Nut Company*, 186 B.R. 98 (Bankr. N.D. Ill. 1995). These courts have reasoned that because § 363 sales are outside of the ordinary course of business, they should not be afforded the business judgment rule. This test generally considers seven factors: (a) whether the fee requested correlates with a maximization of value to the debtor's estate; (b) whether the underlying negotiated agreement is an arms-length transaction

between the debtor's estate and the negotiating acquirer; (c) whether the principal secured creditors and the official creditors committee are supportive of the concession; (d) whether the subject breakup fee constitutes a fair and reasonable percentage of the proposed purchase price; (e) whether the dollar amount of the breakup fee is so substantial that it provides a chilling effect on other potential bidders; (f) the existence of available safeguards beneficial to the debtor's estate; and (g) whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the breakup fee.

- "§ 503(b) Administrative Expense" test - The seminal case is *Calpine Corp. v. O'Brien Environmental Energy, Inc.* (In re O'Brien Environmental Energy, Inc.), 181 F.3d 527 (3d Cir. 1999). The O'Brien case is the only Court of Appeals decision which I came across which discusses breakup fees in the context of a § 363 sale. However, it is also unique in that it is a request for the breakup fee following approval of the sale rather than in a bid procedures motion and the debtor opposed the breakup fee which Calpine was requesting. Despite the fact that the procedural background was a significant factor in the court's decision, many cases have followed O'Brien and looked to § 503(b) administrative expense jurisprudence in evaluating breakup fees.

While the Bankruptcy Court looked to nine factors in its analysis (specifically: (a) whether the relationship of the parties who negotiated the break-up fee was tainted by self-dealing or manipulation; (b) whether the fee hampers, rather than encourages, bidding; (c) if the amount of the fee was unreasonable relative to the proposed purchase price; (d) if the unsuccessful bidder placed the estate property in a sales configuration mode to attract other bidders to the auction; (e) whether the request for a break-up fee served to attract or retain a potentially successful bid, establish a bid standard or minimum for other bidders, or attract additional bidders; (f) if the fee requested correlated with a maximization of value to the Debtor's estate; (g) whether the principal secured creditors and the official creditors committee are supportive of the concession; (h) the existence of available safeguards beneficial to the debtor's estate; and (i) whether there was a substantial adverse impact on unsecured creditors, where such creditors are in opposition to the break-up fee?), the Third Circuit focused

its consideration on the preservation of value of the estate; specifically, whether the record evidence supports the Bankruptcy Court's implicit conclusion that awarding the breakup fees was not necessary to preserve the value of O'Brien's estate.

II. SURVEY OF CASES

- *In re 995 Fifth Avenue Associates, L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989) (approving breakup fee of \$500,000 for \$76 million purchase price (.66%))
- *Official Committee of Subordinated Bondholders v. Integrated Resources, Inc.* (In re Integrated Resources, Inc.) 147 B.R. 650 (S.D.N.Y. 1992) (approving breakup fee of approximately 1% of a \$565 million purchase price)
- *Calpine Corp. v. O'Brien Environmental Energy, Inc.* (In re O'Brien Environmental Energy, Inc.), 181 F.3d 527 (3d Cir. 1999) (denying a \$2 million breakup fee requested by bidder after sale was completed)
- *In re Fruit of the Loom, Inc.*, 274 B.R. 631 (D. Del. 2002) (approving breakup fee in a range of \$22.5 million to \$27.5 million for an offer of \$835 million purchase price)
- *In re T.V.S.I. Holdings, Inc. et al.*, Nos. 90 B 13581-13586, 90 B 13856-13864 (CB) (Bankr. S.D.N.Y. 1991) (approving breakup fee of \$3.5 million for a purchase price of \$30 million cash consideration and preferred stock of the acquiror's parent to satisfy approximately \$108 million in debentures and assumptions of obligations of the debtor)
- *In re Crowthers McCall Pattern, Inc.*, 114 B.R. 877 (Bankr. S.D.N.Y. 1990) (approving breakup fee of \$500,000 for a purchase price of \$45 million (1.1%))
- *In re APP Plus*, 223 B.R. 870 (Bankr. E.D.N.Y. 1998) (approving a 1.25% breakup fee of \$250,000 for a \$20 million purchase price while denying an additional topping fee of \$550,000)

- *In re CXM Inc.*, 307 B.R. 94 (Bankr. N.D. Ill. 2004) (approving a 2.59% breakup fee of \$200,000 for a \$7,726,056 purchase price using O'Brien as the relevant standard)
- *In re President Casinos, Inc.*, 314 B.R. 786 (Bankr. E.D. Mo., 2004) (denying a breakup fee of \$750,000 and approving a breakup fee of \$250,000 utilizing the O'Brien administrative expense standard)
- *In re Hupp Industries*, 140 B.R. 191 (Bankr. N.D. Ohio 1993) (approving a breakup fee of 3.16% of purchase price as reasonable, but denying the fee since it was required to be paid whether or not the proposed sale closed and therefore unduly burdened the estate)
- *In re Bidermann Industries U.S.A., Inc.* 203 B.R. 547 (Bankr. S.D.N.Y. 1989) (denying approval of a 4.4% - 6% breakup fee for a \$93 million purchase price)
- *In re S.N.A. Nut Company*, 186 B.R. 98 (Bankr. N.D. Ill. 1995) (denying a breakup fee where sale was never commenced and estate was liquidated)
- *In re Twenver, Inc.*, 149 B.R. 954 (Bankr. D. Colo. 1992) (denying approval of a 11.11% breakup fee for a \$450,000 purchase price)

CIRCUIT SPLITS CHOICE OF LAW DETERMINATIONS IN BANKRUPTCY COURT

Bankruptcy courts often address causes of action and claims arising under or governed by state law. Often presented is the question of which state's laws to apply. To be discussed here is the further question raised: how does a bankruptcy court make a choice of law determination?

In answering this question, the circuits have split. Some circuit courts have viewed choice of law determinations for a federal court having bankruptcy jurisdiction as a matter of substantive state law. In such instances, those courts have held that the federal court must employ the choice of law rule of the applicable forum state ("state rule"). Other courts have held that federal courts sitting in bankruptcy have the independent discretion to make choice of law determinations ("federal rule"). A third group of courts have sidestepped the issue by deciding either that the substantive choice of law outcome in each case would be the same under either the state or federal rule, or that the contractual choice of law provisions chosen by the parties must be honored.

A. State Rule

1. Sources

Courts following the "state rule" base their authority on the landmark U.S. Supreme Court opinions of Erie and Klaxon. Under Erie, federal courts sitting in diversity must apply the substantive law of the forum state. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938). Several years after Erie, the Supreme Court in Klaxon construed the choice of law determination as a matter of substantive law, thus requiring the application of the choice of law rule of the forum state in diversity cases. Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487, 61 S.Ct. 1020 (1941).

2. Rationale

In the most influential of the circuit court opinions following the "state" approach, In re Merritt Dredging Co., Inc., 839 F.2d 203 (4th Cir), cert. denied sub nom., Compliance Marine, Inc. v. Campbell, 487 U.S. 1236, 108 S.Ct. 2904, 101 L.Ed.2d 936 (1988), the Fourth Circuit followed the perceived mandate of Erie and Klaxon:

We believe ... that in the absence of a compelling federal interest which dictates otherwise, the Klaxon rule should prevail where a federal bankruptcy court seeks to determine the extent of a debtor's property interest.... A uniform rule under which federal bankruptcy courts apply their forum states' choice of law principles will enhance

predictability in an area where predictability is critical. Most important, such a rule would accord with the model established by Erie and Klaxon. Both those cases make clear that federal law may not be applied to questions which arise in federal court but whose determination is not a matter of federal law.... Such is the case with questions regarding the extent of a bankruptcy debtor's property interests.... It would be anomalous to have the same property interest governed by the laws of one state in federal diversity proceedings and by the laws of another state where a federal court is sitting in bankruptcy. Id. at 206 (internal citations omitted); see also In re Nantahala Village, Inc., 976 F.2d 876, 880-81 (4th Cir. 1992) (mechanical application of Klaxon without citation to Merritt Dredging).

3. Circuit and Lower Federal Court Opinions Applying State Rule

a. Second Circuit:

In re Gaston & Snow, 243 F.3d 599 (2d Cir.), cert. denied sub nom., Erkins v. Bianco, 543 U.S. 1042, 122 S.Ct. 618, 151 L.Ed.2d 540 (2001) (rejected the creation of a bankruptcy choice of law rule as an unnecessary creation of federal common law).

b. Third Circuit:

(1) Mechanical Application of Klaxon without Recognizing Circuit Split

Robeson Indus. Corp. v. Hartford Acc. & Indem. Co., 178 F.3d 160, 164-65 (3d Cir. 1999).

(2) “Not Precedential” Opinion following Merritt Dredging

In re PHP Healthcare Corp., 128 Fed. Appx. 839 (3d Cir. 2005) (per curiam) (adopted choice of law rule of “the state in which the Bankruptcy Court resides.”)

(3) Third Circuit Lower Federal Court Decisions Applying State Rule:

In re B.S. Livingston & Co., Inc., 186 B.R. 841, 863 (D.N.J. 1995) (parties agreed, under Klaxon, “that a federal court must look to the forum state's choice of law principles to determine the appropriate state law to be employed.”); In re Presque Isle Apartments, L.P., 118 B.R. 332, 334 & n.1 (Bankr. W.D. Pa. 1990); In re Groggel, 333 B.R. 261, 276 (Bankr. W.D. Pa. 2005). But see In re Route One West Windsor Ltd. P'ship, 225 B.R. 76,

86 (Bankr. D.N.J. 1998) (federal substantive law controlled post-petition interest issue, court honored contractual choice-of-law provision).

c. Fifth Circuit:

Askanase v. Fatjo, 130 F.3d 657, 670-71 (5th Cir. 1997) (mechanically applying Texas choice of law principles without mentioning circuit split, Klaxon or Woods-Tucker, see infra).

d. Seventh Circuit:

Matter of Iowa RR. Co., 840 F.2d 535, 542-43 (7th Cir.), cert. denied sub nom., Union Pacific R.R. Co. v. Moritz, 488 U.S. 899, 109 S.Ct. 244, 102 L.Ed.2d 233 (1988).

e. Eighth Circuit:

In re NWFEX, Inc., 881 F.2d 530, 535 (8th Cir. 1989), aff'd on reh'g by an equally divided court, 904 F.2d 469, 470 (8th Cir.) (en banc) (per curiam), cert. denied sub nom., Pyburn Enterprises, Inc. v. Bird, 498 U.S. 941, 111 S.Ct. 349, 112 L.Ed.2d 313 (1990) (citing Union Nat'l Bank v. Fed. Nat'l Mortg. Ass'n, 860 F.2d 847, 853 n. 13 (8th Cir.1988)) (when deciding the choice of applicable state law district courts are obligated to apply the choice of law principles of the state in which they sit).

f. Tenth Circuit:

Cascade Energy & Metals Corp. v. Banks, No. 95-4045, 1996 WL 124757 (10th Cir. Mar. 21, 1996) (mechanical application of Klaxon in unpublished non-precedential case).

g. District of Columbia Circuit:

Goldstein v. Madison Nat. Bank of Washington, D.C., 807 F.2d 1070, 1072 (D.C. Cir. 1986) (mechanical application of Klaxon).

h. Selected Lower Court Decisions from Other Circuits Applying State Rule:

(1) From First Circuit:

In re Forbes, 191 B.R. 510, 513-14 (Bankr. D.R.I. 1996), reversed on other grounds sub nom., Forbes v. Four Queen Enterprises, Inc., 210 B.R. 905 (D.R.I. 1997) (adopting Merritt Dredging approach); In re Medico Assocs., 23 B.R. 295, 301-02 (Bankr. D. Mass. 1980); In re Maplewood Poultry Co., 2 B.R. 550, 553 (Bankr. D. Me 1980).

(2) From Fifth Circuit:

In re Hill Petroleum Co., 95 B.R. 404, 407 (Bankr. W.D. La. 1988).

(3) From Sixth Circuit:

In re Southwest Equip. Rental, Inc., Nos. 88-33, 89-33, 90-62, 1992 WL 684872, *9 & n.48 (E.D. Tenn. Jul 09, 1992). (Albeit in a footnote, the court comprehensively reviewed the then-existing authorities, and followed Merritt Dredging, *id.* at *9 n.48, to employ Tennessee's choice of law rules in a bankruptcy case.) See also In re Dynamic Enters., Inc., 32 B.R. 509, 514 n.2 (Bankr. M.D. Tenn. 1983); In re Wallace's Bookstores, Inc., 317 B.R. 709, 712-13 & n.3 (Bankr. E.D.Ky. 2004).

(4) From Tenth Circuit:

In re Powell, 29 B.R. 346, 349 (Bankr. D. Colo. 1983); In re Integra Realty Resources, Inc., 198 B.R. 352, 361 (Bankr. D. Colo. 1996).

(5) From Eleventh Circuit:

In re Bagley, 6 B.R. 387, 389 (Bankr. N.D. Ga. 1980); In re Shepard, 29 B.R. 928, 931 (Bankr. M.D. Fla. 1983); In re High-Line Aviation, Inc., 149 B.R. 730, 733 (Bankr. N.D. Ga. 1992).

(6) From District of Columbia Circuit:

In re Int'l Loan Network, Inc., 160 B.R. 1, 17 (Bankr. D. Dist. Col. 1993) (citing Merritt Dredging, 839 F.2d at 205).

B. Federal Rule

1. Sources

Courts following the “independent” or “federal” rule base their authority on certain dicta from the less well-known case of Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 67 S.Ct. 237 (1946). Vanston was a bankruptcy case addressing the substantive issue of post-petition interest under the Bankruptcy Act of 1898, which the Court held was to be addressed under federal law. In passing, the court commented on choice of law principles for federal courts exercising their bankruptcy jurisdiction over state-based claims and causes of action.

Justice Black observed that, within the bankruptcy context, choice of law determinations “requires the exercise of an informed judgment in the balancing of all the interests of the states with the most significant contacts in order best to accommodate the equities among the parties to the policies of those states.” Id. at 162. He distinguished Erie, observing that its holding for federal courts exercising diversity jurisdiction would not necessarily apply where federal courts sit in bankruptcy, as the “bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles.” Id. at 163.

Courts following the “federal rule” articulated in Vanston require a federal bankruptcy court to exercise its “independent” judgment in balancing the equities to determine which state’s underlying substantive law should apply.

2. Rationale

To followers of the “federal rule,” the creation of a federal common law for choice of law determinations enhances the predictability of such decisions in the bankruptcy courts, and reduces “forum shopping” by the parties. Judge Wiseman of the Middle District of Tennessee set forth the policies behind this approach in In re SMEC, Inc., 160 B.R. 86, 90 (M.D. Tenn. 1993), reconsideration denied, 161 B.R. 953 (M.D. Tenn. 1993). After predicting that the U.S. Supreme Court would follow its dicta in Vanston if presented again with the issue of choice of law determinations by bankruptcy courts, Judge Wiseman observed that:

the logic of Vanston is compelling. In a diversity case, it is presumed that the forum state has the greatest interest in seeing its laws applied. In a federal bankruptcy case incorporating state law, this presumption is untenable. There is no necessary reason to believe that the forum state is the state with the greatest interest in a bankruptcy proceeding. In fact, in today's business world, the location of a debtor may bear little relation to the location of his or her property interests or to the corpus of his or her business dealings. A choice of law rule that looks to the state with the greatest interests in the proceeding acknowledges the complex nature of property and transactions and thereby protects state interests. Oftentimes the forum state will be the state with the greatest interests, but there is no need for such a presumption.

This rule also helps prevent forum shopping by debtors. Rather than allow debtors in the shadow of bankruptcy to restructure or relocate their business

dealings in such a way as to gain the benefit of a certain forum's laws, this rule imposes on debtors the laws under which they primarily acted. Likewise, creditors and other parties are not subjected to, or given the benefit of, an unjustified quirk of legal procedure that imposes on them laws under which they rarely or never transacted.

It is true that a bright line rule, such as the forum state rule, has its benefits, most notably its ease of application. But these benefits are bought at the cost of particularity. The special circumstances of a case that may argue against application of the forum state's laws are not given consideration. Preserving particularity, and protecting states' interests and fairness thereby, is ample justification for imposing on courts the possibly more difficult choice of law that may accompany the most significant contacts test. *Id.* at 90-91.

3. Circuit and Lower Federal Court Opinions Applying Federal Rule

a. Ninth Circuit:

In re Lindsay, 59 F.3d 942 (9th Cir. 1995), cert. denied sub nom., Lindsay v. Beneficial Reins. Co., 516 U.S. 1074, 116 S.Ct. 778, 133 L.Ed.2d 730 (1996). A bankruptcy judge in the Northern District of California, in following Lindsay, had described the Ninth Circuit as following the "minority rule" from Vanston. In re Gibson, 234 B.R. 776, 779 (Bankr. N.D. Cal. 1999). The Ninth Circuit has recently mechanically applied the rule from Lindsay in stating, without mentioning the circuit split, that "[i]n a bankruptcy case, the court must apply federal choice of law rules." In re Vortex Fishing Systems, Inc., 277 F.3d 1057, 1069 (9th Cir. 2002). Citing Vortex Fishing, Lindsay and Gibson, the Ninth Circuit's Bankruptcy Appellate Panel has also stated that "[i]n the Ninth Circuit, federal common law choice of law rules apply in bankruptcy cases." In re Miller, 292 B.R. 409, 413 (B.A.P. 9th Cir. 2003).

b. Lower Court Decisions from Other Circuits Applying Federal Rule:

(1) From the Second Circuit, pre-Gaston & Snow:

In re McCorhill Publ'g, Inc., 86 B.R. 783, 792-93 (Bankr. S.D.N.Y. 1988); In re Perret, 67 B.R. 757, 772 (Bankr. N.D.N.Y. 1986); In re Barney Schogel Inc., 12 B.R. 697, 699-700 (Bankr. S.D.N.Y. 1981). But see In re O.P.M. Leasing Servs., 28 B.R. 740, 747-48 (Bankr. S.D.N.Y. 1983) (following Erie and Klaxon).

(2) From the Sixth Circuit:

In re SMEC, see supra; In re Elder-Beerman Stores Corp., 221 B.R. 404 (Bankr. S.D. Ohio 1998).

(3) From the Tenth Circuit:

The Bankruptcy Court for the Northern District of Oklahoma opined that it was not bound to "automatically apply Oklahoma's choice of law rules" as this was "not a diversity case." In re Otasco, Inc., 111 B.R. 976, 980 (Bankr. N.D. Okla. 1990), rev'd on other grounds, 196 B.R. 554, (N.D. Okla. 1991). The choice of law issue was not critical, however, to the outcome because that court also saw "no particular reason why the parties' choice of law should not govern." Id. at 980-81.

(2) From the Eleventh Circuit:

Matter of Ovetsky, 100 B.R. 115, 117 (Bankr. N.D. Ga. 1989); In re L.M.S. Assocs., Inc., 18 B.R. 425, 428 (Bankr. M.D. Fla. 1982).

C. AVOID THE ISSUE AND/ OR HONOR CONTRACTUAL CHOICE

Courts have side-stepped the issue of whether to follow Klaxton or the Vanston dicta where either approach would result in the application of the same state substantive law, or where contractual choice of law provisions are honored. In many instances the applicable underlying substantive state law will be identical, or nearly so, because many states have adopted the Restatement (Second) of Conflict of Laws, various Model Acts, and the Uniform Commercial Code. As well, where the parties to the litigation have agreed to choice-of-law clauses in their contracts, such clauses will customarily be enforced by the courts.

An early and influential decision which avoided the choice between the "state rule" and the "federal rule" is Woods-Tucker Leasing Corp. of Georgia v. Hutcheson-Ingram Dev. Co., 642 F.2d 744 (5th Cir. 1981).

To the extent we are faced with this threshold question of whether a federal or a forum (Texas) choice of law rule applies, we see no need to resolve it. For reasons to be elaborated, we find that Texas, by its adoption of the [Uniform Commercial Code], has provided a choice of law rule specifically directed to contractual choice of law provisions by parties to transactions regulated by the UCC. Texas UCC § 1.105(a). If we were required to exercise independent federal judgment in choosing whether to apply Texas or Mississippi law to this UCC- regulated transaction

involving significant contacts with both Texas and Mississippi, we would likewise look to UCC § 1-105(1), adopted in identical versions in both Texas and Mississippi as part of a national effort to establish a nationally uniform law to govern the validity and effect of commercial transactions. Texas UCC § 1.102(b)(3); Mississippi UCC § 75-1-102(2)(c). As stated in In Re King-Porter Company, 446 F.2d 722, 732 (5th Cir. 1971), although in the context of a different issue arising in a bankruptcy proceeding: "The Uniform Commercial Code has been adopted in all but one state. It should generally be considered as the federal law of commerce including secured transactions." Id. at 748-49; see also In re Professional Investors Ins. Group, Inc., 232 B.R. 870, 885 (Bankr. N.D.Tex. 1999) (apparently applying a Vanston style analysis, but concluding that, because of pre-petition state litigation in Texas, "even if this court looks beyond Erie to the choice of law approach of Vanston, the court would apply Texas procedural law."); In re Consol. Capital Equities Corp., 143 B.R. 80 (Bankr. N.D. Tex. 1992).

On the issue of contractual conflict-of-law clauses, the Sixth Circuit recently reflected as follows:

[t]hough there is a circuit split over what choice-of-law provisions a federal court exercising bankruptcy jurisdiction should apply, both Michigan choice-of-law rules and general equitable choice-of-law policies support enforcing parties' agreed-upon choice-of-law clauses absent any strong public policy concerns to the contrary.

In re Dow Corning Corp., 419 F.3d 543, 548 (6th Cir. 2005).

Other courts around the country have expressed similar views.

1. First Circuit:

In re Morse Tool, Inc., 108 B.R. 384, 385 (Bankr. D. Mass. 1989) (avoids issue as both federal common law and Massachusetts law would use the Restatement); see also In re O'Day Corp., 126 B.R. 370 (Bankr. D. Mass. 1991); In re Engage, Inc., 330 B.R. 5, 9-10 (D. Mass. 2005) (addresses circuit split but avoids issue, as "[t]he choice of law question, whether as a matter of federal common law or Massachusetts, is resolved under the 'most significant relationship,' test set forth in the Restatement (Second) of Conflict of Laws § 188(1).").

2. Third Circuit:

In re Kaplan, 143 F.3d 807, 812 n.7 & 814-15 (3d Cir. 1998)

(respecting parties' contractual choice of law provision and also holding that federal preclusion principles applied to the effect of prior federal judgment); In re Global Indus. Techs., Inc., 333 B.R. 251, 256-57 (Bankr. W.D. Pa. 2005) (despite long discussion of circuit split, avoided issue because "[i]n the instant case there is no difference in the outcome whether the court applies federal common law or Pennsylvania conflict of laws principles because both cite to the Restatement (Second) Conflict of Laws."); In re Am. Metrocomm Corp., 274 B.R. 641, 659 n.3 (Bankr. D.Del. 2002) ("However, in the instant action it does not matter which choice-of-law rule the Court applies because both Delaware and the federal common law apply the Restatement's 'most significant relationship test' to decide choice of law issues."); In re Halpert & Co., Inc., 254 B.R. 104, 123-24 (Bankr. D.N.J. 1999) (no "actual conflict" between states' underlying substantive law).

3. Seventh Circuit:

Despite its earlier mechanical application of Klaxon in Iowa R.R. Co., see supra, the Seventh Circuit sidestepped the circuit split when it addressed the issue more fully. See Matter of Morris, 30 F.3d 1578, 1582 (7th Cir. 1994). ("This controversy need not be resolved here, however, since under either [the Klaxon or independent] approach Iowa's substantive law would be applied . . ."); In re Stoecker, 5 F.3d 1022 (7th Cir. 1993); see also In re Allied Prods. Corp., 288 B.R. 533, (Bankr. N.D. Ill. 2003), aff'd, No. 03-1361, 2004 WL 635212 (N.D. Ill. Mar. 31, 2004) (citing Morris, 30 F.3d at 1581-82) ("The Seventh Circuit has not determined whether the choice of law rules of the forum state are binding in bankruptcy cases, or whether a bankruptcy court may exercise independent judgment as to the appropriate source of substantive law.").

4. Tenth Circuit:

In re Kaiser Steel Corp., 87 B.R. 154, 157-58 (Bankr. D. Colo. 1988). The Kaiser Steel opinion was one of the first to recognize the "clear split of authority whether federal courts sitting pursuant to the special grant of bankruptcy jurisdiction are bound to mechanically apply the Klaxon choice of law rule." The opinion contained a thorough, if now dated, review of the conflicting authorities.

5. Eleventh Circuit:

Two more recent bankruptcy court decisions from the Eleventh Circuit take a nuanced approach, *i.e.*, generally applying Klaxon, but doing so in light of either the nature of the action brought in bankruptcy or any relevant contractual choice-of-law provisions. In re Simpson, 319 B.R. 256, 262-64 (Bankr. M.D. Fla. 2003); In re New Power Co., 313 B.R. 496, 513-14 (Bankr. N.D. Ga. 2004).

D. CONCLUDING REMARKS

A commentator has noted the irony in that, in attempting to bring uniformity to choice of law in the bankruptcy context, courts following the two main approaches have made choice of law rule determinations by bankruptcy courts unpredictable and non-uniform:

The application of federal choice-of-law rules has, in principle, the added virtue of bringing national uniformity to conflicts questions in the bankruptcy context. Of course, the goal of national uniformity can be achieved only when all federal courts apply federal choice-of-law rules. Many continue to apply state rules, however, making uniformity impossible. While courts applying the federal choice-of-law rules stress the virtue of uniformity that their approach would bring (if applied everywhere), courts applying the state choice-of-law rules cite the virtue of predictability that their approach would bring (if applied everywhere). Ironically, the very existence of a split of authority on this question makes the current treatment of choice-of-law in bankruptcy both unpredictable and nonuniform.

J. C. Rozendaal, *Choice of Law in Distinguishing Leases from Security Interests under the Uniform Commercial Code*, 75 TEX. L. REV. 375, 386-87 (footnotes omitted) (1996).

E. ADDITIONAL REFERENCES

Richard E. Coulson, *Choice of Law in United States Cross-Border Insolvencies*, 59 CONSUMER FIN. L.Q. REP. 67 (2005).

Paul R. Glassman, *Choice of State Law in Bankruptcy Cases, Part I*, 24-SEP AM. BANKR. INST. J. 32 (Sep. 2005).

Paul R. Glassman, *Choice of State Law in Bankruptcy Cases, Part II*, 24-OCT AM. BANKR. INST. J. 20 (Oct. 2005).

Conflict of Laws in Bankruptcy: Choosing Applicable State Law and the Appropriate (State or Federal?) Choice-of-Law Rule, BANKR. LAW LETTER (2001).

James T. Markus & Don J. Quigley, *Conflict of Laws—Which State Rules Govern?* 18-NOV AM. BANKR. INST. J. 18 (Nov. 1999).

J. C. Rozendaal, *Choice of Law in Distinguishing Leases from Security Interests under the Uniform Commercial Code*, 75 TEX. L. REV. 375 (1996).

INCONSISTENT OR RECONCILABLE?:
THE MIXED BLESSING OF CIRCUIT SPLITS

I. RELEVANT STATUTES

A. 11 U.S.C. §365(g)(1)

1. Text:

"Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease- (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, 13 of this title, immediately before the date of filing the petition. . ."

2. Legislative history:

The legal fiction which undergirds section 365(g)(1) was first articulated in ***Central Trust Co. of Ill. v. Chicago Auditorium Ass'n***, 240 U.S. 581 (1916), where the Supreme Court held that the filing of the petition in bankruptcy court is the equivalent of repudiation of the contract.

This fictional relation back was codified in 1938 in section 36c of the Chandler Act, which read, "the rejection of an executory contract or unexpired lease, as provided in this Act, shall constitute a breach of such contract or lease as of the date of the filing of the petition. . ."

In enacting section 63c, Congress recognized that the fiction was a necessary mechanical device to ensure that the breach claim shares in the debtor's estate, along with pre-petition creditors, and that the debtor is discharged from liability under the contract, as with pre-petition debts. S. Rep. No 75-1916 at 6 (1938).

B. 11 U.S.C. § 502(q)

1. Text:

"A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be

allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition."

II. CIRCUIT SPLIT:

A. Damages resulting from the rejection of a contract are calculated based upon market conditions as they existed on the date which the contract was actually rejected (minority view— First Circuit).

1. ***In re Good Hope Chemical Corporation***
747 F.2d 806 (1st Cir. 1984)

a. Relevant statute(s):
section 63c, 11 U.S.C. § 103(c) and section 64(a)(1), 11 U.S.C. § 104(a)(1)

b. Facts:
Texas corporation, Good Hope, contracts with West German corporation, K&L, for the manufacture and sale of two heat exchangers. Good Hope agrees to pay the contract price for the heat exchangers in German marks.

Prior to the first payment installment, but after K&L substantially completes the heat exchangers, Good Hope files Chapter 11 petition.

The First Circuit concludes that K&L's cause of action arose under American law, and, therefore, the exchange rate on the breach day prevails. *Id.* at 812.

The exchange rate prevailing on the date of confirmation (the date the contract was actually and finally rejected) results in a larger dollar amount than the exchange rate on the date the petition was filed. *Id.* at 808.

K&L asserts that "fictional breach" on petition date did not give rise to an obligation enforceable against Good Hope on that date. *Id.* at 812.

c. Ruling:

First Circuit cites *Hicks v. Guinness*, 269 U.S. 71(1927)¹, for its definition of "breach date"(upon breach "the event has come to pass upon which your liability becomes absolute as fixed by law."). *Id.* at 812. First Circuit further cites *Hicks* for the proposition that "the fixation of liability is important because the plaintiff's loss, its expectancy from the contract, 'happens when the contract is broken. . .and the plaintiff's claim is for the amount of loss valued in money at that time.'" *Id.* at 812.

First Circuit concludes that: (1) the "relation back" rule "would disrupt the *Hicks* Court's attempt to give the plaintiff his expectancy as of the date his loss became definite" *Id.* at 812; and (2) "[R]elation back rule is necessary in bankruptcy because without it a Chapter 11 debtor would be required to reject an executory immediately upon filing or have its obligation for damages upon rejection treated as a administrative expense entitled to priority under section 64(a)(1)." *Id.* at 812-813.

¹In *Hicks*, a German firm was indebted to an American firm under an account in the amount of 1,079.35 marks, subject to a set off of \$35.35. The debt was outstanding when the war between the United States and Germany began in 1917. The Alien Property Custodian had taken property of the German firm of a value greater than the debt and the American firm brought a suit in equity to recover on the account pursuant to the Trading With the Enemy Act of October 6, 1917. Two issues were raised before the Supreme Court: whether interest accrued during the war and on what date the value of the mark was to be estimated in dollars in order to fix the amount of the decree.

The Supreme Court concluded that the American firm was to recover the value of the account in the dollar value that the marks had on the date when the account was stated. "The loss for which the plaintiff is entitled to be indemnified is the loss of what the contractor would have had if the contract had been performed. . .It happens at the moment when the contract is broken, just as it does when a tort is committed, and the plaintiff's claim is for the amount of that loss valued in money at that time." *Hicks*, 269 U.S. at 80.

2. ***In re James R. Corbitt Co.***
48 B.R. 937 (Bankr. E.D. Va. 1985)

a. Relevant Statute(s):
11 U.S.C. §365(g), 11 U.S.C. §348(c) (deemed rejection 60 days after conversion)

b. Facts:
Three claims were filed based upon the failure of debtor, a residential builder, to construct and convey houses to purchasers.

Chapter 11 petition was filed on March 19, 1981. The case was converted to a Chapter 7 on January 19, 1983.

Construction costs damages were calculated based upon appraisals made on July 1, 1981 and September 21, 1981.

c. Ruling:
Although the Eastern District of Virginia applied the fictional relation back rule with respect to the damage computation for evidentiary reasons, the Court acknowledges that, "in proper circumstances," another date may be used. *Id.* at 942, note 7 (*citing with favor In re Good Hope, supra.*):

"For purposes of determining the status of these claims, the breach date of these contracts relates back and becomes effective March 18, 1981, pursuant to the provisions of Section 365(g)(1). The claims thus become pre-petition claims rather than administrative ones. In proper circumstances, however, another date may be used for purposes of computing the amount of damages. In a case in which fluctuating foreign currency exchange rates materially affected the amount that would be due, the First Circuit considered and rejected the "judgment date" rule applicable in certain non-bankruptcy currency exchange cases. However, the court then declined to follow the relation back provisions of section 365(g)(1) because the purpose of relation back would not have been served in the

particular circumstances. The court held the breach date to be the date the contract actually was rejected by the debtor and fixed the damages as of the actual rejection date. *In re Good Hope Chemical Corp.*, 747 F.2d 806 (1st Cir.1984). Using the date of rejection in the case sub judice, however, would interject more time between the dates of the appraisals, summer 1981, and the date of actual rejection, March 20, 1983, and thus would diminish, rather than enhance, the probative value of claimant's evidence."

B. Damages resulting from the rejection of a contract are calculated based upon market conditions as they existed on the day before the petition was filed (majority view— (Second, Third, Fourth, Fifth, Sixth, Eighth, Ninth)

1. ***In re American HomePatient, Inc.***
414 F.3d 614 (6th Cir.2005)

a. Relevant statute(s):
11 U.S.C. §§365(g)(1) and 502(g)

b. Facts:
AHP entered into a warrant agreement which allowed warrant holders to purchase shares of AHP common stock at an exercise price of \$.01 per share.

AHP filed a voluntary Chapter 11 petition prior to the holders' exercise of their rights.

Following confirmation, AHP rejected the warrant agreement.

Expert testimony set the price per warrant at \$.02692 on the day before the petition was filed, resulting in a damage amount of \$846,369.85. Warrant holder argued that the damage amount was \$6,987,774.10 based upon the stock price on the rejection date.

C. Ruling:
Sixth Circuit relies upon the rules of statutory construction, as well as the use of the terms "determined" and "allowed" and the

definition of those words (determine-"to fix the boundaries of"; allow-"to permit") to conclude that damages are fixed on the day before the petition is filed.

In response to the argument the contract rejection damages are to be determined by state law, the Sixth Circuit wrote that bankruptcy courts have the power to supercede state law where it conflicts with federal bankruptcy law, and that resort to state law is appropriate and/or necessary only when a gap exists in federal bankruptcy law. Because the Bankruptcy Code specifically fixes the date of breach in section 365(g)(1) and provides that a claim arising from rejection is "determined" as if the claim has arisen before the date of the filing in section 502(g), the Court concluded that no such gap exists.

III. CRITICISM OF THE MAJORITY VIEW

- A. Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating debtor's obligation, subject to any qualifying or contrary provision in the Bankruptcy Code. ***Butner v. United States***, 440 U.S. 48, 55 (1979). The "basic federal rule" in bankruptcy is that state law governs the substance of claims, Congress having "generally left the determination of property rights in the assets of a bankrupt's estate to state law." ***Raleigh v. Illinois Dept. Of Revenue***, 530 U.S. 15, 20 (2000).
- B. State law (more specifically U.C.C. §2-713(1)) sets the measure of damages for repudiation by the seller as "the difference between the market price at the time the buyer learned of the breach and the contract price. . ." In other words, the amount of damages should be determined by reference to the prevailing market price "at the time when the buyer learned of the breach."
- C. The AHP rule prevents the non-debtor party from arranging a substitute transaction on the petition date, because the non-debtor party is still obligated as a party to the contract until the debtor repudiates the contract. ***Rejection of Executory Contracts and the Nondebtor Party's Resulting Breach Claim: Exploring the***

IV. COUNTER MEASURES IN THE CODE

- A. Relevant statute(s):
11 U.S.C. 365(d)(2)

1. Text: "In a case under chapter 9, 11, 12, or 13 of the title, the trustee may assume or reject an executory contract or an unexpired lease of residential real property or of personal property of the debtor at any time before confirmation of a plan, but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specific period of time whether to assume or reject such contract or lease."

- B. *In re Enron Corp.*, 330 B.R. 387, 393 (Bankr. S.D.N.Y. 2005):

"While the provisions of the Bankruptcy Code preclude the Claimant from terminating the Power Contract unilaterally, the Bankruptcy Code provides a mechanism for an entity to seek a determination concerning an executory contract. Although a debtor in a chapter 11 case is afforded an opportunity to make a determination concerning assumption or rejection of an executory contract until confirmation of a plan of reorganization, the non-debtor party may seek to reduce the time within which the debtor must make such election by filing a motion seeking to compel the debtor to make a determination concerning assumption or rejection of the contract within a specified period of time."

- C. The *Enron* Court recognized the following test for the application of section 365(d)(2):

In fixing the time for a debtor to assume or reject a contract, the standard applied by the court is whether a debtor has been afforded a reasonable time within which to make its determination on assumption or rejection of the contract. The decision as to whether a reasonable time has been afforded is within the court's discretion as considered under the facts of the particular case. The factors considered by a court in reaching its conclusion include (1) the damage the

non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (2) the importance of the contract to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan; and (4) whether exclusivity has terminated.. In addition, a court must consider the complexity of the case, including the number of contracts to be evaluated, and the need for a court to determine the validity of the contract.

Regarding factor (1), the difference in the damages calculation resulting from its being determined at the deemed rejection date, instead of the actual rejection, is the type of non-debtor damages that arguably would be considered as not compensated by the bankruptcy code in determining whether such factor, in conjunction with the other factors, may warrant setting a specific time within which the debtor would have to assume or reject a particular executory contract. While consideration of factor (1) may be outweighed by some or all of the other factors, especially at the early stages of a complex case; seeking to compel an election by a debtor as to its intent concerning assumption or rejection of a contract is the only remedy available to a non-debtor, counter-party to an executory contract that is not otherwise protected by another section of the Bankruptcy Code. Congress chose to otherwise protect certain parties, including forward contract merchants, in the "safe harbor" provisions but did not include a party such as the Claimant within the ambit of the protection afforded there. It is not the role of this Court to expand those provisions to include such non-covered parties.

In re Enron Corp., 330 B.R. 387,393 n. 10.

- D. At least one commentator has criticized the characterization of section 365(d)(1) as a counter-balance to 365(g). "Compelling early assumption/rejection is not the norm, and, thus, will seldom (if ever) provide nondebtor parties an effective remedy. . .The desire to give the debtor sufficient time to assess the potential value of its assets in formulating a plan. . .will always [discourage early assumption/rejection] and will likely swamp any concern for the nondebtor." 25 No. 12 Bankruptcy Law Letter 1, 10.

V. ADDITIONAL SUPPORT FOR THE MAJORITY VIEW

A. Textual: BAPCPA amendment carves out specific types of executory contracts from the general rule in section 365(g) that damages resulting from the breach of such contracts are calculated as of the day before the petition is filed.

1. Relevant statute:
11 U.S.C. § 562

2. Text:
"If a trustee rejects a

swap agreement,
securities contract (section 741),
forward contract,
commodity contract (section 761),
repurchase agreement, or
master netting agreement

pursuant to section 365(a), or if a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of--

- (1) the date of such rejection; or
- (2) the date or dates of such liquidation, termination, or acceleration.

B. Policy

1. The majority view, although detrimental to the individual creditor, increases the estate and, therefore, benefits creditors as a whole by preventing the enrichment of one creditor based upon post-petition events. The individual creditor, to protect its rights, is entitled to bring a motion to assume or reject.

**AMERICAN BANKRUPTCY INSTITUTE
2ND ANNUAL MID-ATLANTIC BANKRUPTCY WORKSHOP
CAMBRIDGE, MARYLAND, AUGUST 4, 2006.**

**CIRCUIT SPLITS
MOOTNESS OF § 363 SALE APPEAL**

**HON. NANCY V. ALQUIST*
Judge, U.S. Bankruptcy Court for the
District of Maryland
Baltimore, Maryland**

* Judge Alquist thanks Cullen Grace, Law Clerk to Judge Wizmur, and Steven L. Goldberg, Law Clerk to Judge Alquist, for their assistance in the preparation of this outline.

CIRCUIT SPLITS MOOTNESS OF § 363 SALE APPEAL

I. INTRODUCTION

A. STATUTORY FRAMEWORK

1. Section 363(b)(1)² provides, in pertinent part, that the “trustee, after notice and a hearing, may ···· sell ···· other than in the ordinary course of business, property of the estate.
2. Section 363(m) provides:

The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.
3. The purpose of the limitation of appeal in Section 363 is to foster the “policy of not only affording finality to the judgment of the bankruptcy court, but particularly to give finality to those orders and judgments upon which third parties rely.” In re Abbotts Dairies of Pennsylvania, Inc., 788 F.2d 143, 147 (3d Cir.1986) (internal quotation marks and citation omitted).

B. THE QUESTIONS PRESENTED

1. The essential question is when an appeal from a bankruptcy court Section 363 sale Order must be dismissed as moot.
2. In other words, to what extent can there be a viable appeal from a Section 363 sale Order?
3. This may turn upon whether the appellate court can provide any effective relief that will not affect the validity of the sale or lease to a good faith purchaser.

All statutory references herein are to the United States Bankruptcy Code, 11 U.S.C. unless otherwise indicated.

C. THE CONFLICTING APPROACHES

1. The “per se” rule - essentially, the failure of an appellant to obtain a stay pending appeal in and of itself moots any appeal, or
2. A rule that would permit an appeal without a stay if the appellate court could grant relief that would not affect the validity of the transaction.

II. THE CIRCUIT POSITIONS

A. THE MID-ATLANTIC (THIRD AND FOURTH) CIRCUITS

1. THIRD CIRCUIT

- a. In Krebs Chrysler-Plymouth, Inc. v. Valley Motors, Inc., 141 F.3d 490 (3d Cir. 1998), the Third Circuit set forth a two-part test for determining whether the appeal of such an order was statutorily moot: “(1) the underlying sale or lease was not stayed pending the appeal, and (2) the court, if reversing or modifying the authorization to sell or lease, would be affecting the validity of such a sale or lease.” Id. at 499.
- b. The Third Circuit had earlier contrasted what would become the two-part Krebs test with the per se rule in Pittsburgh Food & Beverage, Inc. v. Ranallo, 112 F.3d 645, 648-49 (3d Cir. 1997) but, in Ranallo, found it unnecessary to reach the issue.
- c. The Third Circuit has since adhered to the Krebs standard. See e.g. In re Rickel Home Centers, Inc., 209 F.3d 291, 301-04 (3d Cir. 2000), cert. denied sub nom., L.R.S.C., Co. v. Rickel Home Centers, Inc., 531 U.S. 873, 121 S.Ct. 175, 148 L.Ed.2d 120 (2000) and Cinicola v. Scharffenberger, 248 F.3d 110, 128 (3d Cir. 2001) (case remanded to determine whether the “requested relief would affect the validity of the [Section 363] transaction”). Id. at 128.
- d. Note, however, the statement in dictum in Ranallo that “[w]e recognize that it might be claimed that a bankruptcy court usurped power so that even absent a stay, notwithstanding section 363(m), an order reversing an order approving a sale permissibly could affect the validity of the sale of assets. Such a case in theory could arise if the bankruptcy court approved the sale of assets not even colorably within its jurisdiction.” Ranallo, 112 F.3d at 650. See also Wal-Mart Real Estate Bus. Trust v. Bedford Square Assocs.,

LP, 259 B.R. 831 (E.D.Pa. 2001) (holding that the Bankruptcy Court had at least “colorable jurisdiction” to enter the disputed orders and that dismissal was required because the requested relief would invalidate the section 363 sale.) Id. at 838-39.

2. FOURTH CIRCUIT

- a. In 1985, the Fourth Circuit took a per se approach and held that the chapter 11 debtor’s challenge to a sale order was moot because debtor failed to secure a stay of the approved sale pending appeal and because the interest was sold to a good faith purchaser. Willemain v. Kivitz, 764 F.2d 1019, 1023 (4th Cir. 1985).
- b. In 1998, the Fourth Circuit took the per se approach in a case involving an unstayed order authorizing a transaction for both the sale of assets and the assignment of a lease. In re Adamson Co. Inc., 159 F.3d 896, 898 (4th Cir. 1998) (holding that lessors failure to obtain stay of bankruptcy court order authorizing sale of Chapter 11 debtor’s assets and assumption and assignment of debtor’s lease of manufacturing plant to good faith purchaser rendered moot lessor’s appeal of authorizing order.)
- c. Recently, the Fourth Circuit has again taken a per se approach. In re Rare Earth Minerals, No. 04-2526, 445 F.3d 359 , 364-65 (4th Cir. 2006). (Rejecting a narrow exception vis-a-vis state law interests that had been adopted by the Ninth Circuits.)

3. D.C. CIRCUIT

- a. In 1986 the District of Columbia Circuit adopted a per se rule in In re Magwood, 785 F.2d 1077, 1080 (D.C. Cir. 1986).
- b. In 2004, the District of Columbia Circuit Court has most recently applied the per se rule relying, at least in part³, on its decision in Magwood in an unpublished opinion. Allen v. Wells Fargo Bank, Minnesota, No. 03-7152, 2004 WL 2538492 (D.C. Cir. Nov 09,

³ The D.C. Circuit apparently conflated constitutional with statutory mootness, construing the “present, live controversy” requirement from Hall v. Beals with a per se reading of section 363. Allen, 2004 WL 2538492, at *1 (quoting Hall v. Beals, 396 U.S. 45, 48; 90 S.Ct. 200; 24 L.Ed.2d 214 (1969)).

2004).

B. OTHER CIRCUITS

1. FIRST CIRCUIT

- a. In 1990, the First Circuit adopted a per se rule in In re Stadium Management Corp., 895 F.2d 845, 847 (1st Cir. 1990) rehearing en banc denied, Mar. 12, 1990).
- b. In 2000, the District Court of Massachusetts stated, however, that “[t]he First Circuit has not ruled definitively whether it recognizes the [Ranallo/ Krebs] ‘measure of effective relief’ exception to section 363(m).” In re Whistler Corp. of Mass., 243 B.R. 573, 575 (D.Mass. 2000) (citing Ranallo, 112 F.3d at 651). The Whistler court noted, however, that “[r]ecent decisions of the First Circuit suggest that it does not.” Id.

2. SECOND CIRCUIT

- a. In 1991, the Second Circuit adopted a per se rule in United States v. Salerno, 932 F.2d 117 (2d Cir. 1991). The Second Circuit however, held that dismissal of the appeal did not foreclose the appealing party from raising in the bankruptcy court any appropriate objection to the distribution of the proceeds of the sale.
- b. In the case of In re Gucci, 105 F.3d 837 at 840 (2d Cir.), cert. denied sub nom., Paolo Gucci Design Studio, Ltd. v. Sinatra, 520 U.S. 119, 117 S.Ct. 155, 137 L.Ed.2d 701 (1997), the Second Circuit dismissed an appeal from a Section 363 sale Order but stated, in a footnote, that , “[i]t is not entirely clear why an appellate court, considering an appeal from an unstayed but unwarranted order of sale to a good faith purchaser, could not order some form of relief other than invalidation of the sale. In any event, whatever other relief might be available could presumably be pursued in the bankruptcy court by those entitled to such relief.” Id. at 840 n.1 (citation omitted).
- c. In any event, it appears that the pe se rule is well entrenched in the Second Circuit. See, e.g., In re Baker, 339 B.R. 298 (E.D.N.Y. 2005) stating that “[c]ourts have uniformly held that if a debtor fails to obtain a stay of a sale of properties, appeal of an order authorizing the sale is rendered moot and must be dismissed once the sale to good faith purchasers has taken place and has been

approved.” *Id.* at 303 (citations omitted).

3. FIFTH CIRCUIT

- a. In 1990, the Fifth Circuit adopted a per se rule in Matter of Gilchrist. 891 F.2d 559, 560-61 (5th Cir. 1990). (“Gilchrist’s failure to obtain a stay is fatal to his position, regardless of whether there was jurisdiction; he forfeited the opportunity to contest jurisdiction and cannot be heard to complain at this late date.”) *Id.* at 561 (citing In re Sax, 796 F.2d 994, 997-98 (7th Cir. 1986)).⁴
- b. In 2001, the Fifth Circuit restated its adoption of a per se rule in the case of In re Ginther Trusts, 238 F.3d 686, 689 nn.4-6 (5th Cir. 2001), cert. denied sub nom., Ginther v. Ginther Trusts, 534 U.S. 814, 122 S.Ct. 39, 151 L.Ed.2d 12 (2001). See also Slagter v. Stonecraft, No. 3:05-CV-560BN, 3:05-MC-26JCS, 2006 WL 1520529 (S.D. Miss. 2006).

4. SIXTH CIRCUIT

- a. As recently as 2005, the Sixth Circuit has stated that it “has not directly addressed the issue, but it has held that § 363(m) is not limited to conveyances by trustees and that under § 363(m) a stay pending appeal is required even where the purchaser is a party to the appeal.” Weingarten Nostat, Inc. v. Serv. Merch. Co., Inc., 396 F.3d 737, 741 n.3 (6th Cir. 2005).
- b. The Weingarten court may, however, have indicated that it would take a per se approach when it contrasted “constitutional mootness”, i.e., where a “court of appeals cannot fashion effective relief” due to intervening events, with section 363’s “broader” statutory mootness, under which “[e]ven if the appeal is not moot as a constitutional matter because a court could provide a remedy, the policy favoring finality in bankruptcy sales reflected by § 363(m) requires that certain appeals nonetheless be treated as moot absent a stay.” Weingarten, 396 F.3d at 742.

⁴ Technically, the appeal from the District Court to the Fifth Circuit was not itself mooted; the Fifth Circuit affirmed the District Court’s dismissal of the appeal from the bankruptcy court as moot. Gilchrist, 891 F.2d at 561. Moreover, the Fifth Circuit rejected the appeal based on the one exception commonly recognized by it and other circuit courts following the per se rule— i.e., that the purchaser was not a good faith purchaser—refusing, as with the intervening District Court, to consider it because the appellant had failed to raise it before the bankruptcy court. *Id.*

- c. Nevertheless, in the case of In re Made in Detroit, Inc., 414 F.3d 576, 581 (6th Cir. 2005) (citations omitted in which the Sixth Circuit took a straightforward per se approach stating: “In this case, because the Appellants were denied a stay pending appeal and the Property was sold pursuant to the Committee’s Plan, the only issue before us is whether TPL is a good-faith purchaser under § 363(m).) (emphasis added).

5. SEVENTH CIRCUIT

- a. In 1986, the Seventh Circuit adopted a per se rule in In re Sax, 796 F.2d 994, 997 (7th Cir. 1986) (holding that even if debtor’s yacht was not property of the estate so that the sale of the yacht was not proper, appeal from order approving sale of yacht was rendered moot by failure of maritime lien claimant to obtain stay of sale).
- b. In 1994, the Seventh Circuit decided In re CGI Indus., Inc., 27 F.3d 296, 299-300 (7th Cir. 1994) extended the reach of section 363(m) to a situation where the appellant did obtain a stay of a sales order pending appeal, but only after the trustee had consummated the approved sale.
 - (1) The Seventh Circuit stated that “although section 363(m) does not state explicitly that a stay must be obtained before the sale is consummated, we believe that requirement to be implicit in the very purpose of the rule.
 - (2) Once the sale has gone forward, the positions of the interested parties have changed, and even if it may yet be possible to undo the transaction, the court is faced with the unwelcome prospect of unscrambling an egg.” Id. (quotation and citations omitted).
- c. However, later in 1994 a different Seventh Circuit panel in Matter of Lloyd, 37 F.3d 271, 272-73 (7th Cir. 1994) considered a case in which the bankruptcy judge had issued an order re-zoning a portion of the debtor’s land as her homestead, protected by Wisconsin’s statutes, with the rest to be sold pursuant to section 363.
 - (1) The Seventh Circuit held that the debtor’s “inability to recover the land sold does not render the entire appeal moot because the Wisconsin homestead exemption applies to and follows the proceeds of the sale.” Id. at 273 (citation omitted) .

(2) The Lloyd court noted that by “authorizing a relatively simple change in the zoning, the bankruptcy court could grant [debtor] an adequate homestead and at the same time give due consideration to the interests of the creditors by exempting only enough property to meet [her] entitlement.” Id. at 275.

d. In April of 2006, however, the Seventh Circuit restated its adherence to the per se rule: “In the absence of a stay pending appeal, the good-faith sale of a debtor’s assets is final.” Hower v. Molding Sys. Eng’g Corp., 445 F.3d 935 (7th Cir. 2006). (Since there was a finding of good faith, the sale was “final and this court is powerless to provide [the appellant] the remedy he seeks.” Id.

6. EIGHTH CIRCUIT

a. In 2000, the Eighth Circuit took a straightforward per se approach. See, e.g., In re Wintz Cos., 219 F.3d 807, 812 (8th Cir. 2000) (“Because appellants failed to obtain a stay pending appeal and because the property has been transferred to a bona fide third party purchaser, their attempt to overturn the sale of the Terminal Road property is barred by 11 U.S.C. § 363(m).”).

b. In 2003, however, the Eighth Circuit adopted the Third Circuit’s two-part analysis, stating, in the case of In re Trism, Inc., 328 F.3d 1003, 1006-07 (8th Cir. 2003):

“The language of section 363(m) moots any challenge to an order approving the sale of assets that satisfies two requirements. First, no party obtained a stay of the sale pending appeal. [Cinicola, 248 F.3d at 122; Adamson, 159 F.3d at 897.] Second, “reversing or modifying the authorization to sell would affect the validity of the sale or lease.” Cinicola, 248 F.3d at 122. Id.⁵

⁵ The Eighth Circuit provided a standard for assessing what is the second part of the Krebs test, i.e., whether an appeal challenges the validity of a section 363 sale:

“We conclude a challenge to a related provision of an order authorizing the sale of the debtor’s assets affects the validity of the sale when the related provision is integral to the sale of the estate’s assets. A provision is integral if the provision is so closely linked to the agreement governing the sale that modifying or reversing

7. NINTH CIRCUIT

- a. In 1988, the Ninth Circuit applied a per se rule with an exception for appeals where property is sold to a creditor who is a party to the appeal and the sale is subject to a statutory right of redemption.” In re Onouli-Kona Land Co., 846 F.2d 1170, 1173 (9th Cir.1988).
- b. In 1990 in the case of In re Ewell, 958 F.2d 276, 280 (9th Cir. 1992). the Ninth Circuit stated that it had recognized two exceptions to the section 363 statutory mootness rule: “(1) where real property is sold subject to a statutory right of redemption, and (2) where state law otherwise would permit the transaction to be set aside.
- c. In 1998, the Ninth Circuit rejected an appellant’s argument as to whether mootness should be assessed on the court’s ability to fashion relief, noting that “whether we can fashion effective relief is immaterial.” In re Filtercorp, Inc., 163 F.3d 570, 577 (9th Cir. 1998).

8. TENTH CIRCUIT

- a. In 1997 in the case of In re BCD Corp., 119 F.3d 852, 856 (10th Cir. 1997) the Tenth Circuit, held that an appeal was not moot under section 363 because:
 - (1) In Osborn v. Durant Bank & Trust Co., 24 F.3d 1199, 1203-04, 1210 (10th Cir. 1994), . . . we noted that § 363(m) had removed only the possibility of remedies that would affect the validity of a sale to a good faith purchaser. Id. at 1203-04.
 - (2) Osborn is thus an exception to the general rule of Tompkins⁶ and is available here because, as a practicable

the provision would adversely alter the parties' bargained-for exchange. “

Trism, 328 F.3d at 1007 (citing Cinicola, 248 F.3d at 125-26, and Stadium Mgmt., 895 F.2d at 849).

⁶ In Tompkins v. Frey, 706 F.2d 301, 304-05 (10th Cir. 1983), the court held that where a party appealing from an order authorizing the sale of a debtor’s property fails to obtain a stay of the order and the property is subsequently sold to a “good faith purchaser,” the property is

matter, equitable relief might be granted. See, e.g. Matter of Lloyd, 37 F.3d 271 (7th Cir. 1994) (holding that an appeal would not be dismissed as moot where there was a possibility of recovery, to which the appellant might be entitled, from proceeds of a sale of property in a bankruptcy estate.)

- b. In a recent non-precedential opinion, the Tenth Circuit stated that “in this Circuit equitable relief is available, in the absence of a stay, when the proceeds of the sale have not been commingled with the rest of the bankruptcy estate's funds.” In re Simon Transp. Servs. Inc., 138 Fed. Appx. 52, 56 (10th Cir. 2005).

9. ELEVENTH CIRCUIT

- a. In 1987, the Eleventh Circuit adopted a per se rule in the case of In re The Charter Co., 829 F.2d 1054, 1056 (11th Cir.1987), cert. denied sub nom Cargill, Inc. v. Charter Int’l Oil Co., 485 U.S. 1014, 108 S.Ct. 1488, 99 L.Ed.2d 715 (1988).

removed from the jurisdiction of the courts and the appeal is mooted.