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Installment Land Contracts and Section 365 of the Bankruptcy Reform Act

Shawn R. McCarver

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COMMENT

INSTALLMENT LAND CONTRACTS AND SECTION 365 OF THE BANKRUPTCY REFORM ACT

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I. INTRODUCTION

Andrew Baker, a resident of Maidstone in the State of New Kent, owns residential property (Blackacre) outright as of October 4, 1980. On that date, he entered into an agreement with John Stiles and his wife, Lucy. The agreement, which was properly executed by all parties, provides that John and Lucy are to buy Blackacre by making a down payment to Andrew, and by continuing to make monthly installment payments for the contract term. When all payments have been made, Andrew is to deliver a deed to Blackacre to John and Lucy, as tenants by the entirety. The agreement provides that if John and Lucy default on the contract, Andrew may declare a forfeiture and keep all of the payments as liquidated damages. John and Lucy make the required payments, and, as required by the contract, keep the property adequately insured and the real estate taxes paid. Andrew, however, is not so fortunate. On October 4, 1983, he files a petition in bankruptcy pursuant to chapter 11 of the Bankruptcy Reform Act¹ and a bankruptcy trustee is appointed by the United States Bankruptcy Court for the District of New Kent.

II. THE INSTALLMENT LAND CONTRACT—A PRIMER

The instrument used in this hypothetical is commonly referred to as an installment land contract. The installment land contract is frequently used as a substitute for a mortgage or deed of trust.² It should not be confused with an

1. 11 U.S.C. §§ 1101-1174 (1982).

2. See generally Nelson & Whitman, *The Installment Land Contract—A Na-*

earnest money contract,³ which governs the rights and liabilities of the parties to a real estate sale from the time the bargain is made until closing.⁴ The installment land contract controls the rights and liabilities of the parties during the entire period of the debt.⁵

The installment land contract has been regarded as a pro-seller device due to the forfeiture clause. In theory, if the buyer defaults, the seller can declare a forfeiture, go into possession, and keep all the contract payments as liquidated damages.⁶ Legislative or judicial change in most states has established that such clauses are no longer automatically enforceable.⁷ In fact, an installment land contract could be pro-buyer if the buyer records the contract.⁸

An important distinction between the mortgage or deed of trust and the installment land contract is the status of title upon execution of the documents. Under a mortgage or deed of trust, the buyer obtains both legal and equitable title.⁹ An installment land contract buyer obtains only equitable title.¹⁰

The installment land contract has caused problems in bankruptcy because

tional Viewpoint, 1977 B.Y.U. L. REV. 541. An installment land contract is also referred to as a "contract for deed" or a "long-term land contract." Such contracts can be amortized over relatively short periods (less than five years) or over longer, more traditional financing periods, such as 20 years. *Id.* at 541. An installment land contract usually provides that a buyer make payments over the life of the contract. When all payments have been made, the seller conveys title. If the buyer defaults, the contract usually provides that the seller can declare a default, take possession of the land, and keep the buyer's payments as liquidated damages. The forfeiture provision is generally considered an advantage for sellers. Installment land contracts are typically used in states that provide only for lengthy judicial foreclosure or in states where there are long statutory redemption periods. G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 3.25, at 80 (1979) [hereinafter cited as G. OSBORNE].

3. The earnest money contract is also called a "binder" or "marketing contract." Nelson & Whitman, *supra* note 2, at 541.

4. *Id.* at 542. Matters typically covered include the risk of casualty loss, title reports, and disposition of the earnest money in the event the sale is not completed.

5. *See id.*

6. G. OSBORNE, *supra* note 2, §§ 3.25-.26.

7. *See* Nelson & Whitman, *supra* note 2, at 544; *see also* Comment, *Forfeiture: The Anomaly of the Land Sale Contract*, 41 ALBANY L. REV. 71, 73-74 (1977); Note, *Forfeiture and the Iowa Installment Land Contract*, 46 IOWA L. REV. 786, 788 (1961); Comment, *Installment Contracts for the Sale of Land in Missouri*, 24 MO. L. REV. 240, 243 (1959).

8. Nelson, *The Use of Installment Land Contracts in Missouri—Courting Clouds on Titles*, 33 J. MO. B. 161, 165 (1977). The installment land contract can benefit a buyer who records because a cloud is placed on the seller's title in the event the seller exercises the forfeiture provision. If the jurisdiction does not have a statutory procedure for enforcing forfeiture clauses, a title examiner likely will not pass on the title unless the seller obtains a release from the buyer.

9. G. OSBORNE, *supra* note 2, § 1.5, at 10.

10. *Id.* § 3.25, at 79.

the trustee may assume or reject "executory contracts."¹¹ While the Bankruptcy Reform Act of 1978¹² addressed some of these problems, understanding the effect of the changes requires examination of the installment land contract under the pre-1978 Bankruptcy Act.

III. PRE-1978 BANKRUPTCY LAW

Under section 70(b) of the Bankruptcy Act,¹³ the bankruptcy trustee had the authority to assume or reject executory contracts.¹⁴ Although bankruptcy primarily affects creditors, an installment land contract buyer can suffer injury when the bankrupt is his seller. A seller's trustee could reject a land sale contract even after the buyer had made a substantial down payment.¹⁵ The trustee might reject the contract in order to sell the land to a third party.¹⁶

11. See 11 U.S.C. § 365(a) (1982); notes 13-40, 48 and accompanying text *infra*.

12. 11 U.S.C. §§ 101-151,326 (1982). Congress revised the bankruptcy laws in 1978. Pub. L. No. 96,588, 92 Stat. 2549 (1978).

13. 11 U.S.C. § 110(b) (1976) (repealed 1978).

14. Section 70(b) provided:

The trustee shall assume or reject an executory contract . . . within sixty days after the adjudication or within thirty days after the qualification of the trustee, whichever is later, but the court may for cause shown extend or reduce the time. Any such contract . . . not assumed or rejected within that time shall be deemed to be rejected. If a trustee is not appointed, any such contract . . . shall be deemed to be rejected within thirty days after the date of the order directing that a trustee be not appointed.

See also *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1358 (9th Cir. 1983) (trustee may be liable for failing to take timely steps to reject contract once decision is made to do so).

15. See, e.g., *In re New York Investors Mut. Group*, 143 F. Supp. 51 (S.D.N.Y. 1956). The vendor agreed to sell certain property and the vendee made a large down payment. The land was in the possession of a tenant, who had a right to renew the lease or be paid for improvements made by the tenant. The seller mortgaged the land after entering into the land sale contract.

16. The court required the trustee to return the vendee's down payment. *Id.* at 53. While this returned the buyer to his pre-contract position, the buyer was still deprived of his investment and of any possible bargain, such as having acquired the land for less than fair market value. *New York Investors* was followed in other circuits. See, e.g., *In re Philadelphia Penn Worsted Co.*, 278 F.2d 661 (3d Cir. 1960) (buyer agreed to buy real estate at public auction, make down payment, and receive deed when balance was paid); *Gulf Petroleum, S.A. v. Collazo*, 316 F.2d 257 (1st Cir. 1963) (purchase of property by installment payments, with funds to be escrowed until closing). Commentators felt that *New York Investors* would apply to typical installment land contracts. E.g., Countryman, *Buyers and Sellers of Goods in Bankruptcy*, 1 N.M. L. REV. 435, 451 (1971); Lacy, *Land Sale Contracts in Bankruptcy*, 21 UCLA L. REV. 477, 481 (1973); Lynn, *Bankruptcy and the Land Sales Contract: The Rights of the Vendee Vis-A-Vis the Vendor's Bankruptcy Trustee*, 5 TEX. TECH L. REV. 677, 689 (1974); Nelson & Whitman, *supra* note 2 at 568; Power, *Land Contracts as Security Devices*, 12 WAYNE L. REV. 391, 413 (1966); Note, *Bankruptcy and the Land Sale Contract*, 23 CASE W. RES. 393, 399 (1972).

One policy of the bankruptcy laws is to treat creditors with similar claims equally when claims against the debtor are adjusted.¹⁷ When the trustee rejects an installment land contract, the rights of non-creditor third parties may be affected, especially when the buyer has substantial equity in the contract. If the contract is rejected, the buyer has, at best, an equitable lien for his payments.¹⁸ The question under the Bankruptcy Act was whether the vendee had priority for restitution of his contract payments or only an unsecured claim.¹⁹

Under the Bankruptcy Act, there was no certain way that a buyer could protect himself from a seller's bankruptcy and the subsequent rejection of the installment land contract by the trustee. Traditional contract remedies, such as specific performance, were not available because the trustee could reject executory contracts.²⁰ If, however, the installment land contract created a legal lien in the event of the seller's bankruptcy, the buyer might have been protected.²¹ In one case where the contract expressly gave the purchaser a lien on the property, a court allowed rejection, but only after the new purchaser agreed to refund the down payment.²² Although a prudent installment land

17. *In re Chi-Feng Huang*, 23 Bankr. 798, 801 (9th Cir. 1982); see also Note, *supra* note 16, at 399.

18. See Note, *supra* note 16, at 398. The party whose executory contract is rejected by the trustee is left with only an unsecured claim for breach of contract. *In re Murphy*, 694 F.2d 172, 174 (8th Cir. 1982).

19. See Lacy, *supra* note 16, at 485. Professor Countryman seems to have assumed that the vendee would have an unsecured claim under the Bankruptcy Act. Countryman, *supra* note 16, at 450. If the buyer is an unsecured creditor, he loses his equity in the land and a substantial portion of his payments, since there will probably not be enough money to satisfy all general creditors.

20. One commentator has suggested that a trustee could only use the rights granted by § 70(b) to reject a burdensome contract. This commentator relied on the analogy between the treatment of leases and executory contracts under the Bankruptcy Act. See Note, *supra* note 16, at 399. This argument stemmed from one court's statement that a lease presupposes a continuance, even when a receiver has been appointed, so long as the receivership estate is not burdened by the continuance. *American Brake Shoe & Foundry Co. v. New York Rys.*, 278 F. 842, 483-44 (S.D.N.Y. 1922). Thus, argued the commentator, a bankruptcy trustee should only be able to reject burdensome executory contracts. Professor Lacy has pointed out that § 70(b) had no stipulation that an executory contract be burdensome. Lacy, *supra* note 16, at 481.

A simple solution for the buyer may have been to require the seller, as part of the closing, to deliver a deed to an escrow agent. The argument could be made that such a delivery makes the contract no longer executory. See *Clark v. Snelling*, 205 F. 240 (1st Cir. 1913) (prior to the enactment of § 70(b), bankruptcy trustee not allowed to withhold delivery of deed where buyer had paid the full purchase price and taken possession but had not yet received the deed).

21. See Note, *supra* note 16, at 403. Buyers under installment land contracts, however, seldom have legal liens in this situation. *Id.* at 404; cf. *Cohen v. East Netherland Holding Co.*, 258 F.2d 14 (2d Cir. 1958) (legal lien given effect by a bankruptcy court in the case of a lease). Legal liens have been accepted in the non-bankruptcy installment land contract default. See, e.g., *Spruell v. Blythe*, 215 Md. 117, 137 A.2d 183 (1957) (buyer entitled to compensation and lien upon real estate when seller breached installment contract).

22. *In re New York Investors Mut. Group*, 143 F. Supp. 51, 53 (S.D.N.Y.

purchaser provides for a lien in the event of the seller's bankruptcy, many contracts lack this protection.²³

Another remedy was the imposition of an equitable lien on the property to secure payments already made under the contract.²⁴ Such liens are judicially created because it seems fair to do so, not because of contract provisions.²⁵ Other relief could be available in states which treat installment land contracts as mortgages.²⁶ The argument is that if an installment land contract is treated

1956). *In re Philadelphia Penn Worsted Co.*, 278 F.2d 661 (3d Cir. 1960), which followed *New York Investors*, did not give a clear answer to the lien question under the Bankruptcy Act. *Cf. Gulf Petroleum, S.A. v. Collazo*, 316 F.2d 257 (1st Cir. 1963) (denied purchaser a lien where no down payment had been made on the land, the only payment being made to the vendor to be held in escrow until rezoning of property). Arguably, *Collazo* is consistent with *New York Investors* because there was no down payment in *Collazo*, the purchaser had no interest in the land, and thus, no lien. In *Collazo*, the court held that the escrowed funds were not a part of the bankrupt's estate, 316 F.2d at 260, which gives the same result as if a lien had been allowed, provided that the escrow account is still intact.

23. One reason for this omission could be that the form followed did not contain such a provision. Another reason might be that the parties simply did not think about the problem in advance. A third reason could be that the vendor, who sometimes stands in a superior bargaining position, would not permit the insertion of such a provision into the contract. It is not clear that a clause creating a legal lien in the event of bankruptcy would be enforced against the trustee. Such a clause might be deemed "ipso facto." See 11 U.S.C. § 365(e)(1) (1982). Ipso facto clauses declare that an event (such as a default and acceleration) will occur if a party to a contract declares bankruptcy. Such clauses are not enforced under the Bankruptcy Reform Act, although they were enforced under the Bankruptcy Act. *Id.* § 110(b) (1976) (repealed 1978). One other avenue that might have been tried under the pre-1978 law was imposing a statutory lien in the event of seller's bankruptcy. Holders of other types of statutory liens are given priority over the trustee. See, e.g., *id.* § 545 (1982).

24. See Note, *supra* note 16, at 403, 404; see also Shanker, *The Treatment of Executory Contracts and Leases in Bankruptcy Chapter X and XI Proceedings*, PRAC. LAW., Apr. 1972, at 15, 27. Such a lien provides only a partial remedy. The buyer may still be required to give up possession. Further, the buyer could be deprived of the benefit of his bargain, such as obtaining a low interest rate.

25. See Lacy, *supra* note 16, at 485. The lien is confirmed in non-bankruptcy situations where a vendor defaults. See *National Indem. Co. v. Banks*, 376 F.2d 533, 534 (5th Cir. 1967) (vendee's lien similar to that of vendor for unpaid purchase price); *Cleveland Trust v. Bouse*, 163 Ohio St. 2d 392, 397, 127 N.E.2d 7, 10 (1955) (purchaser entitled to equitable lien for amount paid toward purchase price where vendor breached contract); *Wayne Building & Loan Co. v. Yarborough*, 111 Ohio St. 2d 195, 228 N.E.2d 841, 846 (1967) (vendee does not have to be in possession to have equitable lien); see also J. DAWSON & G. PALMER, *CASES ON RESTITUTION* 327-30 (2d ed. 1969); Annot., 33 A.L.R.2d 1384 (1954). Although no cases have been decided in the bankruptcy courts, equitable liens may not be recognized because other equitable doctrines, such as equitable conversion and specific performance, are not recognized in bankruptcy proceedings. Shanker, *supra* note 24, at 27.

26. See Note, *supra* note 16, at 405. The installment land contract and the purchase money mortgage fulfill the economic function of seller-financing of the unpaid portion of the purchase price. Nelson & Whitman, *supra* note 2, at 541. Use of the installment land contract has been attributed to the unavailability of mortgage financ-

as a mortgage by the state courts, then it should be treated similarly under the Bankruptcy Act.²⁷

The most obvious remedy would have been to avoid installment land contracts if there were a danger of bankruptcy. This option could cause people to stop using a valid form of financing in order to guard against the relatively remote possibility of bankruptcy. This could be particularly inequitable in jurisdictions which allow only judicial foreclosure and where the installment land contract is widely used to avoid the expense and delay of foreclosure.

IV. THE BANKRUPTCY REFORM ACT OF 1978

Section 70(b) of the Bankruptcy Act, which was said to have been declaratory of the case law prior to 1938,²⁸ led to harsh results when a seller went into bankruptcy. As a result of these inequities, many changes were pro-

ing for low down payment sales. See *Lacy, supra* note 16, at 477. Actually, the seller under an installment land contract occupies a position analogous to that of the seller-mortgagee under mortgage financing. Thus, it is difficult to understand why form should control over substance, allowing one result when a seller went into bankruptcy and an opposite result when a mortgagee went into bankruptcy. See *Shanker, supra* note 24, at 29-30. Under the Bankruptcy Act, if the parties had not considered the possibility of bankruptcy, their chosen form of completing the transaction could haunt them at a later date.

27. A court does not necessarily have to apply the state's definition in bankruptcy proceedings. See, e.g., *In re Kaplan*, 18 Bankr. 1018, 1020 (E.D.N.Y. 1982) (federal law determines what is alimony, support, or maintenance obligation for purposes of 11 U.S.C. § 523 (1982)). Federal law determines whether or not an installment land contract is executory. *In re Alexander*, 670 F.2d 885, 888 (9th Cir. 1982). The legal consequence of a failure to perform remaining contract obligations is a state law question. *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1448 n.4 (9th Cir. 1983).

Forceful equitable arguments can be made that the bankruptcy court should allow the state's characterization of an installment land contract to control. It is unfair to treat a document as an installment land contract subject to rejection by a bankruptcy trustee when the parties relied on the fact that the same rights are accorded parties to an installment land contract as are accorded parties to a more traditional mortgage. The counter-argument is that parties should consider the bankruptcy problem in advance and plan the transaction accordingly.

28. See 2 COLLIER ON BANKRUPTCY §§ 365.02-.10 (15th ed. 1983); Turner, *Bankruptcy and Executory Contracts*, 41 TITLE NEWS 114 (1962). It is not entirely accurate to say that § 70(b), as interpreted in installment land contract bankruptcy cases, is a declaration of pre-1938 case law. The issue of the bankruptcy of a seller under an installment land contract vis-a-vis the buyer was not decided until 1956. See *In re New York Investors Mut. Group*, 143 F. Supp. 51 (S.D.N.Y. 1956) (discussed at note 15 *supra*). Although the drafters of § 70(b) did not exclude installment land contracts, this does not necessarily mean that such contracts were to be governed by that section. The better reasoning is that since "executory contract" is not defined under either the Bankruptcy Act or the Bankruptcy Reform Act, the drafters meant for the courts to fashion a definition which would serve the purposes of the Bankruptcy Act and at the same time treat those who had dealt with the bankrupt in a fair manner.

posed.²⁹ The drafters of the Bankruptcy Reform Act clearly intended to alleviate the harshness of section 70(b)³⁰ with 11 U.S.C. § 365.³¹ Like section 70(b), section 365 authorizes the trustee, subject to court approval, to assume or reject executory contracts of the debtor.³²

Unlike its predecessor, however, 11 U.S.C. § 365(i)³³ provides a special rule when the trustee rejects an executory contract of the bankrupt for the sale of real property when the purchaser is in possession.³⁴ When the trustee rejects an executory contract of the debtor for the sale of real property, the purchaser in possession may treat the contract as terminated or remain in possession.³⁵ A purchaser who remains in possession must continue to make all payments due under the contract,³⁶ and the trustee must deliver title in accordance with the provisions of the contract.³⁷ The purchaser who chooses to treat the executory contract as terminated after a trustee has rejected it is governed by section 365(j).³⁸ This section creates a legal lien for the purchaser that attaches to the debtor's interest in the property and secures recovery of any portion of the purchase price paid by the purchaser.³⁹

In enacting these provisions, Congress intended to reach some of the

29. In 1973, Professor Lacy proposed a series of amendments to § 70(b): one restricting the power of a trustee to reject an installment land contract; another to provide for court-supervised renegotiation of the price; and a third to grant the vendee a lien on the real estate for the amount of the payments or improvements. Lacy, *supra* note 16, at 536-38; *see also* Note, *supra* note 16 at 409 (suggested an amendment which would have prevented rejection of the contract if the buyer was performing the terms).

30. *See* H.R. Doc. No. 137, 93d Cong., 1st Sess. 158 (1973).

31. (1982). *See generally* Epling, *Treatment of Land Sales Contracts Under the New Bankruptcy Code*, 1981 ARIZ. ST. L.J. 853.

32. 11 U.S.C. § 365(a) (1982). This subsection also authorizes the trustee, subject to court approval, to assume or reject an unexpired lease of the debtor. These sections augment the avoidance powers accorded the trustee under chapter 5 of the Code. *See, e.g.*, 11 U.S.C. § 548(a)(2) (1982); *see* Epling, *supra* note 31, at 861-62.

33. (1982).

34. 11 U.S.C. § 365(i)(1) (1982).

35. *Id.* This provision allows the buyer to continue with the contract or let the trustee reject it.

36. *Id.* § 365(i)(2)(A). This provision gives the purchaser the right to offset against the payments any damages occurring after the date of rejection by the trustee, provided that such damages arise as a result of the non-performance by the debtor of an obligation owed under the contract. The purchaser has no rights against the bankrupt's estate other than the offset.

37. *Id.* § 365(i)(2)(B). This provision also relieves the seller-debtor of all other obligations under the contract.

38. *Id.* § 365(j).

39. *Id.* Section 365(j) also governs when the purchaser is not in possession of the real estate. Instead of allowing a purchaser out of possession to choose to continue making payments under the contract or to treat the contract as terminated, § 365(j) provides that the lien is the only remedy. Thus, a purchaser out of possession is entitled only to a lien on the debtor's interest in the subject property to secure recovery of any part of the purchase price paid by the buyer. *See id.*

harshness that resulted from a strict application of section 70(b) of the Bankruptcy Act. No longer does the trustee have the right to reject an installment land contract subject to court approval without reckoning in a just way with the purchaser under the contract. The new legislation allows the purchaser to decide whether possession or rejection is best, given the parameters of the statute. The statute also expressly recognizes a kind of specific performance when it requires the trustee to convey title to the purchaser after the purchaser fulfills the contract. Finally, should the trustee decide to treat the contract as terminated, the statute provides the necessary security to increase the chances that the purchaser can recover his investment.⁴⁰ Although these sections seem relatively clear, an accurate assessment of their effectiveness cannot be made without a thorough examination of the cases decided since the enactment of section 365(i) and (j).

V. DECISIONS UNDER SECTION 365 OF THE BANKRUPTCY REFORM ACT

The earliest reported decision under section 365(i) of the Bankruptcy Reform Act noted that sections 365(i) and 365(j) provide the exclusive remedies for parties to executory contracts for the sale of real property.⁴¹ Exclusivity is desirable because the Bankruptcy Reform Act deals with an area that has been preempted by the federal government. If state law were applied, results would be less certain for interstate investors, and the same transaction could be treated differently in different parts of the country.⁴²

40. By imposing a lien on the realty, the buyer is put in a more secure position than a general creditor; his claim is secured by realty which the buyer deemed valuable when the contract was executed.

41. *In re Fisher*, 13 Bankr. 286 (E.D. Pa. 1981). The debtor, owner of certain real property, entered into an installment land contract and pursuant to the contract, the buyer went into possession of the property. Subsequently, the debtor obtained a loan from a bank by executing a promissory note and a document containing a confession of judgment. The bank entered judgment against the debtor, and the debtor filed a voluntary petition in bankruptcy seeking relief under chapter 7 of the Bankruptcy Reform Act, 11 U.S.C. §§ 101-1330 (1982). 13 Bankr. at 287. The debtor claimed an exemption for his interest in the real property. Under the Bankruptcy Reform Act, exempt property is not subject to liquidation. 11 U.S.C. § 522 (1982). The bank contended that the debtor was not entitled to avoid the lien for the reason that the lien was a security interest, as opposed to a judicial lien. The court held that the lien was a judicial lien, subject to the debtor's avoidance powers, and agreed that the docketing of a confessed judgment creates a judicial lien. 13 Bankr. at 287 (citing *In re Burkholder*, 11 Bankr. 346 (E.D. Pa. 1981); *In re Natale*, 5 Bankr. 454 (E.D. Pa. 1980)); see also 11 U.S.C. § 101 (27) (1982) ("judicial lien" means a lien obtained by legal or equitable proceedings). The court denied the bank's request that the trustee avoid the transfer of the realty to the buyer. 13 Bankr. at 287. The court stated that it would not adjudicate issues affecting the buyer when it was not before the court. Furthermore, it noted that the bank had not offered any support for its position that the trustee could avoid a transfer of the property to the buyer. *Id.*

42. A state court's characterization of an installment land contract could determine the applicability of § 365(i) and (j). If a state treats an installment land contract as a mortgage, the bankruptcy courts of that jurisdiction might decide that neither §

It is clear from the Bankruptcy Reform Act that installment land contracts may be rejected by the trustee. What constitutes an installment land contract is less certain. A 1981 decision determined that an interest denominated a land sale contract could be rejected as an executory contract.⁴³ Placing substance over form, the court decided that it was the ultimate judge of whether section 365(i) and (j) apply to a transaction. If a court were to look to form only, then the parties could decide in advance whether these sections would apply. This could prove especially disadvantageous for a buyer using a seller's form. The seller could manipulate the format of the contract in order to insure the applicability or non-applicability of section 365(i) and 365(j).

Once a court determines that a contract is subject to rejection, it must consider the proper standard to apply in allowing rejection.⁴⁴ Unless extraordi-

365(i) nor (j) apply. If each bankruptcy court were allowed to fashion relief different from that provided for in § 365(i) and (j), inequitable results would follow. In an area of the law that is preempted by the federal government, buyers under installment land contracts would find their cases being adjudicated differently depending on where they or their sellers happened to live, or where the land happened to be located. Uniform application of § 365(i) and (j) could hurt buyers using installment land contracts in states where such devices are treated as mortgages. These buyers might expect to be treated as mortgagors under the Bankruptcy Reform Act, only to find out later that a bankruptcy court will treat them as any other buyer under an installment land contract.

43. *In re Summit Land Co.*, 13 Bankr. 310 (D. Utah 1981). The debtor was developer of a recreational park and sold "interests" in the property to buyers by using land sale contracts. The court described the "interests" as recreational use permits. Use in the park was confined to hunting, fishing, hiking, camping, and the like. The agreements prohibited members from building or making permanent improvements. Members used the property intermittently, could delegate their interests, and actually shared the use of the property with other members. *Id.* at 311-12, 318. The debtor filed a petition under chapter 11 and sought to reject the contracts and sell the land free of the interests of the buyers under the executory land sale contracts. *Id.* at 312. This was apparently the only reasonable option for reorganization of the estate. See 11 U.S.C. § 363(f) (1982). For the definitions of the term "executory contact," see note 48 and accompanying text *infra*.

44. The debtor in *Summit Land* argued for the "business judgment rule," which would allow rejection on a showing that the estate would benefit thereby. *Id.* at 314. Defendants argued that land sale contracts could be rejected only if "burdensome." This test requires a showing that performance is unprofitable. Compare *In re Minges*, 602 F.2d 38 (2d Cir. 1979) and *American Brake Shoe & Foundry Co. v. New York Rys.*, 278 F. 842 (S.D.N.Y. 1922) with *In re Tilco, Inc.*, 558 F.2d 1369 (10th Cir. 1977). See also *In re Sombrero Reef Club, Inc.*, 18 Bankr. 612, 617 (S.D. Fla. 1982) (applied business judgment rule). The type of executory contract at issue may influence a court's choice of the test. See, e.g., *In re Bildisco*, 682 F.2d 72, 79 (3d Cir. 1982) (although the usual test is the "business judgment rule," in collective bargaining agreements there must be a thorough scrutiny and balancing of the equities), *aff'd*, 104 S. Ct. 1188 (1984); see also *Shopmen's Local Union No. 455 v. Kevin Steel Prods.*, 519 F.2d 698, 707 (2d Cir. 1975) (distinguishing debtor in possession from pre-bankruptcy entity). The Ninth Circuit has adopted the "business judgment rule." See *In re Chi-Feng Huang*, 23 Bankr. 798, 800 (9th Cir. 1982). The primary issue is whether rejection would benefit the general unsecured creditors. It is proper to refuse to author-

nary circumstances exist, court approval will be granted as a matter of course.⁴⁵ In addition, a court frequently must determine if the buyers under a contract are in possession.⁴⁶ The court is not to be controlled by state law that characterizes interests as possessory or non-possessory, since the need for uniformity requires that some federal meaning be given to the term.⁴⁷ The time share resort industry was dealt a major setback in *In re Sombrero Reef Club, Inc.*,⁴⁸ which held that certain time share interests are executory contracts

ize rejection when the party whose contract is to be rejected would be damaged out of proportion to any benefit to be derived by the general creditors. *Id.* at 801. The *Huang* court concluded that rejection is discretionary where the creditors would receive no benefit, but in any event, a solvent debtor may not petition for bankruptcy and obtain a windfall by rejecting executory contracts. *Id.* at 803.

45. *In re Summit Land Co.*, 13 Bankr. at 315. The court noted that the facts warranted deference to the debtor's business judgment and that, in any event, the facts satisfied the "burdensome" standard. *Id.* at 316.

46. "Possession," like the term "executory contract," is not defined in the Bankruptcy Reform Act. This determination may be necessary in order to determine if the buyer could remain in possession under § 365(i)(2), or whether the buyer could be compelled to receive only the § 365(j) lien.

47. *In re Summit Land Co.*, 13 Bankr. at 317. The court recognized that state court characterizations could be helpful, although not controlling. Looking to § 365(i) and (j) and their legislative history, the court concluded that these interests were not possessory. *Id.* at 317-18; see also note 42 and accompanying text *supra*. The court noted that purchasers in possession receive two economic benefits not granted to purchasers out of possession: appreciation in value and an offset against the contract price for damages resulting from rejection. The purchaser out of possession is required, upon rejection, to settle for a lien on the debtor's interest in the subject property. See 11 U.S.C. § 365(j) (1982). The court also noted the Committee Report's statement that § 365(i) was intended to protect a consumer that purchases a residence under a long-term land sale contract under which title does not pass until the full purchase price is paid. 13 Bankr. at 318; see H.R. Doc. No. 137, 93d Cong., 1st Sess. (pt. II) 158 (1973); see also Lacy, *supra* note 16, at 484 (important reason for protecting the purchaser in possession is that he is likely to be a low-income buyer of a home, farm, or small business). Congress sought to protect buyers who have permanent rather than ephemeral connections with the land, and continuous rather than intermittent connections, and exclusive rather than shared rights. *In re Summit Land Co.*, 13 Bankr. at 318. Considering the characteristics of the "interests" sold by the debtor, the court concluded the purchasers were not in possession. *Id.*; see note 43 *supra*.

48. 18 Bankr. 612 (S.D. Fla. 1982). The debtor brought an action to determine the relative rights of the parties, including holders of time share purchase agreements. Some of the holders had fully paid the contract price, while others had not completed installments. *Id.* at 615. The agreements provided that the price could be paid initially or on installment terms. The debtor believed that rejection of the contracts was necessary to make the real estate marketable. The first issue was whether the debtor was estopped from rejecting the contracts. Despite a stipulation entered into by the debtor in a previous action, the court held that the debtor was not estopped. Although the defendants contended that the contracts under which the purchase price had been paid in full were not executory, the court found that all of the contracts were executory. *Id.* at 616.

The court looked at three definitions of the term "executory." The legislative history for § 365 defines executory contracts as those under which performance remains incomplete to some extent on both sides. H.R. REP. NO. 595, 95th Cong., 1st Sess. 347,

subject to rejection by the trustee in bankruptcy.⁴⁹ The decision could lead to abuse of buyers at the hands of sellers. For example, a land speculator could set up a time share operation and later discover that he could make a better return on his investment. The seller could then declare bankruptcy in an attempt to resell the land. This could deprive buyers of the benefit of their bargain, while allowing a manipulative seller to get out of a risky investment in good financial condition.

The rationale in *Sombrero* was that both the buyer and the seller had continuing obligations.⁵⁰ The case raises implications for owners of condominium units. Condominium owners usually have a continuing obligation to pay fees to an owners association, even after the full purchase price is paid.⁵¹ Likewise, the association agrees to provide a variety of services, including maintenance.⁵² It can be argued that the continuing obligations make the arrangement executory, thus subject to section 365(i) and (j). The contrary argument is that such arrangements should not be considered executory if the usual mortgage or deed of trust is used. To rely on this distinction, however, allows

reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 6303; S. REP. NO. 989, 95th Cong., 2d Sess. 58, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5844. Another definition provides that a contract is executory if "the obligation 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." Countryman, *Executory Contracts in Bankruptcy* (pt. I), 57 MINN. L. REV. 439, 460 (1973), *quoted in In re Cochise College Park, Inc.*, 703 F.2d 1339, 1348 (9th Cir. 1983). The Fifth Circuit defines an executory contract as one where something remains to be done by one or more of the parties. *See Ozard-Mahoning Co. v. American Magnesium Co.*, 488 F.2d 147, 152 (5th Cir. 1974). *Compare Lake Minnewaska Mountain Homes, Inc. v. Smiley*, 11 Bankr. 455 (S.D.N.Y. 1981) (dictum) (contract not executory because one party had no further duties when other party had continuing duty to provide services each year) *with In re Brethren's Home*, 5 BANKR. CT. DEC. (CRR) 658 (S.D. Ohio July 6, 1979) (life-care contracts of retirement home were executory when residents had paid lump sums or assigned all their property to the home and owed no further obligations to the home because the parties to the contract were under a continuing obligation to pay dues [purchasers] and to provide maintenance and services [debtor]). *See also In re Sombrero Reef Club, Inc.*, 18 Bankr. at 616-17 (rejection would benefit the estate, and contracts in question were neither unexpired leases nor executory contracts for the sale of real property, and thus not entitled to protection under § 365(h)(1), (i) or (j)). Section 365(h)(1) gives the same protection to a lessee under an unexpired lease that § 365(i)(1) gives to a purchaser under an executory contract for the sale of real property. 11 U.S.C. § 365(h)(1), (i), (j) (1982). The court also noted that a contract provision required the property to be sold subject to the time-share owner's rights did not preclude the debtor from rejecting the contract. *In re Sombrero Reef Club, Inc.*, 18 Bankr. at 620. The time share agreements were of the "license" or "contract" variety; they provided that buyers were entitled to use the property for a certain period each year for a certain number of years. *Id.* at 614.

49. 18 Bankr. at 620.

50. *Id.* at 616.

51. *See* 1 P. ROHAN & M. RESKIN, *CONDOMINIUM LAW AND PRACTICE* §§ 6.02-.04 (1984).

52. *Id.*

the parties to exalt form over substance. There is no reason why a court should be able to look through a time share agreement and not a mortgage or deed of trust.

In *In re Booth*,⁵³ the *buyer* under an installment land contract declared bankruptcy. The court treated the installment land contract as a lien rather than an executory contract.⁵⁴ Section 365(i) and (j) do not deal with the situation where a buyer is the debtor, and the court's treatment of this situation is only partially helpful to the innocent third party. Section 365 was enacted to help innocent buyers when sellers under installment land contracts declare bankruptcy. Yet when faced with a situation where the buyer declares bankruptcy, the court denied full protection to the innocent third party seller. It is anomalous to treat an installment land contract as executory when the seller declares bankruptcy, yet hold that the same contract amounts to a lien when the buyer declares bankruptcy. It seems that the court applied an equitable conversion argument and treated the buyer as a mortgagor and the seller as a mortgagee having only the right to collect payment using the land as security.⁵⁵ Although the non-debtor sellers relied on the usual definitions of the term "executory contract,"⁵⁶ the court used a policy-oriented approach in treating the installment land contract as a lien rather than an executory contract.⁵⁷ The court noted that two policies reflected in section 365 were the protection of creditors and benefit to the estate, both of which are served by the lien treatment.⁵⁸

53. 19 Bankr. 53 (D. Utah 1982). The vendors in *Booth* moved the court to direct the debtor to assume or reject the contract for deed.

54. *Id.* at 64.

55. *Id.* at 62-64 & n.20.

56. *Id.* at 54-57; *see* note 48 *supra*.

57. 19 Bankr. at 55-64. The court recognized that § 365(i) and (j) were enacted to remedy the situation of non-debtor buyers under pre-1978 law. *Id.*; *see* notes 13-28 and accompanying text *supra*. The court concluded that executory contracts should be defined by the nature of the parties and the goals of reorganization rather than mutuality of commitments. *Id.* at 56. The court stated that a debtor-buyer is free from the constraints of § 365 and that the consequences of applying § 365 should control, rather than the form of the contract. *Id.* at 56-57 n.6.

58. *Id.* at 58-61. Using the lien treatment, the buyer is placed in a position similar to other lienors, while preventing forfeiture and loss of equity. *Id.* at 58. The lien may be "dealt with" in a reorganization plan by scaling down the debt, reducing the interest rate or extending the maturity date. *Id.* at 60-61. As to protection of creditors, the court recognized that lien treatment suspends the right to payment, but that the seller retains the right to hold title as security, thus striking a balance between sellers, other creditors, and the estate. *Id.* at 61. The court recognized that it is an anomalous result if contracts where the debtor is the seller are treated as executory while contracts where the debtor is purchaser are not treated as executory. *Id.* at 62. The court stated, however, that § 365(i) and (j) were enacted to give the non-debtor buyer the protection accorded to a mortgagor. *Id.* Treating contracts for deeds as executory in every instance creates a preference for non-debtor buyers over debtor buyers and for debtor sellers over debtor buyers. Thus, particularized treatment of the installment land contract is necessary to avoid these consequences. *Id.* at 62-64; *see In re*

Bankruptcy courts have not been able to agree on the definition of an "executory contract." While some authors advocate a mechanical interpretation,⁵⁹ the courts tend to use a common sense approach.⁶⁰ A mechanical approach to the problem applies a definition to a particular set of facts, without regard to the intricacies of the case. A common sense approach looks to both a definition and the facts and circumstances of a particular case. The former approach has the advantage of simplicity and certainty, but the disadvantage of less flexibility. The latter has the advantage of being adaptable, but the disadvantage of uncertainty and the possibility of manipulation.

Although section 365(i) was intended to protect consumers that purchase residences under long-term land sale contracts,⁶¹ the statute was not so narrowly drafted and has not been narrowly applied. This section has been applied, for example, to an installment land contract for the sale of a restaurant.⁶²

The question of what constitutes "possession" under the Bankruptcy Reform Act is as significant to section 365(j)⁶³ as it is to section 365(i). The two

Cox, 28 Bankr. 588, 590 (D. Idaho 1983); *see also In re Flores*, 32 Bankr. 455 (S.D. Tex. 1983) (approved reorganization plan modifying seller's rights where debtor was buyer in possession).

59. *See* note 48 *supra*.

60. *In re Biron, Inc.*, 23 Bankr. 241 (S.D. Ohio 1982). The debtor contracted to sell oil and gas leaseholds. At the time the contract was executed, the debtor did not own all of the interests it had contracted to sell. The agreement provided that marketable title would exist only if established for all of the interests which the debtor contracted to sell. *Id.* Although the debtor learned that it would not be able to acquire all of the interests, it executed assignments and transfer orders in favor of the purchaser. *Id.* at 242. The debtor transferred to the purchaser all of the leasehold interests which it did own and the purchaser went into possession of the leaseholds. The debtor filed a chapter 11 petition and applied for permission to reject the contract, which it contended was executory, and for an order requiring cancellation of the assignments and transfer orders. *Id.* at 241. The court overruled the debtor's application, holding that the contract was not executory. *Id.* at 243. The court pointed out that the debtor had conveyed all of the interests that it possibly could, and that the debtor may not successfully contend that a contract is executory because the debtor has not fully performed its terms when it will, in reality, never be able to perform all of the contract terms. *Id.* at 242; *see also In re Anderson*, 30 Bankr. 995, 1011 (M.D. Tenn. 1983) (improperly acknowledged deeds held to be completed transfers rather than executory contracts).

61. *See* note 47 *supra*.

62. *In re Walkup*, 28 Bankr. 225 (N.D. Ind. 1983). The court noted that § 365(i) and (j) were intended to give non-debtor vendees the protection accorded mortgagors. Thus, a plan depending upon rejection of the contract could not stand without the buyers' consent. *Id.* at 227; *see also McCannon v. Marston*, 679 F.2d 13 (3d Cir. 1982) (section 365(i) applied to executory installment sale of condominium unit).

63. The earliest reported decision discussing § 365(j) is *In re 18th Ave. Dev. Corp.*, 10 Bankr. 1 (S.D. Fla. 1980). The plaintiffs contracted to purchase a unit in the debtor's development. The plaintiffs filed for relief from the automatic stay provision, 11 U.S.C. § 362 (1982), and to obtain a determination that they had an equitable lien on the property. 10 Bankr. at 1. Although the unit purchased by the plaintiffs was under construction at the time of their action, the court determined that it was 90%

sections provide alternate remedies. Section 365(i) concerns the purchaser in possession, while section 365(j) addresses the purchaser not in possession. In either situation, the same standard should apply, since possession dictates which of the two sections applies. A uniform, federal approach that examines the statutes, their legislative histories, and the facts is likely to be the standard applied.⁶⁴

Section 365(j) entitles a "purchaser" to a lien where: a purchaser in possession has elected to treat an executory contract for the sale of real property as terminated after a trustee's rejection, or a party is not in possession and the trustee has rejected an executory contract for the sale of real property.⁶⁵ The court will scrutinize a transaction to determine whether ownership interests passed to a "purchaser."⁶⁶ The determination should be based on particular facts and circumstances without regard to a mechanical application of standards.⁶⁷ Factors relevant to the determination would be the parties' intent, the economic substance of the transaction, and whether the buyer actually assumed the benefits and burdens usually associated with his role in the form of transaction chosen.⁶⁸ If the agreement is merely a disguised financing arrange-

complete. The plaintiffs wanted to complete construction on their own. The court noted, without discussion, that should the contract be rejected, the plaintiffs would be entitled to a lien on the amount they had paid. *Id.* at 2. The plaintiffs had paid \$25,000, with the balance due at closing, when the plaintiffs were to have mortgaged their interest. The court denied the plaintiffs an equitable lien. *Id.* To have granted plaintiff's request, the court would have had to find that the debtor had no equity in the property and that the property would not be necessary to an effective reorganization. The court concluded that the debtor did have equity in the property since a lien in favor of plaintiffs would only cover their down payment, and that if plaintiff's request were granted it would destroy the debtor's chances of an effective reorganization. *Id.*; see also *In re 18th Ave. Dev. Corp.*, 10 Bankr. 107, 108 (S.D. Fla. 1981) (section 365(j) lien attaches to the debtor's interest in the property on the date that the bankruptcy petition is filed).

64. See *In re Summit Land Co.*, 13 Bankr. 310, 317-18 (D. Utah 1981); notes 54-57 and accompanying text *supra*.

65. 11 U.S.C. § 365(j) (1982).

66. See *In re Nite Lite Inns*, 13 Bankr. 900 (S.D. Cal. 1981). Burke was the buyer-lessor and Nite Lite the seller-lessee under a transaction styled as a sale-leaseback. *Id.* at 902. The agreements provided that Burke would exchange its interest in certain properties in return for the conveyance by a straw party of certain motel property subject to a ground lease. Burke was to assume a loan originally made to Nite Lite. The exchange property belonging to Burke was to be placed in escrow and sold to make a down payment. The lease agreement required Nite Lite to pay a certain rental to Burke. *Id.* at 904-05. Upon the filing of the Nite-Lite petition, Burke filed an action and contended that the transaction was a sale-leaseback entitling Burke to a § 365(j) lien for the amount of the purchase price paid into escrow. Nite Lite contended that the transaction was merely a financing arrangement. *Id.* at 906. If this were the case, Burke would be in the position of an unsecured lender and would defeat Burke's claim for interest and attorneys fees.

67. *Id.* at 907.

68. *Id.* at 907-08. As to the benefits and burdens issue, the court stated that it would scrutinize the transaction to determine if the normal risks of being a lessor are transferred to the buyer-lessor and whether the rentals paid by the seller-lessee are

ment, then the debtor will really be the "owner" of the property.⁶⁹ The other party will then be considered a "lender" and will not be entitled to a section 365(j) lien because such liens are not designed to protect nominal purchasers who hold legal title as security for a loan.⁷⁰

Section 365(i) and (j) certainly have not solved all of the problems which installment land contracts create in bankruptcy. They have, however, resolved a number of important issues relating to the "standard installment land sale contract" as hypothetically illustrated in the Introduction. Should the trustee in the hypothetical reject the contract, the buyer could use the exclusive remedies⁷¹ set out in sections 365(i) and 365(j). The buyer could remain in possession and continue to make payments, or he could treat the contract as terminated, thus acquiring a lien on the debtor's interest in the property to secure the amount of the purchase price actually paid by the buyer.

VI. CONCLUSION

The 1978 Code has given trustees greater powers to reject installment land sales contracts. Section 365(i) and (j), however, provide greater protections for vendees in the event of rejection. While section 365(i) and (j) will not significantly reduce litigation involved in the rejection or assumption of executory contracts, there will probably be a change in the type of individuals involved in such litigation. Use of the installment land contract is usually attributed to the unavailability of mortgage financing for low down payment sales.⁷² This device is common among many types of purchasers. Installment land contracts have been used by developers of subdivisions and by purchasers of low quality housing.⁷³ They are also commonly used for transactions between individuals, for the sales of farms and businesses, and for the sales of exclusive residential property.⁷⁴ The standard situation is where the device is used to finance an owner-occupied home. By enacting sections 365(i) and (j), Congress has provided a clear solution to the most troubling problems raised by the pre-1978 law.⁷⁵ This will result in fewer homeowners resorting to litigation and should benefit low-income users of installment land contracts.

The issues raised in the cases thus far will not arise in the "standard

reasonably designed to compensate the lessor or merely reflect a repayment of the lessor's acquisition cost plus interest.

69. *Id.* at 909.

70. *Id.* at 910. The court stated that secured status under § 365(j) was intended to protect bona fide buyers of ownership interests in real property.

71. *In re Fisher*, 13 Bankr. 286 (E.D. Pa. 1981).

72. See Lacy, *supra* note 16, at 477.

73. *Id.* at 477-78; see also Mixon, *Installment Land Contracts: A Study of Low Income Transactions, with Proposals for Reform and a New Program to Provide Home Ownership in the Inner City*, 7 HOUS. L. REV. 523 (1970); Warren, *California Instalment Land Sale Contracts: A Time for Reform*, 9 UCLA L. REV. 608 (1962).

74. See Lacy, *supra* note 16, at 478; see also Power, *supra* note 16, at 403-08.

75. See notes 13-28 and accompanying text *supra*.

situation." For example, the question of what constitutes "possession"⁷⁶ will not be an issue since the buyer will be occupying the property as his residence. The standard the court applies in determining whether to allow the trustee to reject a contract has also become less important.⁷⁷ This issue is not important to the buyer in possession since he may elect to remain in possession despite a rejection. Buyers and sellers using the installment land contract in situations other than the owner-occupied residential financing case are probably in a position to hire attorneys to create the arrangements and defend those arrangements in court. For example, such devices may include interests akin to recreational use permits,⁷⁸ time share ownership,⁷⁹ and sale-leaseback arrangements.⁸⁰ Such arrangements are generally used by more affluent individuals, who are in a better position to spend money to litigate.

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76. *In re Summit Land Co.*, 13 Bankr. 310 (D. Utah 1981).

77. Even though courts do not uniformly apply a particular standard, a clear majority have opted for the "business judgment rule." See note 44 and accompanying text *supra*.

78. *In re Summit Land Co.*, 13 Bankr. 310 (D. Utah 1981).

79. *In re Sombrero Reef Club, Inc.*, 18 Bankr. 612 (S.D. Fla. 1982).

80. *In re Nite Lite Inns*, 13 Bankr. 900 (S.D. Cal. 1981).