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BANKRUPTCY: Can Superstars Really Sing the Blues? An Argument for the Adoption of an Undue Hardship Standard When Considering Rejection of Executory Personal Services Contracts in Bankruptcy

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CAN SUPERSTARS REALLY SING THE BLUES? AN ARGUMENT FOR THE ADOPTION OF AN UNDUE HARDSHIP STANDARD WHEN CONSIDERING REJECTION OF EXECUTORY PERSONAL SERVICES CONTRACTS IN BANKRUPTCY

INTRODUCTION

Four young musicians, hoping to become R&B/Hip Hop stars, formed a musical group called BeYon DaMeens ("BYDM").[1] Looking for their first break, BYDM arranged to perform for small audiences at a local bar every week. One night, a talent scout from a small independent record company went to the bar and heard BYDM playing. The scout saw potential in the young group and returned to hear them several more times. Thinking these artists might appeal to a large audience, the scout offered BYDM a long-term recording contract. Under the contract, BYDM was required to record one album for the record company in exchange for advances and royalty payments,[2] with the record company having the option to extend the contract for six additional albums.[3] The band members, anxious to start their recording careers, signed the contract, received their initial advance, and began working on their first album.

During the next eighteen months, the record company spent a great deal of time and money to develop the skill, look and sound of BYDM in order to convert BYDM from a local bar band to one capable of achieving national prominence. In antic-

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[1] The facts presented in this introduction are fictional. No actual person or group is intended to be depicted.

[2] Typically a recording agreement provides that, in exchange for recorded albums, the record company will pay to the artist advances against royalties to be earned from the artist's albums. DONALD S. PASSMAN, ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS 100-02 (1994).

[3] Typically a record company will commit to only one or two albums when the contract is signed, but will reserve the right (the option) to require additional albums. New artists are typically required to record up to nine albums. More established artists, however, may usually contract for only up to six albums. *Id.* at 117-18.

ipation of the release of BYDM's debut album, the record company vigorously promoted and marketed the group. The record company secured spots on music television shows where BYDM would both perform and be interviewed, arranged for BYDM to appear with the well-known and established artists on its roster, and distributed promotional copies of the upcoming album to radio stations nationwide for immediate air time.

Upon the release of BYDM's debut album, *LIVIN' THE HI LIFE*, the group received critical acclaim. Within a few weeks, the album reached the number one spot on the charts in *Record 'Em*, a worldwide music trade magazine. Hoping to prolong the album's success, the record company scheduled an international concert tour with interviews on both radio and television programs in major cities around the world. Excited by their new-found fame, the individual members of BYDM lived the lavish lifestyles of recording superstars. While on tour, BYDM insisted on staying in four star hotel suites and eating in world class restaurants—essentially living their dream lives. In addition, the individual members of BYDM began making purchases so they could each maintain the superstar lifestyle once the tour ended. To ensure BYDM's happiness and success, the record company voluntarily advanced substantial amounts of money, beyond that required under the recording contract. The record company then exercised its option for a second album and while the group was on tour, preparations for this album began.

BYDM's second album, *GOIN' F'BROKE*, was released eighteen months after the release of the debut album and was even more successful. This album opened at the number one spot on the charts in *Record 'Em* and remained there for twelve weeks. In addition, each single release from the album achieved top positions on the *Record 'Em-Singles* chart. Within weeks after this release, fans were screaming for another concert tour, and television shows and radio stations were requesting second and third interviews with the band. The members of BYDM were now considered superstars[4] throughout the world.

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[4] Generally an artist is deemed a "superstar" when an album achieves sales of over 750,000 units. *Id.* at 108.

Although BYDM's albums sold very well, the individual members did not make as much money as they had anticipated, and because they lived the superstar lifestyle, they quickly acquired substantial debt. After speaking with friends and other recording artists, the group learned that other recording stars had more favorable recording contracts. BYDM approached their record company to renegotiate their contract and requested a very large advance. Executives at the record company, aware of the fleeting nature of success and the substantial unrecouped balance attributable to past voluntary advances, offered only an advance sufficient to provide enough cash to cover the band's current debts. BYDM rejected this proposal and negotiations ceased.

Each of the individual members of BYDM then filed bankruptcy petitions seeking relief under chapter 11 of the Bankruptcy Code ("Code"). Ten days later, each member, claiming that the recording contract was burdensome and limited her business opportunities, filed a motion to reject the recording contract under section 365 of the Code.[5] After the bankruptcy, assuming their contract is rejected, BYDM intends to sell their songwriting and performance abilities to the highest bidder.

The above hypothetical illustrates a matter of growing concern in the entertainment industry. Successful recording artists bound by long-term contracts executed at the start of their careers recognize that if they were free to deal on the open market, they would almost certainly make more money. If a record company and artist cannot come to terms in a renegotiation, the artist may seek to reject her contract in bankruptcy with little or no redress for the record company. Although bankruptcy courts generally will not permit a bankruptcy case to continue where the debtor[6] files for relief solely to reject a valid contract in order to enter into a more profitable one,[7] a debtor can easily assert other grounds in support of her claim.

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[5] 11 U.S.C. § 365 (1996). Under section 365, certain contracts to which the debtor is a party as of the date of the filing of the bankruptcy petition may, subject to court approval, be assumed or rejected. *See infra* notes 32-99 and accompanying text for a discussion of section 365.

[6] A "debtor" is defined in the Code as a "person or municipality concerning which a [bankruptcy] case . . . has been commenced." 11 U.S.C. § 101(13) (1996).

[7] *See infra* notes 102-07 and accompanying text.

The current rules relating to rejection of executory[8] personal services contracts[9] in bankruptcy are inequitable and create an incentive for people such as the members of BYDM to use the bankruptcy courts to escape contractual obligations willingly assumed at the start of their careers. A person bound to an executory personal services contract may, with virtually no obstacles, obtain the "protection" of bankruptcy to reject the contract and avoid all contractual obligations. Further, even where a person seeks contract rejection for reasons other than to enter into a more profitable contract, gross inequities may result; either there may be insufficient relief available to the non-debtor party to the contract, or the debtor may not receive the protection that bankruptcy is supposed to offer.[10]

This Note argues for the adoption of an equitable standard to determine when rejection of executory personal services contracts under section 365 is appropriate. Part I of this Note briefly discusses the purpose of bankruptcy protection and explains certain statutory requirements of chapters 7 and 11 and section 365 of the Code. Part I also demonstrates that a recording contract can almost always be rejected at the sole option of the debtor which results in inadequate redress to the non-debtor party to the contract, a failure to adequately protect the debtor, or both. Part II analyzes the options currently available to the non-debtor party to prevent rejection and illustrates that rejection is generally inevitable even where such rejection will result in gross inequity. Part III offers a solution that equitably balances the interests of the debtor and non-debtor parties to executory personal services contracts through the adoption of an undue hardship standard to determine when contract rejection is appropriate.

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[8] Under section 365 of the Code, only executory contracts and unexpired leases may be assumed or rejected. 11 U.S.C. § 365(a) (1996). This Note does not address the treatment of unexpired leases in bankruptcy. *See infra* notes 38-58 and accompanying text for a discussion of the meaning of "executory."

[9] A recording contract is a type of personal services contract. *See, e.g.*, Delightful Music Ltd. v. Taylor (*In re* Taylor), 913 F.2d 102 (3d Cir. 1990); Ferrell v. Robinson Mann Creative Enters., Inc., 211 B.R. 183 (Bankr. E.D. Pa. 1997); *In re* Noonan, 17 B.R. 793 (Bankr. S.D.N.Y. 1982).

[10] *See infra* notes 11-19 and accompanying text.

I. Bankruptcy Protection and the Bankruptcy Code

A. *A General Overview*

The Code allows a person[11] with outstanding debt[12] to seek relief from creditors[13] in bankruptcy court.[14] The purpose of bankruptcy is twofold: it affords creditors an opportunity to recover a portion of their outstanding claims in a controlled and monitored setting, while allowing a debtor to seek refuge in court and obtain a "fresh start," free from financial difficulties.[15] That a debtor has any "rights" in bankruptcy is a relatively new concept.[16] Early bankruptcy law existed primarily for the benefit of creditors. Not only were creditors entitled to the debtor's assets, but the creditors were entitled to imprison the debtor until the balance of debts were paid.[17] As bankruptcy law developed, it became increasingly more sympathetic to the "honest" debtor who, because of poor management skills or simply bad luck, could not pay his bills.[18] Today, it is well established that bankruptcy, under appropriate circumstances, provides relief to both the creditors and the debtor.[19]

A bankruptcy case commences when a debtor files a petition in bankruptcy court under a specific chapter of the Code.[20] The filing of a bankruptcy petition creates a barrier

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[11] A "person" is defined in the Code as an individual, partnership or corporation. 11 U.S.C. § 101(41) (1996).

[12] "Debt" is defined in the Code as a "liability on a claim." 11 U.S.C. § 101(12) (1996).

[13] A "creditor" is defined in the Code as an "entity that has a claim [for a right to payment or a right to an equitable remedy] against the debtor." 11 U.S.C. § 101(10)(A) (1996).

[14] 11 U.S.C. § 109 (1996). Although section 109 does not specifically require that a debtor have debts prior to seeking relief in bankruptcy court, it has been established that a person in bankruptcy must have debts owing. *See, e.g.,* Connell v. Coastal Cable T.V., Inc. (*In re* Coastal Cable T.V., Inc.), 709 F.2d 762 (1st Cir. 1983) (debtor does not have to be insolvent but has to at least have debts).

[15] 1 David A. Epstein et al., Bankruptcy § 1-2, at 2-3 (1992).

[16] *Id.* § 1-1, at 1-2.

[17] *Id.* § 1-1, at 2 (citing Max Radin, *The Nature of Bankruptcy*, 89 U. Pa. L. Rev. 1, 3-4 (1940)).

[18] Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 785-89 (1987).

[19] *Id. See also* Epstein, *supra* note 15, § 1-2, at 2-3.

[20] 11 U.S.C. § 301 (1996). There are five kinds of bankruptcy cases under the Code: (1) chapter 7 involves liquidation of a debtor's assets; 11 U.S.C. § 109(b) (1996); (2) chapter 9 governs cases where the debtor is a government entity; 11 U.S.C. § 109(c) (1996); (3) chapter 11 focuses on reorganization rather than liqui-

between a debtor and her creditors.[21] In general, a creditor's collection efforts must take place during the bankruptcy so that all creditors can share in the debtor's assets in accordance with the nature of the debt owed.[22] In addition, the filing of a bankruptcy petition creates a bankruptcy estate. With certain exceptions, all property owned by the debtor at the time she files her petition becomes "property of the estate."[23] A disinterested person called a "trustee" is then appointed by the court to manage the property of the estate throughout the bankruptcy.[24]

Chapter 7 of the Code, entitled "Liquidation," focuses on the liquidation of the property of the estate and the distribution of the proceeds to the debtor's creditors.[25] In a chapter 7 case, the trustee is responsible for converting all nonexempt property of the estate to cash which is then distributed to the debtor's creditors.[26] Chapter 11 of the Code, entitled "Reorganization," focuses on the reorganization of the property of the estate.[27] Instead of being liquidated, the debtor's assets are restructured pursuant to a reorganization plan.[28] Because

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dation of the debtor's property; 11 U.S.C. § 109(d) (1996); (4) chapter 12 is limited to family farmer law; 11 U.S.C. § 109(f) (1996); and (5) chapter 13 governs individual repayment plans. 11 U.S.C. § 109(e) (1996). Subject to certain restrictions, bankruptcy petitions may be voluntary, involuntary or joint. A voluntary case is commenced by a debtor filing a petition under any operative chapter under which she wants to proceed. 11 U.S.C. § 301. An involuntary case may only be filed under chapters 7 and 11. 11 U.S.C. § 303 (1996). A joint case is voluntary and involves a debtor and a spouse, where the husband and wife are jointly responsible for debts. 11 U.S.C. § 302(a) (1996). This Note discusses only voluntary bankruptcy petitions filed under chapters 7 and 11.

[21] 11 U.S.C. § 362 (1996). Section 362, entitled Automatic stay, is designed to stop creditor harassment, affording a debtor relief from financial obligations and, in chapter 11, an opportunity to form a reorganization plan. *See infra* note 28 and accompanying text.

[22] *Id.* Secured creditors are generally paid first, and then the unsecured creditors are paid in accordance with the priority of their claims. 11 U.S.C. §§ 725, 506, 507 (1996).

[23] 11 U.S.C. § 541 (1996).

[24] 11 U.S.C. §§ 701, 702, 703, 1104 (1996). In a case under chapter 11, however, a trustee is rarely appointed. *See infra* notes 29-31 and accompanying text.

[25] *See generally* 11 U.S.C. §§ 701-766 (1996).

[26] 11 U.S.C. § 704.

[27] *See generally* 11 U.S.C. §§ 1101-1174 (1996).

[28] 11 U.S.C. § 1123. The debtor has 120 days from the initial date of the bankruptcy petition to file a reorganization plan which must be confirmed by the court. 11 U.S.C. §§ 1121(a), (b), 1129. If the debtor does not file a reorganization plan within such time, or if the court rejects the proposed reorganization plan, any

chapter 11 cases generally involve businesses that continue operating after the bankruptcy petition is filed,[29] the Code allows a chapter 11 debtor to remain in control of her assets as a "debtor in possession."[30] Generally, a trustee will not be appointed in a chapter 11 case unless the bankruptcy court finds that the debtor has or will fraudulently manage her assets.[31]

B. *Section 365: Rejection and Assumption of Executory Contracts*

Section 365 of the Code governs the treatment of executory contracts to which the debtor is a party as of the date of the commencement of the bankruptcy filing, regardless of whether the case is filed under chapter 7 or 11.[32] Under section 365, a trustee[33] may, subject to court approval and subject to certain exceptions,[34] reject or assume any executory contract to which the debtor is a party as of the date of the bankruptcy filing.[35] However, assumption of personal services contracts by a trustee without the debtor's consent is expressly prohibited in the Code.[36] Thus, under section 365, where a debtor seeks rejection of her personal services contract, rejection is the only option. As only executory contracts are subject to rejection in bankruptcy, as a threshold matter it must be determined

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interested party, including a creditor, may file a reorganization plan. 11 U.S.C. § 1121(b), (c).

[29] It is not a requirement, however, that a chapter 11 debtor have a business. 11 U.S.C. § 109(a), (d) (1996). *See also* Toibb v. Radloff, 501 U.S. 157 (1991).

[30] 11 U.S.C. §§ 1101(1), 1107. The Code mandates that a debtor in possession perform the same functions as a trustee. 11 U.S.C. § 1107.

[31] 11 U.S.C. § 1104(a)(1).

[32] 11 U.S.C. § 365(a) (1996). Rejection of executory collective bargaining agreements, however, is governed by 11 U.S.C. § 1113 (1996). *See infra* note 90 and accompanying text.

[33] All references in this Note to "trustee" shall refer to both a trustee and debtor in possession, as applicable.

[34] Where applicable law excuses a party from accepting performance, the contract may not be assumed. 11 U.S.C. § 365(e)(2)(A)(i) (1996).

[35] 11 U.S.C. § 365 (1996).

[36] The Code states that: "The trustee may not assume or assign an executory contract . . . of the debtor . . . if applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor . . . and such party does not consent to such assumption . . . ." 11 U.S.C. § 365(c)(1)(A), (B) (1996).

whether recording contracts such as the one described in the hypothetical above are executory.[37]

1. A Recording Contract is Generally Deemed Executory When Considering Whether Rejection is Available Under Section 365

Generally, an executory contract is a contract that is not fully performed.[38] The term "executory," however, is not defined in the Code, leaving the question of what amount of performance due is sufficient to render a contract executory open to judicial interpretation. One definition of executory was developed by Professor Countryman in 1973.[39] Only a contract "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material

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[37] Some courts have found that personal services contracts are excluded from property of the estate and therefore not subject to rejection or assumption under section 365 of the Code. *See, e.g., In re* Carrere, 64 B.R. 156, 158-59 (Bankr. C.D. Cal. 1986); *In re* Noonan, 17 B.R. 793, 797-98 (Bankr. S.D.N.Y. 1982); *In re* Bofill, 25 B.R. 550 (Bankr. S.D.N.Y. 1982). These courts argue that, under the Bankruptcy Act of 1898, personal services contracts were not property of the estate, and because there was no explicit change in the Code deeming personal services contracts property of the estate, these contracts remain excluded. *See* 4A COLLIER ON BANKRUPTCY ¶ 70.22(3) (14th ed. 1978). In addition, section 541(a)(6) of the Code specifically excludes from property of the estate "earnings from services performed by an individual debtor after the commencement of the case." 11 U.S.C. § 541(a)(6) (1996). Some courts also argue that because of section 541(a)(6), personal services contracts may not be assumed by the estate and therefore are not subject to rejection either. *See, e.g., Noonan*, 17 B.R. at 797-98; *Bofill*, 25 B.R. at 552.

Under the prevailing view, the issue of whether a personal services contract is property of the estate is not as relevant. *See, e.g.,* Delightful Music Ltd. v. Taylor (*In re* Taylor), 913 F.2d 102, 106-07 (3d Cir. 1990); All Blacks B.V. v. Gruntruck, 199 B.R. 970, 973-75 (Bankr. W.D. Wash. 1996). Pursuant to section 365(c), a trustee may assume (with the approval of the debtor) or reject any executory contract. 11 U.S.C. § 365(c)(1)(B). "It is the trustee's decision (whether to assume or reject) that determines whether the benefits of an executory contract will or will not become property of the estate." *Taylor*, 913 F.2d at 107. "It is simply a *non sequitur* to suggest that a trustee may not reject an executory contract because it is not property of the estate." *Id.*

[38] BLACK'S LAW DICTIONARY 570 (5th ed. 1990) ("A contract that has not as yet been fully completed or performed. A contract the obligation (performance) of which relates to the future.").

[39] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

breach excusing the performance of the other" is executory.[40] Although Countryman's definition of executory was introduced five years before the Code was enacted and was not expressly adopted by Congress, this definition has been adopted by several jurisdictions.[41]

Other courts have not expressly adopted the Countryman definition but instead rely on legislative history which indicates that "[t]hough there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due *to some extent* on both sides."[42] In *NLRB v. Bildisco & Bildisco*,[43] the Supreme Court implicitly rejected Countryman's definition of executory when it determined that a collective bargaining agreement was an executory contract and therefore subject to rejection under section 365 of the Code.[44] In *Bildisco*, both the debtor and non-debtor parties to the collective bargaining agreement agreed that the contract was executory; the Court nonetheless commented on the definition of executory, thereby implicitly suggesting that the general language of legislative history is the appropriate

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[40] *Id.*

[41] *See, e.g.*, Griffel v. Murphy (*In re* Wegner), 839 F.2d 533, 536 (9th Cir. 1989); Mitchell v. Streets (*In re* Streets & Beard Farm Partnership), 882 F.2d 233, 235 (7th Cir. 1989); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045-46 (4th Cir. 1985); Sloan v. Hicks (*In re* Becknell & Crace Coal Co.), 761 F.2d 319, 322 (6th Cir. 1985); Northwest Airlines, Inc. v. Klinger (*In re* Knutson), 563 F.2d 916, 917-18 (8th Cir. 1977); *In re* III Enters., Inc., 163 B.R. 453, 468 (Bankr. E.D. Pa. 1994); *In re* Bluman, 125 B.R. 359, 362 (Bankr. E.D.N.Y. 1991); *In re* Chateaugay Corp., 102 B.R. 335, 344-46 (Bankr. S.D.N.Y. 1989); Bregman v. Meehan (*In re* Meehan), 59 B.R. 380, 386 (Bankr. E.D.N.Y. 1986); Aetna Casualty & Surety Co. v. Gamel, 45 B.R. 345, 348 (Bankr. N.D.N.Y. 1984); *In re* Norquist, 43 B.R. 224, 228 (Bankr. E.D. Wash. 1984).

However, the Countryman definition has met with some criticism, even in those jurisdictions in which it has been expressly adopted. *See, e.g.*, *Norquist*, 43 B.R. at 228 ("[I]t is the respectful opinion of this court that the adoption of the Countryman definition by the Ninth Circuit should be reexamined . . . . Nevertheless, I feel compelled to examine this case on the premise that the Countryman definition is controlling upon this Court."). *See also* Chattanooga Memorial Park v. Still (*In re* Jolly), 574 F.2d 349, 351 (6th Cir. 1978).

[42] H.R. Rep. No. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 (emphasis added). *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984); *Sloan*, 761 F.2d at 322; *In re* Taylor, 91 B.R. 302, 310-11 (Bankr. D.N.J. 1988).

[43] 465 U.S. 513 (1984).

[44] *Id.* at 522 n.6.

guidepost with which to determine whether a contract is executory.[45] However, applying either Countryman's definition of executory or the suggestion of legislative history that a contract is executory if there remains future performance by both sides, a recording contract will likely be deemed executory and subject to section 365.

When a recording contract is signed, the record company will typically pay a sum of money (an advance) to the artist.[46] In addition, the record company will typically establish a fund (the recording fund) from which all costs incurred in connection with the making of the record are paid.[47] The advances and all amounts paid from the recording fund are recoverable (recoupable) by the record company from royalties generated by sales of the artist's albums.[48] Once an album is recorded, an artist is typically required to relinquish all ownership rights in the master recordings[49] on the album.[50] The record company is then entitled to sell the album, collect all proceeds from album sales, and pay the artist, subject to recoupment, her share of the proceeds.[51]

Recording contracts also contain underlying performance obligations. For example, once an album is recorded and sold, an artist is entitled to receive her share of royalties for the duration of copyright protection.[52] Thus, the record company has the continuing obligation to collect and, subject to recoupment, pay the artist. In addition, the record company will likely have the continuing obligation to maintain books and records relating to the artist's album sales, royalty collection and

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[45] *Id.*

[46] PASSMAN, *supra* note 2, at 100.

[47] PASSMAN, *supra* note 2, at 111-12.

[48] PASSMAN, *supra* note 2, at 100, 102.

[49] A "master recording" is the original recording that is made in a recording studio. All subsequent copies of the record are made from the master recording. PASSMAN, *supra* note 2, at 87-88.

[50] PASSMAN, *supra* note 2, at 89. Typically the rights in the master recordings will transfer to the record company immediately following creation. SIDNEY SHEMEL & WILLIAM M. KRASILOVSKY, THIS BUSINESS OF MUSIC 13 (7th ed. 1995).

[51] PASSMAN, *supra* note 2, at 89. Royalty calculations are based on the suggested retail list price for album sales in the United States. The actual royalty payable is generally nine to thirteen percent for new artists, fourteen to sixteen percent for mid-level artists, and sixteen to twenty percent for superstars. PASSMAN, *supra* note 2, at 109.

[52] SHEMEL, *supra* note 50, at 13-14.

royalty payments, as most recording contracts allow an artist to conduct an audit of the books and records relating to her account.[53]

Similarly, an artist is generally bound, for the duration of copyright protection in each master recording, by warranties, representations and indemnifications made in the recording contract.[54] The warranties and representations typically include promises not to perform or record for another record company, to give all master recordings recorded by the artist to the record company, and to refrain from rerecording songs without the record company's consent. In addition, the artist typically represents that she is not contractually or otherwise prohibited from performing her obligations under the contract, and that her written and recorded songs do not infringe on another's rights.[55] If a dispute arises as a result of a breach or alleged breach of one of these warranties and representations, the artist is often required to defend the record company and indemnify it for any losses.[56]

As a practical matter, the present performance obligations of a record company and artist are dependent on one another; the record company cannot sell an artist's albums if the artist does not record any, and an artist cannot record any albums if the record company does not pay the requisite monies from the recording fund. Failure to perform any of these obligations would likely constitute a material breach.

Further, even where there are arguably no present performance obligations remaining, there are generally continuing underlying performance obligations remaining that are also material to the contractual relationship. For example, where an artist files a bankruptcy petition after she has recorded the requisite number of songs or albums required during the first year of the contract, and the record company has paid the requisite amount of advances and recording costs for that year but has not yet exercised its option to extend the term of the contract for another year, there are no present performance obligations remaining.[57] However, the record company still

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[53] SHEMEL, *supra* note 50, at 21.
[54] SHEMEL, *supra* note 50, at 662-66.
[55] SHEMEL, *supra* note 50, at 662-66.
[56] SHEMEL, *supra* note 50, at 665.
[57] There are no present performance obligations remaining because the record

has the obligation to collect and pay royalties, and the artist still has obligations remaining due to the warranties, representations and indemnifications made in the contract. These obligations continue into the future, and failure to perform any of them would likely constitute a material breach. Thus, the performance remaining by both the record company and the artist at virtually any point during the relationship between the artist and record company will likely be sufficient to render a recording contract executory under any definition.[58]

2. The Effect of Rejection on Restrictive Covenants is Unclear and Results in Inequitable Treatment

Assuming a recording contract is deemed executory, it is subject to rejection under section 365 of the Code. Rejection of a contract in bankruptcy constitutes a breach of the contract as of the date immediately before the bankruptcy petition was filed, giving rise to remedies for breach of contract in the bankruptcy proceeding.[59] The effect of rejection on clauses relating to present performance obligations is clear—once a contract is rejected, it is deemed breached and neither party to the contract has any further present performance obligations.[60] Less clear, however, is the effect of rejection on the underlying performance obligations contained in the contract.

For the non-debtor party to a recording contract, these provisions, particularly the exclusivity[61] and noncompete[62]

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company is not yet obligated to pay more money to the artist and the artist is not yet obligated to record additional albums for the record company.

[58] Generally, courts that have addressed the issue of rejection of recording agreements have found the contracts executory, either implicitly or explicitly. *See, e.g.*, Ferrell v. Robinson Mann Creative Enters., Inc., 211 B.R. 183, 188 (Bankr. E.D. Pa. 1997); All Blacks B.V. v. Gruntruck, 199 B.R. 970 (Bankr. W.D. Wash. 1996); *In re* Taylor, 91 B.R. 302, 310-11 (Bankr. D.N.J. 1988); *In re* Noonan, 17 B.R. 793 (Bankr. S.D.N.Y. 1982). *Cf. In re* Monument Record Corp., 61 B.R. 866, 868 (Bankr. M.D. Tenn. 1986) (recording contract was not executory because the parties entered into a "Mutual Release for Termination of Recording Agreement," pursuant to which all future rights and performance obligations of the parties were terminated).

[59] 11 U.S.C. §§ 365(g), 101(5) (1996).

[60] 11 U.S.C. § 365(g).

[61] Artists are generally required to promise not to render their personal services as a recording artist to anyone else during the term of the contract. SHEMEL, *supra* note 50, at 664.

[62] Artists are generally required to promise not to rerecord their songs for

provisions, are an extremely valuable aspect of the contractual relationship. A record company will pay money to an artist in advance of a finalized album and accordingly, if the artist's album does not succeed, the record company will lose its investment. Record companies are generally willing (and able) to take this risk, in part because of the restrictive covenants contained in the recording agreement. The restrictive covenants allow a record company to finance a new artist in return for the artist's promise not to perform for anyone else. That way, if and when the artist becomes successful, the record company will be able to reap the benefits of its investment. If an artist were free to record and perform for any record company at any time, there would be little incentive for a record company to initially finance and promote the artist.

Two views regarding the effect of rejection on restrictive covenants have emerged. One view equates rejection with cancellation or avoidance, thereby deeming all contractual provisions, including the restrictive covenants contained in the contract, breached.[63] Under another view, only present performance obligations are deemed breached, while restrictive covenants survive rejection.[64] Courts that adhere to the first view of rejection hold that a contract may be rejected or assumed only in its entirety.[65] Thus, once a contract is rejected under section 365 of the Code, both parties to the contract are relieved of all remaining performance obligations, a debtor is free to enter into another contract despite any restrictive covenants

another company during the term of the contract and for a period of time after the term of the contract has expired. *Id.*

[63] *See, e.g.*, *All Blacks*, 199 B.R. at 973-75; Silk Plants, Etc. Franchise Sys., Inc. v. Register (*In re* Silk Plants), 100 B.R. 360, 362 (Bankr. M.D. Tenn. 1989); *Noonan*, 17 B.R. at 798-800; Burger King Corp. v. Rovine Corp. (*In re* Rovine), 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980); *In re* Klaber Bros., Inc., 173 F. Supp. 83, 85 (Bankr. S.D.N.Y. 1959).

[64] *See, e.g.*, Kopolow v. P.M. Holding Corp. (*In re* Modern Textile, Inc.), 900 F.2d 1184, 1191-92 (8th Cir. 1990); Ferrell v. Robinson Mann Creative Enters., Inc., 211 B.R. 183, 189 (Bankr. E.D. Pa. 1997); Fellerman and Cohen Realty Corp. v. Clinical Plus Inc. (*In re* Hirshhorn), 156 B.R. 379, 388 (Bankr. E.D.N.Y. 1993); Cohen v. Drexel Burnham Lambert Group Inc. (*In re* Drexel Burnham Lambert Group Inc.), 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992). *In re* Don & Lin Trucking Co., 110 B.R. 562, 566-68 (Bankr. N.D. Ala. 1990). Although the restrictive covenants will survive, there is no guaranty that the restrictive covenants will be enforceable. *See infra* notes 73-78 and accompanying text.

[65] *See Rovine*, 6 B.R. at 666; *Klaber Bros.*, 173 F. Supp. at 85.

contained in the contract, and the non-debtor is entitled to assert a claim for breach of contract against the bankruptcy estate.[66]

This approach to rejection does not provide adequate redress to the non-debtor party to a personal services contract. A debtor's bankruptcy estate may not have sufficient assets to fully satisfy all unsecured creditors' claims. To the extent that there are assets to be distributed, each unsecured creditor is paid on a pro rata basis with the other unsecured creditors in its class.[67] While this approach may provide some relief to a non-debtor record company with respect to easily quantifiable claims, such as the amount of unrecouped advances and recording costs, it will likely not provide adequate relief for breach of other contractual obligations such as those arising from restrictive covenants.

If a restrictive covenant is deemed breached in bankruptcy, an actual breach, such as an artist having recorded songs for another record company, has not yet occurred. Although the Code specifically gives bankruptcy courts the power to estimate the amount of such damages,[68] any estimate of damages from a bankruptcy induced breach of a restrictive covenant will likely be highly speculative and therefore incapable of serving as a basis for recovery.[69] Thus, this approach to rejection may allow an artist to entirely avoid contractual obligations arising from restrictive covenants with little or no redress to the non-debtor party to such contract.

The second approach to rejection attempts to equitably balance the needs of the debtor and non-debtor parties to personal services contracts. Under the second approach to rejection, once a contract is rejected, the debtor is relieved only of

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[66] The primary policy consideration governing this approach to rejection is that rejection is designed to relieve the estate of burdensome executory contracts while giving the debtor an opportunity to recover financially. *See Rovine*, 6 B.R. at 666; *Silk Plants*, 100 B.R. at 362.

[67] 11 U.S.C. § 507 (1996).

[68] 11 U.S.C. § 502(c) (1996).

[69] Bankruptcy courts look to state law to determine whether breach of a restrictive covenant gives rise to a right to payment in bankruptcy. *See, e.g.*, Grogan v. Garner, 498 U.S. 279, 283 (1991); *In re* Kilpatrick, 160 B.R. 560, 565 (Bankr. E.D. Mich. 1993); *In re* Udell, 149 B.R. 898, 903 (Bankr. N.D. Ind. 1992). In contract law, any estimate of damages that is too speculative may not be a reasonable measure of damages. RESTATEMENT (SECOND) OF CONTRACTS § 352 (1979).

the present performance obligations contained in the contract and not of the effects of not fulfilling those obligations.[70] Rejection of an executory contract in bankruptcy under this approach does not mean that the contract never existed. One court noted that "[t]he most obvious continuing effect of a rejected contract is that rejection ordinarily constitutes a breach of the contract, giving rise to a claim for any resulting damages."[71] In addition, to allow a contract to be assumed or rejected in its entirety would allow the debtor to " 'have its cake and eat it too,' by assuming desirable executory contract obligations while rejecting the burdensome ones."[72]

The second approach to rejection is likely to provide adequate redress to a non-debtor party as the artist will still be bound by the underlying performance obligations contained in the contract, notwithstanding its rejection. In some instances, however, this approach to rejection may impede a debtor's right to a "fresh start." In *Ferrell v. Robinson Mann Creative Enterprises, Inc.*,[73] Ricardo E. Brown, Jr. (professionally known as "Kurupt"), a chapter 11 debtor, sought to reject several executory contracts, including his recording contract with Death Row Records. In addition, Kurupt sought a declaration from the court that he was relieved of all obligations under his contracts.[74] When he filed his bankruptcy petition, Kurupt had assets of over 1.2 million dollars and liabilities of over 20.4 million dollars.[75] Because Kurupt was no longer performing under his contracts, he had no income to pay any of his outstanding debts.[76]

The Bankruptcy Court for the Eastern District of Pennsylvania permitted Kurupt to reject his contracts, but, using the second approach to rejection, held that rejection of the contracts "does not necessarily entitle . . . [Kurupt] to a further decree that [he is] free to enter into any other contracts; that

[70] *See In re* Don & Lin Trucking Co., 110 B.R. 562, 568 (Bankr. N.D. Ala. 1990).

[71] *Id.* at 567.

[72] *Id.* at 568.

[73] 211 B.R. 183 (Bankr. E.D. Pa. 1997).

[74] *Id.* at 185. The decision combined two bankruptcy cases with similar controversies. This Note discusses only the facts and holding of the Ricardo E. Brown, Jr. bankruptcy.

[75] *Id.* at 187.

[76] *Id.*

the non-debtor contracting parties have no rights against [him]; nor that the contracts cannot be specifically enforced against [him] under applicable state law."[77] Although the court recognized that Kurupt was seeking rejection in order to be able to bypass the restrictive covenants contained in the contracts and enter into new contracts, and in fact permitted rejection in part because Kurupt claimed he was unable to perform the contracts and consequently was unable to earn any money, the court refused to relieve him of his underlying performance obligations under the contract.[78] As discussed above, the all-or-nothing approach to rejection generally results either in a failure to provide adequate redress to the non-debtor party to the contract, or a failure to adequately protect a debtor seeking a fresh start in bankruptcy.

3. Recent Amendments to the Code Fail to Provide Sufficient Redress to Non-Debtor Record Companies

In 1988, Congress amended the Code to include additional protection for licensees of intellectual property.[79] Under section 365(n), a non-debtor licensee[80] of intellectual property now has two options when a debtor seeks contract rejection in bankruptcy: the non-debtor may choose to either treat the contract as terminated, or continue with the rejected contract.[81] The choices set forth in section 365(n) do not provide adequate protection for, or adequate redress to, a non-debtor record company. Although section 365(n) attempts to provide

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[77] *Id.* at 191. The court conceded that the non-debtor parties to the contracts may, in fact, not be able to specifically enforce the contracts. However, because Kurupt had not yet breached his covenant not to compete, the issue was not ripe for decision. *Id.* at 191-93.

[78] *Ferrell*, 211 B.R. at 188.

[79] Pub. L. No. 100-506, § 2, 102 Stat. 2538 (1988) (codified as amended at 11 U.S.C. §§ 101(54), 365(n) (1988)). Intellectual property is defined in the Code as "trade secret; invention, process, design, or plant protected under title 35; patent application; plant variety; work of authorship protected under title 17; or mask work protected under chapter 9 of title 17." 11 U.S.C. § 101(35A) (1996). Musical compositions and master recordings are considered works of authorship protected under title 17 and accordingly, fall within the definition of intellectual property in the Code.

[80] Section 365(n) is only applicable where the debtor is the licensor of rights and the non-debtor is the licensee of rights. 11 U.S.C. § 365(n)(1) (1996).

[81] 11 U.S.C. § 365(n) (1996).

additional protection by giving a non-debtor record company the option to retain its rights in songs recorded prior to the bankruptcy, it simultaneously takes away any right to enforce the restrictive covenants in connection with those pre-petition songs.

Legislative history[82] suggests that Congress enacted section 365(n) in response to the Fourth Circuit's decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[83] In July 1982, Richmond Metal Finishers ("RMF") granted to Lubrizol Enterprises ("Lubrizol") the nonexclusive right to use a patented metal coating process technology in exchange for the payment of royalties.[84] One year later, RMF filed a petition under chapter 11 of the Code and sought to reject its contract with Lubrizol.[85] The Fourth Circuit allowed RMF to reject the contract.[86] However, although the contract contained a provision allowing Lubrizol the continued use of the licensed technology in the event of a breach by RMF, the court concluded that as a result of the rejection, Lubrizol was not entitled to the continued use of RMF's technology.[87] Rather, Lubrizol was entitled to only monetary damages.[88] The court noted that its decision could have a "chilling effect" upon the technology industry, in that companies such as Lubrizol may be unwilling to contract with businesses that do not have a history of financial stability.[89] However, because the Code explicitly provided for the special treatment of collective bargaining agreements[90]

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[82] *See* Pub. L. No. 100-506, § 2, 102 Stat. 2538 (1988).

[83] 756 F.2d 1043 (4th Cir. 1985).

[84] *Id.* at 1045.

[85] *Id.* Using the Countryman definition, the court found the contract was executory—Lubrizol had the continuing obligation to pay royalties and maintain and deliver quarterly sales reports, and RMF had continuing warranty, indemnity and notice obligations. *Id.* at 1045-46.

[86] *Id.* at 1047.

[87] *Id.* at 1047-48.

[88] *Lubrizol*, 756 F.2d at 1048.

[89] *Id.*

[90] *See* 11 U.S.C. § 1113 (1996). Section 1113 states in pertinent part that:

> The court shall approve an application for rejection of a collective bargaining agreement only if the court finds that—(1) the trustee has, prior to the hearing, made a proposal that fulfills the requirements of subsection (b)(1); (2) the authorized representative of the employees has refused to accept such proposal without good cause; and (3) the balance of the equities clearly favors rejection of such agreement.

11 U.S.C. § 1113(c) (1996).

and leases of real property,[91] but was silent with respect to the treatment of intellectual property licenses, the court determined that licensees of intellectual property must "share the general hazards created by § 365."[92] Legislative history suggests that after the *Lubrizol* decision, Congress added section 365(n) to the Code to protect American technological development and to ensure that a debtor could not unilaterally take away the right of an intellectual property licensee to use the licensed property by rejecting the license in bankruptcy.[93]

Under section 365(n), once a contract has been rejected, the non-debtor party to the contract has the option to either treat the contract as terminated or to retain its rights under the contract.[94] If the licensee chooses to treat the contract as terminated, the licensor will be deemed to be in breach of the contract as of the date immediately before the case commenced.[95] However, section 365(n) does not address or resolve the uncertainty regarding the affect of rejection on restrictive covenants. Thus, if a non-debtor record company chooses to treat the contract as terminated, the record company may not be adequately protected for its loss.[96]

If the licensee elects to retain its rights under the rejected contract, all rights available to the licensee as of the date of the initial filing, including the right to enforce an exclusivity provision of the contract, will remain in effect for the duration of the license.[97] This option enables a non-debtor record company to retain its interest in songs recorded prior to the commencement of the case.[98] However, by choosing to retain its rights, the licensee waives any claims arising from the performance of the contract.[99] Thus, if after the record company has

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[91] *See* 11 U.S.C. § 365(h) (1996). "If the trustee rejects an unexpired lease of real property under which the debtor is the lessor . . . then the lessee . . . may treat such lease as terminated . . . or . . . the lessee may retain its rights under such lease . . . ." 11 U.S.C. § 365(h)(1)(A)(i), (ii) (1996).

[92] *Lubrizol*, 756 F.2d at 1048.

[93] Pub. L. No. 100-506, § 2, 102 Stat. 2538 (1988).

[94] 11 U.S.C. § 365(n) (1996).

[95] 11 U.S.C. § 365(n)(1)(A) (1996).

[96] *See supra* notes 63-69 and accompanying text.

[97] 11 U.S.C. § 365(n)(1)(B) (1996).

[98] This enables a record company to recoup the advances and other monies paid to the artist in connection with the pre-petition songs.

[99] 11 U.S.C. § 365(n)(2)(C)(ii) (1996).

elected to retain its rights under the contract the record company receives an infringement claim with respect to the artist's pre-petition songs, the artist is no longer required to indemnify the record company for its loss. Section 365(n) essentially forces a record company to choose between relinquishing its rights to the songs recorded before the bankruptcy petition and standing in line with all other unsecured creditors to recover minimal breach of contract damages, or retaining its rights in the pre-petition songs and losing any future claim it may have with respect to a breach of the licensor's warranties and representations made in the contract. These choices provide neither adequate protection nor adequate redress to a non-debtor record company.

II. Currently Available Mechanisms to Prevent Rejection are Inadequate

Once a recording contract is deemed executory and a debtor seeks its rejection pursuant to section 365, there is little the non-debtor party to the contract can do to prevent rejection. Currently there are two possible ways to prevent rejection: (1) the non-debtor party may prove that the debtor filed the bankruptcy petition or the motion to reject the executory contract in bad faith; or (2) the non-debtor party may prove that the debtor's decision to reject the contract was not made with sound business judgment. However, neither alternative provides adequate protection against rejection. The first alternative is extremely difficult for the non-debtor party to prove absent very strong evidence, such as an express admission that the debtor's sole purpose for filing the bankruptcy petition was to reject the contract and enter into a more profitable one. The second is, as a practical matter, very difficult to establish due to the minimal burden required for the debtor to satisfy the business judgment standard.

A. *It is Difficult for the Non-Debtor Party to Establish Bad Faith*

Certain sections of the Code require evidence of good faith[100] but there is no literal requirement that a bankruptcy petition be filed in good faith. Courts have historically imposed a good faith requirement on filing, however, in order to dismiss petitions and motions that were contrary to the purpose and spirit of the Code.[101]

Courts have found bad faith where a debtor files a bankruptcy petition with the sole purpose of rejecting an existing contract in order to enter into a more profitable one.[102] In *In re Carrere*,[103] a soap opera actress under contract with American Broadcasting Company ("ABC") for her performing services on the television show "General Hospital"[104] filed a chapter 11 petition and almost immediately sought to reject her contract with ABC so that she could avoid the restrictive covenants contained in the contract and enter into a more lucrative contract with "A Team."[105] The bankruptcy court ultimately denied Carrere's motion to reject the ABC contract because of Carrere's admission that she filed her petition with the sole purpose of rejecting her ABC contract.[106] The court recognized that "[i]t would be inequitable to allow a greedy debtor to seek the equitable protection of [bankruptcy] when her major

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[100] *See, e.g.,* 11 U.S.C. §§ 1129(a)(3), 1325(a)(3) (1996) (a plan under chapters 11 and 13 must be proposed in good faith).

[101] *See, e.g.,* Securities and Exchange Commission v. United States Realty & Improvement Co., 310 U.S. 434, 455 (1940); *In re* Chinichian v. Campolongo, 784 F.2d 1440 (9th Cir. 1986); *In re* Southern California Sound Sys., Inc., 69 B.R. 893 (Bankr. S.D. Cal. 1987); *In re* Carrere, 64 B.R. 156 (Bankr. C.D. Cal. 1986); *In re* Talladega Steaks, Inc., 50 B.R. 42 (Bankr. N.D. Ala. 1985). *See supra* notes 15-19 and accompanying text for a discussion of the purpose of bankruptcy protection.

[102] *See, e.g., Chinichian,* 784 F.2d at 1444-46; Shell Oil Co. v. Waldron (*In re* Edward Waldron), 785 F.2d 936, 939-41 (11th Cir. 1986); *Carrere,* 64 B.R. at 159-60.

[103] 64 B.R. 156 (Bankr. C.D. Cal. 1986).

[104] *Id.* at 157.

[105] *Id.* While under contract with ABC, Carrere made a guest appearance on the show "A Team" and was then offered a long-term contract to become a regular on the show for considerably more money than she would make under her contract with ABC. *Id.*

[106] *Id.* Carrere admitted that she only entered bankruptcy when her attorney advised that she would be able to reject her ABC contract in bankruptcy. *Id.*

motivation is to cut off the equitable remedies of her employer."[107] However, absent a direct admission by the debtor, a non-debtor will almost certainly be unable to establish that a debtor's sole motivation for filing is to be able to enter into a more profitable contract.

A filing that is solely motivated by the prospect of rejecting an executory contract, however, will not necessarily be found to constitute bad faith.[108] If, by continuing the performance of an executory contract, the debtor will substantially increase her debt or make her debt overly burdensome to the estate, contract rejection may be in the best interest of the estate[109] and accordingly, a court will likely not find bad faith, even if rejection of the contract is the debtor's sole motivation.[110]

Typically courts look to the totality of the circumstances surrounding the filing, including the debtor's finances and motivations for filing, to determine whether a petition was filed in good faith.[111] In *Little Creek Development Co. v. Commonwealth Mortgage Corp.*,[112] the Fifth Circuit enumerated certain factors that, when present, provide strong indicia of bad faith: (1) the debtor has one asset that is encumbered by secured creditors' liens; (2) the debtor's only employees are the principals; (3) there is little or no cash flow in the debtor's business; (4) there are no apparent sources of income to sustain a plan of reorganization; (5) there are only a few unse-

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[107] *Id.* at 160. The court first decided that the right to reject or assume an executory contract does not apply to personal services contracts because they are not property of the estate. *Id.* at 158-59. *See supra* note 37.

[108] *See, e.g.*, All Blacks B.V. v. Gruntruck, 199 B.R. 970 (Bankr. W.D. Wash. 1996); *In re* W. & L. Assocs., Inc., 71 B.R. 962 (Bankr. E.D. Pa. 1987); *In re* Bofill, 25 B.R. 550 (Bankr. S.D.N.Y. 1982).

[109] A court will only permit rejection if the decision to reject is based on sound business judgment. *See infra* notes 115-22 and accompanying text. If rejection will be a burden on the estate, presumably the decision to reject will not have been made with sound business judgment.

[110] For example, in *In re Continental Airlines Corp.*, Continental Airlines sought to reject its collective bargaining agreement after it filed a petition for relief under chapter 11. Despite Continental's clear expectation to be able to reject its contract, the bankruptcy court refused to find bad faith as Continental had other valid reasons for seeking bankruptcy protection, namely, to keep the airline flying. *In re* Continental Airlines Corp., 38 B.R. 67, 71-72 (Bankr. S.D. Tex. 1984).

[111] *See* Little Creek Dev. Co. v. Commonwealth Mortgage Corp., 779 F.2d 1068, 1072 (5th Cir. 1986); *In re* Gucci, 32 C.B.C.2d 191 (Bankr. S.D.N.Y. 1994).

[112] 779 F.2d 1068 (5th Cir. 1986).

cured creditors who hold only small claims against the debtor; and (6) the debtor's property has been posted for foreclosure and the debtor has been unsuccessful in lifting the foreclosure in state court.[113] This list of indicia may assist courts in recognizing bad faith filings, but the list is not exhaustive and, more importantly, cannot be used to definitively determine bad faith.[114] A debtor may satisfy many of the above criteria for a bad faith filing but may still legitimately need the protection of the bankruptcy courts.

B. *A Court Generally Will Find a Debtor's Decision to Reject an Executory Contract Satisfies the Business Judgment Standard*

If a debtor has not filed her petition or sought to reject her contract in bad faith, the court must then determine whether rejection is appropriate.[115] The Code offers no guidance,[116] but courts will generally find a decision to reject an executory contract appropriate where it is based on sound business judgment.[117]

The business judgment standard is easy for a debtor to meet.[118] To satisfy this standard, a debtor need show only that rejection of the contract will *likely* benefit the estate.[119]

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[113] *Id.* at 1072-73.

[114] *Id.* at 1072 ("Determining whether the debtor's filing for relief is in good faith depends largely upon the bankruptcy court's on-the-spot evaluation of the debtor's financial condition, motives, and the local financial realities."). *See also In re* Newark Airport/Hotel Ltd. Partnership, 156 B.R. 444, 448 (Bankr. D.N.J. 1993).

[115] This applies only to cases under chapters 9, 11, 12 and 13. In a case under chapter 7, if an executory contract is not assumed within sixty days, the contract is deemed rejected. 11 U.S.C. § 365(d)(1) (1996). This automatic rejection right is another problem inherent in the Code relating to personal services contracts, but is beyond the scope of this Note.

[116] The Code offers no guidelines with which a court must base its decision to allow rejection; rejection is merely "subject to the court's approval." 11. U.S.C. § 365(a) (1996).

[117] *See, e.g.*, Ferrell v. Robinson Mann Creative Enters., Inc., 211 B.R. 183 (Bankr. E.D. Pa. 1997); *In re* W. & L. Assocs., Inc., 71 B.R. 962 (Bankr. E.D. Pa. 1987).

[118] *See, e.g., Ferrell*, 211 B.R. at 188 (there is a "low threshold necessary" to show the decision to reject was made with sound business judgment); *In re* III Enters. Inc., 163 B.R. 453, 469 (Bankr. E.D. Pa. 1994) ("sound business judgment [is] a standard which we have concluded many times is not difficult to meet.").

[119] *W. & L. Assocs.*, 71 B.R. at 966. *See also* NLRB v. Bildisco & Bildisco, 465

In addition, courts generally will not interfere with a debtor's business decision unless "the decision [to reject] is so unreasonable that it could not be based on sound business judgment, but only on bad faith or whim."[120] As shown in *Ferrell*,[121] a recording artist may easily demonstrate that rejection will likely benefit the estate by simply refusing to perform under the contract.[122]

The difficulties in proving a debtor acted in bad faith coupled with the great deference given to debtors' decisions to reject contracts in bankruptcy severely restricts the ability of the non-debtor party to an executory recording agreement to prevent rejection. Moreover, the current rules relating to executory contracts in bankruptcy may provide inadequate redress to the non-debtor record company, inadequate protection to the debtor artist, or both. These inequitable results demonstrate there is a need for an equitable standard to govern the treatment of executory personal services contracts under section 365 of the Code.

U.S. 513; Robertson v. Pierce (*In re* Chi-Feng Huang), 23 B.R. 798, 800 (9th Cir. 1982); *Ferrell*, 211 B.R. at 188; Johnson v. Fairco Corp., 61 B.R. 317, 320 (Bankr. N.D. Ill. 1986).

[120] *Ferrell*, 211 B.R. at 188 (citing *In re* Hardie, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989)). In *In re W. & L. Assocs., Inc.*, the Bankruptcy Court for the Eastern District of Pennsylvania allowed the debtor in possession to reject an agreement of sale of realty even though the court admitted it had reservations about the debtor's motives. *W. & L. Assocs.*, 71 B.R. at 968. The court suggested that the only way it would refuse a debtor's request to reject a contract was if there was "some element of insider profit at the expense of the estate . . . or valid disinterested creditor opposition," but then stated "we do not consider it our function to second-guess the Debtor's counsel concerning the possible benefits to be attained by the Debtor in this case." *Id.* at 967. *See also Bildisco*, 465 U.S. at 523; Lubrizol Enters., Inc. v. Richmond Metal Finishers, 756 F.2d 1043, 1045; Control Data Corp. v. Zelman (*In re* Minges), 602 F.2d 38, 43-44 (2d Cir. 1979); Sundial Asphalt Co., Inc. v. V.P.C. Investors Corp. (*In re* Sundial Asphalt Inc.), 147 B.R. 72, 81-84 (Bankr. E.D.N.Y. 1992); *In re* Chipwich, Inc., 54 B.R. 427, 430-31 (Bankr. S.D.N.Y. 1985).

[121] 211 B.R. 183 (Bankr. E.D. Pa. 1997).

[122] *See supra* notes 73-78 and accompanying text.

III. AN EQUITABLE STANDARD TO DETERMINE WHEN REJECTION OF EXECUTORY PERSONAL SERVICES CONTRACTS IS APPROPRIATE

As the preceding analysis illustrates, absent highly probative evidence of bad faith, a debtor party to an executory personal services contract will nearly always be able to reject her contract in bankruptcy, thus avoiding her unperformed contractual obligations. Moreover, the non-debtor party to the contract will be left, as a practical matter, with no remedy. The ready availability of personal services contract rejection under current bankruptcy laws creates an incentive for successful recording artists to seek bankruptcy protection to avoid contractual obligations to which they willingly agreed at the start of their careers. In many instances, those seeking protection may live the lavish lifestyle of up and coming superstars. Further, the debtor's stardom may be due in large part to the effort and investment of the non-debtor party to the contract sought to be rejected. The incentives generated and the gross inequities which may result under the current Code can be corrected through the adoption of an undue hardship standard. This would ensure that the debtor is given an adequate fresh start free from burdensome debt and creditor harassment[123] while balancing the interests among the debtor and non-debtor parties to the executory personal services contract. An executory personal services contract should be rejected only where, after consideration of the equities among the debtor and non-

[123] Current bankruptcy laws do not afford a debtor an absolute fresh start in all situations. Certain types of debt, such as alimony, child support payments, and student loans, generally are not dischargeable in bankruptcy. 11 U.S.C. § 523(a)(5), (8) (1996). Alimony and child support payments are dischargeable only if incurred as a result of a divorce decree, a separation agreement or a court order, and student loans are not dischargeable unless the bankruptcy petition is filed at least seven years after the first payment on the loan was due. However, the Code provides an exception—where a student debtor can show that the debt would cause an undue hardship on her and her dependents, the student loans may be discharged. 11 U.S.C. § 523(a)(8)(B) (1996). These rules regarding non-dischargeable debts are not contrary to the purpose of the Code. In these situations, the debtor is still getting a fresh start—her assets will still be liquidated under chapter 7 or her business may still go through a reorganization under chapter 11, and she will be free of most debt and creditor harassment. The only difference is that the debtor is given a "mostly" fresh start instead of an "absolute" fresh start.

debtor parties to such contract, the continued performance by the debtor would create an undue hardship for the debtor.

In order to determine undue hardship, bankruptcy courts need to compare the debtor's post-petition financial well-being if the executory contract is rejected, to her financial well-being if the contract remains in effect. If the difference is inconsequential, rejection should not be permitted. Rejection in that instance would not promote a primary interest of the Code as the debtor's post-bankruptcy financial situation is the same with or without rejection. In addition, rejection would undermine the non-debtor party's reasonable expectation that the contract would be fulfilled and would take away virtually any chance of an adequate remedy for breach of contract. If, however, the court finds that there is a difference in the debtor's post-bankruptcy financial well-being, the court must examine the nature and extent of the difference in order to equitably balance the interests of the parties involved. Where the difference is great, rejection is more likely proper to provide enough of a fresh start to the debtor. Where the difference is small, the court should be less willing to allow rejection.

The court should first look to the nature and extent of the relationship between the debtor and non-debtor party to the contract, including the obligations of the parties under the contract and the investments made by each party prior to the bankruptcy filing. The more time, money and effort a non-debtor party has invested in the contract, the more inequitable it would be to end the contract prematurely. The court should also examine the circumstances surrounding the bankruptcy filing. For example, a near superstar recording artist may have been living a lavish lifestyle that was not affordable under her existing contract, and as a result of her thriftless spending, she acquired a substantial amount of debt. If her recording contract is in line with industry custom, the court should determine whether requiring her to reduce her spending is more equitable than allowing her to reject her contract, enter into a new contract, and allowing her to maintain her lifestyle—or at least have a standard of living higher than that which she could afford under the existing contract. In its evaluation the court should also consider the extent of good faith negotiations between the parties prior to the filing of the bankruptcy petition and the willingness of the parties to make post-petition concessions and modifications to the contract.

The list of considerations described above to determine whether contract rejection is appropriate is not exhaustive. The specific factors to be considered and the weight to be given to each needs to be determined on a case-by-case basis, taking into consideration the facts and equities of each situation. However, the Code should be amended to require that courts perform an undue hardship evaluation whenever rejection of an executory personal services contract under section 365 is requested.

Executory personal services contracts should be included in the Code's list of exceptions to discharge unless the continued performance would cause an undue hardship on the debtor. The current rules relating to rejection of executory contracts are inequitable, resulting in either a failure to adequately protect the debtor, a failure to provide adequate redress to the non-debtor party to the contract, or both. The adoption of an undue hardship standard to determine whether rejection is appropriate will give bankruptcy courts the freedom and the means to determine the most equitable balance between all parties involved.[124]

CONCLUSION

Under the current bankruptcy laws there is insufficient protection against rejection for the non-debtor party to an executory personal services contract. Absent a flagrant showing of bad faith, there is no alternative to rejection. Often, either the non-debtor party to a rejected executory personal services contract has no adequate remedy, or the debtor party to such contract does not receive a sufficiently fresh start. Moreover, the current bankruptcy laws create an incentive for performers to seek or threaten to seek bankruptcy protection to avoid unperformed contractual obligations without risking significant damages for breach of contract.

[124] Bankruptcy courts are well-suited to balance equities. Congress has indicated its belief in the competence of bankruptcy courts to balance equities when considering rejection of collective bargaining agreements. *See* 11 U.S.C. § 1113(C) (1996).

The introduction of an undue hardship standard in determining whether to permit rejection of personal services contracts serves the dual purpose of extending relief to the debtor when necessary, while preserving the reasonable expectations of both parties when they entered into the contract. An undue hardship standard will discourage bad faith filings and will prevent abuse of the bankruptcy courts. Furthermore, such a standard will maintain the equitable balance between parties to executory personal services contracts, and will preserve the underlying purpose of bankruptcy protection without unduly disrupting settled commercial expectations.

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