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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

WHAT IS AN EXECUTORY CONTRACT? A CHALLENGE TO THE COUNTRYMAN TEST

The Bankruptcy Code affords the trustee or the debtor in possession the power to either reject or assume executory contracts and unexpired leases.¹ The rationale underlying this power is that the trustee or debtor in possession should be insulated from contracts that impose burdensome liabilities upon the bankruptcy estate, but also should be able to take advantage of favorable contracts.² The power to assume or reject executory contracts is especially important in reorganization cases where it is used to relieve the debtor in possession of unperformed obligations that would otherwise hamper the debtor's opportunity to make a fresh start.

A question which is often litigated is: "What is an executory contract?" In attempting to answer this question, courts often have relied on a definition formulated by Professor

Vern Countryman of Harvard Law School: An executory contract is one "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."³ Accordingly, if one party fully performed its part of the bargain and there is no further performance required of it, the fact that the other party did not yet perform does not render the contract executory within the meaning of the Bankruptcy Code.

The Countryman test requiring performance due on both sides is based on a functional approach to the trustee's powers. Similar to the power to abandon or accept property of the estate, the option to assume or reject executory contracts and leases is to be exercised only when it benefits the estate. In view of this purpose of benefiting the estate, it does not make sense to permit rejection of contracts which were fully performed on one side, especially since rejection gives the other party a claim against the estate for damages as if the debtor breached.⁴ For exam-

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¹ Bankruptcy Code § 365. The Bankruptcy Code is contained in Title 11 of the United States Code. See Weintraub & Resnick, *Bankruptcy Law Manual* ¶ 7.10.

² See Countryman, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L. Rev. 439, 450 (1973).

³ *Id.* at 460; see *In re Alexander*, 6 C.B.C.2d 771 (9th Cir. 1982), where the court of appeals recently applied the Countryman test to determine that an installment land sale agreement was an executory contract.

⁴ Bankruptcy Code § 365(g).

ple, if a creditor fully performed a contract of sale by delivering goods for which the debtor did not pay, rejection of the contract by the debtor would be meaningless in that "the estate has whatever benefit it can obtain . . . and . . . rejection would neither add to nor detract from the creditor's claim or the estate's liability."⁵ Assumption would also be meaningless as its only effect would be to give the creditor's claim an administrative expense priority.⁶ On the other hand, if there was full performance by the debtor prior to bankruptcy, assumption would not improve upon the debtor's right to performance by the other party and rejection by the debtor could not constitute a breach of a fully performed obligation. Because assumption or rejection of executory contracts could actually benefit the estate only if they remain substantially unperformed on both sides, it is logical to define "executory contract" in the Countryman fashion.

Countryman's Promise Rejected

In *In re Booth*,⁷ a recent bankruptcy court decision, however, the Countryman definition of executory contract was rejected as the sole test in reorganization cases. *Booth* involved the issue of whether a contract for deed, when the debtor is the vendee, is an executory contract. In that case, the sellers made a contract to sell land to the debtor at a price of \$97,200, with \$1,100 down and the balance to be paid over time. The sellers were not required to convey title until the purchase price was paid in full and default in the payment of

the price would result in forfeiture of the purchaser's interest. Upon the purchaser's filing of a chapter 11 petition, the sellers moved for an order directing the debtor to either assume or reject the contract. The debtor demurred, arguing that the installment contract of sale was not executory within the meaning of Section 365 of the Bankruptcy Code and that the sellers' interest should be viewed only as a lien on the land, thereby giving them an allowed secured claim against the estate to the extent of the unpaid portion of the purchase price.

At the outset, it is important to appreciate the consequences of classifying this contract as executory and how the sellers would benefit from such a determination. If executory, the debtor would be required to either affirm the contract by curing defaults or giving adequate assurance of cure as well as by complying with contract by paying future installments when due, or reject the contract which would be considered a breach resulting in forfeiture of all payments which were made.⁸ On the other hand, if the contract was not executory, the debtor would be considered the owner of the land subject to the sellers' allowed secured claim⁹ for the unpaid balance of the purchase price which could be dealt with in the debtor's plan of reorganization. Subject to the Code's requirements for a confirmation, such as the fair and equitable rule, future installments owed to the seller could be reduced and extended and the interest rate might in certain cases be lowered.¹⁰

⁵ Countryman, note 2 *supra*, at 451.

⁶ See Bankruptcy Code § 503.

⁷ 19 B.R. 53 (D. Utah 1982) (Mabey, J.).

⁸ See Bankruptcy Code § 365.

⁹ Bankruptcy Code § 506(a).

¹⁰ See Bankruptcy Code § 1129(b)2(A).

In rejecting the Countryman standard as the test for determining when a contract is executory, the *Booth* court disagreed with the underlying premise that either assumption or rejection always benefits the estate when a contract is substantially unperformed by both parties: "The Countryman test may often define the benefit to the estate, but does it always?"¹¹ The court also disagreed with Professor Countryman's premise that benefit to the estate is the only policy underlying the treatment of executory contracts in bankruptcy: "Section 365, however, reflects a number of policies, including not only benefit to the estate but also protection of creditors."¹²

Section 365

As evidence of Congress' concern for the protection of creditors as one policy reflected in Section 365, the court refers to Sections 365(i) and 365(j), which give special treatment to nondebtor vendees of land sale contracts, who prior to the Bankruptcy Code were treated often as unsecured creditors of the estate upon rejection of the contract by the vendor in bankruptcy. Despite the fact that the estate of the vendor benefited by rejection of the contract in that title would remain in the debtor vendor while relegating the nondebtor vendee to the status of an unsecured creditor, "there was uneasiness over its result, and some courts moved to soften its impact."¹³ Subsequently, Section 365(i) of the Code was enacted to give the nondebtor purchaser

in possession of real estate the right to remain and obtain title despite rejection by the debtor of the unperformed installment sale agreement. Section 365(j) gives similar protection to the purchaser not in possession by giving him a lien on the property to secure repayment of the portion of the price paid. In essence, although these contracts meet the Countryman test for executory contracts, the Code nullifies the effect of such characterization in the interest of benefitting the nondebtor party.

Thus, Sections 365(i) and 365(j), far from representing the Countryman test, are a tonic for the consequence of its application. This suggests that in the final analysis, executory contracts are measured not by a mutuality of commitments but by the nature of the parties and the goals of reorganization. . . . [I]t is the consequences of applying Section 365 to a party, especially in terms of benefit to the estate and the protection of creditors, not the form of contract between vendor and vendee, which controls.¹⁴

Test for Installment Land Sale Contract

In deciding that an installment land sale contract is not executory when the debtor is vendee, despite substantial nonperformance by both parties, the court focused on three factors:

(1) *Enlarging the value of the estate.* Treatment of the contract as an executory contract would result in either forfeiture of the portion of the price already paid or assumption of the burdens of the contract as written, which may be impossible or imprac-

¹¹ *In re Booth*, note 7 *supra*, at 55.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 56-57.

tical in a given case. In comparison, treatment of the sellers' interest as a lien to secure payment of the remaining installments would place the sellers on par with other lienors; forfeiture and the loss of equity would be avoided. "The bankruptcy court, as a court of equity, regards substance over form, demands equality of treatment among creditors, and loathes a forfeiture."¹⁵ By avoiding forfeiture, the estate is enlarged.

(2) *Furthering the rehabilitation of the debtor.* The court noted that executory contracts should be handled to aid in the rehabilitation of the debtor.

If the contract is executory, and if it is assumed during the interim between petition and plan, defaults must be cured, damages must be paid, and adequate assurance of performance must be given, all as costs of administration. If the contract is assumed in a plan, the same conditions must be satisfied with the accumulated cost of administration payable on the effective date of the plan.¹⁶

However, if the contract creates a lien only, assumption is irrelevant, administrative costs are avoided, the debtor's obligation may be dealt with in the plan, and, if it would assist the reorganization, property may be sold free of the lien. Treating the sellers as lienors "allows more latitude in proposing a plan and thereby furthers the rehabilitation of the debtor."¹⁷

(3) *Adequate protection of creditors.* The court analyzed the sellers' position and found that they had only

two rights under the contract. First, the right to payment which is not entitled to "adequate protection" because such right is not, in and of itself, a property interest. Section 361 of the Code "protects against any decrease in value of the lien, it does not guarantee performance of the contract."¹⁸ Second, the sellers have the right to hold title as security, which is adequately protected in view of the nature of the collateral as land. "This strikes a balance between vendors, other creditors, and the estate. Vendors are not preferred, for example, in terms of administrative claims, but are treated on par with other mortgagees . . . who are protected against any decrease in the value of their liens."¹⁹

Before reaching its conclusion, the court had to dispose of a powerful argument supporting the sellers' position that the agreement in question is an executory contract: If installment land sale agreements are not executory contracts, why did Congress include Sections 365(i) and 365(j) in the Code which specifically recognize that such contracts are executory when the debtor is vendor? "Put differently, it would be anomalous if contracts where the debtor *sells* realty are executory but contracts where the debtor *buys* realty are not."²⁰ The court found that this argument was not persuasive for two reasons. First, treatment of the contract for deed as executory when the debtor is vendee, as in the case at hand, ignores the

¹⁸*Id.*; see Weintraub & Resnick, note 1 *supra*, ¶¶ 1.09[5], 8.10, for discussions on adequate protection requirements.

¹⁹*In re Booth*, note 7 *supra*, at 61.

²⁰*Id.* at 62.

¹⁵*Id.* at 58.

¹⁶*Id.* at 60.

¹⁷*Id.* at 61.

reasons for enacting Sections 365(i) and 365(j). Since they were enacted to nullify the effect of classifying such agreements as executory by giving the nondebtor vendee the protection of a mortgagee, treating the contract as a lien where the debtor is the vendee "is consistent with the spirit of these provisions."²¹

The second fault with respect to the sellers' argument based on the presence of Sections 365(i) and 365(j) is that consistency in terminology (e.g., treating all unperformed contracts for deed as executory regardless of whether the debtor is vendor or vendee) would lead ironically to disparity in the treatment of similarly situated nondebtor parties. Whereas Sections 365(i) and 365(j) result in the treatment of a nondebtor vendee as a mortgagor and prevents the debtor from ousting a vendee in possession of the realty upon rejection of the contract, treatment of a contract for deed when the debtor is the vendee as an executory contract would permit complete rejection and forfeiture of the debtor vendee's interest. "The upshot is that nondebtor vendees, by virtue of Sections 365(i) and 365(j), may receive more favorable treatment in bankruptcy than debtor vendees."²²

Although the court expressed reluctance to depart from a rule as workable as the Countryman test, it found that application of the rule in this case contradicts the reason for its existence.

Classifying the contract for deed, where debtor is vendee, as a lien rather than an executory contract

²¹*Id.*

²²*Id.* at 63.

benefits the estate by enlarging the value of the estate and furthering the rehabilitation of the debtor. Sellers, as lienors, enjoy adequate protection. This is in harmony with the rationale for Sections 365(i) and 365(j). The blessings and burdens of reorganization are fairly distributed between creditors and the estate.²³

Conclusion

The-Countryman test, which has a sound theoretical basis as well as practical utility and widespread acceptance, should not be rejected lightly. The decision that an installment land sale agreement is not an executory contract despite substantial nonperformance by both parties is unjustified, especially in view of Sections 365(i) and 365(j) which evidence congressional intent to regard such contracts as executory. Clearly, if such agreements were not executory contracts, there would have been no reason for including in the Code Sections 365(i) and 365(j).

Nonetheless, the result in *Booth* may be justified for a different reason. Despite the fact that the installment land sale agreement is an executory contract, the rejection of it would result in a forfeiture which might have an adverse impact on the debtor's ability to successfully reorganize if the facts would warrant such a conclusion. It has long been recognized that equity abhors forfeitures.²⁴ Moreover, assumption of the agree-

²³*Id.* at 64.

²⁴See *Ledford v. Atkins*, 413 S.W.2d 68 (Ky. 1967); see also *Restatement of Contracts* § 302, which provides: "A condition may be excused without other reason if its requirement . . . will involve extreme forfeiture or penalty. . . ."

ment might have been financially impossible due to the debtor's condition. Thus, in order to avoid the harsh impact of the forfeiture clause, and for the policy considerations discussed in the court's opinion, a bankruptcy court might be justified in exercising its equitable powers²⁵ to treat the executory contract as a mortgage

²⁵ See Bankruptcy Code § 105(a); see also 28 U.S.C. § 1481, which provides that "a bankruptcy court shall have the powers of a court of equity, law and admiralty. . . ."

to secure the unpaid purchase price. This treatment would be similar to the Uniform Commercial Code's treatment of conditional sale agreements as security interests.²⁶ This rationale also fosters flexibility in that it would reserve for bankruptcy courts in other cases the power to treat installment land sale agreements as executory contracts where their rejection or assumption might be appropriate under the unique circumstances of the case.

²⁶ See U.C.C. §§ 9-102(2), 1-201(37).