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Better Winding Up

A Proposal for Improved Winding Up of Executory Contracts

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Abstract

An evaluation problem exists when winding up executory contracts in case of insolvency. The trustee has difficulties in accurately considering the claim for damages that arises if he chooses to reject a contract instead of accepting it. An unequal treatment of creditors and inefficiencies follow. However, a simple reform can solve this problem. If an executory contract is accepted by the trustee, there should be the same claim for damages as if it had been rejected. Only the difference between this claim for damages and the initial claim should be paid directly out of the estate.

JEL-Codes: G33, K39, K35, K22

Besser abwickeln

Ein Vorschlag zur Verbesserung der Abwicklung schwebender Verträge im Insolvenzfall

Zusammenfassung

Bei der Abwicklung schwebender Verträge in der Insolvenz gibt es ein Bewertungsproblem. Der Insolvenzverwalter hat bei der Wahl zwischen der Annahme und Ablehnung eines Vertrages Schwierigkeiten, den durch Vertragsablehnung entstehenden Schadenersatzanspruch richtig zu berücksichtigen. Es kommt zu einer ungleichen Behandlung von Gläubigern und ineffizienten Ergebnissen. Das Problem lässt sich durch eine einfache Reform beheben. Bei Wahl der Vertragserfüllung sollte derselbe Schadenersatzanspruch wie bei Ablehnung bestehen und nur seine Differenz zur vollständigen Erfüllung aus der Masse bezahlt werden müssen.

Im Internet unter:

http://www.wiwi.uni-muenster.de/io/forschen/downloads/DP-IO_04_2015.pdf

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Better Winding Up

A Proposal for Improved Winding Up of Executory Contracts*

1. Introduction

According to the insolvency law in most developed countries,[1] the trustee may choose whether he wants to accept or reject a mutual contract that has not yet been completely executed by both signatories. In case he opts for fulfilment of the contract, the claim F has to be fulfilled completely out of the estate. The signatory, then, is obliged to effect the contracted consideration. If the trustee rejects completion, the signatory will obtain a claim for damages S due to non-performance. This claim for damages, however, is just a simple insolvency claim entitled to settlement according to the insolvency quota q.

In section 2 we will show that this way of winding up executory contracts is problematic. It is rather difficult for the trustee to decide whether the acceptance or the rejection of a contract is in the interest of the creditors or even efficient overall. In section 3 we therefore suggest a change of handling procedures that considerably simplifies the trustee's decision. The suggestion also abolishes an existing unequal treatment of creditors and is in line with the recent legal conception that the contractual relationship is already converted into a claim for damages when the insolvency proceedings are instituted. Section 4 deals with the remaining problems that can be caused by the fact that the signatory might not have the incentive to state his amount of damages correctly. These kinds of problems are more serious and severe in the current legal situation than after the implementation of the proposal for reform. In section 5 the results will be summarised and a conclusion will be drawn.

2. The Decision Problem When Winding Up Executory Contracts

In case of insolvency a debtor is not able to clear his debts completely.[2] If the debtor's assets are still high enough to make regular insolvency proceedings appear worthwhile, these assets will be realised as estate by a trustee to satisfy creditors' claims proportionally according to a uniform quota. A contractual partner who already rendered her services and now awaits the debtor's consideration will only receive a fractional amount of his initial claim. Conversely, if

* This paper is based on *Dilger* (1998 and 2000), both in German and still relevant from my point of view.

[1] E. g. 11 USC 365 in the USA (cf. *Baird* 1993, p. 114-141) or § 103 InsO in Germany.

[2] Otherwise there would not be any insolvency. Theoretically, insolvency due to pure liquidity problems is possible, even though all liabilities can be settled, but this virtually never occurs.

the insolvent debtor has already performed in full, it goes without saying that the contractual partner has to reciprocate not only partly but completely. This benefits the estate and thereby the creditors.

If both signatories have not yet performed (fully), an analogous asymmetry concerning the pending execution of the contract appears to be inequitable. It cannot be expected of the signatory to reciprocate fully even though she knows that the insolvent debtor performs only according to the insolvency quota. However, it is not acceptable that the contract has to be fulfilled completely at the estate's and therewith the creditors' expense at any rate. It might well be possible that due to the insolvency there is no further need for the signatory's performance. Thus the law grants the trustee a choice. On behalf of the creditors he can decide to accept or reject the contract. If fulfilment is chosen, both signatories will have to fulfill the contract completely just as if there had been no insolvency. The debtor's performance is taken from the estate and the signatory's benefits the estate. If the trustee rejects fulfilment, the signatory gains a claim for damages due to non-performance of the contract the same way she would towards a solvent debtor who did not fulfil the contract. However, this claim for damages is not settled ex ante and completely out of the estate but will take part in the allocation of the estate with the uniform insolvency quota.[3]

2.1. The Insolvency Creditor's Problem

The trustee acts on behalf of the creditors. Nevertheless one can ask what aim he should have when deciding about acceptance or rejection of executory contracts. One possibility appears to be the maximisation of the estate. The larger the estate is, the more can be distributed to the creditors. A problem arises from the fact that in case of rejection of the contract, the signatory turns into a further insolvency creditor.

An example shall clarify this point. In the example an insolvent company ordered a machine at the price of $20,000 before insolvency occurred.[4] So far the machine has not yet been delivered and the purchase price has not been paid. Therewith, the trustee has the right to

[3] Partial performances already carried out can be charged against the claim for damages. If these performances exceed the entitled claim, the signatory has to hand the surplus over to the estate.

[4] The following consideration and the example only deal with the case where the contractual partner is the seller of an object or a service while the insolvent company owes money. The remarks basically also apply to the converse case where the insolvent company has to perform a service and receives money for it from the signatory. Only the interpretation of certain variables needs to be changed then. The same is true for the case where both signatories are obliged to render non-monetary services. Claims of damages are already monetary variables anyway.

choose. In order to maximise the value of the estate, he should opt for fulfilment of the contract and pay the machine if and only if the value W is greater than or equal[5] to the claim F = \$20,000 $(W \geq F)$.[6] If the machine is worth less $(W < F)$, may it be because due to termination of production it is no longer needed and can only be resold at a lower price or because it can be sourced at a lower price elsewhere, then the rejection of fulfilment will maximise the value of the estate.

This decision to maximise the estate alone is problematic since the rejection of the contract leads to a claim for damages S.[7] This claim for damages does not concern the estate but the sum of claims which are to be considered. If the insolvency quota q equals zero, no creditor will be affected since there is nothing to allocate anyway. Otherwise, however, a partial maximisation of the estate might harm creditors even though it is done to satisfy their claims at the best possible rate. In our example the trustee maximising the estate would reject fulfilment even if this leads to a claim for damages amounting to S = \$18,000 and the machine is worth W = \$19,999 to the company. With an insolvency quota of $q = 5\%$ the previous creditors will lose \$900 compared to an enlargement of the estate of only \$1. That is because the insolvency creditors would have to share the latter with an additional insolvency creditor, who has a new insolvency claim of \$18,000,[8] whose fulfilment with 5 % takes up \$900 from the estate. The amount will increase accordingly if the insolvency quota rises.

Strictly speaking, it has to be distinguished between the insolvency quota in case of fulfilment versus the one in the event of rejection of the contract. If the trustee chooses fulfilment, the quota q_e equals

$$q_e = \max\left(\frac{T + W - F}{I},\ 0\right),$$

where T stands for the estate and I accounts for the sum of given claims regular insolvency

[5] In case of equality, the decision does not result in a quantitative difference but one can argue that contracts should not be given notice of withdrawal unilaterally without cause.

[6] For reasons of simplification we assume that both *W* and *F* are known. If the value of the subject of a contract is a random variable, then *W* will be the known expected value of that random variable given all parties are risk neutral.

[7] There is an ongoing controversy in legal literature about whether the claim for damages really only arises from the rejection of the fulfilment of the contract or whether it already emerges at the point of the debtor's insolvency. The latter would be a further argument for the reform proposal submitted here; see below section 3.3.

[8] The enlargement is relative to the acceptance of the contract, where \$20,000 would have been paid for the machine worth \$19,999.

creditors obtained separate from the winding-up of the executory contract. In case of rejection, the insolvency quota q_a is

$$q_a = \frac{T}{I+S}.$$

Thus, in case of fulfilment the hitherto existing simple insolvency creditors receive

$$Z_e = q_e \cdot I = \max(T + W - F, \$0),$$

whereas in the event of rejection, they obtain

$$Z_a = q_e \cdot I = \frac{I}{I+S} \cdot T.$$

It is therefore in the interest of the creditors to accept[9] the contract if and only if

$$Z_e \geq Z_a$$

$$\Leftrightarrow \; T + W - F \geq \frac{I}{I+S} \cdot T$$

$$\Leftrightarrow \; \frac{S}{I+S} \cdot T \geq F - W.$$

Unfortunately, plain maximisation of the estate does not guarantee the adherence of the above precondition. It is difficult for the trustee to use the optimum constraint $Z_e \geq Z_a$ directly as a decision rule. At the point of time where he must decide on the continuation of the contract he does not possess all the necessary information on the variables of the inequality. F and W are assumed to be known, but the claim for damages S is normally only numbered by the signatory afterwards. The estate T to be allocated and the extent of the insolvency claims I are not asserted before the closing of the insolvency proceedings. If the trustee maximises the estate *T*, i. e. applies the comparatively simple rule that fulfilment of the executory contract is to be rejected if and only if *F* > *W*, this method will result in an unfavourable decision from the creditors' point of view when it holds that

$$\frac{S}{I+S} \cdot T \geq F - W > \$0 .$$

[9] In the following we disregard the case T + W – F < \$0. If so, the insolvency creditors do not receive anything anyway and are therefore not at all interested in the decision whether or not the contract is continued.

The creditors' financial loss caused by this wrong decision amounts to

$$\frac{S}{I+S} \cdot T + \mathrm{W} - \mathrm{F}.$$

2.2. The Efficiency Problem

In addition to the disadvantage portrayed above, an efficiency problem for the insolvency creditors also arises. In the contemplated example we now assume that the signatory has to scrap the machine in case of rejection of the contract since the customised product is only of value in the insolvent company. In case of W = \$19,999 a value in a similar dimension to that will be destroyed if the trustee only attends to estate maximisation due to the precondition that the value of the estate shall not decrease even if it is only by \$1 ($F - W$). In the event of non-acceptance of the machine, a break-up value amounting to $F - S$ = \$2,000 remains. The result is an efficiency loss of \$17,999.

Since lost profits also justify a claim for damages, the correctly calculated claim for damages S generally equals the difference between the claim F from the rejected contract and the value V of the best utilization of the subject matter of the contract by the signatory or by disposal to a third party. Therefore, it holds

$$S = F - V \Leftrightarrow V = F - S.$$

If the subject matter can be sold or utilised better without further expenses at a price higher than the one stipulated in the contract $(F < V)$, then $S = \$0$. Fulfilment of the contract is efficient if the subject matter can be utilised or resold better by the insolvent company than by the signatory $(W \geq V)$. However, the trustee deciding about compliance does not normally know V. Even if he knew V, he would rather be bound to the creditors' interests than to efficiency at large. Thus, he would not accept the contract according to the efficiency criterion $(W \geq V)$ but either do so in order to maximise the estate $(W \geq F)$ or, in the ideal case with sufficient information, he does the best for the existing insolvency creditors $\left(W \geq F - S/(I+S) \cdot T\right)$. The efficiency loss caused by an inefficient decision amounts to $|W - V|$.

In principle, successful negotiations between the contractual partner and the trustee can solve this efficiency problem. According to the *Coase*-Theorem, negotiations can always result in an efficient outcome if property rights are well-defined, transaction costs do not exist and the

information is symmetrical.[10] In the above example, the machine could be sold at the price of \$19,000 to the advantage of all parties involved. In reality, however, negotiations might fail due to high transaction costs, mutually false estimations in case of asymmetric information or disaccord about the allocation of the profits from the negotiations. Furthermore, insolvency proceedings are redundant anyway if the *Coase*-Theorem is applicable since in that case the parties hereto can reach an efficient negotiation solution without such proceedings. Therefore, the insolvency law should be designed in such a manner that the trustee is able to make an efficient decision concerning acceptance or rejection of an executory contract that follows the insolvency creditors' interests from the first and without complete information.

3. A Proposal for Improved Winding Up

3.1. Proposal for the Benefit of the Insolvency Creditors and for an Increase in Efficiency

In the following a new method for winding up executory contracts is presented that avoids the problems discussed above. The proposal goes as follows: Firstly, the signatory has to numeralise her claim for damages S prior to the trustee's decision. Secondly, this claim for damages will be subtracted from the sum of claims F which is to be acquitted through the estate, and thirdly, it will be filed as a simple insolvency claim. From this it follows that if the signatory states her claim for damages correctly, no change occurs in case of rejection. The claim will be fulfilled with the insolvency quota q, i. e. the signatory receives $q \cdot S$.[11] In case of acceptance, however, the signatory will no longer get her claim F paid in full but will receive $F - S$ in return for her service plus her claim for damages, weighted with the insolvency quota, $q \cdot S$. Altogether, she will thus gets $F - (1-q)S$.

The trustee's decision rule is now rather simple: He refuses compliance if and only if $W < F - S$, and opts for acceptance otherwise. This leads to maximisation of the estate and always is in the insolvency creditors' interest as well. The insolvency quota in case of rejection equals, as hitherto,

$$q_a^V = \frac{T}{I+S} = q_a .$$

[10] See *Coase* (1960).

[11] Strictly speaking, we have to analyse the insolvency quota with respect to the proposal and the rejection of fulfilment. It turns out though that it holds $q_a^V = q_a$.

In case of fulfilment, the insolvency quota amounts to

$$q_a^V = \max\left(\frac{T+W-(F-S)}{I+S}, \$0\right) \geq q_e.^{12}$$

Thus, if rejection is chosen, the present insolvency creditors receive

$$Z_a^V = q_a^V \cdot I = \frac{I}{I+S} \cdot T = Z_a,$$

and

$$Z_e^V = q_e^V \cdot I = \max\left(\frac{I}{I+S} \cdot [T+W-F+S], \$0\right) \geq Z_e$$

if the trustee chooses compliance.

The insolvency creditors want compliance if and only if[13]

$$Z_e^V \geq Z_a^V$$

$$\Leftrightarrow \frac{I}{I+S} \cdot (T+W-F+S) \geq \frac{I}{I+S} \cdot T$$

$$\Leftrightarrow W \geq F-S.$$

This corresponds to the trustee's decision rule mentioned above. As long as the signatory states her claim for damages correctly as $S = F - V$, efficiency is guaranteed through acceptance if and only if $W \geq F - S = V$.[14]

3.2. Consequences for the Signatory and Equal Treatment of Creditors

The proposal might bear disadvantages for the signatory compared to the effective bankruptcy act. In case of rejection, she still receives the very same, namely

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[12] q_e^V and q_e differ in the addition of *S* in both the numerator and the denominator. Since the denominator is greater than the numerator, it generally holds that $q_e^V > q_e$. The border case $q_e^V = q_e$ only occurs if all insolvency creditors' claims are either met in full $\left(q_e^V = q_e = 1\right)$ or not at all $\left(q_e^V = q_e = 0\right)$, and the decision about executory contracts are therefore irrelevant to them.

[13] We disregard the case where $T+W-F+S$ is negative. Since $T \geq \$0$, this case can only occur if the trustee slips up and comes to a false decision.

[14] If $V > F$, an inefficient acceptance of the contract is possible since *S* cannot be negative. In this case, however, negotiations can contribute to an efficient allocation whose advantages then also benefit the estate (at least in part).

$$V + q_a^V \cdot S = V + q_a \cdot S = (F - S) + \frac{T}{I + S} \cdot S .$$

If the trustee refuses fulfilment, however, the signatory only receives, according to the proposal,

$$(F - S) + q_e^V \cdot S = (F - S) + \frac{T + W - F + S}{I + S} \cdot S < F ,$$

while according to effective law her claim would be acquitted completely.[15] Still the proposal does not always have to be to the signatory's disadvantage. The contract is accepted in more cases when applying the proposal. The trustee opts for fulfilment not only in case of $F \leq W$ but also if $F - S \leq W < F$ and acceptance of the contract oftentimes yields slightly more than rejection because of $q_e^V \geq q_a^V$.

Even if the signatory is worse off compared to her current position, she is still not treated worse than other insolvency creditors. Claims dating back to the time before insolvency proceedings were instituted are only settled according to the insolvency quota. Claims that emerge afterwards will be settled completely out of the estate. When the insolvency proceedings have been instituted, the signatory is not forced to perform her services in full while only receiving a fractional amount in return. Instead, she gets the decision-relevant fraction paid completely. The loss constituting the claim for damages, on the other hand, originates from the contract closed previous to the insolvency proceedings. Hence, to treat the signatory and the insolvency creditors equally, the claim for damages is settled only in the amount of the insolvency quota. In real terms, the loss only occurs in case of rejection of the contract, but this can only be averted by the trustee and not the signatory. Therefore, the advantages of avoiding a loss should be added to the estate administered by the trustee. For the signatory, however, the mere possibility of rejection of the contract already constitutes a claim. Thus, damages are awarded for this eventuality at any rate, even if the contract is fulfilled. In addition, the signatory does not have to be forced to perform if the trustee opts for fulfilment of the contract, because, given a correctly quoted claim, the signatory receives at least as much as in case of the best alternative usage of the subject matter of the contract.[16]

[15] If $q_e^V = 1$, the proposal leads to complete acquittance of the signatory's claim as well.

[16] She receives an extra $F - S = V$ due to the trustee's choice of fulfilment, plus the insolvency quota on her claim for damages, i. e. $q_e^V \cdot S$, with $q_e^V \geq q_a^V$ and identity only in case of $W = F - S,\ q = 0$ or $q = 1$.

The Bankruptcy Act and the Insolvency Act provide an advantage for the signatory over the insolvency creditors, since in case of fulfilment of the contract the signatory's claim is paid in full just like it would have been if the debtor had not filed an insolvency petition since the signing of the contract.

3.3. Further Arguments for the Proposal

Formerly, the prevailing opinion among German lawyers was that the claim for damages results from the rejection of the contract. Wolfgang Marotzke disagrees when he writes that the occurrence of insolvency already constitutes a claim for damages.[17] This view gained more and more recognition[18] and can now be called the new prevailing opinion in Germany.[19] "At this stage, altering the legal relationship between the debtor and the signatory right when insolvency proceedings are initiated already corresponds with usual legal practice of the Federal Court of Justice. A unilateral claim for damages due to non-performance supersedes the mutual contract, since the claim for performance is expired."[20]

The proposal for reform presented here is in accordance with this new legal opinion. If the claim for damages results from the occurrence of insolvency, it exists regardless of the trustee's decision on fulfilment or rejection of the contract. If the contract is fulfilled, the damage is averted. In this case, the signatory should be willing to make a payment up to the amount of damages. Imagine that a third party eliminates the damage. If the signatory is not willing to pay as much for the avoidance of damages as the amount of her claim for damages, the actual damage is less than the (excessively) filed claim for damages.

Georg Kuhn and *Wilhelm Uhlenbruck* are of the following opinion: "According to the apparently correct view, the contractual relationship turns into a claim for damages. The contract is suspended. The signatory's claim for performance is turned into a unilateral claim for damages due to non-performance. ... *If the trustee chooses fulfilment of the contract, the obligation is constituted anew with the previous content.*"[21] However, it cannot be understood why, in case fulfilment is chosen, the signatory's position should be improved in such a way that she does not suffer any damages at all and even is able to realise gains, while her claim

[17] See *Marotzke* (1985), pp. 52-77, pp. 73-77 in particular.

[18] Compare *Kuhn/Uhlenbruck* (1994), pp. 355-357, with numerous references.

[19] Compare *Bork* (1995), p. 71.

[20] *Braun/Uhlenbruck* (1997), p. 369, own translation, accentuations left out, with further references.

[21] *Kuhn/Uhlenbruck* (1994), p. 356, own translation with changed accentuations.

for damages is only settled according to the insolvency quota in case of rejection of the contract. New grounds for the contract should be derived from the given status where the signatory's damages already exist.

One can also ask under what circumstances the signatory would voluntarily agree to fulfilment of the contract. That is the case if she is not put in a situation worse than without it. This is guaranteed by the proposal for reform. Applicable law, in contrast, improves her position in case of compliance discontinuously strong. In the initial example with $F = \$20{,}000$, $V = \$2{,}000$ and thus $S = \$18{,}000$, $T = \$100{,}000$ and $I = \$1{,}982{,}000$ shall be given. According to the Insolvency Act, the insolvency quota in case of rejection of the contract, for example due to $F > W = \$19{,}999$, amounts to $q_a = T/(I+S) = 5$ %. Accordingly, the signatory receives $q_a \cdot S = \$900$ as an insolvency creditor; combined with the alternative usage V she then has \$2,900 in total. If the contract is fulfilled, for example because W is only \$1 higher $(F \leq W)$, the signatory receives $F = \$20{,}000$. The change from rejection to fulfilment of the contract, which can be caused by only \$1, even by only one cent, earns the signatory \$17,100.

If the proposal for reform is implemented, the transition proceeds continuously. In case of rejection of the contract, the signatory receives the same amount, i. e. \$900, as insolvency creditor, plus \$2,000 from the alternative utilisation. Rejection, however, occurs already if $W \geq \$2{,}000$. If $W = \$2{,}000$, she also receives

$$(F-S) + q_e^V \cdot S = (F-S) + \frac{T+W-F+S}{I+S} \cdot S = \$2{,}900\ ;$$

if $W = \$19{,}999$, payments of \$3,061.99 arise, and if $W = \$20{,}000$ payments of \$3,062. The payment the signatory receives is increased by 9/10 Cent for every \$1 W rises.

Finally, the proposal for reform argues for the analogy in the treatment of separable performances according to the Insolvency Act. Pursuant to § 105 InsO, concerning the effected partial performances, the signatory only has the legal position of an insolvency creditor, even if the trustee demands fulfilment for the remaining performances. Analogously, a machine that has already been manufactured but was not yet delivered to the debtor can be seen as work performed as well. The signatory is still better off than in case of effected partial performances, because she can at least demand complete fulfilment for alternative usage options. After all, this is not part of her claim for damages, whereas performances already effected cannot be used alternatively any more.

4. The Possibility of Misrepresented Claims for Damages

The proposal does not necessarily assure that the subject matter of the contract is used best, since the signatory might not quote her damage correctly. The efficient utilisation is guaranteed in case of a proper damage statement, because the trustee opts for fulfilment of the contract if and only if it is at least as good as the best outside option $(W \geq F - S = V)$. However, it is in the signatory's interest to overstate her claim for damages if she expects rejection of the contract and to understate the claim if she assumes that the trustee will accept the contract. In the first case, the contract could be accepted even though the value of an alternative usage is higher. This occurs if

$$V = F - S > W \geq F - S(S + O) = V - O,$$

holds with O indicating the overstatement. In the second case, rejection of the contract could occur although fulfilment would maximise the value. If U is the understatement, it holds that

$$V = F - S \leq W < F - (S - U) = V + U.$$

These inefficient decisions on utilisation are only possible, however, if the signatory does not misjudge the trustee's evaluation. She is interested in a highly accurate estimation, since she only benefits from an overstated claim if the expected rejection of the contract really occurs. Otherwise, she only harms herself by the overstatement. Likewise, an understatement leads to harm in case of an unexpected rejection of the contract. This means that the signatory who over- or understates her claim for damages has a strong interest in an efficient decision herself. Furthermore, the higher the over- or understatement, the more likely is a change in the trustee's decision. This limits the extent of the intentional error. If there is too much uncertainty about the trustee's evaluation, the signatory will quote the correct amount of damages anyway.

In addition, the extreme example of understatement where no claim for damages is filed at all $(U = S)$ because the signatory expects fulfilment of the contract, leads to the same outcome as the Insolvency and Bankruptcy Acts. The signatory receives *F*. $W < F$ also results in rejection but, due to the filed claim for damages amounting to $S - U = \$0$, the signatory has to bear the consequences primarily. The estate does not sustain a loss except for possible advantages of the fulfilment of the contract. Therefore, the possibility of an understated claim for damages does not undermine the advantages of the proposal.

According to the Insolvency and Bankruptcy Acts, a possible overstatement of the claim for damages does not influence the trustee's decision on fulfilment or rejection of the contract. In case of fulfilment, the overstatement is irrelevant since the claim for damages is not filed at all. In case of rejection of the contract, however, it is paying for the signatory to overstate. The trustee will have to check the claims for damages thoroughly in order to avoid arbitrarily exaggerated claims.

Even if the proposal for reforming the winding-up of executory contracts is implemented, this type of verification cannot be set aside. However, only inflated claims for damages should be rejected, whereas voluntarily understated claims seem to be acceptable.[22] In addition to this examination whether the damage is overstated or not, which could prove difficult due to existing appraisal costs and scopes, the proposal creates a direct incentive for the signatory not to overstate her claim for damages too much, since that could lead to acceptance of the contract linked with a reduced payment. The present legal situation does not offer such an incentive.

5. Conclusion

Insolvency and Bankruptcy Acts govern the winding-up of mutual contracts that have not yet been (completely) executed by both signatories in case of insolvency the way that the trustee gets the right to choose between fulfilment and rejection of the contract. In case of rejection, the signatory is entitled to a claim for damages which equals a regular insolvency claim. If the trustee accepts the contract, however, it then has to be executed completely by both parties. This arrangement can lead to three problems. Firstly, it may lead to decisions which are unfavourable for the insolvency creditors. Secondly, the outcome can be inefficient, and thirdly, creditors might be treated unequally.

All these problems originate from the fact that a change in the trustee's decision can lead to a great leap in the signatory's position. In case of rejection of the contract, the signatory's claim for damages is settled only according to the normally lower insolvency quota. If the contract is accepted, however, the claim is paid in full.

The proposal submitted here to solve the problems suggests, in accordance with the new prevailing opinion among legal experts, to treat the damages caused by a (possible) rejection

[22] This understatement U is made in order to enhance the payment $F-(S-U)$ in case of fulfilment of the contract but this payment is only granted as long as it is outweighed by the value of the contractual performance.

of the contract as if it had occurred together with the insolvency, and, against effective law, to stick to this treatment even if the trustee chooses fulfilment of the contract. This implies that a claim for damages has to be awarded and settled according to the insolvency quota in any case, whereas the acceptance of the contract only calls for payment of the remaining difference out of the estate. The trustee is then able to act on behalf of the insolvency creditors simply by rejecting all contracts that cost the estate more than they yield, and by accepting the remaining contracts. The signatory is treated like every other creditor, who can also only expect settlement according to the insolvency quota for claims constituted prior to the insolvency. Finally, if the claim for damages is stated correctly by the signatory, efficient allocation is achieved. The signatory may have an incentive to give a falsified statement, which can lead to a loss in efficiency. However, this loss is not greater than currently and it has to be borne by the signatory herself, which limits her incentive for misrepresentation. Therefore, it is advisable to incorporate the proposal for reforming the winding-up of executory contracts submitted here into the Insolvency Act.

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