U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

IN RE:	§	
	§	
MCS/TEXAS DIRECT, INC.,	§	
	§	
Debtor.	§	CASE NO. 02-40229-DML-11

MEMORANDUM OPINION AND ORDER

Before the court are the objections (the "Objections") filed by MCS/Texas Direct, Inc. ("Debtor") and the Official Committee of Unsecured Creditors (the "Committee") to claim number 52 (the "Claim") proved herein by OCE Printing Systems USA, Inc. ("OCE"). The parties have entered into a stipulation of facts which, with the exception noted in part II of this memorandum opinion and order, the court adopts. The court heard oral argument on the Objections on March 9, 2004, and reviewed the Claim, the Objections, the exhibits submitted by OCE and the Committee, and certain other papers filed in this case which are relevant to disposition of this matter. The court has core jurisdiction to consider the Objections. 28 U.S.C. §§ 1334(a) and 157(b)(2)(B). This memorandum opinion and order comprises the court's findings of fact and conclusions of law. FED. R. BANKR. P. 7052 and 9014.

I. BACKGROUND

Debtor was in the business of direct mail production. In March of 1997 Debtor entered into a master lease and associated agreements by which Debtor leased certain printing equipment from OCE (the "Master Agreement").

On January 10, 2002, Debtor commenced this chapter 11 case. On February 7, 2002, Debtor filed a motion seeking authority to sell all of its assets under section 363 of the

Bankruptcy Code[1] in a going concern configuration. Following hearings on February 12 and February 28, 2002, the court entered an order on March 15, 2002, approving bidding procedures for the purchase of Debtor's assets.[2]

At an auction held in the courtroom without the judge present, North American Communications, Inc. ("NAC") was the successful bidder. With the approval of the Committee, and pursuant to the court's order entered on April 25, 2002, Debtor executed an Asset Purchase Agreement (the "APA") with NAC. In addition to a cash purchase price, NAC assumed certain of Debtor's contractual and other obligations. As to some contracts, including the Master Agreement, the APA provided that NAC would have an opportunity "to negotiate terms, if possible" for continued use of OCE's equipment. *See* APA ¶ 2.3. If terms were not negotiated, and the agreements with OCE were rejected, NAC agreed to "satisfy all allowed claims arising from the rejection of executory contracts" by payment of a percentage of such claims equal to that paid by Debtor to general unsecured creditors from Debtor's estate.[3] *See* APA ¶ 2.4.

In the meantime, OCE had filed the Claim in the amount of $1,134,499.33. This amount included both OCE's unpaid prepetition charges under the Master Agreement of $187,503.05 and estimated damages if the contracts with Debtor were rejected. NAC's negotiations with OCE

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1 11 U.S.C. §§ 101-1330 (2004) (hereinafter referred to as the "Code").

2 The court was persuaded by evidence presented by Debtor that its business was deteriorating due to the pendency of the bankruptcy case and that, in the circumstances of this case, time did not permit sale of the assets through the plan. The court therefore approved the sale as justified by a valid business purpose under section 363 of the Code. *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983); *Comm. of Equity Sec. Holders v.Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983).

3 Debtor has confirmed a plan of reorganization under which the proceeds of the sale to NAC will be distributed substantially pro rata to unsecured creditors.

were unsuccessful,[4] and the Master Agreement was formally rejected. NAC and OCE thereafter apparently agreed to a payment to OCE which disposed of all of the Claim but the $187,503.05 of prepetition charges.

II. ISSUE

The stipulation of the parties presents the issue before the court as follows: "The only issue before the Court requires a determination of liability between [Debtor] and [NAC] with respect to the pre-petition [sic] portion only of the [the Claim] in the amount of $187,503.05."

NAC, however, was not a party to the hearing on the Objections. The court therefore restates the issue as whether the $187,503.05 prepetition portion of the Claim is not part of a "claim arising from the rejection of [an] executory contract[]." If it is not, it is subject under the APA to satisfaction from estate funds pursuant to Debtor's plan of reorganization.

III. DISCUSSION

A. Should the Language of the APA Be Construed Independently of the Code?

In determining the issue before it the court must first decide whether the contract language or the provisions of the Code must be construed to reach an answer. The APA governs the allocation of claims as between Debtor's estate and NAC and that agreement is therefore where the court must begin.[5]

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[4] It is not clear whether OCE reclaimed the equipment leased to Debtor. In any event, the Master Agreement was not assumed and has been treated by all parties, including Debtor, OCE, and the Committee, as rejected.

[5] The Committee argues that the Master Agreement provides means for calculating OCE's damages. *See* Master Agreement ¶ 9. Because paragraph 9 of the Master Agreement was used by OCE in determining the amount of the Claim, the Committee urges that the Claim as a whole clearly resulted from rejection of the Master Agreement.

The relevant part of the APA describes the obligation of NAC as satisfaction of "claims arising from the rejection of executory contracts." *See* APA ¶ 2.4. It is this language which will determine whether Debtor is required to pay OCE from the estate. However, the APA does not define "claim," "rejection," or "executory contract." *See* APA ¶ 1.1. Neither does the APA incorporate or refer to section 365 or section 502 of the Code.

If the APA stood alone, it might be appropriate for the court to construe these terms as used in the APA independently of the Code. But the APA was approved and entered into pursuant to an order of this court. The APA was formulated to consummate a sale of property by a chapter 11 debtor under section 363 of the Code. Moreover, the language used by NAC and Debtor in the APA is taken directly from section 502(g) of the Code, from which the court infers that the parties intended to divide liabilities based on categories created by Congress in the Code. The court therefore concludes that the phrase "claims arising from the rejection of executory contracts" must be interpreted to mean claims allowable under Code section 502 in this chapter 11 case which arose through the rejection of executory contracts pursuant to section 365(a) of the Code. Thus, the court turns to the Code to determine whether or not the prepetition amounts included in the Claim are the responsibility of Debtor's estate.

B. Are Prepetition Amounts Due Under a Contract Part of the Claim Arising from Its Rejection?

The Committee argues that the plain language of the Code clearly includes prepetition amounts due under a contract in the claim arising from its rejection. Section 502(g), the Committee maintains, by making a rejection claim effective as of the petition date, requires inclusion in that claim of prepetition amounts due. The Committee also points to section 365(b)

of the Code, which requires cure of defaults, *i.e.*, payment of past due amounts, as part of assumption of a contract. The amounts past due become (like the rest of the contract) entitled to treatment as if incurred postpetition. *See* Code § 365(g)(2). Thus, assumption solidifies all potential breach claims under the assumed contract as priority claims entitled to cost of administration treatment. *In re Harry C. Partridge, Jr. & Sons, Inc.*, 43 B.R. 669, 671 (Bankr. S.D.N.Y. 1984) ("If an executory contract or unexpired lease is assumed after the case is commenced, such assumption creates a new administrative obligation of the estate. Thus a subsequent breach or rejection of that obligation gives rise to an administrative claim of first priority.") (citation omitted). If prepetition amounts due are subsumed into the rights of contract parties arising from assumption, the Committee urges, then logic dictates that a claim "arising from . . . rejection" must also include prepetition amounts due.

Finally, the Committee points to section 502(b)(6), which provides that the claim arising from rejection of a lease of real property consists of two components: (1) a calculation of damages for loss of future rents, *see* Code § 502(b)(6)(A); and (2) under Code § 502(b)(6)(B) amounts owed under the lease prepetition. Though section 502(b)(6) (and its employment contract twin, section 502(b)(7)) does not apply directly to the Master Agreement, the Committee insists this section provides a precise analogy to the case at bar. If a real property lease claim is made up of both an element representing loss of future rentals and an element equal to prepetition amounts due, then OCE's Claim including the prepetition portion also should be deemed as "arising from the rejection" of the Master Agreement.

The court does not find the provisions of the Code so clear, however. First, the analogy of rejection to assumption is not compelling. Prepetition amounts become entitled to cost

treatment by reason of the need for *cure*, not because of assumption. Cure of a contract in connection with assumption is as easily seen as analogous to cure under section 1124(2), which requires cure of prepetition defaults in order to leave a claim unimpaired, as it is a necessity resulting from the categorization of the prepetition arrearages claim as a part of the cost claim engendered through assumption.

As for section 502, the provisions relating to real property leases and employment contracts also do not serve as good analogies. The provision for "unpaid rent" and "unpaid compensation" as part of the claim arising from rejection may be explained by the need to make clear that the caps provided in sections 502(b)(6) and 502(b)(7) do not cover prepetition amounts rather than by a general rule that claims arising from rejection encompass prepetition amounts due.

As for section 502(g),[6] on its face it does not necessarily support the Committee. Certainly it contains no language the plain meaning of which requires that the court treat prepetition arrearages as part of the claim arising from rejection rather than as a claim existing independently of the treatment accorded the underlying contract.

The principal conceptual difficulty with making prepetition arrearages part and parcel of a "claim arising from the rejection" of an executory contract is that the prepetition claim represents value – possession of property, rendition of services – actually received by a debtor. The claim

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[6] Section 502(g) states:

> A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

created by rejection results from no provision of property or services but rather from a debtor's anticipatory breach – a debtor's prospective failure to perform. Dividing the prepetition claim from the claim arising from rejection is consistent with the different treatment afforded a debtor's contract party for performance after entry of an order for relief. Performance providing value after the order for relief results in a cost claim, either for amounts accrued under the contract, *see* Code §§ 365(d)(3) and 365(d)(10), or for the worth of the benefit to the estate. *See In re Ames Dep't Stores, Inc.*, No. 01-42217, 2004 Bankr. LEXIS 201, at * 46 (Bankr. S.D.N.Y. Feb. 26, 2004) (recognizing that claims based on benefit to the estate are properly analyzed under section 503(b) of the Code); *In re KMart Corp.*, 293 B.R. 905, 909-10 (Bankr. N.D. Ill. 2003) (explaining that claims for performance during the case which are analyzed under section 503(b) of the Code must constitute "an actual, concrete benefit for the estate"). Even if the contract is rejected, the contract party is entitled to payment for postpetition value received by a debtor. *See, e.g., Data-Link Sys., Inc. v. Whitcomb & Keller Mortgage Co., Inc. (In re Whitcomb & Keller Mortgage Co., Inc.)*, 715 F.2d 375, 379 n.5 (7th Cir. 1983) (noting that if debtor continued to receive benefits from a contract party during the administration of the estate without paying for said benefits, the indebtedness to the contract party would be entitled to priority status); *In re Waste Systems Int'l, Inc.*, 280 B.R. 824, 826 (Bankr. D. Del. 2002) ("[A] non-debtor party to an executory contract is entitled to an administrative expense claim equal to the value of any post-petition [sic] benefit conferred on the estate prior to . . . rejection . . . .").

That these claims are independent of rejection claims supports a distinction between a claim arising from value received by the Debtor prepetition and a claim solely the result of rejection. Yet, a general analysis of rejection claims arising under the statute based on

categorization tied to value received appears flawed. Section 502(g) provides for allowance or disallowance of a claim arising from rejection *as of the petition date* under subsections (a)-(e) of section 502. By excluding allowance under section 502(f), section 502(g) effectively eliminates priority treatment of Debtor's contract party for any part of its claim pertaining to value provided to the Debtor during an involuntary gap period between the filing of the petition and the order for relief. Rather, the gap period claim is included as part of the general unsecured rejection claim. This necessary result of the plain meaning of the statute suggests that differentiation between prepetition arrearages and a rejection claim based on value actually received would be inappropriate.

In sum, the court concludes that the statute itself does not provide an answer to the issue posed in the instant case. Because the existing provisions dealing with rejection claims cited by the parties follow prior law, the legislative history of the Bankruptcy Code of 1978 does not address the issue at hand and so does not assist the court in parsing the statute.[7] The court thus next turns to caselaw for guidance.

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[7] The court has also researched the predecessors of the sections at issue. Although section 365's predecessor, section 70b of the Bankruptcy Act of 1898 (the "Act") and specific provisions regarding the rejection of contracts in rehabilitative chapters are not helpful because of the extensive changes in section 365, sections 502(g) and 502(b)(6) are largely adapted from sections 63c and 63a(9) of the Act. (In rehabilitative chapters, special provisions were included. *See, e.g.*, section 353 of the Act, applicable in chapter XI cases. *Cf.* section 77(b) pertaining to railroad reorganizations.) Though the provisions establishing treatment of rejected contracts under the Act did not reach their final form until the 1938 amendments, the issue was first dealt with by the 1933 amendments to the Act and the statute was not changed substantively thereafter. *See generally* 3A COLLIER ON BANKRUPTCY ¶ 63.32 (14th ed. 1975). In dealing with leases of real property, the Act apparently gave a landlord the option of proving a prepetition claim either (1) under section 63a(1) (fixed liabilities at the time of filing) or 63a(4) (debt due under a contract; there is no counterpart to section 63a(4) in the Code) or (2) 63a(9). Proof under section 63a(9) thus required including unpaid prepetition charges within the rejection claim. *See* 3A COLLIER ON BANKRUPTCY ¶ 63.33[1] (14th ed. 1975). This gloss on provisions of the Act, substantively the same as the operative provisions of the Code, provides some support for the result arrived at in *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1991) (hereinafter *"Greystone"*), discussed below.

The parties have cited to the court no case directly on point, and the court has found none. However, several courts have faced the issue of how to deal with a contract which is neither assumed nor rejected during bankruptcy. In these cases the court has found what appears to be a definitive answer to the issue at hand. Specifically, in *Greystone*, *supra* note 7, the Court stated:

> A debtor in Chapter 11 must either assume or reject its leases with third parties. If the debtor does neither, the leases continue in effect and the lessees have no provable claim against the bankruptcy estate. . . . A party to a lease is considered a "creditor" . . . only when the party has a claim against the estate that arises from *rejection* of a lease.

Greystone, 995 F.2d at 1281 (citations omitted; emphasis in original).

While the Court of Appeals in *Greystone* was concerned with whether tenants of a debtor whose leases had not been rejected had impairable (votable) claims by reason of their security deposits, there appears to be no reason why *Greystone's* reasoning would not be applicable in the case at bar and binding on the court.[8] *Greystone's* reasoning had been used by other courts in prior cases in which the amount and status of a claim was at issue for distribution purposes. *See Federal's, Inc. v. Edmonton Inv. Co.*, 555 F.2d 577 (6th Cir. 1977); *In re Greenpoint Metallic Bed Co., Inc.*, 113 F.2d 881 (2d Cir. 1940); *Consol. Gas Elec. Light & Power Co. of Baltimore v. United Railways & Elec. Co. of Baltimore,* 85 F.2d 799 (4th Cir. 1936). *See also* 9 COLLIER ON BANKRUPTCY ¶ 7.15[4.1] (14th ed. 1978) ("One who is a party with the debtor to an executory contract does not thereby have a provable claim . . . until the contract has been rejected.").

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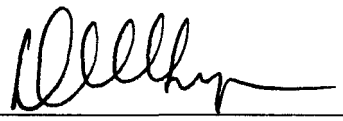
[8] A tenant's deposit would be a contingent right to payment and so within Code § 101(5)'s definition of "claim." The court can see no reason for holding that prepetition amounts due under the Master Agreement should be considered a claim independent of the claim "arising from the rejection" of the underlying agreement if the claim of a tenant for a security deposit is not entitled to be considered separately from disposition of the underlying lease.

CONCLUSION

The Fifth Circuit's holding in *Greystone*, that a contract party has no claim until the contract is rejected, if not precisely on point, is sufficient authority upon which this court may decide the matter before it. The court, following the command of *Greystone*, holds that a party to a contract with a debtor has *no* claim until rejection. Necessarily, therefore, the claim arising from the rejection of an executory contract includes prepetition arrearages due under that contract. Applying *Greystone* to the case at bar, under the APA the Debtor is not responsible to satisfy the prepetition portion of OCE's Claim.

The Objections must be **SUSTAINED.**

SO ORDERED this 30th day of March 2004.



DENNIS MICHAEL LYNN
UNITED STATES BANKRUPTCY JUDGE