UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re

THE OCTAGON CORPORATION Case No. 92-11240 K

Debtor

This proceeding presents the question of whether a Chapter 7 Trustee may limit the claim of a creditor to "damages" even though the creditor seeks "restitution." The Court answers that under the facts of this case, the claim may not be so limited.

The Chapter 7 Trustee objects under 11 U.S.C. § 502 to a claim by Alumax Mills for $162,624.00, representing the return of a down payment which Alumax made on a contract to purchase a "recoiler" machine from Debtor Octagon for $203,280. Alumax alleges that after it made the down payment, Octagon rejected the sale contract, forcing Alumax to look to other sources for parts in order to build the machine itself. Octagon did not give Alumax anything in exchange for the $162,624 down payment, Alumax contends, and Alumax claims that it is entitled to a full refund of that money.

The Trustee, however, argues that the facts are more complex, and that in fact Alumax purchased from an intermediary source the same recoiler machine that Octagon had (in his view) substantially completed. The Trustee also claims that the estate helped Alumax acquire the machine from that intermediary source. He maintains the position that Octagon substantially performed its contractual duties, and consequently that Alumax's claim should be limited to its costs of acquiring the completed machine in excess of the contract price. By the Trustee's calculation, that amount is approximately $46,000.00. He believes that Alumax's claim is high by

over $115,000.00.

The record shows that Octagon completed some of the production of the recoiler and then turned the unfinished piece over to a subcontractor to do further work on the machine. The subcontractor acquired and retained an artisan's lien on the machinery, pursuant to state law, until it was paid for its work.

After filing a petition for Chapter 11 relief, Octagon rejected the contract with Alumax, but the down payment was apparently not segregated and was not returned. At the time that Octagon rejected the sale contract, Alumax clearly had a restitution claim for $162,000, or a damages claim for the price of covering (which would include that $162,000). Octagon also rejected the contract with the subcontractor, leaving the subcontractor with the right to foreclose its artisan's lien on the machine. Octagon then converted its bankruptcy case to Chapter 7.

The Trustee bases his objections on what occurred thereafter. Alumax, still in need of a recoiler, decided to buy the unfinished machine from the subcontractor and finish the work itself. Anticipating what work would still need to be done to complete the machine, Alumax purchased some parts from Octagon for $3,000. Alumax also negotiated with the Trustee to purchase for $20,000.00 whatever rights Octagon still had in the unfinished machine, which were still subject to the subcontractor's artisan's lien.

Subsequently, Alumax purchased the unfinished machine from the subcontractor for $57,000 and completed production of the machine by itself for an alleged additional $72,500 in costs. Alumax characterizes this transaction as the purchase of a "component" from the subcontractor, while the Trustee would argue that what Alumax purchased was a substantially-completed machine. The parties also dispute the estate's role in Alumax's acquisition of the machinery from the subcontractor. These differences in characterizations, however, have no bearing on the resolution of Alumax's claim.

The Trustee argues that the estate should be rewarded for substantial performance of the Alumax contract. This is the common law notion that, "substantial, and not exact, performance accompanied by good faith is all the law requires in the case of a contract to entitle a party to recover on it." 22 N.Y. Jur. 2d *Contracts* §§ 315-320 at 193 (1982). Any deviation from the contract terms that cost Alumax money, the Trustee concedes, could be awarded to Alumax as damages. The Trustee, then, would like the Court to find that there was no material breach of the contract, and then equitably adjust the contract price.

There are several problems with this suggestion even if one were to assume that the estate could be credited with "substantial performance" of a contract that it had already rejected under 11 U.S.C. § 365, as discussed later.

The Uniform Commercial Code does not contemplate any notion of substantial performance without the buyer's consent. The buyer, according to the U.C.C., has the right to refuse to accept any goods that do not fully conform to the contract. This has become known as the "perfect tender" rule. *See* N.Y. U.C.C. Law § 2-601 (McKinney 1993). No court can force a buyer of goods (as opposed to real estate) to accept anything less then what the contract specifies, even if it would award the buyer damages to compensate for the deviation.

Additionally, it is difficult to reconcile an attack on Alumax's claim based upon substantial performance, or even quantum meruit, with the fact that the Trustee sold all of his right, title and interest in the machine to Alumax for $20,000 subsequent to the rejection of the contract. This sale would seem to prevent the Trustee from raising any affirmative defenses against Alumax. It also would seem to have transferred to Alumax any right that Octagon might have had to sue the subcontractor for a commercially unreasonable foreclosure sale, or breach of contract, for example. Alumax bargained with the estate for the ability to obtain clear title from the subcontractor, even though no deal with the subcontractor had been struck. (The $57,000 paid to

the subcontractor by Alumax might have reduced any claim by the subcontractor against the Debtor's estate by some amount.) In all it seems incongruous that Alumax should be viewed as not having taken "clear" of the Trustee's objections to its restitution claims, in the absence of an express reservation of such objections in the documents manifesting the sale.

But most importantly, the estate rejected the executory contract with Alumax. Rejection of an executory contract in a bankruptcy case, by definition, constitutes a breach of that contract. 11 U.S.C. § 365(g). The U.C.C. dictates that, "Where the seller fails to make delivery or repudiates . . . then with respect to any goods involved . . ., the buyer may cancel and whether or not he has done so may . . . recover[ ] so much of the price as has been paid." U.C.C. § 2-711(1). The rejection of the sale contract constituted a repudiation of that contract.[1] U.C.C. § 2-711 therefore allows Alumax to recover any down payment, as well as sue for consequential damages. The Chapter 11 estate rejected the contract, and Alumax rescinded the contract.[2] The Chapter 7 Trustee cannot enjoy the benefit of reference to the price contained in the now non-existent contract unless Alumax seeks damages, rather than, or in addition to, restitution.[3]

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[1]"Repudiation can result from action which reasonably indicates a rejection of the continuing obligation." U.C.C. §2-609 Official Comment 2. Certainly rejection of a contract satisfies that definition.

[2]"[A] rescission because of a material breach by the adverse party is a termination or discharge of the contract for all purposes. It puts an end to it as if it had never been made." 17A Am.Jur2d Contracts § 543 (1991)(footnote omitted).

"[T]he rule followed in most jurisdictions [is] that if performance is prevented by the breach of the other party, the plaintiff has the right to treat the contract as rescinded and sue for the reasonable value of the property or services provided." 22 Am.Jur2d Damages § 57 (1988)(footnote omitted).

[3]Unless damages are claimed, the estate may not enjoy the benefit of reference to the contract price, having rejected the burdens of the contract, including the risks of inability to perform it. The Trustee would like to relegate Alumax to the same position as if the estate had assumed the contract

Alumax seeks restitution only.

Really, then, the Trustee seeks to compel Alumax to claim damages, since its damages might have been less than what it paid down. But Octagon was holding $162,624.00 for which no value was delivered (by Octagon or its Trustee) beyond whatever rights and property were separately bargained for and paid for. Alumax's success in obtaining "the" recoiler without suffering greater loss should not result in a windfall for Octagon's other creditors.

The claim of Alumax Mills, Inc. is allowed in full.

SO ORDERED.

Dated: Buffalo, New York
January 24, 1995

/s/Michael J. Kaplan
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U.S.B.J.

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and then performed only "substantially," with resulting extra cost to Alumax. Indeed, he wishes Alumax relegated to a worse position than that, for here Alumax's "extra cost" would share pro-rata with prepetition unsecured claims, rather than enjoy an administrative expense priority as it would if the contract had been assumed and then only "substantially" performed.