A BUYER IN DEFAULT, AN INTRANSIGENT SELLER, AND THE BUYER'S ABILITY TO ASSUME A REAL PROPERTY PURCHASE CONTRACT DESPITE ITS MATERIAL BREACH

By A. Kenneth Hennesay, Jr.[1]

I. Introduction

Even under nearly ideal credit market conditions, residential land development in California is a challenging business. It requires a deft touch to manage dual track funding and entitlement timelines toward a practical (let alone optimal) revenue point. In 2007, credit market conditions reversed precipitously, triggered by the subprime mortgage crisis.[2] Removing the bottom rung of the homebuyer ladder has led to a residential inventory overhang and a near halt to new home construction in the markets that have been residential development hot spots over the past few years. The consequence to residential land developers is obvious – a perfect storm of constricting credit and soft demand that has depressed land values and reduced or eliminated value in development projects. A substantial amount of land under development has been or will be either sold at deep discounts or mothballed until conditions improve.[3]

Land development deals made while land values move through a trough will be subject to heightened entitlement and funding coordination challenges. At some point, developers and land sellers will perceive that land values are beginning to appreciate again. Contracts to purchase land at relatively low prices will then gain "bonus value" that is above the value added by any entitlements obtained by the developer. These bonus value situations are ripe for conflict between developer/buyers and land sellers where the land is under contract and under development while its value appreciates. Under these circumstances, the seller may be tempted to exploit any arguable default by the developer for leverage in renegotiating the purchase price or attempt to terminate the contract and seek to recover the perceived bonus value through a sale to another party.

The developer's economic interest in the land, including the value added by any entitlement or other pre-development work and the bonus value of any land price appreciation, could be subject to a total loss if the seller effectively terminates the contract. An action to enforce the contract by the developer likely would involve adequate tender of cure of the alleged default, as well as the seller's potential equitable defenses to enforcement such as unclean hands or laches. If the right and ability to cure the default under state law is uncertain, or if winning the right to cure under state law involves litigation that is so costly and cumbersome that it would leave the developer/buyer only the chance of a Pyrrhic victory, a chapter 11 case may be

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[2] Robert Stowe England, *Anatomy of a Meltdown*, MORTGAGE BANKING, Oct. 2007, at 38.

[3] *See, e.g.*, Jim Wasserman, *Home Builders Mothball Projects*, THE SACRAMENTO BEE, November 9, 2007, at D4.

considered as an option to prevent termination of the contract and preserve the buyer's opportunity to recognize the benefit of its bargain through the right of assumption of the contract pursuant to § 365.[4]

Section 365 provides that assumption requires a cure of past defaults, adequate assurance of future performance (if any), and compensation for any pecuniary loss, such that the seller ultimately will receive the full benefit of its economic bargain. Accordingly, there are three principle issues that must be resolved in connection with assumption of a contract under § 365. First, whether the contract to be assumed is executory (i.e., a contract under which the obligations of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other). Second, what payment or other performance is required to cure and compensate the nondebtor party for the debtor's prepetition default. Third, if the contract calls for continuing obligations on the part of the debtor, the court must determine whether the debtor has provided adequate assurance of future performance.

The question addressed by this article and a companion article in this volume,[5] is to what extent do the matters that would be addressed in an enforcement action in state court control or affect the resolution of the three primary issues considered by the bankruptcy court in the context of assumption. The language and structure of § 365, considered in a vacuum, could be construed to require deference to state law on the consequences of a prepetition material breach of a contract that might render the contract unenforceable under state law. For example, § 365 does not define "executory contract." An accepted shorthand definition is a contract with *performance due on both sides*, such that a failure by either party to perform its obligations would result in a material breach of the contract. Is a contract executory for purposes of § 365 when a prepetition material breach by the debtor relieved the nondebtor party of any performance obligations under state law (such that performance is no longer "due" from that party)? Further, does § 365, which states that a contract may be assumed only if any defaults are cured, actually provide a trustee or debtor in possession with the power to cure such defaults, or must any power to cure be derived from applicable nonbankruptcy law? Finally, does § 365 preempt the nondebtor party's reliance on "equitable defenses" to enforcement of the contract?

If the answers to these questions are "no," § 365(b) arguably could be rendered almost meaningless (indeed, what purpose would the section serve if a debtor cannot assume a contract in material default, and only if it has the power to cure under nonbankruptcy law?). Ninth Circuit case law instructs that the mere fact of a material breach by a debtor does not render a contract not executory and not assumable. Section § 365(b) grants a debtor the broad power to cure all defaults under a contract, thereby eliminating all of the consequences of such defaults (including the consequence of relieving the nondebtor party of its duty to perform). Upon a debtor's cure, the nondebtor party can no longer rely on the debtor's pre-assumption defaults as an excuse of its own performance. Moreover, "equitable defenses" to enforcement of a contract should have no bearing on the debtor's ability to assume that contract. The Bankruptcy Code

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[4] Unless otherwise indicated or clear from the context in which a citation appears, citations in this article are to title 11 of the United States Code (the "Bankruptcy Code").

[5] Daniel H. Slate & Alex E. Spjute, *Section 365: To What Extent Do Equitable Principles and State Law Affect Assumption?*, 29 CAL. BANKR. J. 473 (2008) (the "Slate article").

defines the equities between the parties in the context of assumption. Equitable rights under state law do not preempt bankruptcy law – it is the other way around. The nondebtor party will receive the full benefit of his economic bargain, as required by § 365, and will have no remaining damages claims against the debtor or estate.

Many companies file chapter 11 to preserve defaulted contracts which are critical to the company's continued business. If a debtor's prepetition contract default is not curable under § 365, many chapter 11 cases would never be filed. Section 365 renders irrelevant the question of why the default occurred - did the debtor have a legitimate excuse for nonperformance; did the debtor experience a business downturn that prevented timely performance; did the debtor favor other creditors of the other contracting party and, therefore, did not have the economic means to perform; did the debtor not intend to perform; was the debtor unable to perform for some other reason, including due to the debtor's lack of financial wherewithal at the time the contract was entered into. These questions (and their answers) are not relevant inquiries under § 365. Instead, § 365 focuses on preserving value to the debtor's estate that otherwise might be lost outside of bankruptcy and adhering to the economic bargain between the parties as closely as possible.

II. Hypothetical Dispute Concerning a Debtor's Proposed Assumption of a Real Property Purchase and Sale Contract

This article and its companion assume the following hypothetical facts. A chapter 11 debtor in possession is a party, as buyer ("Buyer"), to a contract ("Contract") for the purchase and sale of California real property ("Property"). The Contract provides that California law governs. The Buyer failed to perform certain monetary obligations under the Contract. The Contract provides for a 10-day cure period with respect to that breach. The Buyer failed to cure timely prepetition as required by the Contract. The Contract has no "time is of the essence" provision. The Buyer's breach of the Contract is material. The Contract does not contain any provision regarding a right to terminate the Contract by either party. The seller ("Seller") did not take any action to terminate or rescind the Contract prepetition. The Buyer believes that the current value of the Property is greater than the purchase price and that the value is a multiple of the purchase price amount once the Property is fully entitled. To protect its valuable interest in the Contract, the Buyer files a voluntary chapter 11 petition. As of the petition date, the Buyer has not paid the purchase price to Seller under the Contract and the Seller has not transferred title to the Buyer. The Buyer seeks to assume the Contract but the Seller objects on the alleged grounds that the Contract is not executory because the Buyer's prepetition material breach and the Seller's equitable defenses of unclean hands and laches render the Contract unenforceable against the Seller under California law.

III. Analysis of the Hypothetical Dispute Under California Law

Assuming the hypothetical facts above[6] and applying California law, the fate of the Buyer's interest in the Contract and the Property could be, at best, subject to substantial

[6] The analysis of the effect of the Buyer's breach under California law could be substantially different with some additional facts. For instance, if the Buyer alleged a breach by the Seller under the contract, that breach might have excused the Buyer's own performance. Typical breach of contract litigation in these circumstances involves competing claims of breach by the

uncertainty in litigation over the breach and, at worst, at the mercy of the Seller. Traditionally, a default would prevent the Buyer from enforcing the Contract against the Seller, because the Seller would no longer be required to accept the Buyer's late cure. The Buyer's breach and failure to cure timely under the Contract would allow the Seller the option to elect certain remedies, including termination of the Contract.

The Contract would not terminate automatically, however, as a consequence of the Buyer's breach. Once the applicable cure period has expired, then, the Contract would be in a state of limbo, subject to the Seller's election of remedies and potential equitable relief from forfeiture for the benefit of the Buyer, depending on the circumstances. The obvious danger to the Buyer would be that the Seller could elect to terminate the Contract at any time, and the Buyer could lose any rights it has in the Contract and any interest it has in the Property.

A. The Buyer's Material Breach of the Contract Allows the Seller an Election of Remedies, Including Contract Termination

The Contract does not specify that time is of the essence. Under such circumstances, a default based on timeliness of performance does not necessarily constitute a material breach of the Contract.[7] The Contract does provide, however, for a time period within which a party must cure any default. Failure to cure or provide assurance of a timely cure could render the default a material breach.[8]

A material breach does not automatically terminate a contract.[9] "A breach, even if material, does not automatically discharge the contract; it excuses the injured party's performance, and gives him the election of certain remedies."[10] Where the buyer under a real property purchase agreement has materially breached the agreement, the seller has several remedies to choose from: (1) termination or rescission of the agreement; (2) specific

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parties against each other. Moreover, California case law in the area of real property purchase contract disputes has developed anti-forfeiture concepts, that could allow for an "untimely cure" by the Buyer under appropriate circumstances.

[7] Johnson v. Alexander, 63 Cal. App. 3d 806, 813, 134 Cal. Rptr. 101 (1976) ("Delay in performance is a material failure only if time is of the essence.").

[8] Under the hypothetical facts, the Buyer's default was a material breach of the Contract.

[9] Ely v. Bottini, 179 Cal. App. 2d 287, 296, 3 Cal. Rptr. 756 (1960) ("A breach does not terminate a contract as a matter of course but is a ground for termination at the option of the injured party. . . . Thus a finding of termination is not one which must be implied from a finding of a breach."); *see also* B.L. Metcalf General Contractor, Inc. v. Erne, 212 Cal. App. 2d 689, 693 (1963) (nonbreaching party has option of remedies, including termination).

[10] 1 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Contracts* § 853 (10th ed. 2005) [hereinafter WITKIN]; *see also Ely*, 179 Cal. App. 2d at 296 ("If a party desires to treat a breach as justifying a rescission he must elect to do so;" where a party elects to proceed under the contract, his exclusive remedy for breach is damages); *In re* Aslan, 909 F.2d 367, 370 (9th Cir. 1990) (breach presents nonbreaching party with option to "treat its own obligations under the contract as discharged and claim damages for the breach or to waive the breach and treat the contract as still in effect." (quoting Benevides v. Alexander (*In re* Alexander), 670 F.2d 885, 887, n. 1 (9th Cir. 1982)).

performance; or (3) damages resulting from the breach.[11] Should the nonbreaching party opt to terminate, it must exercise this right in a clear manner.[12]

Accordingly, under California law, even though the Buyer's material breach did not terminate the Contract automatically, the Buyer's rights under the Contract and interest in the Property are very much at risk. As discussed below, the Buyer may not be able to compel the Seller to perform under the Contract, even if the Buyer is ready, willing and able to tender full performance. The Seller enjoys tremendous leverage under these circumstances and, where the value of the Property is rising, the Seller has a powerful incentive to terminate the Contract.

B. The Buyer May Not Be Able to Enforce the Contract After its Breach and Failure to Cure Timely

If the goal of the Buyer is to preserve its interest in the Property and realize the value of the Contract over the objection of the Seller, the bottom line is that the Buyer will need to be prepared to perform. It is questionable, however, whether that will be enough under California law, after the Buyer's default and the running of the cure period under the Contract. Assuming that the Buyer could make an argument that it is ready, willing and able to perform, it could bring an action for specific performance.[13]

1. A Party's Right to Specific Performance Is Conditioned upon its Own Full Performance

The traditional rule is that where time is of the essence, one must perform or adequately tender performance within the time fixed in the contract in order to obtain specific performance.[14] The terms of the Contract appear to conflict on this point. On one hand, the

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[11] WITKIN, *supra* note 10,at § 853; M. STEVEN ANDERSEN, ET AL., 1 CALIFORNIA REAL PROPERTY REMEDIES AND DAMAGES § 4.31 (Bonnie C. Maly, et al. eds., 2d ed. 2007) [hereinafter ANDERSEN].

[12] *See* Whitney Inv. Co. v. Westview Dev. Co., 273 Cal. App. 2d 594, 602-03, 78 Cal. Rptr. 302 (1969) (citing CAL. CIV. CODE §§ 1689, 1691) ("While a notice of termination or cancellation of a contract for breach need not be formal and explicit, it should clearly indicate to the defaulting party that the injured party considers the contract terminated."); B.L. Metcalf General Contractor, Inc. v. Erne, 212 Cal. App. 2d 689, 693, 28 Cal. Rptr. 382 (1963); Ely v. Bottini, 179 Cal. App. 2d 287, 296, 3 Cal. Rptr. 756 (1960) ("A breach does not terminate a contract as a matter of course but is a ground for termination at the option of the injured party. . . . . Thus a finding of termination is not one which must be implied from a finding of a breach.").

[13] If the non-breaching party elects to keep the contract alive for the "benefit of both parties," the breaching party may cure its breach by tendering performance: "After the buyer's failure to complete performance on time and seller's notice that no delay will be tolerated, the buyer may still attempt to perform at a later date." ANDERSEN, *supra* note 11, at §4.31.

[14] CAL. CIV. CODE § 3392; Pitt v. Mallalieu, 85 Cal. App. 2d 77, 80-81, 192 P. 2d 24 (1948) (citing § 3392 and holding: "Failure to pay the money within the specified period of time deprives the vendee of his right of action to enforce performance of the vendor who holds the privilege of terminating the agreement of sale. [Citations omitted.] Upon his failure to make payment the vendee committed a breach, and no affirmative act by the vendor was necessary to

Contract does not provide that time is of the essence. Time is not assumed to be of the essence, and general contract law principles would require that performance be completed within a reasonable period of time.[15] On the other hand, the Contract provides for a 10-day cure period. Combined with a specified date for performance, the Seller could argue that time was of the essence under the Contract, notwithstanding the lack of a specific provision using that particular language.[16] A court would be required to construe the entire agreement of the parties to determine whether the Buyer's rights are strictly limited to any time for performance specified thereunder.[17]

If a California court determines that time is not of the essence under a contract for the purchase of real property, it has substantial equitable discretion to grant a decree of specific performance conditioned upon concurrent performance (payment of the purchase price and transfer of title) by the parties.[18] Some courts have exercised such discretion even where they found that time was of the essence under the contract, in order to avoid a forfeiture of the benefit of the defaulting party's bargain.[19] As a result, a party may obtain specific performance if it can allege and show that it is ready, willing, and able to perform, even if that party previously breached the contract.[20]

2. The Equitable Remedy of Specific Performance May Be Subject to Equitable Defenses

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terminate the vendee's right of enforcement."); 15 RICHARD A. LORD, WILLISTON ON CONTRACTS § 47:3 (4th ed. 2007) [hereinafter WILLISTON] (citing Martin v. Morgan, 87 Cal. 203, 25 P. 350 (1890), Groobman v. Kirk, 159 Cal. App. 2d 117, 323 P. 2d 867 (1958), and Lindsey v. Wright, 84 Cal. App. 499, 258 P. 438 (1927)); ANDERSEN, *supra* note 11, at § 5.12; *cf.* Wachovia Bank v. Lifetime Industries, Inc., 145 Cal. App. 4th 1039, 1050, 52 Cal. Rptr. 3d 168 (2006) (if an optionee is in default under the option agreement, the optionee is not entitled to specific performance).

[15] ANDERSEN, *supra* note 11, at, at § 4.6, (citing, *inter alia*, CAL. CIV. CODE § 1657).

[16] *Id.* at § 5.15.

[17] Root v. American Equity Specialty Ins. Co., 130 Cal. App. 4th 926, 940, 30 Cal. Rptr. 3d 631 (2005); Nash v. Superior Court, 86 Cal. App. 3d 690, 696, 150 Cal. Rptr. 394 (1978) (whether parties have agreed buyer's right is conditioned upon performance by specified date requires interpretation of contract), *disapproved on other grounds in* Malcolm v. Superior Court, 29 Cal. 3d 518, 528, n. 5, 629 P. 2d 495 (1981)) (citing Katemis v. Westerlind, 120 Cal. App. 2d 537, 542, 261 P. 2d 553 (1953)).

[18] WILLISTON, *supra* note 14, at § 47:3 (citing Barkis v. Scott, 34 Cal. 2d 116 (1949); Pease v. Brown, 186 Cal. App. 2d 425, 8 Cal. Rptr. 917 (1960); Scarbery v. Bill Patch Land & Water Co., 184 Cal. App. 2d 87, 7 Cal. Rptr. 408 (1960); Selby v. Battley, 149 Cal. App. 2d 659, 309 P. 2d 120 (1957); *Katemis*, 120 Cal. App. 2d 537).

[19] *See, e.g.*, Williams Plumbing Co. v. Sinsley, 53 Cal. App. 3d 1027, 126 Cal. Rptr. 345 (1975).

[20] WILLISTON, *supra* note 14, at § 47:3 (citing Koyer v. Willmon, 150 Cal. 785, 90 P. 135 (1907); Altman v. Blewett, 93 Cal. App. 516, 269 P. 751 (1928); Lewis v. Fowler, 80 Cal. App. 717, 252 P. 786 (1927)); ANDERSEN, *supra* note 11, at §5.15.

Because specific performance is an equitable remedy, the claim is subject to certain equitable defenses. The axiom "He who seeks equity must do equity" gives rise to the rather generic equitable defense of "unclean hands."[21] Unclean hands prevents enforcement of a contract where there is unconscionable conduct or bad faith in the transaction that results in prejudice to the party against whom the contract would be enforced.[22]

Equity also will not aid a party who sleeps on its rights.[23] Accordingly, an unreasonable delay in attempting to enforce the contract that results in prejudice to the other party also could give rise to the equitable defense of laches in an action for specific performance.[24] There is no particular rule on the length of delay that would support a laches defense, and each case must be decided on its own facts.[25]

As the foregoing should make quite clear, from the Buyer's perspective, proceeding with a specific performance action under the assumed facts is fraught with peril. The Buyer faces layers of risks that could destroy all of its interests in the Contract and the Property. Everything in the litigation will have to break the Buyer's way to avoid a total loss of the bargained-for value. If the Seller takes action to terminate the Contract, the Buyer must rely on the court to find that such termination was not justified because the Buyer was not in material breach. To avoid a finding of material breach, the Buyer actually may have to perform or at least tender performance and hope for the best pending the outcome of the litigation. The litigation likely would be very time-consuming and expensive, given the nature of the claims and defenses that would put at issue all of the facts and circumstances of the negotiation of and performance under the Contract.

IV. Analysis of the Hypothetical Dispute under the Bankruptcy Code

A. The Bankruptcy Code's Comprehensive Scheme for Preserving the Value of Contract Rights Through Assumption

1. The Purpose of § 365 and the Powers of Assumption and Cure

Section 365(a) authorizes a debtor in possession, subject to the court's approval, to assume or reject an executory contract. Generally, if the debtor has defaulted under the executory contract, it must cure, or provide adequate assurance that it will promptly cure, the default.[26] It must also compensate the nondebtor party, or provide adequate assurance that it will promptly compensate the nondebtor party, for any actual pecuniary loss to such party resulting from the debtor's default.[27] Finally, the debtor must also provide adequate assurance of future performance of its obligations under the contract.[28]

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21 ANDERSEN, *supra* note 11, at §5.38.
22 *Id.*; *see also* 13 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Equity*, § 9 (10th ed. 2005).
23 ANDERSEN, *supra* note 11, at §5.39 (citing CAL. CIV. CODE § 3527).
24 58 CAL. JUR. 3D *Specific Performance* § 37 (2008).
25 *Id.*
26 11 U.S.C. § 365(b)(1)(A).
27 11 U.S.C. § 365(b)(1)(B).
28 11 U.S.C. § 365(b)(1)(C).

The purpose of § 365's assumption power is to balance the state law contractual rights of the nondebtor party to receive the benefit of its bargain with the federal law equitable right of the debtor to have the opportunity to reorganize. This purpose is accomplished by forcing the debtor to cure any prepetition defaults upon assumption while prohibiting the nondebtor party from enforcing any prepetition default remedies.[29]

2. "Executory Contract" Defined

(a) Whether a Contract is "Executory" is a Question of Federal Law

Whether an agreement is an "executory" contract for purposes of § 365 is a question of federal law.[30] Accordingly, resorting to state law is insufficient to determine whether a contract is executory; the court must consider the purposes of § 365 and apply state law in aid of those purposes.[31]

(b) The Ninth Circuit Applies the Countryman Definition

The Ninth Circuit has adopted the definition of executory contract stated by Professor Countryman. Under this definition, executory contracts are those in which the obligations of both parties are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[32] For bankruptcy purposes, then, an executory contract is one under which each side has some potential duty to fulfill in the future.[33]

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[29] Coleman Oil Co., Inc. v. Circle K Corp. (*In re* Circle K Corp.), 190 B.R. 370, 376 (9th Cir. BAP 1995), *aff'd*, 127 F.3d 904 (9th Cir. 1997), *cert. denied*, 522 U.S. 1148, 118 S. Ct. 1166 (1998); Frito-Lay, Inc. v. LTV Steel Co., Inc. (*In re* Chateaugay Corp.), 10 F.3d 944, 954-55 (2d Cir. 1993) ("The main purpose of § 365 is . . . providing a means whereby a debtor can force others to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.").

[30] *In re* Qintex Entertainment, Inc., 950 F.2d 1492 (9th Cir.1991); *In re* Munple, Ltd., 868 F.2d 1129, 1130 (9th Cir. 1989); Murphy v. Griffel (*In re* Wegner), 839 F.2d 533, 536 (9th Cir. 1988); *Alexander*, 670 F.2d at 888; *In re* Coordinated Financial Planning Corp., 65 B.R. 711, 713 (9th Cir. BAP 1986) ("For purposes of § 365, executory contracts are defined under federal, not state law.").

[31] *See* Dunkley v. Rega Properties, Ltd. (*In re* Rega Properties, Ltd.), 894 F.2d 1136, 1139 -40 (9th Cir. 1990), *cert. denied*, 498 U.S. 898, 111 S. Ct. 251 (1990) ("[c]ase law has further established that the bankruptcy courts, as courts of the United States, have power to supersede state law where it conflicts with the federal bankruptcy law which the court is primarily bound to enforce").

[32] Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973); *In re* Robert L. Helms Constr. and Dev. Co., 139 F.3d 702, 705 (9th Cir. 1998); *Alexander*, 670 F.2d at 888 ("There is no need to look at state law for the meaning of executory contract."); *Munple*, 868 F.2d at 1130; *Wegner*, 839 F.2d at 536.

[33] N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 522, n.6, 104 S. Ct. 1188 (1984) (citing legislative history); *see also* Pacific Express, Inc. v. Teknekron Infoswitch Corp. (*In re* Pacific Express, Inc.), 780 F.2d 1482, 1487 (9th Cir. 1986).

The Countryman definition furthers a practical approach to assumption or rejection so that the use of the power to assume or reject could have some benefit to the estate. Under nonbankruptcy law, there are three possible types of executory contracts: (i) the debtor has fully performed, but the nondebtor party has not; (ii) the nondebtor party has fully performed, but the debtor has not; or (iii) both parties may have not yet fully performed.[34]

The estate would garner no benefit from § 365 with respect to the first situation. Assumption would not improve the debtor's right to performance by the other party, and rejection would be deemed a breach of a contract already performed. Likewise, use of the assumption/rejection powers would not benefit the estate in circumstances where the nondebtor party has fully performed. Since the debtor already has received all potential benefits under the contract, assumption would not benefit the estate and rejection would neither add nor detract from the creditor's claim against the estate. Only contracts that fall under the third scenario fit the purpose of § 365 to give the debtor the power to rid itself of burdensome obligations or compel nondebtor parties to complete performance notwithstanding the debtor's prior defaults or the bankruptcy.[35]

3. Determining Whether a Contract Is Executory Must Be Done within the Context of the Purposes of § 365 and the Debtor's Broad Right to Cure Defaults

(a) The Proper Use of State Law in the Analysis

Within the federal law definition of executory contract, state law is applied to determine certain discrete issues with respect to the contract such as whether a valid, binding contract ever was formed. State law is also applied to determine whether, once formed, the contract was ever terminated prepetition.[36]

State law also controls the definition of "material" terms under the contract (*i.e.*, when failure of performance would constitute a material breach).[37] The point of this analysis,

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[34] 3 L. King, COLLIER ON BANKRUPTCY ¶ 365.02[1] at 365-17 (15th ed. rev. 2005).

[35] The Ninth Circuit also follows Countryman's reasoning in support of his definition of executory contract. *Munple*, 868 F.2d at 1130 ("This means that when a party has substantially performed its side of the bargain, such that the party's failure to perform further would not constitute a material breach excusing performance by the other party, a contract is not executory.").

[36] Miles v. Southeastern Farm Supply, Inc. (*In re* Southeastern Farm Supply, Inc.), 11 B.R. 89 (Bankr. M.D. Ala. 1981); Federated Stores Realty, Inc. v. Final Touch Boutique, Inc. (*In re* Final Touch Boutique, Inc.), 6 B.R. 803 (Bankr. S.D. Fla. 1980); Hazen v. Hospitality Associates, Inc. (*In re* Hospitality Associates, Inc.), 6 B.R. 778 (Bankr. D. Or. 1980).

[37] Hall v. Perry (*In re* Cochise College Park, Inc.), 703 F.2d 1339, 1348 (9th Cir. 1983); *Aslan*, 909 F.2d at 369; *Wegner*, 839 F.2d at 536; *In re* Riodizio, Inc., 204 B.R. 417, 424 (Bankr.S.D.N.Y.1997) *In re* Streets & Beard Farm Partnership, 882 F.2d 233, 235 (7th Cir.1989); *see also* Terrell v. Albaugh (*In re* Terrell), 892 F.2d 469 (6th Cir. 1989) (federal law defines term "executory contract," but question of legal consequences of one party's failure to perform its remaining obligations under contract is issue of state law).

however, is not to determine whether the debtor could enforce the contract outside of bankruptcy. It is merely to discern whether the future failure of the parties to perform any of their respective obligations could result in a material default under the contract, such that the contract is executory for purposes of § 365.

(b) The Bankruptcy Code Provides a Broad Power to Cure

Section 365(b) provides a debtor with a broad power to cure prepetition defaults in connection with assumption of an executory contract.[38] This power extends even to material breaches of a contract that, outside of bankruptcy, would enable the nondebtor party to refuse counter-performance.[39]

The power to cure means taking care of the triggering event and returning to pre-default conditions, thus nullifying the consequences of the default.[40] Thus, § 365(b) empowers the debtor "to compel performance by the nondebtor party to the contract notwithstanding the debtor's or the trustee's default provided certain conditions are met."[41] Assumption and cure means that "the other party no longer can excuse its refusal to perform based upon the debtor's pre-petition breach."[42]

(c) A Prepetition Material Breach by the Debtor Does Not Render a Contract Non-Executory for Purposes of § 365

The Ninth Circuit has held that under California law, failure to fully perform an obligation under a contract results in a material breach "if it is so dominant or pervasive as in any real or substantial measure to frustrate the purpose of the contract."[43] In *Aslan*, the seller and buyer entered into a contract to sell real property where the seller was to provide certain documentation to the buyer in order to allow the buyer to calculate possible risks of the sale. Some, but not all, of the documentation was provided to the buyer and the sale was not completed. The Ninth Circuit held that the contract was executory and could be rejected under § 365.

In *Alexander*, the Ninth Circuit treated the issue of the effect of the debtor's prepetition breach as an academic question in a footnote, not as a determinative issue.[44] The Ninth Circuit noted that the debtor "may have breached the contract" but that fact did not affect the contract's "executory quality" since the nondebtor party treated the contract as still in effect.[45] Accordingly, any prepetition breach by the Buyer did not render the Contract non-executory.[46]

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[38] *In re* Sigel & Co., 923 F.2d 142, 145 (9th Cir. 1991).

[39] In *Sigel*, the Ninth Circuit adopted the definition of "cure" established by the Second Circuit in *In re* Taddeo, 685 F.2d 24 (2d Cir. 1982).

[40] *Sigel*, 923 F.2d at 145.

[41] *In re* Lucre, Inc., 339 B.R. 648, 656 (Bankr. W.D. Mich. 2006).

[42] *Id.* at 657.

[43] *Aslan*, 909 F.2d at 370 (citations omitted).

[44] *Alexander*, 670 F.2d at 887, n. 1.

[45] *Id.*

[46] *Id.*; *see also Aslan*, 909 F.2d at 371 (if party chooses to treat breached contract as in effect, it

The Ninth Circuit further explained the application of these principles in *Qintex*.[47] Qintex Entertainment Corp. and its affiliate debtors operated a motion picture studio and were parties to certain production and subdistribution agreements. The Qintex debtors moved for bankruptcy court approval of the sale of substantially all of their business assets, including assumption and assignment of the contracts.[48] The bankruptcy court approved the sale and the district court ruled that the contracts to be "sold" were not executory.[49] On appeal, the Ninth Circuit affirmed in part (certain contracts were not executory), but reversed with respect to Qintex's contract with Otto Preminger for the colorization and distribution of his films.[50]

The Ninth Circuit examined the unperformed duties and obligations of each party to determine the executory status of the Preminger contract and noted that it contained several significant unperformed obligations on both sides.[51] Among those was the debtor's obligation to colorize four films.[52] Qintex admitted that it had not colorized two of the four films and had failed to provide Preminger with distribution statements and royalty payments. The Ninth Circuit noted that these breaches of the contract were "substantial and [went] to the heart of the agreement."[53] Despite the fact that Qintex had materially breached the agreement, the Ninth Circuit held that it may assume the agreement subject to curing any defaults pursuant to § 365(b)(1).[54]

Qintex demonstrates that even a material breach of a contract is subject to cure and the contract may be assumed as long as the debtor complies with § 365(b). Bankruptcy courts that apply the Countryman definition of executory contract universally recognize the principle that a debtor's prepetition material breach does not render a contract non-executory for purposes of § 365.[55] The opportunity to cure defaults is an express and fundamental power set forth in the Bankruptcy Code and to deem a contract not executory based on a prepetition default or breach would strip this fundamental power of any effective force.[56]

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is not converted from being executory to non-executory).

47 *Qintex*, 950 F.2d at 1492.

48 *Id.* at 1494.

49 *Id.* (For reasons not disclosed in the Ninth Circuit's opinion, the district court presided over proceedings subsequent to the sale regarding Qintex's right to assume and assign contracts).

50 *Id.* at 1498.

51 *Id.* at 1496.

52 *Id.* at 1497.

53 *Id.*

54 *Id.*

55 *Id.*; *Alexander*, 670 F.2d at 887, n. 1 ("A prepetition breach does not somehow convert an executory contract into an executed contract.").

56 *In re* RLR Celestial Homes, Inc., 108 B.R. 36, 45 (Bankr. S.D.N.Y. 1989) (to deem a contract terminated and no longer executory simply because the debtor has defaulted or breached the contract before the commencement of the bankruptcy case "would contravene the express authorization for curing defaults as expressed in 11 U.S.C. § 365(b)(1)"); *In re* W&L Assocs., Inc., 71 B.R. 962, 966 (Bankr. E.D. Pa. 1987) ("We certainly cannot agree that the fact that a debtor has breached a contract pre-petition renders it non-executory. Most debtors have breached at least some executory contracts pre-petition, and 11 U.S.C. § 365(b) provides them with an opportunity to cure or provide adequate protection to the oblige and retain their

(d) Bankruptcy Courts Recognize a Clear Distinction Between Material Breach by a Debtor Under a Contract (Executory) and Termination of the Contract (Non-Executory)

Bankruptcy courts make a clear distinction between situations involving a debtor's material breach of a contract from those where the contract actually is terminated under state law prepetition.[57] Thus, if the Seller failed to elect to terminate or rescind the Contract prepetition, any prepetition breach by the Buyer would not render the Contract non-executory.[58] Section 365's cure power should be applied to contracts that have not been terminated effective prepetition.[59]

(e) The Proper Areas of Bankruptcy Court Inquiry in Determining Whether a Contract is Executory

Thus, to determine whether § 365(a) applies (*i.e.*, whether a contract is executory), the evidentiary matters to be resolved by the bankruptcy court are:

- Does the contract to be assumed actually exist? Was a valid, binding agreement formed? If so, has it been terminated prior to the petition date?
- If a valid contract exists and has not been terminated prepetition, the court must review the contract to determine the respective obligations of the parties;
- The court must determine if any of these obligations remain unperformed;
- The court must determine whether these unperformed obligations are material under state law (*i.e.*, if not performed, would that constitute a material breach of the contract). If so, then the contract at issue is executory.

As set forth below, the United States Court of Appeals for the Ninth Circuit has ruled that the type of obligations within the Contract that remain unperformed on both sides are material. Accordingly, the Contract should be determined to be executory.

4. Contracts for the Purchase and Sale of Real Property that Remain Unperformed Are Executory Contracts – A Debtor Can Assume Such a Contract and Proceed to Closing

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contractual rights."); *In re* Nemko, Inc., 163 B.R. 927 (Bankr. E.D.N.Y. 1994).

[57] 2 NORTON BANKRUPTCY LAW & PRACTICE 3D § 46:5 (2008) [hereinafter NORTON] ("The mere existence of a prebankruptcy default does not necessarily transform the contract into a nonexecutory agreement. However, where there has been a default and the contract or lease was terminated before bankruptcy, there may be no rights existing as Code § 541 property of the estate to which Code § 365 may apply.") (citing, *inter alia*, *Alexander*, 670 F.2d 885); *see also Sigel*, 923 F.2d at 145; *In re* Masterworks, Inc., 100 B.R. 149, 151 (Bankr. D. Conn. 1989).

[58] *Aslan*, 909 F.2d at 371 (if party chooses to treat breached contract as in effect, it is not converted from being executory to non-executory); *Alexander*, 670 F.2d at 887, n. 1.

[59] NORTON, *supra* note 57, at § 46:18 (citing *Alexander*).

Where the debtor is a vendee under a real property purchase agreement, the debtor can assume and proceed to closing by curing any prepetition default in failure to pay the purchase price by producing the cash required for closing.[60]

(a) Until Closing, Material Obligations Remain Unperformed

In a typical real property purchase and sale contract, after the agreement has been entered into but before a sale closing has occurred, the seller still has the obligation to provide good title and deliver the appropriate deed and the buyer still is obligated to pay the purchase price. Either party's failure to perform these required obligations would be a material breach, meeting the Countryman test.[61]

The outer boundaries of what may be considered an executory contract for the sale and purchase of real property have been well defined under Ninth Circuit law for more than 20 years.[62] Where the purchase price has not been paid in full and title not transferred, a contract for the sale of property constitutes an executory contract.[63] On the other hand, full payment of the purchase price by the vendee and actual transfer of title by the vendor render the contract non-executory on each respective side.[64]

(b) Completion of Performance, Not Mere Tender, Is Required to Render a Contract Non-Executory

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[60] Cherkis and King, COLLIER REAL PROPERTY TRANSACTIONS AND THE BANKRUPTCY CODE § 4.01[2], 4-13 (Rel. 19, 2004).

[61] *In re* Dunes Casino Hotel, 63 B.R. 939, 947 (D.N.J. 1986).

[62] *See Cochise College Park, Inc.*, 703 F.2d at 1348 (where the debtor-vendor's only remaining obligation under certain land sale contracts was to deliver a warranty deed upon completion of payments by the nondebtor vendees, the contracts would nonetheless still be executory).

[63] *Alexander*, 670 F.2d at 888; Investors Dev. Co. v. Forum Homes, Inc. (*In re* Investors Dev. Co.), 7 B.R. 772 (Bankr. D.N.J. 1980); Record Company, Inc. v. Bummbusiness, Inc. (*In re* Record Company, Inc.), 8 B.R. 57 (Bankr. S.D. Ind. 1980) (buyer owed part of purchase price and seller had various obligations to not compete, provide access to records, etc.); *Terrell*, 892 F.2d at 472 (land sale contract is executory within meaning of § 365 because under state law both parties have substantial obligations left to perform; debtors are obligated to make installment payments for several more years, and although sellers had surrendered occupancy of the land, they had not surrendered legal title); Shaw v. Dawson (*In re* Shaw), 48 B.R. 857, 860 (Bankr. D.N.M. 1985); Bank of Honolulu v. Anderson (*In re* Anderson), 36 B.R. 120, 124 (Bankr. D. Haw. 1983); Hunts Point Tomato Co., Inc. v. Roman Crest Fruit, Inc. (*In re* Roman Crest Fruit Inc.), 35 B.R. 939, 948 (Bankr. S.D.N.Y. 1983) (even though "[a]ll that remained for the debtor to do at closing, upon securing [a] written consent [from a government authority] and receiving the purchase price, was to satisfy its warranty and representation of no liens and encumbrances and to turn over possession of the property to the plaintiff," the contract was executory).

[64] *In re* Leefers, 101 B.R. 24, 27 (C.D. Ill. 1989).

For bankruptcy purposes, it is one party's prepetition completion of performance, not merely the tender of final performance, that renders a contract non-executory.[65] In *Alexander*, the debtor had entered into a contract for the sale of her home to the plaintiffs Ronald and Karole Benevides. On the date of the closing, the Benevideses had deposited the additional funds necessary to close escrow and had received a loan commitment from a financial institution to pay the balance of the purchase price.[66] Therefore, the Benevideses had tendered full performance. Nevertheless, the debtor refused to close. Applying the Countryman definition, the Ninth Circuit concluded that the contract remained executory because performance still remained due on both sides, even though the plaintiffs had tendered full performance.[67]

B. The Bankruptcy Law Definition of Executory Contract Cannot Be that All Materially Breached Contracts Are Not Executory

1. An Appropriate Statutory Construction of § 365 Must Comport with the Bankruptcy Purposes of Assumption of Executory Contracts

A statute should be construed as a harmonious whole and where a provision is ambiguous (such as what qualifies as an "executory contract" for purposes of § 365(a)), the meaning is "clarified by the remainder of the statutory scheme ... [when] only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law."[68] Section 365 constitutes a comprehensive scheme for the treatment of a debtor's unexpired contracts and leases. To excise subsection (a) and its undefined reference to "executory contract" from the remainder of the section would be fatal to the purposes of the section as a whole, and a fundamental error of statutory construction.

The meaning of "executory contract" that the Slate article proposes – which would exclude all contracts that a debtor materially breached prepetition and was unable to enforce under state law – is absolutely incompatible with § 365(b)'s express power to cure defaults. This interpretation of "executory contract" also clearly conflicts with that applied by the Ninth Circuit. Even in the absence of controlling authority, this interpretation should be rejected because it would do violence to § 365's assumption, cure and compensation scheme. The only permissible meaning of "executory contract" that produces a substantive effect that is compatible with the

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[65] *Alexander*, 670 F.2d at 887 (contract for sale of land is executory where nondebtor vendee had deposited in escrow the funds necessary to close, but debtor refused to convey title or surrender possession); *RLR Celestial Homes*, 108 B.R. at 44; *In re* McDaniel, 89 B.R. 861, 873 (Bankr. E.D. Wash. 1988); *W&L Assocs.*, 71 B.R. at 965-66; *Shaw*, 48 B.R. at 860; *In re* Sundial *Asphalt Co.*, 147 B.R. 72, 83 (E.D.N.Y. 1992) ("[s]everal other courts have held that a land sale contract which the debtor-vendor sought to reject was executory even when the purchase price due under the contract had been tendered, but when neither title nor possession had been transferred and no order for specific performance had been entered." (citations omitted)); *In re* Balco Equities Ltd., Inc., 323 B.R. 85, 95-96 (Bankr. S.D.N.Y. 2005); *In re* Scanlan, 80 B.R. 131, 134 (Bankr. S.D. Iowa 1987).

[66] *Alexander*, 670 F.2d at 886.

[67] *Id.* at 886-87.

[68] United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 371, 108 S. Ct. 626 (1988).

Bankruptcy Code, as required by the rules of statutory construction, is one that allows for a debtor to assume contracts notwithstanding any prepetition breach (subject to cure, compensation, and adequate assurance of future performance), so that it might realize the value of the rights under the contract for the benefit of the bankruptcy estate.

2. No Bankruptcy Authority Holds that a Default in Performance Renders a Contract Non-Executory and Prevents Assumption

No bankruptcy case holds that a debtor may not assume a contract because of the debtor's prepetition breach (unless the breach led to a prepetition termination of the contract). Likewise, there is no authority for the proposition that a bankruptcy court must conduct an evidentiary hearing to determine whether a contract has been rendered unenforceable by the debtor's failure to perform prepetition, as a condition to the debtor's assumption of that contract.

C. Assumption of the Contract Does Not Necessarily Depend upon Whether the Contract Remained "Enforceable" under State Law as of the Petition Date

Whether a contract is 'enforceable' by the debtor pursuant to applicable nonbankruptcy law is not determinative of whether it is executory and assumable in bankruptcy. To hold otherwise would be to mistakenly conflate state law regarding material breach of contracts and § 365. The legal consequence of a material breach are completely different under California law and the Bankruptcy Code. California law is primarily concerned with protecting the injured party, while the Bankruptcy Code has the dual goals of providing the nondebtor party with the economic benefit of is bargain and allowing the debtor's bankruptcy estate to preserve valuable contract rights through a broad power to cure defaults. It is no surprise, then, that California law on the consequence of breach is entirely different that bankruptcy law.

The concept of "enforceability" of a contract has been referenced in several cases in the assumption context, but it is critical to pay close attention the usage of that term. These cases do not support the argument that a contract is not executory if the debtor materially breached the contract prepetition. As set forth above, however, the mere fact of a material breach does not render a contract non-executory for purposes of § 365.[69] Bankruptcy courts do not approach the question of whether a contract is executory by determining whether a contract is "enforceable" under state law. The cases that use the word "enforceability" in the context of deciding what contracts are executory all deal with *whether a contract was actually formed – i.e.*, whether any valid, binding and enforceable contract *ever* existed.[70] None of these cases support the proposition that a debtor's prepetition material breach that prevents a debtor from enforcing a contract outside of bankruptcy *also* renders a contract nonexecutory and unassumable.[71]

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[69] *Alexander*, 620 F.2d at 887, n. 1.

[70] *In re* III Enters., Inc. V, 163 B.R. 453, 459 (Bankr. E.D. Pa. 1994), *aff'd*, Pueblo Chemical, Inc. v. III Enters. Inc. V, 169 B.R. 551 (E.D. Pa. 1994); Campbell v. CG Realty Invs., Inc. (*In re* CG Realty Invs., Inc.), 79 B.R. 249, 253 (Bankr. E.D. Pa. 1987); *In re* Waldron, 36 B.R. 633, 634 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936 (11th Cir. 1986), *cert. denied*, Waldron v. Shell Oil Company, 478 U.S. 1028 (1986); *In re* Coast Trading Co., 26 B.R. 737, 739 (Bankr. D. Or. 1982).

[71] *III Enters.*, 163 B.R. at 459-60 (although noting that definition of executory contract should

D. In the Context of Assumption of an Executory Contract, The Equities Between The Parties Are Determined By The Bankruptcy Code; State Law Equitable Defenses Do Not Apply

Section 365 strikes an equitable balance between the interests of the bankruptcy estate and the interests of the nondebtor party to an executory contract. The Bankruptcy Code balances the interests of the estate in preserving valuable contract rights, on the one hand, against the nondebtor party's rights under state law to receive the benefits of its economic bargain. With respect to the hypothetical, the alleged equitable defenses to specific performance of the Contract that emanate from the Buyer's breach would be rendered moot because the legal consequences of the Buyer's alleged breach would be extinguished upon cure and compensation. The equitable balance between the parties established by the Bankruptcy Code would be sustained in this fashion.

1. With Respect to Assumption and Rejection of Contracts, § 365 Preempts State Law Equitable Remedies

Where the Bankruptcy Code prescribes a specific creditor remedy, it preempts all state law remedies that relate to the same creditor interest.[72] Accordingly, courts in various circumstances have held that § 365 preempts the state law remedies that might otherwise be available to parties to an executory contract.[73]

Several cases have overruled objections to rejection of an executory contract based on state law equitable remedies. In particular, courts consistently hold that once a contract is rejected, the equitable remedy of specific performance is no longer available.[74]

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be very broad, the court held that no valid contract was ever formed); *CG Realty Investments*, 79 B.R. at 251 (valid option contract never existed); *Waldron*, 36 B.R. at 636 (binding, enforceable option was formed); *Coast Trading*, 26 B.R. at 738 (valid and enforceable oral agreement was formed).

[72] *See In re* MGS Marketing, 111 B.R. 264, 267-68 (9th Cir. BAP 1990) (citing, *inter alia*, *In re* Coast Trading Co., Inc., 744 F.2d 686, 690 (9th Cir.1984)) (remedy established by § 546 preempts creditor's common law fraud remedies).

[73] *See, e.g., In re* Arden and Howe Associates, Ltd., 152 B.R. 971, 975-76 (Bankr. E.D. Cal. 1993) (§ 365(h)(2) preempts all state remedies (an injunction in this instance) for breach of a restrictive use covenant by the trustee and by the trustee's successors); *In re* McLean Enters., Inc., 105 B.R. 928, 932-33 (Bankr. W.D. Mo. 1989) (section 365 preempts state law with respect to surrender and termination of lease); Volkswagen of America, Inc. v. Dan Hixson Chevrolet Co. (*In re* Dan Hixson Chevrolet Co.), 12 B.R. 917, 924 (Bankr. N.D. Tex. 1981) (Bankruptcy Code preempts state regulatory proceedings with respect to termination of motor vehicle dealership).

[74] *See In re* Nickels Midway Pier, LLC, 332 B.R. 262 (Bankr. D.N.J. 2005), *aff'd in part, vacated in part*, 372 B.R. 218 (D.N.J. 2007) (holding that the Bankruptcy Code preempts states law equitable remedy of specific performance); *In re* Aslan, 65 B.R. 826, 831 (Bankr. C.D. Cal. 1986) *aff'd* 909 F.2d 367 (stating that "an executory contract for sale of real property can be rejected and the potential action for specific performance will be transformed into a pre-petition claim, which may be discharged in the bankruptcy."); Newman Grill Systems, LLC v. Ducane

The court's analysis in *Nickels* is instructive. In *Nickels*, the debtor sought to reject an executory contract and the potential buyer of the property objected on several grounds, including the ground that the contract could not be rejected because the buyer would be entitled to specific performance under state law. The court rejected this argument under principles of federal preemption:

> Federal law preempts state law in three situations: "(1) express preemption, (2) field preemption… or (3) conflict preemption." … [C]onflict preemption is appropriate if a state law conflicts with a federal law such that "(1) it is impossible to comply with both state law and federal law; or (2) the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.* at 273-74. The court reasonably inferred preemption by the comprehensive nature of the Code and by the fact that "allowing specific performance would obviously undercut the core purpose of rejection under § 365(a)."[75]

While these rejection/specific performance cases involve the flip side of our assumed facts (here, the Seller is seeking an equitable remedy to prevent assumption), the analysis is the same. The equitable defenses raised would provide the Seller with a remedy that, by any other name, would effect a rescission of the Contract. Under California law, upon material breach of a contract, a non-breaching party to may elect to rescind or terminate the contract or to stand on the contract and seek damages. This election is equivalent to the specific performance/damages election addressed in the above cases. For the same reasons, then, the Seller's effort to divest the Buyer's bankruptcy estate of property through purported "equitable defenses to assumption" should fail. The Bankruptcy Code provides a specific and comprehensive remedy to the Seller with respect to any prepetition defaults by the Buyer. The Bankruptcy Code's express remedies upon assumption supplant all state law equitable remedies arising from default.

2. After the Buyer Files its Chapter 11 Petition, It May Be Too Late for the Seller to Rescind the Contract[76]

Gas Grills, Inc. (*In re* Ducane Gas Grills, Inc.), 320 B.R. 341 (Bankr. D.S.C. 2004); Butler v. Resident Care Innovation Corp., 241 B.R. 37 (D.R.I. 1999); TKO Properties., LLC v. Young (*In re* Young), 214 B.R. 905 (Bankr. D. Id. 1997); Stone Street Capital, Inc. v. Granati (*In re* Granati), 270 B.R. 575, 585-86 (Bankr. E.D. Va. 2001), *aff'd*, 63 Fed. Appx. 741 (4th Cir. 2003).

[75] *Nickels*, 332 B.R. at 273 (citing Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985) (stating also that § 365(g)'s "legislative history makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party").

[76] Courts have consistently held that the alleged unclean hands of a prepetition debtor are not imputed to a debtor in possession or trustee, acting as a representative of the estate to exercise powers granted by the Bankruptcy Code. Aimtree Co. v. AT&T Corp. (*In re* Aimtree Co.), 202 B.R. 154, 159 (D. Kan. 1996). Here, the Buyer, acting as representative of the bankruptcy estate, invokes the Bankruptcy Code's express and exclusive power of assumption of the Contract. As set forth above, the Seller's rights are protected by the Bankruptcy Code's cure and compensation provisions, and the Seller cannot rely on the Buyer's alleged prepetition conduct to prevent the exercise of powers conferred by the Bankruptcy Code.

Under the hypothetical, the Seller has not taken any steps to rescind or terminate the Contract. Also, one may infer from the Seller's invocation of a laches defense that more than a minimal amount of time has passed from the time for performance to the Buyer's petition date. Under these circumstances, the Seller may not now be entitled to any equitable remedy that would effect a transfer of the Buyer's interest in the Contract or in the Property itself. California law requires that a rescinding party promptly give notice of its intent to rescind.[77] Additionally, California law requires a rescinding party to restore or offer to restore the other party everything of value which the rescinding party received from the non-rescinding party under the contract.[78]

3. The Seller's "Equitable Remedies" May Be Avoidable under the Bankruptcy Code

Enforcement of equitable remedies in favor of the Seller could have the effect of a transfer of the surplus value in the Contract from the Buyer's bankruptcy estate to the Seller. To allow the Seller to cause what would in essence be an involuntary transfer from the estate of this value would violate a fundamental purpose of the Bankruptcy Code of maximizing the value of the estate for all interested parties as well as specific provisions related to postpetition transfers of estate assets.

(a) The Buyer's Interest in the Contract and the Property Constitute Property of the Estate

Section 541 defines "property of the estate" as being comprised of, among other things "all legal and equitable interests of the debtor in property as of the commencement of the case." The Buyer's interest in the Contract constitutes an interest in property and, as such, is property of the estate under § 541.[79] The Buyer also may hold an equitable interest in the Property itself, by virtue of its interest in the Contract.

The *Hathaway* case presents a very interesting analysis of the Bankruptcy Code's juxtaposition with California law of equitable remedies, and demonstrates how far a bankruptcy court may be willing to delve go in demonstrating the supremacy of the Bankruptcy Code's equitable scheme over state law concepts of equity. In *Hathaway*, a purchaser under land sales contracts assigned his interest in the purchase escrow to Hathaway Ranch Partnership in which the purchaser was a limited partner. A dispute arose between the original purchaser and his general partners, and Hathaway filed its bankruptcy petition. After the bankruptcy case was filed, the original purchaser filed suit against the debtor claiming that he was fraudulently induced into assigning the contracts to the debtor and seeking the "reassignment" of his interest in the escrows. In *Hathaway*, the court first determined that under California law, the debtor's interest in the escrow agreements conveyed to the debtor "immediate equitable title to the subject property, and upon satisfaction or performance of the escrow conditions, legal title to the

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[77] CAL. CIV. CODE § 1691(a); Zeigler v. Hathaway Ranch Partnership (*In re* Hathaway Ranch Partnership), 127 B.R. 859, 863 (Bankr. C.D. Cal. 1990).

[78] *Hathaway Ranch*, 127 B.R. at 863 (citing CAL. CIV. CODE § 1961(b)).

[79] *See, e.g.*, Computer Communications, Inc. v. Codex Corp. (*In re* Computer Communications, Inc.), 824 F.2d 725, 730 (9th Cir. 1987) (contract comes within the definition of "property of the estate," even despite a nonassignability clause or the existence of a bankruptcy default clause).

property passes to the grantee."[80] Accordingly, based on the Buyer's interest under the Contract, the Buyer may hold equitable title to the Property itself, which interest would constitute property of the estate under § 541.

(b) "Equitable Remedies" that Divest the Estate of Contract Rights Are Akin to Rescission or the Imposition of a Constructive Trust

In *Hathaway*, the court also had to determine the nature of the "reassignment" remedy sought by the plaintiff in that case. The court reasoned that the two most likely characterizations were rescission and constructive trust.[81] The court then concluded that the plaintiff could not be seeking rescission because the plaintiff had not acted promptly enough or offered to return the consideration he received under the contract as required by California Civil Code § 1691. The court also noted that the plaintiff alleged in the complaint that he would not have assigned his interest in the property had he known of the debtor's misrepresentations. Based on these circumstances, the court went on to hold that:

> This is another way of saying that Debtor wrongfully acquired the Property from Plaintiff. Therefore, Plaintiff seeks a judicial determination that because of Debtor's misconduct, the Property was transferred to Plaintiff as beneficiary of a constructive trust.
>
> I conclude that the equitable remedy Plaintiff seeks is the imposition of a constructive trust.[82]

The allegations made by the plaintiff in *Hathaway* mirror those that the Seller might make under our hypothetical to support a laches or unclean hands "defense" to assumption of the Contract based on the Buyer's prepetition conduct – effecting either a rescission of the Contract or like transfer of the Buyer's equitable interest in the Property. Since the Seller never sought rescission prepetition a bankruptcy court following *Hathaway* might construe the relief sought by the Seller as being the imposition of a constructive trust over the Buyer's equitable interest in the Property.

Whereas the *Hathaway* case related to the use of § 544 to avoid the constructive trust remedy, a bankruptcy court faced with a postpetition assertion of such equitable remedies could prevent a purported "transfer" of equitable rights from the estate by application of § 549. Section 549 provides that a transfer of property of the estate that occurs after the commencement of the case and that is not authorized under the Bankruptcy Code or by the bankruptcy court may be avoided. The Seller's postpetition request for equitable relief from the Buyer's right to assume the Contract is not authorized under the Bankruptcy Code, nor is it likely that a bankruptcy court would ever approve such a "transfer" of the estate's interests without any consideration.

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[80] *Hathaway*, 127 B.R. at 863; *see also* Abrams v. Motter, 3 Cal. App. 3d 828, 847, 83 Cal. Rptr. 855 (1970); Mamula v. McCulloch, 275 Cal. App. 2d 184, 194, 79 Cal. Rptr. 571 (1969); Rogers v. Davis, 28 Cal. App. 4th 1215, 1223, 34 Cal. Rptr. 2d 716 (1994); CAL. CIV. CODE § 1662.

[81] *Id.*

[82] *Hathaway*, 127 B.R. at 864.

4. Any Equitable Remedies Arising from the Buyer's Non-Performance Will Be Rendered Moot by Assumption and Cure

The equitable remedies sought by the Seller under the assumed facts relate to the Buyer's failure to perform. Section 365(b), however, conditions assumption of an executory contract on the debtor curing defaults and compensating the nondebtor party for its actual pecuniary loss resulting from such defaults. Upon assumption and cure, therefore, all consequences of the Buyer's prior nonperformance would be eliminated and the entire basis for the Seller's alleged equitable remedies will disappear.[83]

V. The Procedural Question: Does Court-Approved Assumption Have the Same Effect as a Specific Performance Decree in favor of the Buyer?

Determining that the Buyer has the power under the Bankruptcy Code to assume the Contract with court approval is all well and good. But how far does the bankruptcy court's order approving assumption get the Buyer toward obtaining title to the Property? As a practical matter, it may depend on how the Buyer presents the issue procedurally to the bankruptcy court. The reported decisions do not provide a uniform guide as to the proper method to assume and enforce an executory contract for the purchase of real property.

A debtor may assume an executory contract, subject to the provisions of § 365 and court approval, either by motion which initiates a contested matter[84] or as part of its chapter 11 plan.[85] If assumption is presented by motion, courts have followed diverging paths as to the effect of a ruling on the assumption motion. The United States Court of Appeals for the Second Circuit has held that an assumption motion proceeding is a "summary proceeding" testing only the business judgment of the debtor or trustee in connection with the proposed assumption.[86] In *Orion Pictures*, the Second Circuit held that any substantive rights of the party could only be determined through the related adversary proceeding that the chapter 11 trustee had filed against

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[83] *Cf.* Girard v. Ball, 125 Cal. App. 3d 772, 783, 178 Cal. Rptr. 406 (1981). In *Girard*, a customer brought an action against an electrical contractor alleging promissory fraud, among other things. The electrical contractor was awarded summary judgment. On appeal, the California Court of Appeal upheld summary judgment on the grounds that the electrical contractor's full performance under the terms of the contract negated each and every element of a cause of action for promissory fraud, as matter of law. *Id.* at 783-84. ("Since the persons who entered into the agreements concur on their terms and there was actual performance of the agreements, there cannot be any misrepresentation."). *Id.* Without a misrepresentation, the electrical contractor could have no knowledge of falsity. Performance was evidence of intent to perform, not intent to defraud. Finally, performance meant that the plaintiff suffered no damages – he received the benefit of his bargain. *Id.*

[84] FED. R. BANKR. P. 6006 and 9014.

[85] 11 U.S.C. § 1123(b)(2).

[86] Orion Pictures Corp. v. Showtime Networks, Inc. (*In re* Orion Pictures Corp.), 4 F.3d 1095, 1097 (2d Cir. 1993), *cert. dismissed*, 511 U.S. 1026, 114 S. Ct. 1418 (1994).

the nondebtor party alleging anticipatory breach of the contract.[87] The Second Circuit reversed the bankruptcy court's adjudication of the issue of breach in the context of the motion to assume and ordered that issue be determined through the pending adversary proceeding.[88]

Likewise, in the case of *Carlisle Homes*, the debtor in possession commenced a proceeding to assume an option to purchase real property concurrent with an adversary proceeding seeking to compel specific performance of the option contract.[89] The bankruptcy court heard the matters together and approved assumption and issued a specific performance decree in favor of the debtor.[90]

On the other hand, in a different case the same court ordered relief on an assumption motion (without a pending adversary proceeding) that would appear to have the same effect as a decree of specific performance.[91] In *Walden Ridge*, the court approved the debtor's assumption of a contract to purchase real property over the nondebtor party's objection and ordered the closing to occur within 30 days of entry of the court's order.[92] The court's opinion did not address the procedural question of whether assumption was a "summary proceeding" or a contested matter that had all the requisite procedural protections of an adversary proceeding. Presumably, the court was of the latter view.

As shown by these cases, assumption of a contract for the purchase and sale of real property by motion could be a preliminary skirmish with a subsequent adversary proceeding addressing the substantive issues of default, or it could be the entire battle. Joining the assumption motion with an adversary proceeding reduces the risk of an *Orion Pictures* limitation on the assumption order. But that procedural tactic carries the substantial risk of the tail wagging the dog - litigation over breach of contract issues in the adversary proceeding could become the court's focus, marginalizing the debtor's right to assume and cure the contract which was the entire purpose of the bankruptcy case.

Assumption of a contract through a chapter 11 plan may provide a more certain procedural outcome. If the plan provides for assumption of the contract and a closing of the acquisition of the property at issue in connection with the debtor's proposed treatment of creditors, the contract may be assumed and the nondebtor party bound to the terms of the plan.[93] The plan confirmation process itself brings into vivid focus the purpose of the proposed contract assumption within the context of the debtor's overall reorganization. Rather than the case being about the discrete facts of the timing, nature, and effect of each party's prepetition performance and defaults under the contract prepetition, in the plan confirmation context, the bankruptcy court will take in the issue of assumption with the proper perspective of § 365's balancing of the interests of the bankruptcy estate and the nondebtor party to the contract.

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87 *Id.* at 1099.

88 *Id.*

89 Carlisle Homes, Inc. v. Azzari (*In re* Carlisle Homes, Inc.), 103 B.R. 524 (Bankr. D.N.J. 1988).

90 *Id.* at 527.

91 *In re* Walden Ridge Development, LLC, 292 B.R. 58, 67-68 (Bankr. D.N.J. 2003).

92 *Id.*

93 11 U.S.C. § 1141(a).

VI. Conclusion

Assumption of executory contracts is one of the most fundamental powers of the Bankruptcy Code. So long as a valid, binding contract exists and has not been terminated as of the petition date, a debtor likely will be granted an opportunity to assume that contract, subject to cure and full compensation to the nondebtor party pursuant to § 365. In this way, the Bankruptcy Code protects the benefit of the economic bargain for both the bankruptcy estate and the nondebtor party.

Under the facts assumed for purposes of this article, the Seller's alleged defenses to enforcement of the Contract ultimately arise from the Seller's dissatisfaction with the Buyer's prepetition performance (or lack thereof) under the Contract. The Seller did not make an early election to terminate or rescind the Contract, so it must be presumed to have chosen to stand on the Contract. The material terms of payment of the purchase price and transfer of title remain to be performed by the parties, which qualifies the Contract as executory. To the extent that the Buyer cures any prepetition defaults and compensates the Seller for any actual pecuniary loss, as required by § 365, alleged "defenses" of the Seller to assumption based on any prepetition failure of performance should be rendered moot. Accordingly, the Buyer should be allowed to proceed with assumption of the Contract.