Privatization of Corrections: Is the State Out on a Limb When the Company Goes Bankrupt?

Cathy E. Holley

NOTES

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I. Introduction

The incarceration of convicted criminals is an important matter to law enforcement officials and the public at large. Institutional correctional services consume significant governmental energy and resources. In 1983[1] corrections, including jails, prisons, probation, and parole, cost

1. Nineteen eighty-three is the most recent year for which the total cost of corrections is available from the Bureau of Justice.

over 10.4 billion dollars.[2] In 1985 approximately 503,000 people were imprisoned in federal and state correctional facilities.[3] The provision of prison services must occur on a continuous basis, and space must be available for every convicted criminal. As certain commentators have noted, "[o]ne cannot simply let offenders wait in line for an opening."[4]

Historically, local, state, and federal government has overseen and operated our nation's prisons. In operating correctional facilities, public administrators currently face numerous concerns, including overcrowding, escalating costs, and increased demand for prison space.[5] The contracting of prison services to private companies offers government a possible solution to these problems. The concept of privatization, however, is one of the most controversial topics in the field of corrections today.[6]

Federal and state governments already have taken advantage of the cost effectiveness offered by private vendors in operating aftercare facilities or supplying specific institutional services.[7] In the past, private companies also have designed and built prison facilities for the government to manage. The new element to the current movement proposes that private companies both build the facilities and oversee their operation on a contractual, for-profit basis.[8]

The privatization of corrections is supported by numerous factors, the most important of which is the private vendor's ability to provide economically efficient services.[9] In addition, private companies, not

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2. U.S. DEP'T OF JUSTICE, BUREAU OF JUSTICE STATISTICS BULLETIN, JUSTICE EXPENDITURE AND EMPLOYMENT, 1983 (July 1986).

3. U.S. DEP'T OF JUSTICE, BUREAU OF JUSTICE STATISTICS BULLETIN, PRISONERS IN 1985 (June 1986). The figure for 1984 was approximately 464,000 people. *Id.* at 10. The increase from 1984 to 1985 represents the third largest increase in the absolute number of additional inmates since prisoner statistics were first collected in 1926. *Id.* at 1.

4. Travis, Letessa & Vito, *Private Enterprise and Institutional Corrections: A Call for Caution*, 49 FED. PROBATION, Dec. 1985, at 11.

5. "The dilemma faced by the public administrator is that jails and prisons have no control over the size of their populations, the demand for their services, or the standards of operation to which they will be held by tbe courts." *Id.*

6. "Few proposals in the field of corrections have stimulated as sbarply divided opinions as the prospect of contracting with the private sector for the management of prison and jail facilities." Mullen, *Corrections and the Private Sector*, NATIONAL INST. OF JUSTICE RESEARCH IN BRIEF 1 (U.S. Dep't of Justice Oct. 1984).

7. *Id.*

8. Travis, Latessa & Vito, *supra* note 4, at 12.

9. *Id.* at 13. Private vendors have greater market incentive for lowering operating costs and can utilize a cost-management approach as opposed to the government's budget-administration approach. Therefore, the same dollar amount will result in either more service or at least better service. *See generally* NATIONAL INST. OF JUSTICE, U.S. DEP'T OF JUSTICE, THE PRIVATIZATION OF CORRECTIONS (1985) [hereinafter PRIVATIZATION OF CORRECTIONS] (discussing both the advantages and disadvantages of involvement by the private sector in the prison industry and some standard contracting approaches used in currently operating private prison facilities).

bound by governmental "red tape," possess increased flexibility to respond immediately to needs presented.[10] Moreover, private companies can offer expertise in design, construction, and management by employing recognized experts in the field of penal corrections.

The major criticism of privatization is the presence of a hidden cost in management contracting—the cost of monitoring the private vendors to ensure that the prisoners are treated in accordance with established guidelines.[11] Because of the commodity involved, the government must ensure the precise execution of the contractual covenants, resulting in additional costs to the actual operation of prison facilities. Moreover, numerous unresolved legal and political issues present counterarguments to any benefits that privatization might offer. These issues include: (1) whether a private company's operation and maintenance of a prison facility constitutes "state action," which would expose the company to potential liability under 42 U.S.C. Section 1983 and (2) whether the government may, under the United States Constitution, delegate control of a prison facility to a private entity.[12] Thus, numerous unanswered questions must be considered if government and a private company are to contract successfully for private management of correctional institutions.

This Note addresses only one of the critical issues that government and a private vendor must consider when planning and contracting for the private company's services: the effect on the contract if the company subsequently files for bankruptcy. Important questions include whether the contract automatically becomes void upon the filing for bankruptcy, whether the filing for bankruptcy constitutes a breach of the contract on the part of the private company, and whether the company may assign its contractual obligations to another company for subsequent operation. One section of the Bankruptcy Code (Code), section 365, sets forth the rights and responsibilities of the parties to an executory contract and, thus, governs the contracting for prison services.

This Note explains how section 365 of the Code would operate in the event of the filing for bankruptcy under Chapter 7 by a private company that had contracted to perform correctional services. Part II sets forth a hypothetical situation, involving a state and a private company, in order to illustrate the possible consequences of and conflicts in applying section 365. Part III discusses section 365 and the relevant

10. Mullen, *supra* note 6, at 6.

11. The contract should provide for frequent on-site inspection programs and renewal procedures to ensure continued performance. *Id.*

12. *See* Rohhins, *Privatization of Corrections: Defining the Issues*, 69 JUDICATURE 325, 325-31 (1986).

bankruptcy case law interpreting the subsections of 365. Part IV applies section 365 to the contractual provisions and other facts discussed in the hypothetical situation. Part V recommends several appropriate contract provisions for avoiding potential problems that may arise out of bankruptcy. Finally, Part VI highlights several related issues that a state and private company should consider in negotiating and drafting a contract for prison services.

II. Hypothetical Situation[13]

In the State of Reserve, the Supreme Court of Reserve ordered the executive branch to cease its practice of overcrowding prison facilities and improve conditions within the jurisdiction's prison facilities. Reserve spent 8.5 million dollars annually in the operation and maintenance of correctional facilities. After careful evaluation, the Reserve legislature concluded that no additional funds could be budgeted for the operation of state prisons. The Reserve legislature appointed a committee to study the alternative of allowing a private vendor to operate the prisons. Professional organizations provided the committee with information concerning prison privatization.[14]

The Reserve legislature determined that privatization of the state's correctional facilities would mitigate many of the current problems. Consequently, Reserve's Correction Commission issued a Request For Proposal (RFP) to contract for design, construction, and management of Reserve's correctional facilities.[15] Several companies submitted documents in accordance with the Commission's request. The Commission conducted a quantitative and qualitative analysis of these companies, comparing not only the companies' budget proposals, but also their experience, service, and operational philosophies. Reserve ultimately chose Prison Management Incorporated (PMI) to operate the state's existing prison facilities and to construct additional facilities in the near future.

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13. The company and the situation described in this hypothetical situation are fictitious and are not intended to represent any existing company or situation. Any similarity to an existing company is unintentional.

14. For a symposium of scholarly work on the privatization of prison facilities, see *Privatization and Prisons*, 40 Vand. L. Rev. 813 (1987).

15. RFPs consist of a private company's proposals for operating the state's corrections facilities. Depending on the extent of the state's needs, this report may include proposals for prison design, construction, or management, or any combination of the three.

A typical RFP includes the company's incorporation history and other aspects of the company such as its place of incorporation, the corporate structure, the management's philosophy, the company's experience in the field, any present facilities the company may be operating, personnel backgrounds, corporate capital, budgeting plans, proposals for design, construction, and management, and perhaps contractual provisions critical to negotiating an agreement. The document may contain any other characteristics that the company thinks will distinguish it from the competition.

Subsequently, PMI and Reserve entered into a contract (the Contract), which required PMI to maintain and operate the state's facilities in accordance with the law and governmental standards. One of PMI's primary responsibilities was to conduct regular inspections and report to the contract monitor the dates of the inspections and any problems discovered. In addition, the Contract required PMI to maintain current records on all prisoners housed in the facilities and to make these records available to the official in charge of inmate goodtime awards and release dates. The Contract provided for a monitor whose responsibilities included checking for compliance with these covenants and other covenants in the contract.[16]

The Contract also provided for Reserve's duties, including making monthly payments based on the prisons' costs of operation. The contract monitor employed by the State would evaluate PMI's performance. The monitor's duties were to protect the prisoners' constitutional rights and to ensure that PMI complied with all applicable state and federal laws. In addition, Reserve maintained insurance on the existing facilities and increased coverage to account for renovations completed by PMI.

During the contract negotiations, the State stipulated several contract provisions as safeguards against unfortunate future events. The Contract contained an ipso facto clause[17] allowing either party to terminate the Contract with sixty days' notice to the other party. Termination could be for any reason, including the insolvency of PMI, the appointment of a trustee, or the filing of a bankruptcy petition. If termination occurred, the obligation to operate the prisons would revert back to the State. In addition, the Contract contained a clause providing that, in the event of PMI's subsequent insolvency, the Contract could not be assigned to a third party without the State's consent, which the State could withhold for any reason. If Reserve prevented an attempted assignment, all prison operations would revert back to the State.

PMI operated Reserve's correctional facilities for over two years. The transition from state to private control went smoothly. Recently, however, the Reserve Supreme Court ruled that all prison cells must be no less tban twelve feet in length and contain no fewer than four elec-

16. A contract between a government and private company will contain many more provisions than those described in this hypothetical situation. Contracting is the most difficult aspect of deciding to privatize corrections. Even the most experienced draftsmen may have difficulty planning for these complex services and anticipating unforeseen circumstances. *See generally* McEntee, *City Services: Can Free Enterprise Outperform the Public Sector?*, BUS. & SOC'Y REV., Fall 1985, at 43.

17. *See infra* notes 52-73 and accompanying text.

trical outlets to operate the television set and clock radio, which are also required for every cell. PMI failed in the contract negotiations to foresee the possibility of these changes. The Contract contains no provision for state assistance for the required alterations. PMI bore the entire financial burden and as a result depleted its capital reserve. After completing some of the renovations and purchasing most of the televisions, PMI filed for bankruptcy under Chapter 7 of the Bankruptcy Code. The federal bankruptcy court subsequently appointed a trustee (the Trustee) to gather PMI's remaining assets for the benefit of PMI's unsecured creditors.[18] These events present the issue of what effect PMI's filing for bankruptcy has on the contract between Reserve and PMI.

III. Operation of Section 365

Three goals are paramount to the design of the Code:[19] (1) provide the debtor with a fresh start; (2) maximize the value of the debtor's property; and (3) treat parties with an interest in the property fairly.[20] Section 365, designed to affect these three goals, determines the consequences of a debtor's contractual debts. A "debt" is a liability on a claim.[21] "Claim" is a broad term encompassing rights to payment and rights to equitable remedies.[22] Therefore, if the debtor is bound to a contract, then the contract represents a claim in bankruptcy belonging to the party to whom performance is due.[23]

Once a Chapter 7 petition is filed, the court appointed trustee must manage the bankruptcy estate.[24] The trustee's duties include the disposition of executory contracts, which also are considered a part of the bankruptcy estate.[25] In order to protect the debtor, the Code contains an automatic stay provision that stops, among other things, all collection efforts, harassment, and foreclosure actions.[26] The automatic stay

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18. This Note discusses only the Chapter 7 straight bankruptcy petition. The operation of § 365 of the Code, however, also applies to a Chapter 11 business reorganization. Section 365 also raises many additional, more complex issues apart from a Chapter 7 bankruptcy.

19. The Code governs all bankruptcy cases commenced on or after October 1, 1979.

20. Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 Am. Bankr. L.J. 223 (1981).

21. 11 U.S.C. § 101(11) (1982).

22. *Id.* § 101(4).

23. Because the Code determines when a contract constitutes a claim in bankruptcy, "if the debtor is party to a contract on which he is bound to perform the party to whom performance is due has a claim in bankruptcy if he has a right to payment or an interest in property under the contract." R. Jordan & W. Warren, Bankruptcy 819 (1985).

24. 11 U.S.C. § 704(1) (Supp. III 1985).

25. *Id.*

26. *Id.* § 362. Section 362(a) operates to stay:

(1) the commencement or continuation . . . of a judicial, administrative, or other . . . pro-

allows the debtor to attempt a repayment or reorganization plan or simply to be relieved of the financial pressures that led to bankruptcy.[27]

A. *General Rule in 365(a)*

Section 365 is an effort by the Code's drafters to balance the broad powers needed by the trustee for determining the treatment of executory contracts against the need to protect the rights and expectations of those who have contracted with the debtor.[28] Putting aside statutory exceptions, section 365(a) establishes the general rule applicable to executory contracts: the trustee has the right to assume or reject any executory contract or unexpired lease of the debtor, subject only to the court's approval.[29] This right is not absolute, and subsequent sections impose limitations on the trustee's exercise of this broad power.[30]

The trustee must evaluate each executory contract for its possible prospective benefits. Assumption of a contract raises the nondebtor party from a general unsecured creditor to a first priority administrative expense.[31] Consequently, the trustee must consider carefully whether the bankruptcy estate, if the contract is assumed, is in a financial position to accept liability under the contract as a first priority administrative expense.[32] Under a Chapter 7 bankruptcy, the trustee will assess the value of a contract as a saleable asset to a third party to determine whether to assume the contract. If the trustee rejects the contract, the nondebtor party is not without a remedy because rejection constitutes a breach, enabling the nondebtor to file a claim.[33] Filing a

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> ceeding against the debtor . . .; (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title; (3) any act to obtain possession of property . . .; (4) any act to create, perfect, or enforce any lien against property of tbe estate; (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim tbat arose before the commencement of the case under this title; (6) any act to collect, assess, or recover a claim against the debtor tbat arose before tbe commencement of the case under this title; (7) the set off of any debt owing to the debtor that arose before the commencement of the case under this title; and (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Id.

27. H.R. REP. No. 595, 95th Cong., 2d Sess. 340, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6296.

28. 2 COLLIER BANKRUPTCY MANUAL ¶ 365.01, at 365-1 (L. King 3d ed. 1979) [hereinafter COLLIER].

29. 11 U.S.C. § 365(a) (Supp. III 1985). "[T]be trustee, subject to the court's approval, may assume or reject any executory contract . . . of the debtor." *Id.* The scope of § 365 includes both executory contracts and unexpired leases.

30. *Id.*

31. R. AARON, BANKRUPTCY LAW FUNDAMENTALS § 9.04[1], at 9-34.1 (1984).

32. *See* 2 COLLIER, *supra* note 28, ¶ 365.01, at 365-2.

33. *See generally* 11 U.S.C. § 365(g) (1982) (differentiating between executory contracts based on the date of assumption and those based on the date of nonassumption).

claim, however, allows the nondebtor only to share pro rata with other creditors—sometimes "a very empty right."[34]

B. *Limitations on the General Rule*

Subsections (b), (c), and (d) of section 365 impose limitations on the trustee's exercise of the broad powers granted in 365(a). Subsection (b) concerns defaults by the debtor in an executory contract, either before or after the filing of a petition. If the debtor has defaulted on a contract, the trustee may not assume the executory contract unless, at the time of assumption, the trustee has (1) cured the default, or provided adequate assurance that it will be promptly cured; (2) compensated the nondebtor party for actual pecuniary loss due to the default, or provided adequate assurance that such compensation is forthcoming; and (3) provided adequate assurance of future performance under the contract.[35] A default based on an ipso facto or bankruptcy clause whose operation would terminate the contract automatically or permit a party to terminate the contract in the event of bankruptcy[36] would not constitute a default under this provision.[37] Subsection (b), however, does not apply if the debtor is not in default on an executory contract.[38]

Subsection (c) imposes further limitations on the trustee's power to assume or assign a contract. Unless the nondebtor party consents, the trustee may not assume or assign an executory contract if applicable nonbankruptcy law excuses the nondebtor party from either accepting performance or rendering performance to the debtor or an assignee of the contract.[39] *In re Harms*[40] illustrates how subsection (c) operates. Arnold C. Harms, the only general partner in a limited partnership, filed for bankruptcy under Chapter 11.[41] Based on the fiduciary obligation among partners, the court held that applicable nonbankruptcy law prevented the limited partners from having to accept substituted performance from someone with whom the partners were not in privity of

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34. 2 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 11.11, at 356 (3d ed. 1986).

35. 11 U.S.C. § 365(b)(1)(A)-(C) (Supp. III 1985).

36. *See infra* notes 52-73 and accompanying text (discussing ipso facto or bankruptcy clauses).

37. 11 U.S.C. § 365(b)(2) (Supp. III 1985). *See generally* S. REP. No. 989, 95th Cong., 2d Sess. 58, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5844 [hereinafter SENATE REPORT].

38. Cook & Kelly, *The Status of Executory Contracts Under the Bankruptcy Code*, 6 A.L.I/ A.B.A. COURSE MATERIALS J., Apr. 1982, at 7, 11 (citing *In re* Perretta, 7 Bankr. 103 (Bankr. N.D. Ill. 1980)).

39. 11 U.S.C. § 365(c)(1) (Supp. III 1985). "This prohibition applies only in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract. . . ." SENATE REPORT, *supra* note 37, at 59.

40. 10 Bankr. 817 (Bankr. D. Colo. 1981).

41. *Id.* at 819.

contract.[42] When the court appointed a trustee, the partnership dissolved because the trustee was not the party with whom the limited partners contracted. The trustee in this case was unable to assume the position of general partner because he was not the person with whom the limited partners had contracted.[43]

Section 365(c)(2) imposes an additional limitation on contracts to borrow funds. The trustee may not assume or assign an executory contract to make a loan or create other debt financing.[44] The legislative history of subsection (c)(2) indicates that the provision's purpose is to prevent a party to a transaction that is based on the financial strength of a debtor from having to extend new credit to the debtor.[45] A contract to provide goods or services with payments over time may be assumed; a creditor, however, is not required to extend cash to a debtor.[46]

Subsection (d) imposes a time limitation on the trustee's power to assume or reject an executory contract. Under a Chapter 7 bankruptcy, the trustee has sixty days after the order for relief in which to assume or reject the contract; otherwise, the contract is deemed rejected automatically.[47] A Chapter 7 bankruptcy involves gathering the debtor's property into the estate and liquidating the property to satisfy holders of eligible rights and interests.[48] This process effectively ends the commercial life of a debtor. Thus, the automatic rejection provision coincides with the objectives of a Chapter 7 petition by rejecting all contracts not affirmatively assumed.[49] The language of subsection (d)(1) and the general rule in subsection (a) seem to be contradictory. Under

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42. "Under applicable nonbankruptcy law, the limited partners in a limited partnership do not have to accept substituted performance from a general partner other than the one with whom they have contracted." *Id.* at 821.

43. *Id.*

44. "The trustee may not assume or assign an executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegations of duties, if— . . . (2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the henefit of the debtor, or to issue a security of the debtor . . . ." 11 U.S.C. § 365(c)(2) (Supp. III 1985).

45. SENATE REPORT, *supra* note 37, at 58-59.

46. 2 COLLIER, *supra* note 28, ¶ 365.03, at 365-20.

47. 11 U.S.C. § 365(d)(1) (Supp. III 1985). This subsection permits the court to grant "additional time" for cause, provided the request is made within the 60-day period. *Id.* Subsection (d)(2) establishes the deadlines for bankruptcy petitions filed under Chapter 9, 11, 12 or 13. "[T]he trustee may assume or reject an executory contract . . . at any time before the confirmation of a plan but the court, on request of any party to such contract . . ., may order the trustee to determine within a specified period of time whether to assume or reject such contract. . . ." *Id.* Subsection (d) does not indicate whether the court may shorten the time period for assumption or rejection. One commentator has suggested that the period for assumption or rejection can be shortened pursuant to tbe "all writs" provision of § 105(a) of the Code. *See* Cook & Kelly, *supra* note 38, at 21.

48. Julis, *supra* note 20, at 224.

49. *See supra* text accompanying note 20.

the general rule, assumption or rejection is "subject to court approval";[50] under subsection (d)(1), on the other hand, in a Chapter 7 case the executory contract is deemed rejected if not affirmatively assumed within the sixty-day time period. The apparent inconsistency between these two subsections has been left for the courts to reconcile.[51]

C. *Invalidation of Bankruptcy Termination Clauses*

The Code makes certain bargained-for contractual provisions unenforceable. Section 365(e)(1) invalidates ipso facto-bankruptcy clauses by providing that an executory contract may not be modified or terminated after the commencement of an action in bankruptcy based on the insolvency or financial condition of the debtor.[52] Congress indicated that the invalidation of ipso facto clauses was necessary to assist the debtor in either rehabilitation or liquidation cases and to remedy previous cases that permitted a bankruptcy clause to deprive the estate of a valuable asset.[53] However, in order to assure that the nondebtor receives the full benefit of its bargain, the advisory committee notes indicate that courts should be sensitive to the invalidation of ipso facto clauses when invalidation would affect the nondebtor party's rights in the executory contract.[54] Subsection (e)(1) overrides state law enforcing ipso facto clauses;[55] therefore, even if the state recognizes the legal effect of these clauses, the Code will prevail. If a party terminates the contract for a valid reason, other than the reasons listed in section 365(e)(1),[56] then the contractual relationship will end. The Code does not recognize any remaining assumable interest.[57]

Subsection (e)(1) prohibits the termination of a contract "after the commencement" of the bankruptcy petition "solely" on an ipso facto

50. *See supra* note 29 and accompanying text.

51. 2 COLLIER, *supra* note 28, ¶ 365.02[1], at 365-59.

52. Subsection (e)(1) provides:

> [A]n executory contract . . . may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . . . that is conditioned on—
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> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
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> (B) the commencement of a case under this title; or
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> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

11 U.S.C. § 365(e)(1) (1982).

53. SENATE REPORT, *supra* note 37, at 59.

54. *Id.*

55. "Subsection (e)(1) also supersedes state law that allows enforcement of such clauses." 2 COLLIER, *supra* note 28, ¶ 365.03, at 365-18 (footnote omitted).

56. *See supra* note 52.

57. 2 COLLIER, *supra* note 28, ¶ 365.03, at 365-19.

clause.[58] The legislative history indicates that even though a bankruptcy clause cannot control the disposition of an executory contract, the clause is not entirely invalid.[59] Thus, a termination clause may be exercised prior to the debtor's filing of a petition in bankruptcy even if the termination is based "solely" on the debtor's insolvency.[60] A federal bankruptcy court in Florida reached this conclusion in *In re LJP, Inc.*[61] in which the debtor, LJP, Inc., had a bottling contract with the Royal Crown Cola Company (RCC).[62] RCC notified LJP, Inc. that RCC was terminating the agreement pursuant to the termination provision in the contract.[63] Thirty days later LJP, Inc. filed for bankruptcy and sought to invalidate the termination under section 365(e)(1).[64] Considering the circumstances of a prepetition notification of termination based on the debtor's insolvency, the court distinguished the termination of a contract after the commencement of bankruptcy from a prepetition termination. Whereas section 365(e)(1) expressly prohibits terminations after a debtor files for bankruptcy, the section does not invalidate terminations prior to filing for bankruptcy.[65] Consequently, a contract providing for automatic termination with or without notice to the debtor and prior to the debtor's filing for bankruptcy results in the debtor having no protection under the Code because the contract's terms are enforceable.[66] In effect, the courts have created a situation in which a bargained-for termination right stipulated in a contract can preempt the Code if triggered at the appropriate time.

Subsection (e)(1) places an additional limitation on the trustee's power to assign an executory contract. In *In re Anne Cara Oil Co., Inc.*[67] a bankruptcy court in Massachusetts viewed a valid expiration or

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58. 11 U.S.C. § 365(e)(1) (1982).

59. SENATE REPORT, *supra* note 37, at 59.

60. Ruben, *Legislative and Judicial Confusion Concerning Executory Contracts in Bankruptcy*, 89 DICK. L. REV. 1029, 1044 (1985).

61. 22 Bankr. 556 (Bankr. S.D. Fla. 1982).

62. *Id.* at 557. The contract contained the following termination provision: "This Agreement and any and all rights of LICENSEE hereunder and any and all obligations of RCC hereunder shall immediately terminate, without the requirement of notice to LICENSEE, upon the occurrence of any of the following: . . . (4) The insolvency of LICENSEE; . . . ." *Id.*

63. *Id.*

64. *Id.*

65. The Code does not prohibit termination before bankruptcy of a contract because of insolvency. Section 365(e)(1) expressly probibits the termination or modification of any contract "at any time *after* tbe commencement of the case" solely on account of insolvency. 11 U.S.C. § 365(e)(1) (1982) (emphasis added). This subsection also prohibits termination or modification of any contract solely because of the commencement of a bankruptcy case. The express provisions of § 365(e)(1) indicate tbat the legislature did not intend to invalidate the prepetition termination of a contract solely on the grounds of insolvency. *LJP, Inc.*, 22 Bankr. at 558.

66. Ruben, *supra* note 60, at 1045.

67. 32 Bankr. 643 (Bankr. D. Mass. 1983).

termination date in an executory contract as a limitation on the debtor's right to assume and assign the contract in the event a bankruptcy petition is filed. The agreement allowed the creditor to terminate the contract for any one of several reasons after notifying the debtor.[68] The creditor gave notice on both January 12 and March 15 that it would terminate the contract on April 15; subsequently, the debtor filed for bankruptcy on April 14.[69] The debtor, hoping to suspend the termination, sought protection under the automatic stay provision.[70] The court, however, held against the debtor because the automatic stay does not toll the mere running of time.[71] Thus, the Code does not prevent a contract from terminating by its own terms and does not grant debtors greater powers under a contract than the debtors have outside of bankruptcy.[72] If the trustee assumes a contract, the contract is accompanied by all of its provisions and conditions, including internal limitations, one of which is the contract's expiration date.[73]

D. *Assignment of the Executory Contract*

The value of an executory contract in a Chapter 7 case depends on the ability of the trustee to sell the contract to a third party and thereby increase the assets of the bankruptcy estate. Section 365(f) authorizes the trustee to assign an executory contract.[74] Except as provided in section 365(c),[75] the trustee may assign an executory contract notwithstanding a contrary provision in the contract itself or some applicable law prohibiting, restricting, or conditioning the assignment of the contract.[76] Before an executory contract may be assigned, the trus-

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68. *Id.* at 644.
69. *Id.* at 645-46.
70. *Id.* at 646.
71. *Id.* at 647.
72. *Id.* The court stated: "The general rule is . . . if the [nondebtor] party had a right to terminate the arrangement, that right survives adoption of the contract by the trustee. . . ." *Id.* (citing Thompson v. Texas Mex. Ry., 328 U.S. 134, 141 (1946)).
73. *In re* Nashville White Trucks, Inc., 5 Bankr. 112, 116 (Bankr. M.D. Tenn. 1980).
74. 11 U.S.C. § 365(f) (1982).
75. *See supra* notes 39-46 and accompanying text.
76. Subsection (f) provides:

> (1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract . . . of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract . . ., tbe trustee may assign such contract . . . under paragraph (2) of this subsection.
>
> (2) The trustee may assign an executory contract . . . of the debtor only if—
>
> (A) the trustee assumes such contract . . . in accordance with the provisions of this section; and
>
> (B) adequate assurance of future performance by the assignee of such contract . . . is provided, whether or not there has been a default in such contract.

11 U.S.C. § 365(f)(1)-(2) (1982).

tee must assume the contract according to the provisions of subsection (f), and the assignee must provide adequate assurance of future performance even though no default of the executory contract has occurred.[77]

Subsection (c) provides that an executory contract is not assumable if applicable law excuses the nondebtor party from accepting performance or rendering performance to another party.[78] Subsection (f), on the other hand, provides that an executory contract may be assumed if the requirements of that subsection are followed.[79] In operation, no conflict is present between the two subsections. Subsection (f)(1) excepts subsection (c), retaining the possibility that applicable law may prevent the contract's assumption or assignment. The primary function of subsection (f) is to allow the trustee to assign a contract when a contractual provision bars such action, even if applicable law in the state recognizes the legal effect of these provisions.[80] Moreover, section 365(f)(3) invalidates clauses of a contract that terminate or modify the contract if an assignment takes place.[81] After the trustee assigns the assumed contract, the estate is absolved of liability for any breach of the contract after the assignment.[82]

E. *Backdating of the Contract if Rejected*

In the event that an executory contract is rejected, section 365(g) sets the date on which the rejection constitutes a breach. If the executory contract is rejected expressly or by operation of subsection (d)(1),[83] the rejection constitutes a breach as of the day immediately preceding the date on which the petition was filed.[84] Backdating the breach to the prepetition date classifies the injured party as a general unsecured cred-

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77. *Id.*

78. 11 U.S.C. § 365(c) (Supp. III 1985). For a general discussion of 365(c), see *supra* notes 39-46 and accompanying text.

79. *See supra* note 76 and accompanying text.

80. *See In re* Nitec Paper Corp., 43 Bankr. 492, 498 (Bankr. S.D.N.Y. 1984).

81. SENATE REPORT, *supra* note 37, at 59. Contract clauses preventing assignment are contrary to the policy of § 365(f). *Id.*

82. 11 U.S.C. § 365(k) (Supp. III 1985). "Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment." *Id.*

83. *See supra* notes 47-51 and accompanying text.

84. Subsection (g)(1) states: "[T]he rejection of an executory contract . . . of the debtor constitutes a breach of such contract . . . — (1) if such contract . . . has not been assumed under this section or under a plan confirmed under 9, 11, or 13 of this title, immediately before the date of the filing of the petition. . . ." 11 U.S.C. § 365(g)(1) (1982). The remainder of subsection (g) specifies times for different cases that are converted from different chapters in the Code. *See* SENATE REPORT, *supra* note 37, at 60.

itor.[85] Without a provision changing the date of the breach, the breach would occur after the petition was filed so that the injured party's claim would be classified as an administrative expense.[86] Subsection (g)(2)(A) applies when a contract has been assumed, subsequently rejected, and, prior to rejection, the case has not been converted from a rehabilitation case under either Chapter 11 or 13 to a Chapter 7 case. In these special circumstances, the date of the breach is the time of rejection, and the injured party's claim is classified as an administrative expense.[87]

When one party to a contract has gone bankrupt, section 365 attempts to reach an equitable result by balancing the rights of the contracting parties. This section, however, should be carefully considered by contracting parties not only at the time one party has gone bankrupt, but also at the planning and negotiating stages of the contractual relationship. By understanding section 365, draftsmen can determine what provisions should be included in a contract in order to reach the desired result, which provisions ultimately will be given effect, and what to expect when a trustee in bankruptcy invokes section 365.

IV. Application of Section 365 to the Hypothetical Situation

A. *Executory Contract*

Because section 365 is triggered only if a contract is executory, the first issue is whether the Contract in the Hypothetical Situation meets this criterion. The term "executory contract" is not defined in section 365 or anywhere else in the Code. According to the Commission on the Bankruptcy Laws, the lack of a clear definition was intentional; more precise statutory language might have altered the well understood meaning of "executory contract" by an unintended omission or inclusion.[88] The legislative history of section 365 provides some guidance by characterizing executory contracts as "contracts on which performance remains due to some extent on both sides."[89] On the other hand, several federal courts of appeals recognize Professor Vern Countryman's definition of executory contract:[90] "[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 consti-

85. 2 D. Cowans, *supra* note 34, at 374.

86. *Id.*

87. 2 Collier, *supra* note 28, ¶ 365.05, at 365-24. An administrative expense is a secured expense that will he paid over an unsecured expense.

88. Commission on the Bankruptcy Laws of the United States, Report to Congress, H.R. Doc. No. 137, 93d Cong., 1st Sess. 198, 199 (1973).

89. Senate Report, *supra* note 37, at 58.

90. *See* Cook & Kelly, *supra* note 38, at 9 (listing the appellate and hankruptcy courts that have adopted Professor Countryman's definition of executory contract).

tute a material breach excusing the performance of the other."[91]

If the Contract is not deemed executory, section 365 will not apply; consequently, the Contract would be breached because it is nonassumable by the estate.[92] The impact of the breach on the parties to the Contract depends on how the court applies the Code and relevant nonbankruptcy law.[93] If the court does not consider the breach "material" under nonbankruptcy law, Reserve would be obligated to perform the remaining obligations of the Contract for the benefit of the bankruptcy estate. The State would be left with a right to damages through a pre-petition claim under section 101(4).[94] However, if the court does characterize the breach as material under nonbankruptcy law, Reserve would be relieved of rendering further performance and would have to join the other unsecured creditors waiting for the distribution of the estate.[95]

The contractual provisions described in the hypothetical are sufficient to support a finding that the Contract is executory. PMI must conduct regular inspections of the facilities and file a report with Reserve detailing the results of the inspections. Reserve also must make regular payments and maintain a contract monitor in order to review PMI's performance under the Contract. Thus, performance remains due on both sides throughout the life of the Contract.[96] When filing for bankruptcy, the Contract must be executory; however, if any part of the Contract remains unperformed, the whole Contract is executory.[97] Once the court determines that the Contract is executory, the parties must work within the parameters of section 365 and its limitations in order to determine the parties' rights.

B. *Time Period for Rejection or Assumption*

Assuming the Contract is executory, the general rule of section 365 applies. Thus, the Trustee may reject, assume, or assign the Contract. The next issue is whether the State may prevent the Trustee from re-

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

92. Julis, *supra* note 20, at 249. If a contract was previously in default, the default cannot be cured. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. Whetber the contract is executory is a factor the parties should take into consideration at the drafting stage. The focus should be on which result—a determination of executory or not executory—would yield the desired outcome. *See generally id.* (challenging the Countryman definition and proposing an outcome determinative analysis for evaluating whether a contract is executory).

97. *See In re* Universal Medical Serv., Inc. 325 F. Supp. 890, 891 (E.D. Pa. 1971), *aff'd*, 460 F.2d 524 (3d Cir. 1972).

jecting the Contract. Section 365 makes rejection of an executory contract subject to court approval. PMI, however, has filed a Chapter 7 petition for bankruptcy. Section 365(d)(1) provides that in liquidation cases a contract automatically terminates after sixty days if it is not assumed.[98] Reserve cannot prevent the passing of time; therefore, rejection can occur without court approval.[99] If rejection does occur, then the consequences would be similar to an ordinary breach. Reserve would be left only with the prospect of money damages.[100]

C. *Ipso Facto Termination Clause*

A third issue arises when Reserve attempts to terminate the Contract based on PMI's filing of a bankruptcy petition. Reserve has bargained for the right to terminate the Contract upon PMI's insolvency, bankruptcy, or other specified events. The termination clause comes within the explicit language of section 365(e)(1), which prevents Reserve from terminating the Contract because of bankruptcy. Subsection (e)(1) prohibits post-petition termination of the Contract based "solely" on bankruptcy. But what if, after the filing for bankruptcy, other factors present grounds for invoking the termination clause under the "other specified events" clause of the Contract? According to one commentator, the language in this subsection suggests that the Code's draftsmen intended to allow automatic termination if other factors outside the termination provision are present.[101] These "other factors" will come under close scrutiny because courts generally are reluctant to sanction the termination of a valuable asset based on a bankruptcy clause.[102]

The court in *In re Nashville White Trucks, Inc.*[103] followed the above reasoning. The debtor was routinely late with lease payments,

98. *See generally supra* notes 47-51 and accompanying text.

99. The operation of subsections (a) and (d) together implies that the "subject to" language in subsection (a) is limited to situations involving Chapter 11 or Chapter 13 when rehabilitation is the overriding emphasis.

100. *See supra* notes 93-95 and accompanying text. The operation of subsection (d)(1) also leaves open a window of 60 days during which Reserve may have to wait for the Trustee's decision. This interim waiting period for a determination by PMI raises a number of questions: What happens to the prison's operations in the interim? Are the prisoners still fed and guarded? Does PMI have to perform any duties under the Contract? Can PMI force Reserve back into the business of corrections even though the Contract required notice 60 days prior to termination? What happens if PMI promptly seeks court approval to reject the Contract—should it be granted? What happens *after* rejection? Before privatization of corrections facilities expands even more, the Code and nonbankruptcy law should address these unique concerns presented by the privatization of corrections.

101. Ruben, *supra* note 60, at 1043.

102. 2 COLLIER, *supra* note 28, ¶ 365.02, at 365-6.

103. 5 Bankr. 112 (Bankr. M.D. Tenn. 1980).

delinquent in open account payments, late with monthly financial statements, and below working capital requirements.[104] The federal bankruptcy court in Tennessee permitted post-petition termination because bankruptcy was not the cause of termination, but merely the event that triggered a final decision.[105] The court, however, did not indicate whether bankruptcy was included among the "numerous other factors" or whether the other factors alone supported the termination.[106]

Reserve, therefore, may be able to utilize the Contract's termination clause if the court follows the negative inference of section 365(e)(1) and allows termination based on "other factors." This clause will be effective if the draftsmen did not trigger termination "solely" on the basis of bankruptcy. Reserve might also terminate the Contract by invoking the termination clause prior to the filing for bankruptcy based on PMI's insolvency. Subsection (e)(1) invalidates ipso facto clauses only after bankruptcy is filed. Thus, an ipso facto clause provides Reserve with two methods of terminating the Contract in the event of PMI's bankruptcy.

D. Termination-at-Will Clause

A termination-at-will clause, not covered by the Code, may avoid the effect of section 365.[107] Under such a termination provision, termination is not conditioned on bankruptcy. Section 365(e)(1), therefore, is not applicable. When faced with a termination-at-will clause, courts either will enforce and honor the expectations of the parties or strike down the clause by asserting general principles of bankruptcy law.[108]

Several courts have faced termination-at-will clauses in circumstances in which a prepetition notice of termination resulted in the termination occurring after the filing of the petition.[109] These cases generally involve a termination notice given by the nondebtor prior to the filing of a bankruptcy petition. The notice includes a specified date on which the contract will terminate according to its own terms. Before that date, however, the other party usually files a bankruptcy petition, hoping that the automatic stay will prevent the contract from lapsing so

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104. *Id.* at 114.

105. *Id.* at 117.

106. Ruben, *supra* note 60, at 1044.

107. The following is an example of a termination-at-will clause: "either party may terminate this contract upon thirty days written notice." *Id.* at 1045 n.88.

108. *Id.* at 1046.

109. Schokbeton Indus., Inc. v. Schokbeton Prods. Corp., 466 F.2d 171 (5tb Cir. 1972); *In re* Anne Cara Oil Co., Inc., 32 Bankr. 643 (Bankr. D. Mass. 1983); *In re* LJP, Inc., 22 Bankr. 556 (Bankr. S.D. Fla. 1982); *In re* Benrus Watch Co., Inc., 13 Bankr. 331 (Bankr. S.D.N.Y. 1981); *In re* Beck, 5 Bankr. 169 (Bankr. D. Haw. 1980); *In re* Nashville White Trucks, Inc., 5 Bankr. 112 (Bankr. M.D. Tenn. 1980).

that it can be assumed under section 365(a).[110] *In re Nashville White Trucks, Inc.*[111] held that an executory contract may be assumed subject to all of its provisions and conditions, one of which is the expiration date.[112] This result was necessary to prevent future parties from either contracting for a shorter notice period to prevent the loss of a bargained-for termination right by an intervening bankruptcy petition or terminating the contract at the first sign of financial weakness.[113] Thus, termination clauses and expiration dates are an integral part of the Contract and accompany the Contract when it is assumed.

The nondebtor still must be aware of the other party's financial situation and anticipate a filing for bankruptcy to invoke a termination-at-will clause. This clause begins a race between the debtor and creditor.[114] If the creditor notifies the debtor of termination before the debtor files a petition in bankruptcy, the creditor prevails. If the court refuses to recognize the termination-at-will clause,[115] the effect will be to compound the loss for the nondebtor and compound the gain for the debtor. In the negotiation process the nondebtor may concede other material terms in order to obtain the debtor's assent to the termination clause. If the termination clause is not recognized, the nondebtor will lose not only the bargained-for advantage of the clause, but also any terms conceded to secure the clause's acceptance.[116] The debtor no longer is subject to the termination clause and will enjoy the advantage of any concessions given by the nondebtor for the termination clause's acceptance. Thus, Reserve should have been aware that the termination clause might not be recognized by the court and should not have conceded much in negotiating for the clause's acceptance.

E. *Assignment of the Executory Contract*

If the Contract is not terminated pursuant to a termination clause, PMI may wish to assume and assign the Contract to Knuckles & Associates, a security service wishing to expand its operations by managing a

110. *See supra* notes 71-72 and accompanying text.
111. 5 Bankr. 112 (Bankr. M.D. Tenn. 1980).
112. *Id.* at 116.
113. Ruben, *supra* note 60, at 1047.
114. *Id.* at 1048.
115. The Code is silent about the effect of termination-at-will clauses. This silence has resulted in conflicting decisions about enforcement of these provisions. Because section 365(e)(1) does not automatically avoid this type of termination, some courts avoid a finding of termination by relying on the broad equitable power granted by § 105(a), which provides that: "[t]he bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.* at 1045 n.89.
116. *Id.* at 1054-55.

correctional facility.[117] As a security service it is quite successful, but it has never operated any type of correctional institution. The service, however, feels confident that it can operate Reserve's corrections facilities more efficiently than PMI. The general partners have studied corrections operations and have developed a plan for operating the prisons that was developed by combining several current systems. Assignment could significantly increase the value of the bankruptcy estate because Knuckles & Associates is willing to pay for the Contract.

This fifth issue, assignment of the Contract, raises a number of questions: (1) whether Reserve can prevent the Contract's assignment to Knuckles & Associates; (2) whether section 365 imposes any limitations on PMI's general power to assign the Contract; and (3) if Reserve negotiates and obtains a clause preventing or conditioning assignment, whether the clause will be given effect when PMI subsequently files for bankruptcy.

Subsection (f) lists the requirements that PMI must meet in order to assign the Contract.[118] Assignment to a third party can occur only if the Trustee is able to assume the Contract by satisfying the requirements of section 365(b)(1). Subsection (b)(1) imposes three requirements: the Trustee must (1) cure any defaults or provide adequate assurance that the defaults will be promptly cured; (2) compensate Reserve for any actual pecuniary loss resulting from the default; and (3) provide adequate assurance of future performance under the Contract.[119] These requirements, however, are not applicable in the case of a default under an ipso facto clause.[120]

The Code does not provide a statutory definition or standard for what satisfies the requirement of "adequate assurance" in the context of a contract. Adequate assurance is defined in section 365(b)(3) only for the limited purposes of a shopping center lease.[121] The special provisions of this subsection, designed to protect the nondebtor party, are operative when a trustee wishes to assign a lease. No default is required to trigger the provisions.[122] Subsection (b)(3) prescribes four conditions

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117. PMI has no interest in a straight assumption of the Contract because of a Chapter 7 filing and can only realize a benefit to the bankruptcy estate if the Contract is assigned. Knuckles & Associates is the firm that desires to purchase PMI's interest.

118. *See generally supra* notes 74-82 and accompanying text (discussing the operation of subsection (f)).

119. 11 U.S.C. § 365(b)(1)(A)-(C) (Supp. III 1985); *see supra* notes 35-38 and accompanying text (discussing the operation of subsection (b)).

120. 2 COLLIER, *supra* note 28, ¶ 365.03, at 365-18. This is consistent with the invalidation of ipso facto clauses in subsection (c).

121. *See* 11 U.S.C. § 365(b)(3) (Supp. III 1985).

122. *Id.* This subsection indicates two situations in which "adequate assurance" is triggered: (1) under (b)(1) when there has been a default in the contract or lease, and (2) under (f)(2)(B) when a shopping center lease is to be assigned. *Id.*

that must be met to satisfy the requirement of adequate assurance. A trustee must adequately assure the landlord that (1) the proposed assignee will be in a similar financial condition; (2) the percentage of rent due will not substantially decline; (3) the assignment is subject to all the provisions of the lease; and (4) the assignment will not disrupt the tenant mix or balance in the shopping center.[123] The standards supplied for a shopping center lease provide a model for drafting similar contractual provisions in the privatization context. During the contract negotiations, Reserve and PMI should have inserted a provision in the Contract similar to the one in section 365(b)(3) that defines adequate assurance. Such a provision would be enforceable because an assumed contract is accompanied by all of its provisions and conditions and the Contract must be assumed before it can be assigned.[124]

Some contracts, however, are not assignable. Section 365(c)(1)[125] is an exception to a trustee's general power granted in subsection (f)(1) to assign executory contracts.[126] Subsection (c)(1) originally was invoked only for personal service contracts.[127] The court in *In re Pioneer Ford, Inc.*, however, held that the language of (c)(1) does not limit its effect to personal service contracts but refers generally to contracts that are not assignable under state law.[128] *In re Taylor Manufacturing, Inc.*[129] followed this reasoning and applied the personal service limitation to a contract to resolve the conflict between subsections (c)(1) and (f)(1).[130] The goal behind subsection (f)(1) apparently is to allow the bankruptcy court to disregard contractual provisions that specifically prohibit or limit assignment, even though courts typically give effect to these clauses.[131] Subsection (c)(1), nevertheless, refers to state laws that prohibit assignment "whether or not" a contract refers to assignment.[132]

Subsection (c)(1) prohibits the assignment of a contract if "applicable law" excuses the nondebtor party from rendering performance to

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123. *Id.* § 365(b)(3)(A)-(D).

124. *In re* Nashville White Trucks, Inc., 5 Bankr. 112, 116 (Bankr. M.D. Tenn. 1980).

125. *See supra* notes 39-43 and accompanying text.

126. *In re* Pioneer Ford Sales, Inc., 729 F.2d 27, 28 (1st Cir. 1984). As long as the requirements of (f)(2) are satisfied, subsection (f)(1) allows the executory contract to be assigned even if a contractual provision or applicable law forbids assignment.

127. *Id.* at 28-29 (citing *In re* Taylor Mfg., Inc., 6 Bankr. 370 (Bankr. N.D. Ga. 1980)).

128. *Id.* "State laws typically make contracts for personal services nonassignable . . .; but they make other sorts of contracts nonassignable as well . . . . The legislative history of § 365(c) says nothing about 'personal services.' To the contrary, it speaks of letters of credit, personal loans, and leases . . . . Tbe history thereby suggests that (c)(1)(A) has a broader reach." *Id.* at 29.

129. 6 Bankr. 370 (Bankr. N.D. Ga. 1980).

130. *Pioneer Ford Sales*, 729 F.2d at 29.

131. 11 U.S.C. § 365(f)(1) (1982).

132. *Id.*

another entity, unless the nondebtor party consents.[133] Because "applicable law" in this section means applicable nonbankruptcy law,[134] this subsection prevents assignment of contracts that contract law ordinarily makes nonassignable.[135] Moreover, in subsection (c)(1) the clause, "whether or not such contract . . . prohibits or restricts assignment,"[136] prevents the use of contractual language to restrict the trustee's general assignment powers when contract law allows assignment.[137] The focus is on the state's general law concerning the type of contract and not on the contractual provision limiting assignment. Thus, whether a bargained-for nonassignability clause in a contract is enforceable depends solely on nonbankruptcy law.[138]

Reserve and PMI should have determined during the negotiation process whether nonbankruptcy law of the State of Reserve would permit or prevent assignment to assess the value of a nonassignability clause. If the assigument did occur, section 365(k)[139] would relieve the bankruptcy estate and the Trustee of any liability for a breach occurring after the assignment.[140] The possibility of an assignment is an important factor that should have influenced Reserve's initial decision to privatize. The decision to privatize should focus not only on cost-efficiency and benefits, but also on the actual amount of control that the state is relinquishing and on who ultimately will likely be managing the facilities.

V. Recommendations

If a state decides to turn over the operation of its correctional facilities to a private company, the contract should be drafted against the background of all applicable laws, including bankruptcy laws. The draftsmen of a contract should secure each party's rights in case litigation becomes necessary. The drafters should be aware of what laws will govern the contract's validity and performance. The Code will dictate the validity of some contractual provisions and may determine whether a future relationship will exist between the parties. Knowledge of these

133. 11 U.S.C. § 365(c)(1)(A) (Supp. III 1985).

134. *Pioneer Ford Sales*, 729 F.2d at 28 (citing the legislative history of subsection (c)(1)).

135. *Id.* Nonbankruptcy law affects "contracts that cannot be assigned when the contract itself is silent about assignment." *Id.*

136. 11 U.S.C. § 365(c) (Supp. III 1985).

137. *Pioneer Ford Sales*, 729 F.2d at 28.

138. The following are examples of nonbankruptcy laws that prevent assignment: N.Y. State Fin. Law § 138 (McKinney 1974) (making certain government contracts unassignable); N.Y. Gen. Mun. Law § 109 (McKinney 1977); N.C. Gen. Stat. §§ 147-162 (1978). *See also Pioneer Ford Sales*, 729 F.2d at 29.

139. *See supra* note 82 and accompanying text.

140. 11 U.S.C. § 365(k) (1982).

potential consequences also should influence the negotiation process.

The draftsmen should incorporate several specific provisions into the contract in order to preserve the rights of the state.[141] First, the contract should provide adequate assurance of future performance by the trustee in assuming the contract according to the rules of section 365(b)(1)(C). The state, however, may include several burdensome conditions precedent in the contract to deter the trustee from assuming the contract.[142] In spite of the difficulty of negotiating a nonassumable contract,[143] the state might be able to bargain for a contract that renders assumption so burdensome that assumption probably would not occur.[144] If the trustee offers adequate future assurances, the problems associated with assumption and assignment would not arise. Likewise, if the conditions precedent render the contract virtually unassumable, the problems of assumption could be avoided.

A second possibility is the use of a termination-at-will clause that provides for prepetition notice of termination.[145] Section 365(e)(1) has been interpreted to apply only after bankruptcy has been filed.[146] Professor Ruben suggests the following contractual provision for the state:

> Licensor [the state] may terminate this agreement upon thirty days written notice to licensee [the private company]. Licensee must inform licensor of its intention to file a petition in bankruptcy at least five days prior to filing such a petition. Debtor's filing without conforming to this requirement shall be deemed a material, pre-petition incurable breach.[147]

This provision would provide the state five days within which to supply the debtor with notice of the contract's termination; the intervening filing of bankruptcy would not stop the contract from terminating by its own terms.[148] Although the state would discriminate against the debtor solely on the basis of insolvency, that discrimination would occur prepetition.[149] Thus, a full understanding of the applicable law in addition to careful drafting of the contract might allow a state to preserve its termination right without departing from the provisions of the Code.

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141. *See generally* Ruben, *supra* note 60.

142. *Id.* at 1058.

143. Too many other material terms in a contract might have to be conceded in order to get a nonassumable contract signed. *Id.*

144. *Id.* The state, however, must prefer tbe contract not to be assumed for this suggestion to be effective. If the party to the contract does want the contract assumed, then the contractual provisions would set out what the party would consider to be fair and easily satisfiable requirements for adequate assurance.

145. *Id.*

146. *See supra* notes 58-66 and accompanying text.

147. Ruben, *supra* note 60, at 1058-59.

148. *Id.* at 1059; *see supra* notes 70-71 and accompanying text.

149. Ruben, *supra* note 60, at 1059.

VI. Conclusion

The privatization of prisons is an appealing solution to the budgetary problems of many states.[150] Privatization has been practiced for many years, but currently is being expanded to alleviate modern needs and pressures.[151] However, although proposals to contract for adult correctional facilities may resolve some problems, these proposals raise a number of additional political, administrative, and legal issues yet to be resolved.

The primary political issue centers on the fact that the operation of correctional facilities constitutes a powerful exercise of state power to deprive persons in custody of the liberties all other citizens enjoy.[152] The private company will be licensed to exercise the state's police power, which is derived from the state's authority to administer discipline and prevent escapes. The concern is whether this delegation is proper. As a consequence of privatization, administrative issues also arise involving the private company's quality of service, staff accountability, and contract monitoring.[153] Legal issues center both on the state's statutory authority to contract with a private firm[154] and the government's liability under the contract.[155] One commentator states that contracting out does not relieve the state of its potential liabilities, but does remove the state's control over how these liabilities may arise.[156]

In addition to the political, administrative, and legal issues involved in privatization, other areas of the law govern the relationship

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150. McEntee, *supra* note 16, at 43.

151. Privatization of Corrections, *supra* note 8, at 55. "The development of the juvenile courts was marked by tbe birth of privately operated facilities for juveniles, a tradition which extends to this day." *Id.*

152. *Id.* at 70.

> The delegation of this authority to private providers raises issues not encountered in contracting for more mundane services such as bus transportation or solid waste disposal. In a facility entirely operated by the private sector, a range of management functions involving the classification and control of inmates (including the use of deadly force) migbt be delegated to the private contractor.

Id.

153. *Id.* at 74-76.

154. *Id.* at 76. The state authority may implicitly prohibit facility management or fail to address the issue. Many states, however, do authorize service contracts, but this authorization will not necessarily include the entire service function that is to be managed by a private company. *Id.*

155. *Id.* Because the management of private facilities is a relatively recent development, "no body of case law bas yet emerged to clarify the respective liabilities of public and private agencies. There is, however, no legal principle to support the premise that public agencies will be able to avoid or diminish their liability merely because services have been delegated to a private vendor." *Id.*

156. *Id.* "[A] private contractor essentially acts as an extension of the state. Thus, if the contractor errs, the state has retained its authority and may share the liability." *Id.* at 76-77.

between the private company and the state. Under the bankruptcy law, the power of the debtor to reject, assume, or assign an executory contract allows for broad control by the debtor over the future relationship of the parties. This general rule is subject to limitations, but the debtor's power definitely far exceeds the protections provided to the state. Moreover, key words in several provisions of section 365 lack statutory definitions, which causes difficulty in interpreting this provision. The courts have exacerbated the problem by supplying their own varying brand of statutory interpretation, creating confusion where Congress intended clarity. Considering the number of unanswered issues associated with privatization, a state should not privatize without grasping the magnitude and complexity of these problems. These issues should be addressed before privatization occurs, when sufficient time is still available to consider alternative solutions.

Special interest legislation to amend the Code is a potential avenue for resolving the bankruptcy issues in the privatization of corrections facilities. For example, in response to *NLRB v. Bildisco & Bildisco*,[157] Congress enunciated through the Code the procedure and standard for rejecting a collective bargaining agreement.[158] Although the drafting of section 1113 is less than perfect, the provision announces a comprehensive standard that covers the delicate concerns that collective bargaining agreements often raise. Privatization represents a similarly delicate issue that merits special attention by Congress before states adopt large-scale privatization plans. Unfortunately, a privatization amendment to the Code may not occur for some time. Thus, the privatization

157. 465 U.S. 513 (1984). The respondent filed a voluntary Chapter 11 bankruptcy petition for reorganization. *Id.* at 517. In 1979, prior to the filing of bankruptcy, the respondent negotiated a three-year collective bargaining agreement with the union, expressly providing that operations would continue if bankruptcy supervened. *Id.* at 518. In 1980 the respondent failed to meet some of the obligations of the collective bargaining agreement. *Id.* After filing bankruptcy, the respondent submitted a request to the bankruptcy court for permission to reject the collective bargaining agreement under § 365(a) of the Code. *Id.* The Court considered collective bargaining agreements to be executory contracts. *Id.* at 521-22. The major issue for the Court was what standard should govern the rejection of a collective bargaining agreement under reorganization. The respondent argued for the business judgment standard, but the Court concluded that a stricter standard was needed, and noted the special nature of the contract and the law creating the agreement. *Id.* at 523. The Court held "that the Bankruptcy Court should permit rejection of a collective-bargaining agreement under § 365(a) of the Bankruptcy Code if the debtor can show that the collective-bargaining agreement burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract." *Id.* at 526.

158. 11 U.S.C. § 1113 (Supp. III 1985).

contract itself should anticipate the difficult issues that accompany placing the traditionally public function of operating prisons into private hands.

*Cathy E. Holley**

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