BANKRUPTCY LAW NEWSLETTER

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WESTERN DISTRICT OF MICHIGAN CHAPTER

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STATUS AND RIGHTS OF THE PARTIES TO THE POST-PETITION, PRE-REJECTION/ASSUMPTION EXECUTORY CONTRACT

By Samuel R. Maizel

The Bankruptcy Code, 11 U.S.C. § 365, provides that, subject to court approval and certain limitations, debtors can assume or reject any executory contract. It is an area of the law described as a "thicket ... where ... lurks a hopelessly convoluted and contradictory jurisprudence."[1] "[I]n no area of bankruptcy has the law become more psychedelic than in the one titled 'executory contracts.'"[2] And no area of the law of executory contracts is more psychedelic than the status and rights of the parties to an executory contract after the filing of the petition but before it is assumed or rejected.

The status of an executory contract after filing of the bankruptcy petition but before its assumption or rejection is disputed. The competing views turn upon whether the contract is deemed automatically property of the estate or becomes property of the estate only after it is assumed. "One view, the exclusionary analysis, holds that executory contracts remain outside the estate prior to assumption. The competing view is that they enter the estate initially, but are thereafter subject to abandonment via rejection."[3]

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1 In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (quoting Andrew, Executory Contracts Revisited: A Reply to Professor Westbrook, 62 U. Colo. L. Rev. 1 (1991)).

2 Drexel Burnham, 138 B.R. at 690 (quoting Westbrook, A Functional Analysis of Executory Contracts, 74 Minn. L. Rev. 227, 228 (1989)).

3 In re Drexel Burnham Lambert Group, Inc., 138 B.R.

The latter view has the better case; it seems more consistent with the broad definition of "property of the estate" in 11 U.S.C. § 541(a)(1).[4] If an executory contract was not property of the estate, it would (1) not be protected by the automatic stay, (2) the non-debtor party could refuse to perform until the contract was formally assumed, thereby forcing the debtor to assume or reject without having to file a motion.[5] If the non-debtor refused to perform and, in effect, terminated the contract, the debtor's eventual decision to assume might be rendered meaningless. However, even if the contract is property of the estate, the status of the contract during the interim period, and the rights and responsibilities of the parties to the contract during the interim period remain to be clarified.

During the period after the filing of the petition but before the debtor assumes or rejects the contract (the "gap period"), the contract remains "in effect."[6] This does not mean that an executory contract is informally assumed by conduct.[7] A debtor retains the power to assume or reject. It merely means that where a debtor-in-possession continues to perform an executory contract, and thereby forces the non-debtor party to continue to perform,[8] both parties are bound by the terms of the contract -- the contract is "unaffected by the bankruptcy filing."[9] As noted by the many cases cited above, "this result is consistent with decisions under the former Bankruptcy Act ... and [w]here Congress has not evidenced an intent to change established pre Code law, courts should interpret the Code as continuing that legal principle."[10]

The only circuit to address this issue directly, however, concluded that the contract was not "effective" in the gap period. In In re University Medical Center,[11] the Third Circuit

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687, 701 (Bankr. S.D.N.Y. 1992).

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See, e.g., In re Alert Holdings, Inc., 148 B.R. 194, 203 (Bankr. S.D.N.Y. 1992) (unassumed executory contracts are property of the estate protected by the automatic stay); In re Seymour, 144 B.R. 524 (Bankr. D. Kan. 1992) (unassumed contract is property of the estate subject to rejection); Drexel Burnham Lambert Group, 138 B.R. at 701-02 (same).

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In re McLean Indus., Inc., 96 B.R. 440 (Bankr. S.D.N.Y. 1989).

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In re Public Serv. Co., 884 F.2d 11, 15 (1st Cir. 1989); In re Whitcomb & Keller Mortgage Co., 715 F.2d 375, 378-79 (7th Cir. 1983); In re Cochise College Park, Inc., 703 F.2d 1339, 1352 (9th Cir. 1983); Federal's, Inc. v. Edmonton Inv. Co., 555 F.2d 577, 579 (6th Cir. 1977); Smith v. Hill, 317 F.2d 539, 542 n.6 (9th Cir. 1963); Consolidated Gas Elec. Light & Power Co. v. United Rys. & Elec. Co., 85 F.2d 799, 805 (4th Cir. 1936).

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E.g., University Medical Ctr., 973 F.2d 1065, 1075-79 (3d Cir. 1992).

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A debtor-in-possession makes an executory contract enforceable against the non-debtor party prior to assumption if the debtor performs its obligations under the contract. See, e.g., Public Serv., 884 F.2d at 14; McLean Indus., Inc., 96 B.R. at 447-49 and cases cited therein.

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In re Polysat, Inc., 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993).

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Polysat, 152 B.R. at 890 (citing Dewsnup v. Timm, 112 S. Ct. 773, 779 (1992); In re Erin Food Servs., Inc., 980 F.2d 792, 800 (1st Cir. 1992)).

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973 F.2d 1065 (3d Cir. 1992).

held that the debtor was entitled to recover under the doctrine of quantum meruit rather than under the provisions of the contract in a dispute over payment with the Medicare Program. This idea -- that the debtor is entitled to rely on the contractual relationship without regard for the contractual terms -- is inconsistent with other provisions of the Bankruptcy Code's treatment of executory contracts. For example, nothing in the Code permits a debtor to demand that a creditor comply with the terms of an executory contracts but modify its obligations to the disadvantage of the United States. Even if a debtor properly assumes or rejects an executory contract, it cannot modify the nondebtor's obligations unilaterally.[12] Assumption of an executory contract simply requires both parties to continue to perform according to the contracts' terms.[13] On the other hand, rejection of an executory contract merely constitutes a breach of the contract; it does not invalidate the contract or make it nonexistent.[14]

Courts like that in University Medical Center come to the puzzling conclusion that the filing of the bankruptcy petition and debtor's failure to assume or reject the executory contract results in the contracts' terms requiring payment to the debtor remaining extant, but its terms which are deemed "burdensome" to the debtor somehow vanish. However, filing of a bankruptcy petition should "not repudiate the debtor's obligations" under an executory contract.[15] Nor can a debtor logically argue that payments are due under an executory contract but that at the same time the contract's provisions do not effectively exist. "An agreement cannot 'exist' for one purpose yet take on a 'nonexistent' quality which works to the advantage of one party or another."[16] If nothing in the Bankruptcy Code authorizes a court to expand the debtor's rights under an executory contract when it expressly allows the debtor to take an action, a court cannot, relying on the debtor's failure to act, hold that the Bankruptcy Code authorizes it to expand the debtor's rights under the contract. To the contrary, a debtor's contractual rights, which form part of its bankruptcy estate, come into the estate as they exist on the date of the filing of the bankruptcy

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See, e.g., In re Gunter Hotel Assocs., 96 B.R. 696, 698 (Bankr. W.D. Tex. 1988) ("overwhelming case authority that a bankruptcy court is not free to re-write an executory contract upon either its assumption or its rejection"); see also Westbrook, A Functional Analysis of Executory Contracts, 74 Minn. L. Rev. 227, 231 (1989) ("'Assume' and 'reject' are merely bankruptcy terms for the decision to perform or to breach, an election open to any party to a contract outside of bankruptcy.").

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United States v. Gerth, 991 F.2d 1428, 1432 (8th Cir. 1993); Public Serv., 884 F.2d at 15; Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection", 59 Colo. L. Rev. 845, 847 (1988) ("Assumption permits the estate to obtain the benefits of continued performance by the nondebtor party to the contract, as would assumption by an ordinary contract assignee.").

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In re Continental Airlines, 981 F.2d 1450, 1459-60 (5th Cir. 1993); Modern Textile, 900 F.2d at 1191; In re Murphy, 694 F.2d 172, 174 (8th Cir. 1982) (rejection of an executory contract is not the equivalent of recision); In re Child World, Inc., 147 B.R. 847, 852 (Bankr. S.D.N.Y. 1992) (same).

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Public Serv. Co., 884 F.2d at 16.

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Continental Airlines, 981 F.2d at 1459; In re Heafitz, 85 B.R. 274, 279 (Bankr. S.D.N.Y. 1988) (In evaluating executory contracts to determine if recoupment is permissible, a party cannot "simply pick and choose only those provisions that further its position while ignoring more specific provisions that hinder its position.").

petition.[17]

As executory contracts remain in effect pending assumption or rejection because the debtor has not rejected the contract, and the bankruptcy court may not alter the legal obligations of the parties to the contract, the debtor should not be allowed to take the benefits of the contracts but be shielded from the contracts' burdens.[18] A debtor-in-possession may not take the benefits of an executory contract without accepting the burdens, simply through the expedient of not formally assuming the contract.

> [I]t makes little difference as to the issues concerning these claims . . . whether the debtor expressly assumed the contract or merely knowingly conformed to its terms. The debtor could not seek and accept the benefits of the [executory contract] under the favorable terms of the contract without for the time of enjoying them, accepting and yielding to terms deemed burdensome.[19]

Courts should refuse to allow a debtor to take the benefits of an executory contract and then have the court shield it from the contract obligations it wishes to avoid. Enforcing the terms of the contract is "consistent with the bankruptcy policy of requiring that executory contracts be assumed or rejected in whole."[20]

While this area of the law remains subject to controversy, the result is uncertainty for all nondebtor parties to executory contracts. The practical result is that the nondebtor party to an executory contract is bound to a contractual relationship but without any idea of the terms controlling this contractual relationship. This treatment is not equitable nor compelled by the Bankruptcy Code, and all too typical a result for creditors in bankruptcy proceedings.

RECENT BANKRUPTCY COURT DECISIONS

6th Circuit and Supreme Court decisions are summarized by John Potter. There are no Western District or Eastern District cases to report.

In Re: The Julien Company, Oakland

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17 See 11 U.S.C. § 541. The legislative history of section 541 shows that the debtor's rights are not expanded "against others more than they exist at the commencement of the case." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 367-68 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 82-3 (1978).

18 See, e.g., In re B & L Oil Co., 782 F.2d 155 (10th Cir. 1986); In re Mohawk Indus., Inc., 82 B.R. 174, 177-78 (Bankr. D. Mass. 1987).

19 In re Public Ledger, Inc., 161 F.2d 762, 767 (3d Cir. 1947); accord B & L Oil Co., 782 F.2d at 159; In re Midwest Serv. and Supply Co., 44 B.R. 262 (D. Utah 1983); In re Public Serv. Co., 107 B.R. 441, 446 (Bankr. D.N.H. 1989); In re Hiler, 99 B.R. 238, 244 (Bankr. D.N.J. 1989); In re Alpco, Inc., 62 B.R. 184, 188-89 (Bankr. S.D. Ohio 1986).

20 Brown v. General Motors Corp., 152 B.R. 935, 938 (W.D. Wis. 1993).

Gin Co v Jack Marlow, Trustee for The Julien Co., 1995 FED App. 0029P (6th Cir.), File Name 95a0029p.06, Case No. 93-6201 (January 25, 1995). Plaintiff, Oakland Gin Co (Oakland) the Debtor, The Julien Company entered into contracts whereby Oakland, on behalf of a number of farmers, sold cotton to Debtor. Oakland, after baling and loading the cotton for delivery, would draw a draft on Debtor with an accompanying bill of lading. The draft and bill would then be submitted to the Bank for payment out of Debtor's account when the cotton was delivered. Oakland would deliver the cotton to the Julien Warehouse Co., a subsidiary of Debtor. The warehouse was operated by Federal Compress & Warehouse Company (Federal) pursuant to a management agreement. The parties intended for the cotton to remain at the warehouse only long enough for it to be reshipped as orders were filled. Consequently, the contracts did not provide for the use of warehouse receipts, since it would not be stored.

In December of 1991, Oakland delivered four shipments of cotton to Debtor. Several days later it forwarded drafts to the Bank for payment. The Bank dishonored the drafts, so Oakland requested that Federal return the cotton. Federal then filed an interpleader action in Alabama state court to determine who had title to the cotton. Debtor subsequently filed its bankruptcy petition and Defendant, Jack Marlow, was appointed trustee. The interpleader action was then removed to bankruptcy court. The bankruptcy court found that the trustee had superior title as a lien creditor of the estate. The district court affirmed.

In its appeal Oakland advanced numerous arguments as to why its interest in the cotton was superior to that to Debtor's estate. The Court of Appeals, nevertheless, affirmed the lower court decision.

First, Oakland argued that Federal and/or Julien Warehouse owed Oakland an obligation as bailee, to return the cotton to Oakland, as bailor, upon demand. The Court, however, found that Federal operated the warehouse mainly for the benefit of Debtor, through a management agreement with Debtor's subsidiary, the Julien Warehouse Co. In their course of dealing, Debtor was designated the shipper, Julien Warehouse Co. was Debtor's consignee, and Oakland was Debtor's agent. Further, no storage receipts were intended or used in the transaction. Federal retained custody of the cotton only so long as to immediately re-ship the cotton to Debtor's customers. Accordingly, no bailment existed under Tennessee law. Additionally, since Oakland was not a bailee, it cannot claim a security interest by possession under Tenn. Code §47-9-304.

Second, Oakland argued delivery of the cotton was conditional on payment. Tennessee Code §§ 47-2-507(2) and 47-2-511(1) provides that as a conditional seller, it had a right to reclaim the goods and the right to a security interest. The Court held that for Oakland to considered a conditional seller, delivery and payment must be concurrent conditions. The reality of Oakland's contract with Debtor, however was not that of a conditional seller, since delivery and payment did not happen concurrently.

Next, Oakland asserted that Section 262 of the United States Warehouse Act, 7 U.S.C. §241 *et seq* imposed an obligation of Federal to release the cotton upon its oral demand. The Court rejected this assertion since Section 262 only covers those transactions evidenced by a "receipt" and agricultural products "stored" in warehouses. Since the cotton was neither "stored" nor evidenced by a "receipt", this Section of the Warehouse Act is inapplicable.

Finally, Oakland argued that pursuant to Tennessee Code §47-2-702(2), where a seller discovers that the buyer has received

goods on credit while insolvent he may reclaim the goods upon demand made within 10 days of receipt. This Section allows the demand to be oral and defines insolvency, in part, to be when a debtor has ceased to pay his debts in the ordinary course of business. Further, the lower court erred in applying 11 U.S.C. §546© which requires insolvency as defined by the bankruptcy code and a written demand for return of the goods be made within 10 days of delivery. The bankruptcy court cannot retroactively apply §546© to a creditor prior to a debtor's bankruptcy. The Court stated that the majority of courts have adopted the view that §546© provides the exclusive remedy for a seller who seeks to reclaim goods from a debtor in bankruptcy. See In Re Contract Interiors, Inc., 14 B.R. 670, 675 (Bankr. E.D. Mich. 1981). In adopting the majority view, the Court stated that the right of reclamation is valid although bankruptcy intervenes. However, precise conditions must be met as defined by §546© before the right is recognized.

In Re: United States v Dishman Independent Oil, Inc. et al. 1995 FED app. 0039P (6th Cir.), File Name 95a0039p.06, Case No. 93-6246 (January 31, 1995). Defendant, Dishman Independent Oil, sued among others Penny Oil Corporation (Debtors in state court for $365,522.00 as due on the sale of petroleum products. On January 11, 1991, Dishman obtained a prejudgment attachment against Debtors. On January 14, 1991, the prejudgment attachment was served and Dishman seized personal property of the Debtors. The property seized included diesel fuel, cash, checks, and equipment. Later, Dishman was forced to file a Chapter 11 voluntary petition and the suit was removed to bankruptcy court as an adversary proceeding. On April 27, 1992, a $365,522.25 judgment in favor of Dishman was entered.

Immediately prior to the date of the state court trial, Debtors assigned their interest in the seized property to IRS. Consequently, the IRS obtained a continuance to prepare for trial as the new owners of the attached property. On January 29, 1992, three months prior to the bankruptcy court judgment in Dishman's favor, the IRS filed a tax lien against Debtors for $2.9 million. On May 29, 1992, the IRS intervened in Dishmans bankruptcy proceeding and filed a motion for summary disposition seeking a determination that its tax lien was valid and prior to any interest of Dishman in the attached property of Debtors. The bankruptcy court denied the IRS's motion. Dishman then filed its own motion for summary disposition which was granted after finding that its attachment lien was perfected by the April 27, 1992 judgment. The district court affirmed and the IRS appealed.

The Court of Appeals reversed. Dishman had not yet been granted judgment at the time the federal tax lien was filed. Therefore, at the time the federal tax lien was filed, property subject to Dishman's attachment lien and its amount remained uncertain. Consequently, the tax lien had higher priority. United States v Acri, 348 U.S. 211 (1955).

In Re: Elmer & Doria Walter, United States v John Hunter, Trustee, 1995 FED app. 0043P (6th Cir.), File Name 95a0043p.06, Case No. 93-4315 (February 3, 1995). On October 19, 1989, Debtors, Elmer and Doria Walter, filed a Chapter 11 Petition. Debtors owned a 1986 Kenworth Tractor at the time of the filing. Debtor listed the IRS as a creditor. Their assessed IRS tax liabilities relating to filed notices of tax liens totaled $389,395.01, including interest and penalties. On February 7, 1990, the IRS filed a second proof of claim for this amount and unsecured priority and

general claims totaling $2,595.79.

On June 5, 1990, the Debtors' motion, the case was converted to a Chapter 7 case with Defendant, John Hunter as trustee. The Trustee took possession of the Kenworth and sold it for $24,000.00, free and clear of liens. The Trustee then filed an objection to the IRS's proof of claim, asserting that as a bona fide purchaser of the truck, the tax liens could be avoided. Thus, the IRS's secured claims could be avoided and treated as unsecured priority claims. The bankruptcy court sustained the trustee's objection, concluding that under 11 U.S.C. §542© tax liens did not extend to motor vehicles under IRC §6323(b)(2). The district court reversed, stating that while a trustee is given the position of a hypothetical bona fide purchaser, the Trustee in this case failed to acquire possession of the truck before acquiring notice of the tax liens.

The Court of Appeals affirmed the district court, albeit for difference reasons. First, the trustee may avoid the federal tax liens if a hypothetical bona fide purchaser who obtained the truck on the Chapter 11 petition filing date could avoid such liens. 11 U.S.C. §545(2). A federal tax lien arises automatically when the tax liability is assessed and is made valid against third parties by the filing of notice of federal tax lien. IRC §6323(a). Since the IRS had filed notice of federal tax liens by the time the petition was filed, its liens were valid against third parties, except for certain purchasers under IRC §6323(b)(2). Nevertheless, a strict reading of §545(2) reveals that a trustee is not given the status of a bona fide purchaser, instead, he is given the power to avoid statutory liens where a hypothetical bona fide purchaser could avoid them.

Additionally, imputing characteristics of a debtor-in-possession to a hypothetical bona fide purchaser would lead to difference results depending on whether an actual trustee or a debtor-in-possession was exercising the avoidance. IRC §6323(b) affords protection only for a "purchaser". A bona fide purchaser is not necessarily a purchaser for purposes of the IRC §6323(b)(2). Accordingly, a trustee standing in the shoes of a hypothetical bona fide purchase does not fall within the protection of the statute. A debtor-in-possession and a hypothetical bona fide purchase are two separate persons. The bankruptcy code does not grant hypothetical possession to a hypothetical bona fide purchaser. Therefore, the Trustee may not avoid the IRS's lien under 11 §545(2).

EDITOR'S NOTEBOOK

Earlier this month you should have received your Registration materials for the 1995 Seminar. If you did not receive a copy of the Registration materials, please contact my office. This year's Seminar was orchestrated by Rayman & Hamlin and Robert E. Lee Wright. We encourage everyone to attend.

LOCAL BANKRUPTCY NOTICE

The Bankruptcy Court recently conducted a customer satisfaction survey.

After compiling the results of the survey we found that there were a number of respondents who requested that the direct phone number of the Judge's case administration teams and law clerks be advertised.

In response to this request all inquiries regarding the status of a case may be made directly to the case administrators of the Judge assigned to the case. This is the most efficient way for the caller to get in touch with the person who is most familiar with the case.

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Judge Howard's Team:
456-2909 or 456-2473
Law Clerk: 456-2907

Judge Gregg's Team:
456-2946 or 456-2308
Law Clerk: 456-2052

Judge Stevenson's Team:
456-2293 of 456-2099
Law Clerk: 456-2959

We hope by making people aware of these direct numbers we will be able to provide better service to the public and bar. Feel free to contact me should you require additional information.

Michael Ley
Chief Deputy Clerk

LOCAL BANKRUPTCY STATICS

The following is a summary of the number of bankruptcy cases commenced in the United states Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the months of March of 1995. These figures are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	March of 1995	March of 1994	March of 1993
Chapter 7	455	455	492
Chapter 11	7	9	11
Chapter 12	0	0	2
Chapter 13	160	157	144
Totals	622	621	649

Bankruptcy Chapter	January - March of 1995	January - March of 1994	January - March of 1993
Chapter 7	1133	1084	1203
Chapter 11	19	22	32
Chapter 12	6	2	8
Chapter 13	397	390	366
§304	1	0	0
Totals	1556	1498	1609

STEERING COMMITTEE MEMBERS

Dan Casamatta (1996)	(616)456-2002
John Grant (1997)	(616)774-0641
Tim Hillegonds (1995)	(616)459-6121
Mary Hamlin, Editor (1996)	(616)345-5156
Jeff Hughes (1996)	(616)336-6000
Pat Mears (1995)	(616)776-7550
Hal Nelson (1997)	(616)459-9487
Steven Rayman, Chair-elect (1995)	(616)345-5156
Brett Rodgers (1997)	(616)732-9000
Tom Sarb (1995)	(616)732-9000
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Peter Teholiz (1995)	(517)886-7176
Janet Thomas (1996)	(616)726-4823
Rob Wardrop (1997)	(616)459-1225
Bob Wright, Chair (1995)	(616)454-8656

NOTICE FROM FEDERAL BAR ASSOCIATION

Effective May 1, 1995 Chief Judge Gibson is retiring as a Federal District Judge for the Western District of Michigan. We wish to thank Judge Gibson for his many years of dedication and service.

Effective May 1, 1995 Judge Enslen will assume the responsibilities of Chief Judge for the Federal District Court for the Western District of Michigan.

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