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Can Trustee Recover Payments on Assumed Contract under a Fraudulent Transfer Theory?

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Assumption of an executory contract or unexpired lease entitles the nondebtor party to the contract to certain benefits, including the cure of all monetary defaults under the contract. *See* 11 U.S.C. §365(b). Contract assumption also serves as a potential defense to avoidance actions seeking to recover payments made on the contract. The question posed here is whether contract assumption bars fraudulent transfer actions to the extent they seek to recover payments made on the contract.

Contract Assumption as a Bar in Preference Litigation



Thomas G. Macauley

In preference litigation, it is well established that the assumption of an executory contract bars a subsequent suit to avoid and recover as a preference payments made pursuant to that contract.² Nevertheless, the decisions do not focus merely on the trustee's inability to sustain his burden of proof under

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§547(b)(5)—that is, whether the transfer provided the contract party with a greater return on its debt than if the transfer had not taken place and the party had received a distribution under a chapter 7 liquidation. Rather, the courts focus on “the unique set of rights”³ provided to contracting parties by §365 and its “telling” language.⁴ According to the Third Circuit, “as a matter of fairness, before requiring the

amounts owed prior to assumption. If Congress had intended to deprive contracting parties of monies they received pre-petition, why would Congress require that all defaults be cured prior to assumption? Serendipity would determine whether a contracting party is subjected to a preference suit. We believe Congress passed §365 to ensure that a contracting party is made whole before a court can force the party to continue performing with a bankruptcy debtor. Permitting a preference suit after an assumption order would undermine that purpose.⁶

Cover Feature

creditor to perform [under an assumed contract], courts require the debtor-in-possession (DIP) “to give the other contracting party the full benefit of [its] bargain.”⁵ The Seventh Circuit's language is even more emphatic:

The language and intent behind §365 is decisive. The language of §365(b)(1) is unequivocal. A party to an executory contract must be paid all amounts due him under the contract before the contract may be assumed. In drafting §365(b)(1), Congress went further than requiring that the trustee guarantee payment for future performance under the contract. It required that the trustee guarantee payment of all

Official Committee of Unsecured Creditors v. Aust (In re Network Access Solutions Corp.)

Chief Judge **Mary F. Walrath** of the U.S. Bankruptcy Court for the District of Delaware addressed contract assumption as a defense to fraudulent transfer and other causes of action on a motion to dismiss in *Official Committee of Unsecured Creditors v. Aust (In re Network Access Solutions Corp.)*.⁷ In that case, the creditors' committee commenced a postconfirmation action to avoid and recover payments made to the debtors' two officers prior to the chapter 11 filing. The committee challenged salary, bonus and other payments made to the officers on grounds of actual and constructive fraud

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² See, e.g., *Kimmelman v. The Port Auth. of N.Y. and N.J. (In re Kivi Int'l Air Lines Inc.)*, 344 F.3d 311, 321 (3d Cir. 2003) (holding that payments to defendants are not recoverable as preferences “because, had the creditors not received the payments pre-petition, they would have received amounts reflecting those sums, in any event, when the bankruptcy court approved the cures of the assumed agreements”); *In re Superior Toy & Mfg. Co.*, 78 F.3d 1169, 1174 (7th Cir. 1996) (“An assumption order divests the trustee of subsequent claims to monies paid under the contract whether they were paid pre-petition or post-petition. Sections 547 and 365 are mutually exclusive avenues for a trustee. A trustee may not prevail under both.”); *Phillip Servs. Corp. v. Luntz (In re Phillip Servs. (Del.) Inc.)*, 284 B.R. 541, 553 (Bankr. D. Del. 2002) (concluding that “once an executory contract is assumed, the trustee or debtor may not maintain a preference action to recover payments made pre-petition pursuant to the contract”).

³ *Kimmelman*, 344 F.3d at 317.

⁴ *Superior Toy*, 78 F.3d at 1174.

⁵ *Kimmelman*, 344 F.3d at 318 (quoting H.R. Rep. No. 95-595, at 348 (1977), reprinted in 1978 U.S.C.A.N. 5963, 6304-05) (first alteration added).

⁶ *Superior Toy*, 78 F.3d at 1174.

⁷ 330 B.R. 67 (Bankr. D. Del. 2005).

under federal and Virginia law and breach of fiduciary duty. Shortly after the commencement of the chapter 11 cases; however, the debtors had moved to assume the officers' employment agreements. The bankruptcy court had approved the assumption of the employment agreements after the committee had amended their terms to its satisfaction.⁸

In addressing the officers' motion to dismiss based on contract assumption, Judge Walrath initially noted that the standard for approving assumption of the employment agreements is the business judgment rule, which requires the bankruptcy court to find that the debtors acted on an informed basis, in good faith, with the honest belief that contract assumption was in the estates' best interest.⁹ Judge Walrath viewed her prior business judgment finding with respect to the employment agreements as law of the case.¹⁰ She then reasoned that such a finding "is too antithetical" to the committee's causes of action seeking recovery of transfers authorized under the employment agreements.¹¹ Accordingly, the bankruptcy court granted the motion to dismiss with respect to payments made pursuant to the assumed pre-petition employment agreements, but denied the motion to dismiss with respect to any payments not expressly authorized by or outside the scope of the employment agreements.¹²

Specifically, with respect to the committee's constructive fraud counts, Judge Walrath reasoned that her prior business judgment finding would preclude a subsequent finding that the transfers were made for less than reasonably equivalent value.¹³ She also applied the Seventh Circuit's reasoning in *Superior Toy* that a pre-petition transfer cannot be cured if it is to be avoided subsequently.¹⁴ With respect to the actual fraud counts, the bankruptcy court concluded that good faith, which is one of the foundations of the business-judgment test, cannot coexist with actual fraud.¹⁵ Finally, the breach of fiduciary duty and self-dealing counts failed to state a claim because the prior business judgment finding

applied to board decisions on employee compensation, which are usually entitled to the protection of the business judgment rule.¹⁶

Separately, the bankruptcy court held that the committee was judicially estopped from seeking to recover payments authorized under the employment agreements.¹⁷ The committee ultimately supported the assumption of the employment agreements and was able to reap the advantages of officers' specialized knowledge and expertise to maximize value for unsecured creditors.¹⁸ Having obtained this advantage, the committee was estopped from destroying the incentives offered to the officers in the form of the assumed employment agreements.¹⁹

Vision Metals Inc. v. SMS Demag Inc. (In re Vision Metals Inc.)

Judge Walrath also applied the contract assumption defense to constructive fraud claims on a motion for reconsideration in *Vision Metals Inc. v. SMS Demag Inc. (In re Vision Metals Inc.)*.²⁰ In that case, after agreeing to design, sell, maintain and supervise the installation of equipment for the debtors, the defendant failed to meet certain specific performance guarantees. As a result, the parties entered into a second agreement under which the defendant agreed to continue to provide parts and services in order to meet the performance guarantees. The second agreement also released the debtors from part of their payment obligation and released any claims of the debtors against the defendant. After the debtors commenced their chapter 11 cases, the bankruptcy court approved the debtors' proposed assumption of the second agreement.²¹

Although Judge Walrath reconsidered her prior ruling granting judgment to the defendant on the pleadings with respect to the debtors' federal and state law constructive fraud claims, she reached the same result on a different ground: the contract assumption defense.²² Judge Walrath

viewed as law of the case her prior finding that assumption of the second agreement was in the best interests of the debtors and their creditors.²³ The prior "best interests" finding would not permit the bankruptcy court to view the assumed agreement and the transfers made thereunder as constructively fraudulent.²⁴ The bankruptcy court also held that judicial estoppel precluded the debtors from seeking to void the assumed agreement after arguing successfully that its settlement of claims was in the best interests of the debtors and its creditors.²⁵ Judge Walrath viewed her conclusion as analogous to decisions holding that contract assumption precludes subsequent efforts to recover payments on the contract as preferences.²⁶

Near the end of her opinion, however, Judge Walrath notes that "assumption of a contract under §365 of the Bankruptcy Code may not always provide a defense to a fraudulent conveyance action."²⁷ It is not readily apparent how *Taylor*, which does not address contract assumption, might provide an exception to contract assumption as a defense. In that case, the court addressed whether the debtor received reasonably equivalent value for transferring 293 shares of stock pursuant to an agreement.²⁸ The court could not grant summary judgment to the defendant, even though it provided the debtor "with exactly the amount of value required" under the agreement, because there was "no evidence of the actual fair market value of the stock at the time of transfer."²⁹ There was no evidence of the stock's value because it could not be determined by review of the agreement.³⁰

It would be a mistake to view *Vision Metals* as creating an exception to the contract assumption defense merely when the value of the transfer cannot be determined by review of the contract. Parties in interest and the bankruptcy court will always measure the benefits and burdens of an executory contract proposed to be assumed, regardless of whether they can be readily determined from the four corners of the contract.

⁸ *Id.* at 75.

⁹ *Id.* at 75.

¹⁰ *Id.* at 76.

¹¹ *Id.* at 75.

¹² *Id.* at 79.

¹³ *Id.* at 76.

¹⁴ *Id.*

¹⁵ *Id.* at 77.

¹⁶ *Id.*

¹⁷ *Id.* at 78.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ 327 B.R. 719 (Bankr. D. Del. 2005).

²¹ *Vision Metals Inc. v. SMS Demag Inc. (In re Vision Metals Inc.)*, 325 B.R. 138, 141 (Bankr. D. Del.), *reh'g granted*, 327 B.R. 719 (Bankr. D. Del. 2005).

²² *Vision Metals*, 327 B.R. at 722.

²³ *Id.* at 722-23.

²⁴ *Id.* at 723.

²⁵ *Id.*

²⁶ *Id.* at 723-24 (citing authorities set forth in note 1, *supra*).

²⁷ *Id.* at 724 (citing *Taylor v. Riverside Franklin Props. Inc. (In re Taylor)*, 228 B.R. 491 (Bankr. M.D. Ga. 1998)).

²⁸ *Taylor*, 228 B.R. at 501.

²⁹ *Id.*

³⁰ *Id.*

Rather, Judge Walrath's cautionary language in *Vision Metals* should be read as defined by *Network Access*—which Judge Walrath issued just one month later—in which she carefully delineated that the contract assumption defense applies to transfers made pursuant to the assumed agreement, but not to transfers unauthorized by the agreement or made outside of its scope.³¹

Schnelling v. Crawford (In re James River Coal Co.)

A recent decision from the U.S. Bankruptcy Court for the Eastern District of Virginia applies the contract assumption defense without any reference to *Network Access* or *Vision Metals*. In *Schnelling v. Crawford (In re James River Coal Co.)*,³² the liquidating trustee commenced a post-confirmation action to avoid and recover, among other things, transfers made pursuant to a pre-petition settlement agreement with two of the debtors' former officers and a partnership affiliated with them. Pursuant to the settlement agreement, the debtors transferred money and other benefits, forgave loan balances and gave releases of liability. At plan confirmation, after the parties modified the settlement agreement to exclude the releases, the bankruptcy court approved its assumption.³³

In moving to dismiss the federal and state law claims alleging actual and constructive fraud, the defendants argued that the debtors' assumption of the settlement agreement barred the trustee from avoiding the transfers.³⁴ Judge Kevin R. Huennekens agreed that the trustee could not avoid the transfers set forth in the assumed contract as modified because the debtors had "accepted the benefits and the burdens of the remainder of the contract."³⁵ Nevertheless, since at the parties' request the bankruptcy court had excluded the release provisions from the contract to be assumed, Judge Huennekens concluded that the trustee could avoid the releases, as well as any other transfers made outside of the settlement agreement.³⁶

Although Judge Huennekens did not cite to *Network Access* or *Vision Metals*

in his decision, it is largely consistent with their application of the contract assumption defense. For instance, *James River* appropriately applies the contract assumption defense only to those transfers made pursuant to the assumed agreement. One potential distinction is that *James River* limits the contract assumption defense to the terms of the amended agreement, but *Network Access* applies the defense more broadly to the terms of the pre-petition agreement. That distinction raises the question of whether, in a case when an agreement is amended and assumed, the contract assumption defense insulates transfers made pursuant to the terms of the pre-petition agreement but outside the terms of the amended agreement.

Conclusion

The importance of the contract assumption defense as applied beyond preferences should not be underestimated in view of the increased use of fraudulent-transfer allegations to avoid pre-petition transfers. Preference allegations are more difficult to sustain with the recent congressional enhancement of the ordinary-course-of-business defense.³⁷ Moreover, avoidance complaints often include a fraudulent transfer count nowadays notwithstanding the ethical implications.³⁸ Therefore, creditor committees should be wary of the implications posed by contract assumption, and defendants to avoidance actions should be vigilant to determine whether the challenged transfers have any relation to an assumed executory contract. ■

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³¹ See *supra* text accompanying note 11.

³² Adv. No. 06-03037-KRH, 2007 Bankr. LEXIS 159 (Bankr. E.D. Va. Jan. 12, 2007).

³³ *Id.* at *36.

³⁴ *Id.* at *50.

³⁵ *Id.* at *51; see, also, *id.* at *54 n.18, *56 n.20.

³⁶ *Id.* at *52.

³⁷ See 11 U.S.C. §547(c)(2) (amended 2005) (now requiring proof to satisfy either objective or subjective standard, instead of both standards).

³⁸ Although a plaintiff can easily establish a *prima facie* case for a preference and thereby shift the burden to the defendant to establish an applicable defense, see 11 U.S.C. §547(g), the burden of proof remains throughout with a plaintiff seeking to prove a fraudulent transfer under federal or state law.