There's a Preference Defense Hiding in Plain View

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Preference litigation has become so commonplace that bankruptcy attorneys have become blasé. Plaintiff's counsel presumes that all payments made to creditors within 90 days prior to the bankruptcy filing date are potentially avoidable preferences. In answering any given complaint, defense counsel generally invokes the standard defenses embodied in 11 U.S.C. §547(c) (and, occasionally, a defense or two based on 11 U.S.C. §550 and Fed. R. Civ. P. 7012) before cranking out a cookie-cutter answer. Most of us think that is all there is to handling a preference case...right?


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Wrong. In fact, there is a completely separate inquiry that counsel on both sides of a preference case need to make—namely, *was there an assumed contract (or lease)*? From the preference defendant's standpoint, contract/lease assumption is a great defense because it turns on a legal issue and bypasses the factual detail that is involved in the contemporaneous exchange defense under §547(c)(1), the ordinary business defense under §547(c)(2) and the new value defense under §547(c)(4). However, the blasé preference defense attorney might overlook the contract/lease assumption defense because it is *not* contained in §547(c); instead, it lurks in the *intersection between* §547 and the various contract assumption provisions in the Bankruptcy Code (*e.g.*, §§365, 1110).

The widely quoted opinion on the subject is *In re Superior Toy Manufacturing Co. Inc.*, 78 F.3d 1169 (7th Cir. 1996). In *Superior Toy*, the debtor entered into a licensing contract with a division of Playtex on Feb. 7, 1989—just 13 months before an involuntary chapter 7 petition was filed against Superior Toy on March 9, 1990. The debtor converted the case to chapter 11 and, on Nov. 8, 1990, the debtor moved to assume the contract with Playtex under 11 U.S.C. §365. The cure amount was $6,565. The bankruptcy court approved the assumption.

On Dec. 26, 1991, the case was re-converted to chapter 7 and the trustee filed several preference cases—including one against Playtex for the $46,063.30 in royalties that the debtor had paid to Playtex during the 90-day preference period. The trustee alleged that the $46,063.30 was a preferential transfer because it satisfied all of the elements of 11 U.S.C. §547(b), as the debtor had paid the $46,063.30 (1) to or for the benefit of a creditor, (2) on account of antecedent debt, (3) while the debtor was insolvent, (4) within 90 days before the bankruptcy filing date and (5) that enabled Playtex to receive more than it would receive in a chapter 7 liquidation if the transfer had not been made and the creditor received only a dividend in the chapter 7 case.

About the Author

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Playtex filed a motion to dismiss the preference case under Fed. R. Bankr. P. 7012(b)(6), alleging that the trustee failed to state a preference claim because the trustee's predecessor—the chapter 11 debtor—had assumed the license agreement pursuant to Bankruptcy Code §365 which *required*, as a condition to that assumption, that all payments owing to Playtex be brought current. The bankruptcy court granted Playtex's motion and held that (1) the chapter 7 trustee was bound by the assumption of the Playtex license agreement during the chapter 11, and (2) because Bankruptcy Code §365 required the debtor to cure all defaults before the Playtex agreement could be assumed, as a matter of law the trustee was *precluded* from satisfying the fifth element of §547(b). The trustee appealed to the district court, which affirmed the bankruptcy court, and then appealed to the Seventh Circuit.

In *Superior Toy*, the Seventh Circuit held that Code §§365 and 547 are in conflict, but the unequivocal language of §365 is decisive because §365(b)(1) *requires* that the trustee guaranty payment of *all* amounts owing to the nondebtor contracting party—not just future payments. The Seventh Circuit reasoned that §365(b)(1) "trumps" §547(b) because: "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?" 78 F. 3d at 1174. The Seventh Circuit concluded that "permitting a preference suit after an assumption order would undermine §365" and reasoned: "Sections 547 and 365 are mutually exclusive avenues for a trustee. A trustee may not prevail under both. Nor may a subsequent trustee pursue one course, when her predecessor has pursued another." 78 F.3d at 1174.

The Seventh Circuit noted that its decision was consistent with the Ninth Circuit's ruling in *In re LCO Enters.*, 12 F.3d 938 (9th Cir. 1993) (holding that a trustee is not entitled to use Bankruptcy Code §547 to recover pre-petition lease payments after that lease had been assumed pursuant to Bankruptcy Code §365), and with the Eleventh Circuit's ruling in *Seidle v. GATX Leasing Corp.*, 778 F.2d 659 (11th Cir. 1989) (holding that a trustee cannot use Bankruptcy Code §547 to recover pre-petition contract payments for equipment when the debtor had invoked it rights under Bankruptcy Code §1110 to retain possession of the equipment by curing past defaults and keeping the payments current). 78 F. 3d 1174-1175. Thus, the Seventh Circuit's ruling in *Superior Toy* aligned it with the Ninth and Eleventh Circuits. Several courts have followed *Superior Toy*. *See, e.g.*, *In re Philip Servs. (Del.) Inc.*, 284 B.R. 541, 553 (Bankr. D. Del. 2002), *aff'd*, 303 B.R. 574 (D. Del. 2003); *In re Kiwi Int'l Air Lines Inc.*, 344 F.3d 311, 318 (3d Cir. 2003); *In re Greater Southeast Community Hosp. Corp. I*, 327 B.R. 26, 31 (Bankr. D. D.C. 2005); *In re Dehon Inc.*, 352 B.R. 546, 561 (Bankr. D. Mass. 2006).

Other courts, however, have reached the same outcome as *Superior Toy* using a *res judicata* or equitable estoppel approach, and these courts hold that the preference case against a nondebtor party whose contract or lease with the debtor has been assumed is barred by *res judicata*. *See, e.g.*, *In re Phoenix Restaurant Group Inc.*, 53 Nos. 301-12036, 303-573A, 2005 WL 114327 (Bankr. M.D. Tenn. Jan. 10, 2005); *In re Virtual*

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Network Servs. Corp., 97 B.R. 433, 435 (Bankr. N.D. Ill. 1989). Even some of the courts that focus on the fact that contract/lease assumption obliterates the plaintiff's ability to satisfy §547(b)(5) also analyze facts supporting preclusion or equitable estoppel to deny the debtor permission to escape its obligations to perform a contract that it assumed. *See, e.g., Seidle v. GATX Leasing*, 778 F.2d at 665 (11th Cir. 1989). This is consistent with the concept best articulated in *In re Greater Southeast Community Hospital Corp. I*, 327 B.R. 26, 36 (Bankr. D. D.C. 2005):

> [O]nce an executory contract is assumed pursuant to a trustee's power of assumption, then as between the trustee and the other party, the executory contract is necessarily assumed for all purposes in the case.

Between the *Superior Toy* line of cases and the "*res judicata*/equitable estoppel" line of cases, the contract/lease assumption preference defense appears firmly established, and this has practical implications for all attorneys who handle preference cases. Before filing any preference case, plaintiff's counsel should cross check the debtor's payment records against the list of assumed contracts and leases so as to avoid suing a party whose contract has already been assumed under Code §§365, 1110, a confirmed plan or otherwise. (After all, plaintiff's counsel wants to avoid any chance that an aggressive preference defense attorney might seek sanctions under Fed. R. Bankr. P. 9011). Preference defense counsel needs to determine whether the defendant has or had an executory contract or unexpired lease with the debtor, and if so, whether it was (or is going to be) assumed.

Indeed, the contract/lease assumption preference defense has implications for the entire chapter 11 bankruptcy case. Chapter 11 debtors, who are already concerned about improvidently assuming a contract or lease and incurring additional administrative obligations for rent or other contract performance, now have additional reason for concern because contract/lease assumption has the effect of releasing or barring any potential preference claim against the nondebtor party to the contract or lease. Conversely, counsel representing the nondebtor party relative to assumption of any executory contract or unexpired lease should consider inserting language in the assumption order or plan to have the court confirm that the assumption bars any preference claim against the nondebtor party to the assumed contract or lease. (If the preference suit was filed before the lease or contract was assumed, then the assumption order or plan confirmation order, as the case may be, should require the dismissal of the preference case with prejudice.)

The bottom line is simple: If the debtor assumes the executory contract or unexpired lease, then neither the debtor nor a subsequently appointed trustee can pursue a preference action against the nondebtor party to that contract or lease. The contract/lease assumption defense is powerful and often operates as a "slam dunk" defense—even though it is not set forth in §547(c), but instead "hides" in plain view in the various contract and lease assumption provisions embodied in the Bankruptcy Code. ■