

The Final Word on the Contract Assumption Defense to Preference Action

By

Bradley D. Blakeley

When a creditor provides services to a debtor, one of the considerations given is whether such services should be done on a long-term contract basis. One of the benefits can be that such contracts, if assumed by the debtor postpetition, can insulate the creditor from preference exposure. Such is the case in the recent decision from the Colorado bankruptcy court in *Centrix Financial, LLC*.

In *Centrix*, the debtors sold their assets and the liquidating trustee filed an action to recover nine transfers to the defendant totaling in excess of \$500,000. In response, the defendant filed a motion for summary judgment asserting that the alleged preferential transfers cannot be recovered through avoidance powers because they were payments made on an executor contract that the debtor later assumed and assigned. The trustee opposed the motion on three grounds – ambiguity as to the contract assumed, the contract assumption defense does should not be recognized by the court and assuming the court finds that the contract assumption defense is a valid defense, it should not do so in this case because the defendant failed to plead it in its answer.

The trustee asserted that there were two contracts between the debtors and the defendant and assumption motion failed to specify the contract, which the trustee asserted created ambiguity as to whether the payments made by the debtors fell under the assumed contract. The Defendant asserted that, while there were two accounts, the later contract integrated the first contract. The result was that there were two accounts governed by one contract. The court found that the plain language of the the later contract demonstrated that the debtors and defendant intended that it include all provisions of the earlier contract, plus the additional services to be rendered by the defendant. Take away – when more than one contract is in place with a debtor, be sure to demand that the debtor that identify the specific contract assumed.

As for the impact of the debtor's assumption of the contract, the fundamental purpose of § 365 is to make the nondebtor contracting party whole upon assumption of the executory contract. Section 365 requires the cure of all outstanding defaults, compensation for damages attributable to the debtor's breach, and adequate assurance of future performance.

The defendant argued that § 365's purpose is directly at odds with a trustee's avoidance power that would permit recovery of the payments made under the assumed contract. Thus, the estate must elect to either assume the contract or exercise its avoidance powers to recover payments under it.

The court found no case squarely on point in the Tenth Circuit, but did recognize that a majority of the courts that have addressed the issue have recognized the contract assumption defense as a complete bar to the trustee's avoidance powers. Many of these courts reasoned that assumption and preference powers are mutually exclusive because they are fundamentally inconsistent. Allowing a preference suit after assumption would undermine Congress' intent that a contracting party is made whole prior to being forced into fully performing.

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

The court went on to find that the debtors' estates had already been enriched by the assumption and assignment of the contract, stating that it would be manifestly unjust to allow the estate to retain the benefit conferred by assumption and assignment, but nevertheless allow the trustee to recover amounts that his predecessor had been required to pay under § 365.

The trustee argued that the hypothetical liquidation described in § 547(b)(5) must be determined as of the petition date, rendering post-petition events irrelevant. He contended that the cases relied on by defendant were erroneously decided because the contract assumption occurred post-petition. The court chose to follow other precedent that found that the contract assumption defense was not predicated on the trustee's ability to meet § 547(b)(5). Take away – the premise that permitting a preference suit after assumption undermines the intent and purpose of § 365 should control and provide a complete defense.

The defendant did not specifically plead the contract assumption defense in its answer, and the trustee, in his final argument, asserted that the failure to plead it operated as a waiver of the defense. The contract assumption defense was first asserted in the defendant's discovery responses provided on the discovery cut-off date.

The court found that, unlike other defenses, the assumption of the contract defense rests on a purely legal question and does not require any discovery. Based on this reasoning, the court found this to be a closer call than the trustee's other arguments, but determined that trustee was sufficiently apprised of the defense and suffered little or no prejudice from its later assertion. Take away – even the best crafted arguments can be undermined by an oversight or lack of investigation at the outset of a case.