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Alert

District Court Finds No Implied Assumption of Contract

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When a Chapter 11 debtor never sought "court approval to assume" an executory service contract, it "did not assume" the contract, held the U.S. District Court for the Eastern District of Virginia on June 28, 2019. *In re Toys "R" Us, Inc.,* 2019 WL 271305, *1 (E.D. Va. June 28, 2019). Affirming the bankruptcy court, the district court agreed that the Bankruptcy Code ("Code") "requires court approval before assumption" and that "parties cannot assume contracts by words or conduct." *Id.* According to the contract counterparty, "C," the debtor had allegedly promised "to assume the contract," *Id.* at *1, *2, but the bankruptcy court never decided the issue. *Id.* at *1n.2. In any event, said the district court, "this case is not the 'rare instance' in which a party's conduct constitutes implied assumption," citing *In re A.H. Robins Co.,* 68 B.R. 705, 710 (Bankr. E.D. Va. 1986). The real question raised by *Toys* is whether a contract can ever be impliedly assumed by a trustee or Chapter 11 debtor-in-possession ("DIP").

Relevance

The *Toys* decision confirms the general rule: a trustee or DIP must obtain prior "court approval" to "assume… any executory contract…." *In re Whitcomb & Keller Mortg. Co., Inc.,* 715 F. 2d 375, 380 (7th Cir. 1983), quoting Code § 365(a). In other words, assumption "can only be effected through an express order of the judge." *Id.* citing *In re American National Trust,* 426 F. 2d 1059, 1064 (7th Cir. 1970). But the court in *Toys* barely dealt with the contract counterparty's defensive argument that the debtor had impliedly assumed its contract, saying that courts "allow implied assumption… in rare circumstances," with no meaningful analysis. Purporting to summarize one decision, it said that the court had permitted implied assumption when the debtor "tried to reject a real estate contract that required it to pay the broker a commission." 2019 W.L. 2713051, at *2, citing *In re Clavis Smith Building, Inc.,* 112 B.R. 768, 769 (Bankr. E.D. Va. 1990). That summary is, of course, meaningless.

The court in *Toys* also held that "[i]mplied assumption requires more than just the [debtor's] 'acceptance of benefits.'" *Id*. quoting *In re A. H. Robins Co.,* 68 B.R. 705, 711 (Bankr. E. D. Va. 1986). The requirement of a court order is clear, but further analysis of those few cases that have permitted implied assumption of a contract would be helpful to courts and practitioners.

Courts are generally correct in requiring prior court approval for contract assumption. As noted in *Robins*, which found no implied assumption, courts cannot ignore "the stated requirements of" Code §365(a) for prior court approval; to do so "could encourage collusion [by] a debtor-in-possession and specific creditors of [its] choosing [because] the parties could agree to effect an assumption of an executory contract between them and later present their actions to the court for the perfunctory step of nunc pro tunc court approval. If the court approval stage were relegated to the status of a mere formality, all notice requirements would be eviscerated and both the power of the court to grant approval and the conditional right of the creditors to object would be rendered meaningless." *Robins*, 68 B.R. at 711. Courts also want to know and creditors also have a right to be heard when a DIP or trustee

assumes a contract because administrative priority "is given to expenses arising under [any assumed] pre-existing contracts." *In re Klein Sleep Products, Inc.,* 76 F.3d 18, 20 (2d Cir. 1996).

Still, why have some courts permitted implied assumption? Are their decisions aberrational? Can these decisions be relied on in future cases? For sure, as *Toys* shows, an argument that the trustee or DIP's acceptance of benefits mandates assumption will not succeed.

Analysis of Implied Assumption Cases

Actions and Benefits. One court held in *In re Reda, Inc.,* 54 B.R. 871, 880 (Bankr. D. N.D. Ill 1985) "that a debtor had assumed [a] contract by its actions." A fire insurance adjuster had entered into a pre-bankruptcy contract with the debtor in that case after the debtor's restaurant sustained a fire. The debtor had agreed to pay the adjuster a percentage of any insurance proceeds by assigning a percentage of the proceeds to the adjuster. After finding that the debtor's contract was executory, the court explained why the DIP had impliedly "assumed the contract." *Id.* at 880. The DIP had accepted a settlement check from the insurance company, before any reorganization plan had been confirmed but never moved to assume the adjuster's agreement. In the court's view, the "debtor's actions" presented the "rare instance" of implied assumption: "the adjuster "continued to provide services for the debtor" after bankruptcy; the "debtor knew what was happening"; the "debtor has willingly accepted the benefits of the contract and therefore must also assume the burdens"; and the debtor never requested the adjuster "to cease representing it in the handling of the fire loss." *Id.* "But for the efforts of [the adjuster] there would be no fund [for creditors] to be battling over." *Id.* at 881. "[T]he debtor could not accept the check without also obligating itself to pay" the adjuster under its pre-bankruptcy contract. *Id.* at n.25. In sum, the court relied not only on the unique benefit conferred on the estate by the adjuster, but also on the DIP's knowing, willful conduct. *Reda* is a close case that, at most, should be limited to its facts. Other courts have either disagreed with or declined to follow its reasoning; See, e.g., *In re S.N.A. Nut Co.,* 191 B.R. 117 (Bankr. N.D. Ill. 1996); *In re Consumer Health Services of America, Inc.,* 171 B.R. 917 (Bankr. D. Col. 1994).

Continued Reliance and Benefits. Another bankruptcy court held that a DIP had impliedly assumed a pre-bankruptcy contract with a real estate agent who "was the sole procuring cause" of a contract for the sale of the debtor's property. *In re Clavis Smith Building, Inc.* 112 B.R. 768, 769 (Bankr. E.D. Va. 1990). Although the DIP sought court approval of the asset sale "without payment to" the agent, the agent argued that DIP had "assumed its agreement." *Id.* Although "the debtor has not formally assumed the contract," held the court, it has "assumed it by its words and deeds …. [The agent] was still obligated to nurse the [asset] sale through, oversee the completion of the construction of the house and … other details … [The] debtor relied on [the agent] for more than … providing a … buyer … [T]he debtor looked to [the agent] to draft [an] Agreement … " *Id.* at 770. Unlike *Reda*, no other court has rejected *Clavis*. Both *Robins* and *Toys*, however, cite *Clavis* approvingly.

Inaction: Acceptance of Benefits; Principles of Equity. Another bankruptcy court, in the context of a preference action, held that a debtor had impliedly assumed a contract because it "continue[d] to receive benefits under [the] contract" and "must also bear the burdens or obligations imposed under the contract." *In re Yonkers Hamilton Sanitarium Inc.,* 22 B.R. 427, 435 (Bankr. S.D.N.Y 1982), aff'd, 34 B.R. 385, 388 (S.D.N.Y. 1983) (". . . basic principles of equity" guided decision, "Having accepted the benefit of this. . . . agreement in the term of continued funding, the [trustee] cannot now be granted relief from the corresponding burden of the agreement . . . ."). Both courts in *Yonkers* apparently relied on the particular facts of the case to reach an equitable result. Their disregard of Code 365(a)'s clear

language has led other courts to reject the *Yonkers* analysis. See, e.g., *In re California Canners and Growers,* 62 B.R. 18, 24 (9th Cir. BAP 1986) (concurring opinion) ("I disagree with [*Yonkers* and another similar case] to the extent that they hold that the debtor's continuance of a business relationship with the creditor justifies . . . recoupment of prepetition contract claims in the absence of court approved assumption of the contract under Code § 365(a)) ; *In re Advanced Professional Home Health Care, Inc.,* 82 B.R. 837, 841 (Bankr. E.D. Mich 1998) (*Yonkers* decided on "equitable principles"; "To deny the clear language of [§365(a)] requiring conscious decisions by the trustee, in favor of an equitable doctrine . . not mentioned in the Code is not possible for this court."), rev'd on other grounds, 94 B.R. 95, 97 (E.D. Mich. 1988).

Comment

Implied assumption of a contract is indeed rare, requiring a persuasive set of facts and a sympathetic court. For practical purposes, practitioners should assume the doctrine is illusory, to be used only defensively as a last resort. Courts will, for valid reasons, require prior court approval. And creditors, whose claims will be subordinated to any assumed liability, will strenuously oppose any implied assumption argument.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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