

Section 365 of the Bankruptcy Code Preempts Provisions of State Dealer Statutes

Andrew Ziemianski, J.D. Candidate 2015

Cite as: *Section 365 of the Bankruptcy Code Preempts Provisions of State Dealer Statutes*, 6 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 30 (2014).

Introduction

In bankruptcy proceedings, the rejection of an executory contract by a trustee under section 365 of the Bankruptcy Code¹ constitutes a prepetition breach of contract, which gives rise to a general unsecured claim.² The rejection damages claim, which is governed by state common law, will generally not be paid in full in bankruptcy.

The Bankruptcy Code will impliedly preempt state statutes that impose additional statutory damages, as these statutes impose damages for economic benefit of the counterparty and “frustrate section 365’s purpose of giving a debtor the power to decide which contracts it will assume and assign or reject”³ For example, certain states have attempted to impose additional rejection damages in the context of automobile dealer-manufacturer relationships through state dealer statutes. These dealer statutes pose penalties to a debtor who breaches an executory contract it has with an automobile dealership. A court will likely hold that a state

¹ 11 U.S.C. §365 (1982).

² 3 COLLIER ON BANKRUPTCY, ¶ 365, at 365-29,30 (Alan N. Resnick & Henry J. Sommer eds., 2013).

³ See *In re American Suzuki Motor Corp.*, 494 B.R. 466, 476 (Bankr. C.D. Cal. 2013) (quoting *In re Old Carco*, 406 B.R. 180, 205-06 (Bankr. S.D.N.Y. 2009)).

statute is implicitly preempted by section 365 of the Bankruptcy Code under the Supremacy Clause,⁴ if there is a conflict between the state statute and section 365.

Recently, dealerships attempt to claim statutory damages on top of the common law breach of contract damages after debtors reject executory contract with the dealerships.⁵ Bankruptcy courts in the Central District of California and in the Southern District of New York have held that these state dealer statutes' additional remedies for rejection of executory contracts frustrates the purpose of section 365 of the Bankruptcy Code and are thus preempted by the Bankruptcy Code.⁶ In so holding, the two courts opined that the economic nature of the dealer statutes were clearly opposed to section 365's purpose of receiving the economic benefits from rejection that are necessary for the ultimate benefit of the estate and its creditors.⁷

This Article is separated into four parts. Part I discusses a basic background of section 365 of the Bankruptcy Code and its purpose. Part II discusses more broadly state dealer statutes and the legislative purpose for them. Part III discusses the current status of the law on whether section 365 of the Bankruptcy Code preempts the state dealer statutes. Part IV discusses the practical effects of such preemption.

I. Background of Section 365 of the Bankruptcy Code

Under section 365 of the Bankruptcy Code, a trustee or debtor in possession may assume or reject executory contracts and unexpired leases.⁸ With this power, a trustee or debtor in possession exercises its business judgment to make efficiency-based decisions as to which

⁴ U.S. CONST. ART. VI.

⁵ *Id* at 472-473 (Creditor claimed \$531,867 under the repurchase category and \$1,063,734 of treble damages under Fla. Stat. § 320.64(30)).

⁶ *Id.* at 477 (stating that the Florida statute remedies run counter to the federal policy of bankruptcy reorganization); *In re Old Carco*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009).

⁷ *In re American Suzuki*, at 477 (presenting that federal bankruptcy law preempts these local and state economic windfalls to dealers when there is no public health or safety issues present).

⁸ 11 U.S.C. §365 (2012).

contracts to reject and which to assume (or assume and assign) in order to facilitate a successful reorganization or liquidation.⁹

The term “executory contract” is not defined in the bankruptcy code,¹⁰ but the legislative history of section 365 points to the Countryman definition as the prevalent definition, which provides:

A contract under which 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 performance of the other.¹¹

As such, a contract that has been fully performed by one party is not considered executory under the Countryman definition.¹² The vast majority of bankruptcy courts have adopted the Countryman definition for executory contracts, but also in recent years some courts have used a slightly different test.¹³ “Under the functional approach, ‘the question of whether a contract is executory is determined by the benefits that the assumption or rejection would produce for the estate.’”¹⁴

Section 365 creates an avenue by which the debtor can maintain business relations with creditors after filing for bankruptcy, where creditors might be hesitant to continue such

⁹ Carl N. Pickerill, *Executory Contracts Re-Revisited*, 83 AM. BANKR. L.J. 63 (2009) (“Part of the allure of bankruptcy comes from the fact that debtors can make reasoned efficiency-based judgments about which prepetition contracts...”).

¹⁰ 3 COLLIER ON BANKRUPTCY, ¶ 365, at 365-16 (Alan N. Resnick & Henry J. Sommer eds., 2013).

¹¹ Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L.REV. 436, 460 (1972).

¹² 3 COLLIER ON BANKRUPTCY, ¶ 365, at 365-16 (Alan N. Resnick & Henry J. Sommer eds., 2013) (stating that the provision of the bankruptcy code that views rejection of executory contract as a breach would make no sense if debtor has already performed).

¹³ Carl N. Pickerill, *Executory Contracts Re-Revisited*, 83 AM. BANKR. L.J. 63, 66 (2009).

¹⁴ *In re Bradlees Stores*, Nos. 00–16033, 00–16035, 00–16036, 2001 WL 34809984, at *6 (Bankr. S.D.N.Y. Mar. 28, 2001) (quoting *In re Riodizio*, 204 B.R. 417, 422 (Bankr. S.D.N.Y. 1997)).

relation.¹⁵ The debtor is allowed to reject or assume a contract as it sees fit, but it must assume or reject the entirety of the contract.¹⁶ This allows a debtor to assume his more favorable contracts, while absolving the debtor from performing under its unfavorable contracts.¹⁷

The general effects of rejection of a contract is that it does not terminate the contract between the parties, but instead only constitutes a prepetition breach of contract claim.¹⁸ This is compared to where the debtor assumes a contract, which would instead be treated as a post-petition administrative claim.¹⁹ Upon a rejection of an executory contract, the counterparty becomes a general unsecured creditor of the estate for damages from the rejection.²⁰ While attaining the status of general creditor hurts the counter party's interest,²¹ it in turn benefits the estate and debtor's other creditors. In addition, if a contract is breached or rejected after it has been assumed, the breach is entitled to administrative expense status.²²

II. State Dealers Statutes

State dealer statutes have existed since 1936.²³ The general purpose of these dealer statutes, as stated in multiple statements of purpose in the dealer acts,²⁴ is to protect dealer investments and prevent manufacturers from exerting undue control on the dealerships. Due to

¹⁵ *In re Chateaugay Corp.*, 10 F.3d 944 (2d Cir. 1993).

¹⁶ Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 519

¹⁷ *Id.* at 519.

¹⁸ 11 U.S.C. § 365(g) (2012).

¹⁹ 3 COLLIER ON BANKRUPTCY, ¶ 365, at 365-29,30 (Alan N. Resnick & Henry J. Sommer eds., 2013).

²⁰ *In re Minges*, 602 F.2d 38, 41 (2nd Cir. 1979).

²¹ A general creditor will receive a smaller distribution on account of the decreased claim due to the new status as an unsecured creditor.

²² *In re Klein Sleep Products*, 78 F. 3d 18, 28 (2d Cir. 1996).

²³ Carla Wong McMillian, *What Will It Take to Get You in A New Car Today?: A Proposal for A New Federal Automobile Dealer Act*, 45 GONZ. L. REV. 67, 71 (2010).

²⁴ "It is the intent of the legislature to protect the public health, safety and welfare of the citizens of the state by regulating the licensing of motor vehicle dealers and manufacturers, maintaining competition, providing consumer protection and fair trade and providing minorities with opportunities for full participation as motor vehicle dealers." Fla. Stat. § 320.605 (2013).

the nature of the relationship between the two parties, dealers are “completely dependent on the manufacturer for their supplies of cars.”²⁵ The Supreme Court has even recognized this disparity in bargaining power in the case of *New Motor Vehicle Bd. of Cal. v. Orrin W. Fox, Co.*²⁶ There, the court stated “[t]he disparity in bargaining power between automobile manufacturers and their dealers prompted States to enact legislation to protect retail car dealers from perceived abusive and oppressive acts by the manufacturers.”²⁷ The fear of the manufacturer’s inclination to abuse their position of power over dealerships has induced twenty-five states to pass dealer statutes to regulate the manufacturer dealer relationship.²⁸

The dealer acts themselves cover almost every aspect of the manufacturer-dealer relationship.²⁹ Much like regulations applying to automobile dealers that protect consumers from abuse by dealers, the regulations in dealer acts similarly protect auto dealers from manufacturers. The coverage extends to areas such as “grounds for franchise cancellation . . . , vehicle forcing, territorial security, delays in delivery from the manufacturer, coercion, cooperative advertising and dealership transferability” and beyond.³⁰ Some of these state dealer acts also include penalties to a manufacturer that cause a dealer to incur pecuniary damages.³¹ This is exemplified by Florida’s dealer statute, which states “[a]ny person who has suffered pecuniary loss . . .

²⁵ “Motor Vehicle Dealers and Motor Vehicle Manufacturers Florida Reacts to Pressures in the Market Place”, 29 FLA; S. REP. NO. 84-2073, at 2 (1956).

²⁶ *New Motor Vehicle Bd. of Cal. v. Orrin W. Fox, Co.*, 439 U.S. 96 (1978).

²⁷ *Id.* at 100-01 (recognizing that motivation for action by Congress and State legislatures is the difference in bargaining power between automobile manufacturers and dealers).

²⁸ Carla Wong McMillian, *What Will It Take to Get You in A New Car Today?: A Proposal for a New Federal Automobile Dealer Act*, 45 GONZ. L. REV. 67, 72 (2009).

²⁹ McMillian, *supra* note 27, at 67.

³⁰ Richard L. Smith, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125, 132-33 (1982) (describing state regulation of automobile franchising).

³¹ FLA. STAT. § 320.697 (2013); WIS. STAT. § 377, 378 (1958).

because of the violation of a licensee . . . has a cause of action against the licensee for damages and may recover in an amount equal to 3 times the pecuniary loss.”³²

There is some debate over the necessity of the extent of the regulation the dealer statutes impose. Congress has attempted acted on this subject, passing the Automobile Dealer’s Day in Court Act (“ADDICA”),³³ which some might argue is enough regulation on the dealer-manufacturer relationship. ADDICA requires manufacturers “to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer”³⁴ ADDICA’s attempt to remedy the harsh conduct that manufacturers have engaged in at the national level makes the state dealer statutes seem like overkill in comparison. Some economist have even found a lack of substantial evidence of opportunistic behavior by manufacturers to justify these.³⁵ No matter whether justified or not, federal courts have taken a close look at these dealer statutes and started to cut off, with surgical precision, those portions which are preempted by federal law.

III. Courts Have Found That Section 365 of the Bankruptcy Code Preempts State Dealer Statutes

Among the bankruptcy courts that have heard cases where the debtors have challenged the additional penalties from state dealer statutes, there is little disagreement. Section 365 of the Bankruptcy Code preempts those portions of state dealer statutes that impose additional damages on debtors who reject executory contract.³⁶ The two important recent cases on this topic are *In re*

³² FLA. STAT. § 320.697 (2013).

³³ 15 U.S.C. § 1226(a)(2) (2012).

³⁴ *See id.*; McMillian, *supra* note 27, at 71.

³⁵ McMillian, *supra* note 27, at 85.

³⁶ *In re Old Carco*, 406 B.R. 180, 199, 200 (Bankr. S.D.N.Y. 2009); *In re American Suzuki Motor Corp.*, 494 B.R. at 473.

*American Suzuki*³⁷ out of the Central District of California and *In re Old Carco*³⁸ from the Southern District of New York. Both courts found that the additional damages imposed by the dealer statutes at issue would frustrate section 365's purpose of "giving the debtor the power to decide which contracts it will assume and assign or reject by allowing other dealers to restrict that power."³⁹

In *American Suzuki*, the bankruptcy court found that Florida's Dealer statute calculation of damages for rejected contracts was preempted by section 365 of the Bankruptcy Code.⁴⁰ The debtor in the case, a Suzuki product wholesaler, filed a petition for chapter 11, and afterwards offered and negotiate settlements with the majority of dealerships it supplied. The creditor in this case was the only dealership that did not accept a settlement offer, causing the debtor to reject its contract with creditor dealership. The creditor argued that, in addition to its damages from a common law claim for breach of contract, its rejection claim should include damages provided by the Florida Motor Vehicle Licenses Act.⁴¹ Specifically, the Florida Motor Vehicle Licenses Act provided for a trebling damages, a calculation damages under buy-back requirements, a calculation of damages under the "repurpose" category, and the payment of reasonable attorney's fees.⁴² The bankruptcy court rejected the creditor's proposed damages calculation and held that section 365 of the Bankruptcy Code preempted the Florida dealer statutes relied on by the creditor.⁴³

³⁷ *In re American Suzuki Motor Corp.*, 494 B.R. 466 (Bankr. C.D. Cal. 2013).

³⁸ *In re Old Carco*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009).

³⁹ *Id.* at 200.

⁴⁰ *In re American Suzuki Motor Corp.*, 494 B.R. at 474.

⁴¹ Fla. Stat. § 320.64(30); Fla. Stat. § 320.697 (2013).

⁴² *In re American Suzuki Motor Corp.*, 494 B.R. 466 (Bankr. C.D. Cal. 2013).

⁴³ *Id.* at 473 (affirming that the debtor argues that Florida statutes cited by the plaintiff are preempted by federal law).

Similarly, in *In re Old Carco*, the bankruptcy court sided with the debtor and held that rejection damage calculations imposed by a state dealer statute were preempted by Section 365.⁴⁴ The debtor in *Old Carco*, Chrysler LLC and its subsidiaries, filed for bankruptcy under chapter 11 and sought to reject all their executory contracts with certain dealerships they supplied. The creditor dealerships formed a committee to protest these rejections and brought suit against the debtors. The creditors argued, among other things, that debtors were required to abide by remedies provided by certain dealer statutes, which contained buy-back requirements and specific types of damages to be awarded to the creditors. The bankruptcy court rejected the creditors' arguments and held that section 365 of the Bankruptcy Code preempted the dealer statutes, as they restricted the debtor's power to choose which contracts to assume or reject.⁴⁵

When determining whether portions of state dealer statutes are preempted by federal law, the bankruptcy courts have applied a test used by the Ninth Circuit in *In re Baker & Drake*. Under that test, the court will first examine the "intent and sweep of the federal statute" in question.⁴⁶ Second, the court must determine whether the state statute stands as an obstacle to the execution of the objectives of the section of the Bankruptcy Code in question.⁴⁷

The bankruptcy courts in *In re American Suzuki* and *In re Old Carco* examined and relied upon the congressional purpose for allowing a debtor to reject a contract under section 365 of the Bankruptcy Code.⁴⁸ The two purposes of rejection, as declared by the *American Suzuki* court, are (1) that the debtor is relieved of burdensome future contract obligations while trying to reorganize, and (2) that rejection allows the counterparty to file a general unsecured claim

⁴⁴ *In re Old Carco*, 406 B.R. 180, 205-207 (Bankr. S.D.N.Y. 2009).

⁴⁵ *Id.* at 206.

⁴⁶ *In re Baker & Drake Inc.*, 35 F.3d 1348, 1352 (9th Cir. 1994).

⁴⁷ *Id.* at 1353 (Stating that obstacles to accomplishment of the objectives of Congress will be preempted).

⁴⁸ *In re American Suzuki Motor Corp.*, 494 B.R. 466, 475 (Bankr. C.D. Cal. 2013)

against the estate.⁴⁹ Moreover, the *American Suzuki* court determined that Congress gave the trustee or debtor in possession the power to reject an executory contract in order to allow the debtor to receive the economic benefits necessary to allow it to reorganize or liquidate.⁵⁰

Permitting the rejection of executory contracts is for the ultimate benefit of the debtor's estate and its creditors.⁵¹ As the *American Suzuki* court stated, “[the] remedies [provided for by the state dealer statutes] run counter to the federal policy of bankruptcy reorganization and are therefore preempted.”⁵²

IV. Creditors Should Not Rely on State Dealer Statutes in an Automobile Manufacturer's Bankruptcy Case

The importance of these bankruptcy court rulings on state dealer acts is that creditors who rely on the state statutory law to calculate additional damages on top of those provided by common law should be cautious. Cases like *In re American Suzuki* and *In re Old Carco* demonstrate that bankruptcy courts will likely hold that section 365 implicitly preempts a state dealer statute that imposes significant burdens on the debtor following the rejection of a dealership agreement. Effectively, this means that a bankruptcy court will not allow a state legislature to circumvent section 365 in order to protect dealerships in that state. As a result, if a bankruptcy court follows the current case law, a dealership's rejection damages claim will be less than it would have been had it been calculated under the dealership statute. For example, in *American Suzuki*, after tossing out the additional damages, the court determined the creditor's claim to be worth only \$21,461.00, after its original claim under the Florida Statute's calculation of damages was for \$1,595,601.

⁴⁹ *Id.* (quoting *In re Rega Properties, Ltd.*, 894 F.2d 1136, 1140 (9th Cir. 1990)).

⁵⁰ *Id.* at 477 (Stating the purpose of Section 365 contract reorganization is to permit debtor to receive economic benefits).

⁵¹ *See id.* at 37.

⁵² *Id.* at 477.

American Suzuki demonstrates that, in an automobile manufacturer’s bankruptcy case, a creditor dealerships should try to negotiate a settlement with the debtor, in order to receive the debtor’s remaining inventory or to secure some of financial benefits the creditor received under the rejected contract. In *In re American Suzuki*, the debtor extended such an offer to the 220 other automotive dealers it supplied, including the creditor at issue.⁵³ Yet, the creditor was the only dealer that did not accept the debtor’s offer or negotiate a separate settlement with the debtor. As a result, the creditor was unable to obtain, among other things, the benefits of maintaining its parts and service dealer status for another eight years and was only received a general unsecured claim for the reduced amount.

While under the current case law, section 365 of the Bankruptcy Code likely preempts state statutes with similar provisions to those in the Florida dealer statute, there is a brief statement in dicta in *American Suzuki* that calls such preemption into question.⁵⁴ Interestingly, the *American Suzuki* court briefly mentioned that a state statute with a public health and safety purpose might outweigh federal interest in upholding section 365 of the Bankruptcy Code.⁵⁵ Specifically, the court opined that “Congress did not intend to preempt all state regulation, but only those grounded on policies which were outweighed by the relevant federal interest.”⁵⁶ This statement opens the door for the possibility that a court would hold that section 365 of the Bankruptcy Code does not preempt a state statute that provides additional rejection damages and that is grounded in public health and safety (assuming that such a statute actually exists). For the time being, however, creditors asserting claims for rejection damages under state statutes that

⁵³ *In re American Suzuki Motor Corp.*, 494 B.R. 466, 471 (Bankr. C.D. Cal. 2013).

⁵⁴ *See In re American Suzuki Motor Corp.*, 494 B.R. 466 (Bankr. C.D. Cal. 2013).

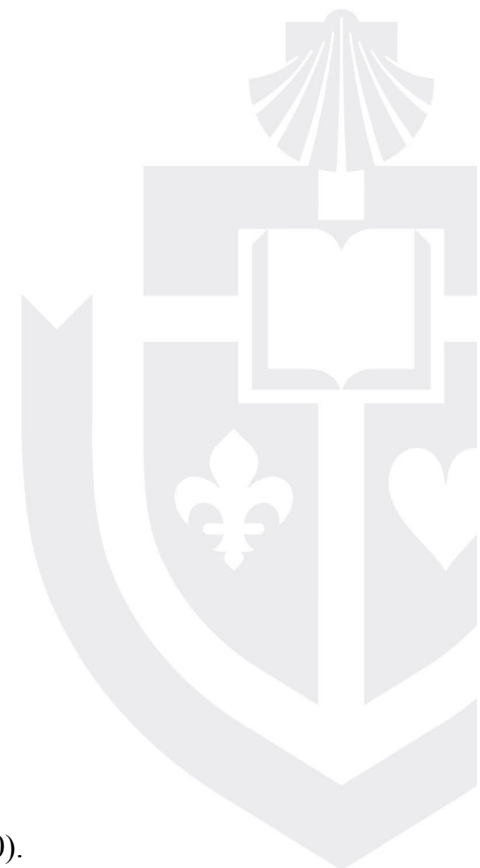
⁵⁵ *Id.*; *In re Mirant*, 378 F.3d 511, 525 (5th Cir. 2004)

⁵⁶ *In re American Suzuki Motor Corp.*, 494 B.R. at 475.

provide for additional damages or remedies that not available under common law will be preempted by section 365 of the Bankruptcy Code.⁵⁷

Conclusion

Bankruptcy courts have feverishly defended a debtor’s ability to reject a contract under section 365 of the Bankruptcy Code. In a particular, courts have concluded that section 365 of the Bankruptcy Code preempts a statute that superimposes additional remedies other than those provided by common law because such a statute that “undercut[s] the core purpose of rejection” provided for in section 365 of the Bankruptcy Code. Therefore, if an automobile-manufacturer debtor rejects its contracts with its dealerships, the amount of the dealerships’ allowed claims will likely be less than the amount provided for under applicable state dealer statutes.



⁵⁷ See *id.*; *In re Rega Properties, Ltd.*, 894 F.2d 1136, 1140 (9th Cir. 1990).