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# **INSTALLMENT LAND CONTRACTS IN PURCHASER BANKRUPTCY**

## **ABSTRACT**

The executory contract analysis under § 365 of the Bankruptcy Code has long challenged judges, practitioners, and scholars. The challenge of understanding the purpose of § 365 and reaching an equitable result thereafter is most profound when confronting installment land contracts. The parties to an installment land contract, typically the purchaser, can become insolvent and enter bankruptcy, and consequently, the rights of the parties may be altered dramatically as a result of applying bankruptcy law. The express provisions of § 365 have provided some clarity for the rights of the parties in seller bankruptcy. In the case of purchaser bankruptcy, however, the language of the Bankruptcy Code is not much help, and courts have devised inconsistent ways to characterize installment land contracts.

This Comment argues that an installment land contract should be presumed a mortgage in purchaser bankruptcy. When analyzing installment land contracts in purchaser bankruptcy, courts have asked whether the contract is an “executory contract” under § 365. However, this inquiry has resulted in distortion of the parties’ property rights and inconsistent applications of bankruptcy law by courts, and has illustrated the lack of utility of § 365 for installment land contract purchasers. The proper question to ask is whether an installment land contract functions like a security device, to which § 365 is inapplicable. When asking this question and considering the benefit to the estate and equitable outcome, courts should presume that an installment land contract is a mortgage. The mortgage presumption, however, may be rebutted if the installment land contract does not function like a mortgage or if there are other equitable considerations against the presumption. The rebuttable mortgage presumption would preserve the purchaser’s property rights while retaining installment land contracts as a viable real estate device.

## **INTRODUCTION**

The executory contract analysis under § 365 of the Bankruptcy Code (Code) has long been challenging to judges, practitioners, and scholars. The challenge of understanding the purpose of § 365 and reaching an equitable

result thereafter is most profound when the law confronts installment land contracts. The parties to an installment land contract, typically the purchaser, can become insolvent and enter into bankruptcy, and the rights of the parties may be altered dramatically as a result of applying bankruptcy law. Historically, inequity resulted from seller bankruptcies under the Bankruptcy Act of 1938 where the seller could reject the installment land contract and force the purchaser to lose the property and his past payments.<sup>1</sup> The express provisions in § 365 have provided some clarity for the rights of the parties in seller bankruptcy.<sup>2</sup> In the case of purchaser bankruptcy, however, the language of the Code is not much help, and courts have devised inconsistent ways to characterize installment land contracts.

An installment land contract should be presumed to be a mortgage in purchaser bankruptcy because applying § 365 would ignore the purchaser's property rights and would not provide any benefit to the estate. While state laws may allow installment land contracts to occupy an ambiguous place in between other real estate devices, such as mortgages or leases, the parties' rights have to be clearly categorized into either contractual rights or property rights in bankruptcy law.<sup>3</sup> Because of the Code's dichotomous treatment of contracts and secured properties,<sup>4</sup> the rights of the seller and purchaser of an installment land contract are inevitably skewed in purchaser bankruptcy. Two key issues that arise in purchaser bankruptcy are (1) whether a court should focus on contract law or property law by default in treating an installment land contract; and (2) whether the court should ultimately characterize the installment land contract primarily as a contract or a security device. This Comment explores the inconsistent treatment of installment land contracts in purchaser bankruptcy, discusses the inequities resulting from the executory contract treatment, and proposes that a rebuttable mortgage presumption would preserve the purchaser's property rights and benefit the estate while retaining installment land contracts as a viable real estate device.

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<sup>1</sup> See generally Frank R. Lacy, *Land Sale Contracts in Bankruptcy*, 21 UCLA L. REV. 477 (1973).

<sup>2</sup> 11 U.S.C. § 365(i), (j) (2006). The Code also has special provisions for lessees and licensees who, similar to purchasers in seller bankruptcy, are the non-debtor parties that have been relying on the now bankrupt lessors or licensors respectively. *Id.* § 365(h), (n). These provisions mitigate the inequitable consequences of bankruptcy by reducing the power of the trustee in bankruptcy under § 365.

<sup>3</sup> See generally Mitchell R. Julis, *Classifying Rights and Interests under the Bankruptcy Code*, 55 AM. BANKR. L.J. 223 (1981).

<sup>4</sup> See generally *id.*

Part I discusses the nature of installment land contracts, the relevant Code provisions, and the judicial treatment of installment land contracts in various jurisdictions. Part II examines why applying § 365 to installment land contracts results in incoherent state property rights, especially in light of the true lease jurisprudence. This Part instead suggests a better approach would be for courts to presume that installment land contracts are mortgages. Part III discusses the functionality and equity considerations behind a possible rebuttal of the mortgage presumption of installment land contracts in purchaser bankruptcy.

## I. BACKGROUND ON INSTALLMENT LAND CONTRACTS AND EXECUTORY CONTRACTS IN BANKRUPTCY

The most common way to purchase property is to obtain conventional long-term financing and convey to the lender a security interest in the property.<sup>5</sup> In this context, applicable state mortgage law provides the rights of the parties and the procedures in case of default.<sup>6</sup> Unfortunately, some buyers are not able to make the large down payments that may be required for conventional financing. Sellers may find state mortgage laws unattractive—perhaps due to the state’s expensive foreclosure process. Instead of entering into a purchase money mortgage arrangement governed by state mortgage law, the purchaser and the seller may enter into a contract for selling the property for monthly installment payments over a decade or more.<sup>7</sup> The simplicity of this instrument, commonly referred to as an installment land contract, has attracted purchasers (vendees) and sellers (vendors) for different reasons. State courts have struggled to characterize installment land contracts in a manner consistent with their respective property laws.<sup>8</sup>

This Part will first explore the ambiguous nature of installment land contracts and various states’ enforcement of installment land contracts. Then, it will discuss the applicable Code provisions for installment land contracts and how federal courts have treated installment land contracts in purchaser bankruptcy.

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<sup>5</sup> See BAXTER DUNAWAY, 1 THE LAW OF DISTRESSED REAL ESTATE § 1.3 (2012).

<sup>6</sup> See *id.*; *infra* text accompanying notes 21–22, 44–46.

<sup>7</sup> 15 POWELL ON REAL PROPERTY § 84D.01[1] (Michael Allan Wolf ed. 2009).

<sup>8</sup> See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 3.38 (5th ed. 2010), available at Westlaw, 1 REALFNLA § 3.38.

### A. *The Nature of Installment Land Contracts*

Installment land contracts incorporate a combination of contract and property principles, and state courts and legislatures have often confronted difficulties characterizing them.<sup>9</sup> Typically, the seller under an installment land contract—also called a “contract for deed” or “land sale contract”—receives monthly installments of the sale price of the property usually for over a decade or more from the purchaser.<sup>10</sup> The purchaser may take immediate possession of the property once the contract period starts.<sup>11</sup> Often the contract is not recorded, and the seller retains full legal title against the purchaser until the very end of the contract’s term.<sup>12</sup> Under the strict terms of the contract, the purchaser does not have any present or future interest in property, except for the current possession, until the full payment of the contract price. Therefore, the seller’s title is not defeasible by the purchaser during the contract period or before full payment.<sup>13</sup> Nonetheless, the purchaser usually pays taxes on the property and maintains the property as if he is the owner.<sup>14</sup>

A unique feature of an installment land contract is the forfeiture clause.<sup>15</sup> The forfeiture clause usually provides that upon default of the purchaser, the seller as the title holder can repossess the property and keep the purchaser’s past payments as liquidated damages.<sup>16</sup> Although judicial and legislative responses in various states have greatly reduced the potency of the forfeiture clause, several states still enforce some versions of forfeiture.<sup>17</sup> Installment land contracts provide greater protection for the sellers with this possibility of forfeiture. The enhanced seller protection of installment land contracts allows

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<sup>9</sup> See *id.* §§ 3.27, 3.33 (discussing state courts and legislatures characterizing installment land contracts as a mortgage); Eric T. Freyfogle, *Vagueness and the Rule of Law: Reconsidering Installment Land Contract Forfeitures*, 1988 DUKE L.J. 609, 613–14 (noting that some courts are deciding installment land contracts are mortgage-equivalents while others are not making such analogy). Courts also have made a distinction between installment land contracts and earnest money contracts. *Id.* at 630.

<sup>10</sup> NELSON & WHITMAN, *supra* note 8, § 3.26; see also Jacob Rabkin & Mark H. Johnson, 25-21 CURRENT LEGAL FORMS WITH TAX ANALYSIS, form 21.19 (providing a sample installment land contract for residential property).

<sup>11</sup> NELSON & WHITMAN, *supra* note 8, § 3.26; see also Jacob Rabkin & Mark H. Johnson, 25-21 CURRENT LEGAL FORMS WITH TAX ANALYSIS, form 21.19.

<sup>12</sup> 15 POWELL, *supra* note 7, §§ 84D.01[1], 84D.02[1].

<sup>13</sup> NELSON & WHITMAN, *supra* note 8 §§ 3.26, 3.33. If the installment land contract allows prepayment, the purchaser may end the contract term early and advance the conveyance of title.

<sup>14</sup> *Id.* § 3.26; see also Rabkin & Johnson, *supra* note 11, form 21.19 (providing a sample installment land contract for residential property).

<sup>15</sup> See NELSON & WHITMAN, *supra* note 8, § 3.27.

<sup>16</sup> *Id.* § 3.26.

<sup>17</sup> 15 POWELL, *supra* note 7, § 84D.03[1].

risk-averse sellers to enter into a contract with financially challenged potential buyers.<sup>18</sup> An installment land contract is similar to a purchase money mortgage where the purchaser pays monthly installments over many years eventually to own the property.<sup>19</sup> The purchasers who cannot obtain traditional mortgages because of their financial status can utilize the installment land contract to have a “mortgage” in effect.<sup>20</sup>

One possible reason why the sellers and buyers enter into installment land contracts is the characteristics of the state mortgage law.<sup>21</sup> Because of the prevailing understanding that an installment land contract is a pro-seller device, one may explain its popularity in pro-mortgagor states where the only recourse for a mortgagee is judicial foreclosure.<sup>22</sup> Although some argue that installment land contracts should be abolished as more states allow power-of-sale foreclosures, installment land contracts still serve the purpose of providing low-income buyers a means to finance property in jurisdictions where sellers believe the risk involved in a mortgage with low-income buyers is too high.<sup>23</sup> These circumstances that typically accompany the use of installment land contracts raise important equity concerns in bankruptcy.<sup>24</sup>

The best way to understand the rights of the seller and the purchaser in an installment land contract is to compare their respective rights to those of the parties in transactions structured using other devices, such as a short-term earnest money contract, mortgage, and lease. An installment land contract may share some similarities with each instrument but is not completely identical to any.<sup>25</sup>

1. *Installment Land Contract Versus Earnest Money Contract, Mortgage, and Lease: Comparison with Respect to the Parties' Relative Property Rights*

There are practical and functional considerations as to why an installment land contract seems to straddle the relatively definite lines marked by different

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.* § 84D.01[1].

<sup>20</sup> *Id.* (quoting *Ellis v. Butterfield*, 570 P.2d 1334, 1336 (Idaho 1977), which calls an installment land contract a “poor man’s mortgage”).

<sup>21</sup> NELSON & WHITMAN, *supra* note 8, § 3.38.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* (discussing RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4, cmt. d (1997)).

<sup>24</sup> See discussion *infra* Part II.B.4.

<sup>25</sup> See NELSON & WHITMAN, *supra* note 8, § 3.26; 15 POWELL, *supra* note 7, § 84D.01[1].

devices. An installment land contract, as a “sale,” is a transaction in form similar to an earnest money contract.<sup>26</sup> However, the transaction incorporates property rights that are found in mortgage or lease arrangements.<sup>27</sup> There are several aspects of an installment land contract that assist the understanding of how it compares to other devices: the payment arrangements, duration of contract, possession of property, control of property, and eventual ownership. Although it is difficult to determine what exactly an installment land contract purchaser has, the purchaser’s rights to the property are somewhere between a mortgagor’s property rights and a lessee’s property rights.<sup>28</sup> The control of property during the term of the contract and the eventual conveyance of title suggest that the purchaser’s rights lie closer to the mortgagor’s rights than to the lessee’s rights.<sup>29</sup>

In form, an installment land contract may mimic an earnest money contract, but in substance, an installment land contract is not comparable to an earnest money contract. An earnest money contract is a short-term contract for the sale of real property in which there is no a transfer of possession before the closing and delivery of title.<sup>30</sup> The primary purpose of an earnest money contract is to convey title and ownership of the property in exchange for a lump sum or a few series of payments; the purchaser becomes the owner of the property when the transaction closes (usually within a couple of months).<sup>31</sup> An earnest money contract stipulates the rights of the parties during the term of the contract as the payments are made and the title is delivered.<sup>32</sup> Similarly, an installment land contract stipulates the rights of the seller and the purchaser during the installment payment period.<sup>33</sup> Strictly adhering to the installment land contract’s terms, the purchaser has no right to title to or equity in the property before full payment.<sup>34</sup> Although an installment land contract may seem like an

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<sup>26</sup> See NELSON & WHITMAN, *supra* note 8, § 3.26; 15 POWELL, *supra* note 7, § 84D.01[1].

<sup>27</sup> 15 POWELL *supra* note 7, § 84D.01[2]; Eric T. Freyfogle, *The Installment Land Contract As Lease: Habitability Protections and the Low-Income Purchaser*, 62 N.Y.U. L. REV. 293, 308–10 (1987).

<sup>28</sup> See *infra* text accompanying notes 38–51.

<sup>29</sup> One may view an installment land contract as similar to a “lease-and-purchase” with a nominal purchase price, i.e., the last month’s installment. State property law, however, may recharacterize such arrangement as a disguised security device. See *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 804 F.2d 193, 199–200 (2d Cir. 1986).

<sup>30</sup> Compare Rabkin & Johnson, *supra* note 11, form 21.19 (sample installment land contract for residential property) with *id.*, form 21.37 (sample short-term earnest money contract for an office building).

<sup>31</sup> NELSON & WHITMAN, *supra* note 8, § 3.26.

<sup>32</sup> *Id.*

<sup>33</sup> See, e.g., Rabkin & Johnson, *supra* note 11, form 21.19 (sample installment land contract for residential property).

<sup>34</sup> NELSON & WHITMAN, *supra* note 8, § 3.33.

earnest money contract with an extremely long “closing” period—for example, fifteen years rather than three months, an installment land contract is not an earnest money contract.<sup>35</sup> The significantly longer term of an installment land contract indicates that any analogy between an installment land contract and an earnest money contract, even in form, should be questionable.<sup>36</sup> More importantly, because an installment land contract gives the purchaser immediate possession and control of the property, it functions differently from an earnest money contract.<sup>37</sup>

On the other hand, an installment land contract is very similar to a mortgage—especially a seller-financed purchase money mortgage—because immediate possession and a prolonged payment period are characteristics of a mortgage.<sup>38</sup> Like the purchaser of an installment land contract, the mortgagor pays monthly installments over many years to eventually become the unencumbered owner of the property.<sup>39</sup> During the terms of the mortgage and the installment land contract, both the mortgagor and the purchaser have control over the property, pay taxes, make improvements, and maintain the premises.<sup>40</sup> Some commentators argue the distinction between the two should be abolished,<sup>41</sup> and some state legislatures have statutorily eliminated the distinction between mortgages and installment land contracts that functionally resemble mortgages.<sup>42</sup> However, many other states keep installment land contract purchaser’s and mortgagor’s rights distinct.<sup>43</sup> Unlike a mortgagor, an

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<sup>35</sup> An earnest money contract is an example where the contractual principles dominate. The contract sets out the allocation of risks for a short time between the execution and the closing. NELSON & WHITMAN, *supra* note 8, § 3.26. Of course, the equitable doctrines regarding property rights are applicable during the payment period, and the transaction is viewed as a generic sale where—just like any other sales—the payment and the conveyance of property are not simultaneous but reasonably close to show the parties’ intent to make a swift sale. Therefore, the § 365 inquiry is appropriate to earnest money contracts which are similar to contracts for sale of goods and services.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> 15 POWELL, *supra* note 7, § 84D.01[2].

<sup>39</sup> *Id.*

<sup>40</sup> NELSON & WHITMAN, *supra* note 8, § 3.26.

<sup>41</sup> *Id.* § 3.38 (discussing RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4, cmt. d (1997)).

<sup>42</sup> *See, e.g.,* Lucas v. Bishop, 956 P.2d 871, 873 (Okla. 1998) (discussing an Oklahoma statute that provides “[a]ll contracts for deed . . . made for the purpose of establishing an immediate and continuing right of possession . . . shall to that extent be deemed and held mortgages, and shall be subject to the same rules of foreclosure . . . as are prescribed in relation to mortgages.” (quoting OKLA. STAT. tit. 16, § 11A)).

<sup>43</sup> *See* NELSON & WHITMAN, *supra* note 8, §§ 3.28, 3.29. Some state courts that are known to enforce the forfeiture clause have ruled an installment land contract can be an equitable mortgage based on the terms of the contract and the intent of the parties, but in their view, the rights of the seller and the purchaser originate from the contractual arrangement not the inherent functions or characteristics of the installment land contract.



installment land contract purchaser may face forfeiture instead of being protected by the state foreclosure process.<sup>44</sup> Although the scope of the purchaser's rights varies greatly depending on the jurisdiction, the purchaser's rights generally are less than those of a mortgagor on the same property.<sup>45</sup>

Some characteristics of an installment land contract may be comparable to those of a lease.<sup>46</sup> An installment land contract is like a lease because, during the contract term, the purchaser does not have any current interest in title and only has the right to possess the property.<sup>47</sup> The similarity becomes more pronounced once the forfeiture clause is enforced because the purchaser will have no interest or restitution damages after the forfeiture.<sup>48</sup> It would be as if the possession and monthly payments had been a lease arrangement where the purchaser only had possessory rights.<sup>49</sup> However, unlike the lessee, a purchaser has more control over the property similar to a mortgagor and can compel conveyance of the property once the payments are complete.<sup>50</sup> The argument that analogizes an installment land contract to a lease emphasizes the typical purchaser's financial instability, the possibility of an overpriced contract because of the seller's attempt to reduce his risk, and as a result, the high likelihood of forfeiture.<sup>51</sup> However, if the purchaser does pay in full, he will be entitled to the title to the property unlike a lessee. Therefore, a purchaser is entitled to something more than a lessee, but the competing possibilities of eventual ownership and conditional "equity"—that can be destroyed through forfeiture—raise the question to what extent a purchaser is more entitled than a lessee.

## 2. *Enforcement of the Contractual Rights Under Installment Land Contracts*

One of the prominent concerns in analyzing an installment land contract is the enforcement of its forfeiture clause. In theory, the seller and the purchaser

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*See e.g.*, Russell v. Richards 702 P.2d 993, 995–96 (N.M. 1985); Bishop v. Beecher, 355 P.2d 277, 278–79 (N.M. 1960) (recognizing the utility of installment land contracts in light of risk allocation and reaffirmed its refusal to consider an installment land contract as a mortgage).

<sup>44</sup> See discussion *infra* Part I.A.2.

<sup>45</sup> 15 POWELL, *supra* note 7, § 84D.01[2].

<sup>46</sup> See generally Freyfogle, *supra* note 27.

<sup>47</sup> *Id.* at 308, 312.

<sup>48</sup> See *supra* text accompanying notes 10–14.

<sup>49</sup> Freyfogle, *supra* note 27, at 308–09.

<sup>50</sup> NELSON & WHITMAN, *supra* note 8, § 3.26.

<sup>51</sup> See Freyfogle, *supra* note 27, at 308–09.

of an installment land contract exercise their freedom to contract, and the forfeiture clause permits the seller to terminate all rights of the purchaser in the event of default.<sup>52</sup> According to the typical terms of a forfeiture clause, the purchaser does not have a right of redemption upon default and may lose both the possession of the property and all past payment if the seller exercises the forfeiture clause.<sup>53</sup> When installment land contracts first emerged, courts in many jurisdictions honored the intent of the contracting parties and enforced the forfeiture clause as written.<sup>54</sup> However, state jurisprudence had developed to diverge from strict enforcement.

There are two dimensions to how state installment land contract jurisprudence developed: (1) whether the state judicially or legislatively addressed installment land contract enforcement; and (2) whether the state considers an installment land contract to be more like a contract or a mortgage.<sup>55</sup> How exactly one state law compares to another in these two dimensions is a matter of degree.

The forfeiture clause lost much of its power as some state legislatures started to focus on the parties' property rights rather than the strict terms of the contracts. Some state laws have ameliorated the inherently harsh characteristics of installment land contracts for the purchaser in various ways and, as a result, created a gradation of different seller and purchaser rights across the country. States such as Oklahoma have codified the rule that a typical installment land contract arrangement creates a mortgage, and the seller's remedy is limited to foreclosure.<sup>56</sup> Other states such as Illinois, Michigan, and Ohio provide in statutes some mortgage-like purchaser protections such as grace period, notice of forfeiture, restitution, and even

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<sup>52</sup> 15 POWELL, *supra* note 7, § 84D.03[2].

<sup>53</sup> NELSON & WHITMAN, *supra* note 8, §§ 3.26, 3.27, 3.33; Rabkin & Johnson, *supra* note 11, form 21.19.

<sup>54</sup> 15 POWELL, *supra* note 7, § 84D.03[1]; NELSON & WHITMAN, *supra* note 8, § 3.27.

<sup>55</sup> *See, e.g.*, Lucas v. Bishop, 956 P.2d 871, 873 (Okla. 1998) (referring to Oklahoma statute that defines an installment land contract is like a mortgage (citing 16 OKL. ST. ANN. tit. 16, § 11A)); Mackiewicz v. J.J. & Assocs., 514 N.W.2d 613, 621 (Neb. 1994) (finding that the installment land contract is almost equivalent to a mortgage); Russell v. Richards, 702 P.2d 993, 995–96 (N.M. 1985) (finding that the installment land contract provisions are enforceable as written); Keene v. Schnetz, 468 N.E.2d 125, 127–28 (Ohio Ct. App. 1983) (referring to Ohio statute that does not analogize an installment land contract to a mortgage (citing OHIO REV. CODE §§ 5313.05, 5313.06)).

<sup>56</sup> Lucas, 956 P.2d at 873 (“All contracts for deed . . . made for the purpose of establishing an immediate and continuing right of possession . . . shall to that extent be deemed and held mortgages, and shall be subject to the same rules of foreclosure . . . as are prescribed in relation to mortgages.” (citing 16 OKL. ST. ANN. tit. 16, § 11A)).

possible foreclosure depending on the extent of past installment payments and the use of the property (residential or commercial).<sup>57</sup>

In other states, courts have provided protection for purchasers in installment land contracts. The judicial treatment of installment land contracts varies significantly state by state. Courts in Nebraska and Kentucky, for example, have effectively ruled that an installment land contract is a mortgage “for all intents and purposes.”<sup>58</sup> States such as Indiana judicially treat an installment land contract as a mortgage with a few exceptions.<sup>59</sup> Some states like Florida and California judicially provide many mortgage-like protections for the purchasers without an explicit ruling that an installment land contract is a mortgage.<sup>60</sup> A few states like New Mexico and South Dakota allow limited judicial purchaser protections and enforce the pro-seller contract terms to a great extent.<sup>61</sup>

### *B. An Overview of the Treatment of Installment Land Contracts Under the Code*

There are two possible treatments of installment land contracts under the Code: (1) a court may find an installment land contract is an “executory contract;” or (2) a court may find that it creates a security interest on property similar to a mortgage.<sup>62</sup> If an installment land contract is an executory contract,

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<sup>57</sup> *Eppers v. First Nat'l Bank of Lake Forest*, 503 N.E.2d 589, 591–92 (Ill. App. Ct. 1987) (citing 735 ILL. COMP. STAT. 5/9-104.1(a)); *Keene v. Schnetz*, 468 N.E.2d 125, 127–28 (Ohio Ct. App. 1983) (citing OHIO REV. CODE §§ 5313.05, 5313.06); *Gruskin v. Fisher*, 273 N.W.2d 893, 896–97 (Mich. 1979) (citing MICH. COMP. LAWS §§ 600.5750, 600.5726); *see also* NELSON & WHITMAN, *supra* note 8, § 3.28; RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4 (1997). The provision of mortgage-like remedies in these states does not imply bankruptcy courts' analyses of installment land contracts are similar. *See* discussion *infra* Part II.A.3.

<sup>58</sup> *Mackiewicz v. J.J. & Assocs.*, 514 N.W.2d 613, 621 (Neb. 1994); *see also* *Sebastian v. Floyd*, 585 S.W.2d 381, 383 (Ky. 1979). For further discussion, *see* NELSON & WHITMAN, *supra* note 8, § 3.29.

<sup>59</sup> *See, e.g., Skendzel v. Marshall*, 301 N.E.2d 641, 645–47, 650 (Ind. 1973) (noting that forfeiture is appropriate if the purchaser abandons the property or has paid minimal amount of money). For further discussions, *see* NELSON & WHITMAN, *supra* note 8, § 3.29.

<sup>60</sup> RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4 (1997); *see, e.g., Petersen v. Hartell*, 707 P.2d 232, 239–40 (Cal. 1985); *see also* NELSON & WHITMAN, *supra* note 8, § 3.29.

<sup>61</sup> *See, e.g., Russell v. Richards*, 702 P.2d 993, 995–96 (N.M. 1985); *Heikkila v. Carver*, 378 N.W.2d 214, 218–19 (S.D. 1985).

<sup>62</sup> *See, e.g., Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469 (6th Cir. 1989) (executory contract); *Mitchell v. Streets (In re Streets & Beard Farm P'ship)*, 882 F.2d 233 (7th Cir. 1989) (security interest on property); *O'Brien v. Ravenswood Apartments, Ltd. (In re Ravenswood Apartments, Ltd.)*, 338 B.R. 307 (6th Cir. B.A.P. 2006) (executory contract); *Heartline Farms, Inc. v. Daly*, 128 B.R. 246 (Bankr. D. Neb. 1990) (security interest on property), *aff'd*, 934 F.2d 985 (8th Cir. 1991); *In re Speck*, 50 B.R. 307 (Bankr. D.S.D. 1985) (executory contract), *aff'd*, 798 F.2d 279 (8th Cir. 1986); *Shaw v. Dawson (In re Shaw)*, 48 B.R. 857 (Bankr. D.N.M. 1985) (security interest on property).

the trustee may “assume or reject” the executory contract in its entirety.<sup>63</sup> If an installment land contract creates a security interest in the property in purchaser bankruptcy, the seller has a secured claim against the estate and should follow the relevant Code provisions regarding secured claims.<sup>64</sup> In determining which Code section applies, courts have asked if an installment land contract is “executory” for the purposes of bankruptcy law.

### 1. *The Meaning of “Executory” in § 365*

The Code does not define the term “executory contract” anywhere.<sup>65</sup> There are two approaches in analyzing the applicability of § 365: the Countryman Approach and the Functional Approach. The vast majority of cases follow the Countryman Approach, but a few cases adopted the Functional Approach, especially when courts found that the Countryman Approach may yield problematic results.<sup>66</sup>

The legislative history of § 365 suggests congressional approval of Professor Countryman’s definition of executory contract.<sup>67</sup> According to Professor Countryman’s articles, an executory contract for bankruptcy purposes is “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 the performance of the other.”<sup>68</sup> Professor Countryman reasoned that if the debtor has materially performed, then only the non-debtor’s material obligations are remaining.<sup>69</sup> The contract is wholly beneficial to the estate, and the trustee should not be given an option to reject it accidentally.<sup>70</sup> If the non-debtor has materially performed, then only the debtor’s material obligations are remaining.<sup>71</sup> The contract is wholly burdensome to the estate, and the trustee should not be given an option to accidentally assume it and elevate the non-

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<sup>63</sup> 11 U.S.C. § 365(a) (2006).

<sup>64</sup> *Id.* § 506.

<sup>65</sup> 3 COLLIER ON BANKRUPTCY ¶ 365.02[2][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011).

<sup>66</sup> *See, e.g.,* *Thompkins v. Lil’ Joe Records, Inc.*, 476 F.3d 1294, 1305 n.13 (11th Cir. 2007); *Sipes v. Atl. Gulf Comtys. (In re Gen. Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996).

<sup>67</sup> H.R. REP. NO. 95-959, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304 (“Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.”); 3 COLLIER, *supra* note 65, ¶ 365.02[1].

<sup>68</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 457–58.

<sup>71</sup> *Id.* at 457.

debtor's claim to administrative status, which would give it priority over other secured claims.<sup>72</sup> Therefore, it is only when the contract is materially unperformed on both sides that the trustee should be given an option to assess the value of the contract and decide whether to assume or reject it.<sup>73</sup>

When adopting the Countryman Approach, courts often ask whether the nonperformance of either party to the contract would result in material breach.<sup>74</sup> Although Professor Countryman focused on mutual, unperformed material obligations, the underlying reasoning for this inquiry is to determine what would benefit the bankruptcy estate.<sup>75</sup> Professor Countryman noted that "all contracts to a greater or lesser extent are executory," but the reason for specifying the scope of "executory" for bankruptcy purposes is to determine what would benefit the estate.<sup>76</sup> As one commentator pointed out, applying the material breach test can be thought of as a proxy for the benefit of the estate.<sup>77</sup> Almost all courts have adopted, or at least approved of, the Countryman Approach and applied the material breach test to contracts to determine the applicability of § 365.<sup>78</sup>

However, following the Countryman Approach, courts often have blindly applied the material breach test and sometimes reached inequitable results.<sup>79</sup> Some courts and critics have questioned the merits of the Countryman Approach and argued for a refocus on the benefit to the estate.<sup>80</sup> The material breach test was devised to shield against the trustee's possible mistakes in making an unnecessary commitment or committing an unfavorable breach.<sup>81</sup> Although the material breach test produces sensible results in many contract transactions, the test has produced problematic results in certain complicated

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<sup>72</sup> *Id.* at 459–60.

<sup>73</sup> *Id.* at 461.

<sup>74</sup> See 3 COLLIER, *supra* note 65, ¶ 365.02[2].

<sup>75</sup> See *In re Booth*, 19 B.R. 53, 55 (Bankr. D. Utah 1982).

<sup>76</sup> Countryman, *supra* note 68, at 450 (quoting 1 S. WILLISTON CONTRACTS § 14 (3d ed. 1957)).

<sup>77</sup> Carl N. Pickerill, *Executory Contracts Re-Revisited*, 83 AM. BANKR. L.J. 63, 104 (2009).

<sup>78</sup> 3 COLLIER, *supra* note 65, ¶ 365.02[2].

<sup>79</sup> Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 240–42 (1989); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding 'Rejection'*, 59 U. COLO. L. REV. 845, 884–89 (1988).

<sup>80</sup> *In re Booth*, 19 B.R. 53; Andrew, *supra* note 79, at 889–95; Jerry Porter, *Vendee Bankruptcy: Installment Land Contracts and Section 365 of the Bankruptcy Code*, 24 BULL. BUS. L. SEC. ST. B. TEX. 33, 39 (Nov. 1986) (suggesting § 105 equity powers may allow a functional approach in understanding § 365 rather than analyzing the form of the contract); Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 AM. BANKR. INST. L. REV. 463, 465–70 (1997). See generally Westbrook, *supra* note 79.

<sup>81</sup> Countryman, *supra* note 68, at 457.

contracts where the rights and obligations of the parties are difficult to characterize.<sup>82</sup> Some examples include option contracts,<sup>83</sup> noncompete covenants,<sup>84</sup> and intellectual property licensing agreements.<sup>85</sup> Installment land contracts are another example to which Professor Countryman's material breach test does not neatly apply.<sup>86</sup>

Courts have responded to the anomalies arising from the Countryman Approach in various ways. They have often defended the approach by focusing on a single reference in the legislative history, which suggests that Congress had some version of the Countryman Approach in mind for § 365.<sup>87</sup> While adhering to the Countryman Approach, some courts have adjusted the scope of the word "executory" to reach equitable results.<sup>88</sup>

Against the heavy precedent following the Countryman Approach, one case proposed a different line of reasoning, often referred to as the Functional Approach. The court in *In re Booth* declined to follow the Countryman Approach and decided to focus on the benefit to the estate.<sup>89</sup> The court correctly noted that Professor Countryman proposed the material breach test because the contract may be beneficial to the bankruptcy estate only when there are material obligations left on the both sides.<sup>90</sup> However, the court raised the question of whether applying the Countryman Approach will always

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<sup>82</sup> Westbrook, *supra* note 79, at 240–42.

<sup>83</sup> *E.g.*, *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D. Minn. 1985) ("It is inappropriate to apply a generalized rule such as Countryman to all situations." (quoting *In re Adolphsen*, 38 B.R. 776, 779 (Bankr. D. Minn. 1983) (option contract case))) (contract for deed in purchaser bankruptcy).

<sup>84</sup> *E.g.*, *In re Norquist*, 43 B.R. 224, 226–27 (Bankr. E.D. Wash. 1984) (warning against the "adherence to the rigid Countryman definition" in the covenant not to compete case, as it may fail to support "the purpose and spirit of the Bankruptcy Code").

<sup>85</sup> Westbrook, *supra* note 79, at 240 (noting that Congress had to step in to fix the commercially disruptive result arising from *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 765 F.2d 1043 (4th Cir. 1985) (a case involving a rejection of a technology license), *superseded by statute*, Intellectual Property Bankruptcy Protection Act of 1988, Pub. L. No. 100-506, -102 Stat. 2538 (codified as 11 U.S.C. §§ 101, 365(n) (2006))).

<sup>86</sup> Some courts have argued that Professor Countryman's description of executory contracts was meant to address only non-installment contracts such as earnest money contracts. *Heartline Farms, Inc. v. Daly*, 128 B.R. 246, 251 (Bankr. D. Neb. 1990), *aff'd*, 934 F.2d 985 (8th Cir. 1991).

<sup>87</sup> *Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469, 471 (6th Cir.1989) (citing H.R. REP. NO. 95-959, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304); *see also In re Speck*, 50 B.R. 307, 308 (Bankr. D.S.D. 1985), *aff'd*, 798 F.2d 279 (8th Cir. 1986); *Shaw v. Dawson (In re Shaw)*, 48 B.R. 857, 859 (Bankr. D.N.M. 1985); *supra* note 66.

<sup>88</sup> *See, e.g., In re Norquist*, 43 B.R. at 229–30.

<sup>89</sup> *In re Booth*, 19 B.R. 53, 64 (Bankr. D. Utah 1982).

<sup>90</sup> *Id.* at 55.

benefit the estate.<sup>91</sup> The court reasoned that the executory contract analysis should be performed in light of the benefit to the estate, which is the ultimate focus in bankruptcy.<sup>92</sup> The *In re Booth* court, and others that soon followed it, noted that courts should not focus too much on the form (i.e. unperformed material obligations on both sides of the contract) when determining whether a contract is an “executory contract” for § 365 purposes.<sup>93</sup>

Critics of the executory contract jurisprudence have embraced the approach of *In re Booth* and urged that courts should not adhere to Professor Countryman’s rigid test but instead focus on the benefit to the estate.<sup>94</sup> They argue against a special bankruptcy meaning of “executory,” which courts have understood to imply material and mutually unperformed obligations.<sup>95</sup> This criticism emphasizes that the material breach test does not serve any meaningful purpose in bankruptcy.<sup>96</sup> One critic argued that instead of focusing on the form of a contract, courts should take a Functional Approach of determining the applicability of § 365 based on what would benefit the bankruptcy estate.<sup>97</sup> Another critic argued that any unperformed contract should be governed by § 365.<sup>98</sup> In essence, these criticisms suggest that the Countryman Approach misleadingly links benefit to the estate to the word “executory” in § 365 and gives an unnecessary special meaning to the word.<sup>99</sup> At least one circuit court and several lower federal courts have adopted and approved the Functional Approach.<sup>100</sup> However, only a minority of courts follow the Functional Approach because of the apparent disregard of the statutory language “executory” and the wealth of case law embracing the Countryman Approach.<sup>101</sup>

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<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 56–57.

<sup>93</sup> *Arrow Air v. Port Auth. of N.Y. & N.J. (In re Arrow Air, Inc.)*, 60 B.R. 117, 121–22 (Bankr. S.D. Fla. 1986); *In re Adolphsen*, 38 B.R. 776, 778–79 (Bankr. D. Minn. 1983); *In re Booth*, 19 B.R. at 56–57.

<sup>94</sup> See Westbrook, *supra* note 80, at 465–70. See generally Westbrook, *supra* note 79.

<sup>95</sup> Andrew, *supra* note 79, at 889–90; Westbrook, *supra* note 79, at 239–40.

<sup>96</sup> Westbrook, *supra* note 79, at 240–42.

<sup>97</sup> *Id.* at 243–44.

<sup>98</sup> Andrew, *supra* note 79, at 889–90.

<sup>99</sup> *Id.* at 889–90; Westbrook, *supra* note 79, at 239–40.

<sup>100</sup> See, e.g., *Thompkins v. Lil’ Joe Records, Inc.*, 476 F.3d 1294, 1305 n.13 (11th Cir. 2007) (noting that the court has “tacitly approved” the “functional approach”); *Sipes v. Atl. Gulf Cmty. (In re Gen. Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996) (finding that the land sale contract is executory to benefit the seller’s bankruptcy estate).

<sup>101</sup> See, e.g., *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 44 (Bankr. D.R.I. 1999) (“[T]he functional analysis expressly ignores the statutory mandate that the contract be executory under § 365.”); *In re*

## 2. *Executory Contracts Under § 365*

If a court finds that an installment land contract is “executory,” the trustee has to decide either to perform fully or to reject and breach the contract. The Code provides that the trustee may “assume or reject” the contract subject to the court’s approval.<sup>102</sup> To assume the contract, the trustee must cure the default, if any; compensate the other party for pecuniary loss resulting from the default; and provide adequate assurance of future performance.<sup>103</sup> Section 365 provides a broad right to cure, and the trustee is not necessarily required to perform exactly what is written in the contract.<sup>104</sup> Courts have ruled that as long as the trustee can offer a “substantial equivalent” of the full compliance of the contract, the cure is adequate.<sup>105</sup> In assuming the contract, the trustee also has to show an adequate assurance of future performance, which depends on the facts of each case.<sup>106</sup> Certain contracts involving personal services may not be assumable, but this exception generally does not apply to installment land contracts.<sup>107</sup>

If a court finds that an installment land contract is an executory contract, the trustee is often forced to make a decision to assume or reject the contract in a relatively short time. In a liquidation case, if the trustee does not assume or reject an executory contract within sixty days, the contract is deemed

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Child World, Inc., 147 B.R. 847, 851 (Bankr. S.D.N.Y. 1992) (“Manifestly, [the functional] approach ignores the statutory requirement that the contract to be assumed or rejected must be ‘executory.’”).

<sup>102</sup> 11 U.S.C. § 365(a) (2006). The relevant parts of § 365(a) provide that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” *Id.* This provision makes exceptions for commodity contracts addressed in §§ 765–66, but installment land contracts do not fall into that category. *Id.*

<sup>103</sup> *Id.* § 365(b)(1)(A)–(C).

<sup>104</sup> 3 COLLIER, *supra* note 65, ¶ 365.06[3][b].

<sup>105</sup> *Id.*

<sup>106</sup> 11 U.S.C. § 365(b)(1)(C); *see also* 3 COLLIER, *supra* note 65, ¶ 365.06[3][a]. In determining whether an assurance is adequate, “courts have considered some of the following factors: the debtor’s payment history, presence of a guarantee, presence of a security deposit, evidence of profitability . . . [and] the general outlook in the debtor’s industry.” *Id.*

<sup>107</sup> *See* 11 U.S.C. § 365(c). Section 365(c)(1) provides that the trustee cannot assume the contract if a nonbankrupt party to the contract does not consent or is excused based on nonbankruptcy law. *Id.* § 365(c)(1). This provision is applicable, for example, to a non-assignable personal service contract, which depends on particular personal skills, where the nonbankrupt party does not accept the assignee’s replacement of the debtor’s performance. 3 COLLIER, *supra* note 65, ¶ 365.07[1]. Because installment land contracts generally do not depend on personal skills or performances, they are not likely to fall into this category of exceptions. Section 365(c)(2) also has a limited exception for contracts for certain debt financing. 11 U.S.C. § 365(c)(2). However, the scope of the provision is narrow because it does not reach all types of contracts that extend credit to the debtor. 3 COLLIER, *supra* note 65, ¶ 365.07[2].



rejected.<sup>108</sup> In other cases, courts usually have concluded that once a contract is determined to be executory, the trustee must either assume or reject the executory contract quickly.<sup>109</sup>

Once the trustee determines whether he is able to assume the executory contract, he needs to decide whether it is beneficial to the bankruptcy estate to assume—or assume and assign—the contract.<sup>110</sup> This step is crucial because the decision to assume the executory contract requires the estate to perform the contract in full.<sup>111</sup> Furthermore, the trustee can only assume the contract in its entirety, and once the trustee assumes the contract, all the costs associated with curing or performing the contract obtain the status of administrative expenses,<sup>112</sup> which have priority over unsecured claims.<sup>113</sup> After the trustee decides to assume the contract, a court generally reviews the decision to assume based on the business judgment standard.<sup>114</sup> Once the trustee assumes the executory contract, he may assign the contract to a third party if he finds the assignment would be beneficial to the bankruptcy estate.<sup>115</sup>

The significance of the assumption of a contract cannot be overstated. In effect, the assumption of the contract overrides the policy against contracting

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<sup>108</sup> 11 U.S.C. § 365(d)(1). The relevant portion of § 365(d)(1) provides that “[i]n a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease . . . of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause within such 60-day period, fixes, then such contract or lease is deemed rejected.” *Id.*; see also 3 COLLIER, *supra* note 65, ¶¶ 365.03[6] n.52, 365.05[1].

<sup>109</sup> Generally, in chapters 9, 11, 12, and 13 cases executory contracts are assumed or rejected before the confirmation of a plan. See 11 U.S.C. § 365(d)(2) (2006); see also 3 COLLIER, *supra* note 65, ¶ 365.03[6]. A few courts and academics have reasoned that the trustee may choose to neither assume nor reject an executory contract, and when the contract is not assumable or the trustee decides not to assume or reject, the contract can “ride through” bankruptcy in a chapter 11 case. *Id.* The contract is not terminated or deemed rejected in this case and would continue to exist throughout bankruptcy and thereafter. *Id.* For more discussion on “ride through” and implications of an assumption or rejection, see Andrew, *supra* note 79, at 878–81.

<sup>110</sup> See 3 COLLIER, *supra* note 65, ¶ 365.02[2]. If the executory contract is not in default, the trustee would not determine if he can assume the contract based on § 365(b). *Id.* ¶ 365.09. Instead, the trustee would skip the § 365(b) step, and determine whether to assume or assign the contract. *Id.*

<sup>111</sup> *Id.* ¶ 365.03[2].

<sup>112</sup> See 11 U.S.C. § 503(b).

<sup>113</sup> *Id.* § 507(a)(2). In bankruptcy law, the cost of curing and performing the executory contract has been considered administrative. 3 COLLIER, *supra* note 65, ¶ 365.LH[1]. The implication of the elevated status of the seller of an assumed installment land contract in purchaser bankruptcy will be discussed in Part II.B.3.

<sup>114</sup> 3 COLLIER, *supra* note 65, ¶¶ 365.03[1], 365.03[2].

<sup>115</sup> 11 U.S.C. § 365(f). The trustee has to provide adequate assurance that the third-party assignee will perform the contract in order to assign the contract. 3 COLLIER, *supra* note 65, ¶ 365.09[1]. Adequate assurance of performance is only assurance of material performance and need not be exact compliance. *Id.* Once the contract is so assigned, § 365(k) relieves the trustee and the bankruptcy estate from any future liability after the assignment. 11 U.S.C. § 365(k); see also 3 COLLIER, *supra* note 65, ¶ 365.09[1].

around bankruptcy law behind the § 365 provisions.<sup>116</sup> Section 365 sets out certain contract clauses that are not enforceable in bankruptcy.<sup>117</sup> Any contract clause that attempts to terminate or modify the rights and obligations of the parties upon insolvency, bankruptcy, or appointment of a trustee is not enforceable.<sup>118</sup> Similarly, contract clauses that attempt to terminate or modify the contract upon assumption or assignment of the contract are invalid.<sup>119</sup> Therefore, an attempt to contract around bankruptcy law through clauses that are triggered directly or incidentally by the party's bankruptcy is unenforceable.<sup>120</sup> One policy reason behind these provisions may be to void the contracting parties' attempt to be materially unaffected by one of the parties' entry into bankruptcy.<sup>121</sup> However, the assumption of a contract may undermine this policy since the assumed contract enjoys administrative status and will be performed in full, and the non-debtor parties are materially unaffected by the debtor's bankruptcy.<sup>122</sup>

If the trustee determines that the executory contract is not beneficial to the estate, the trustee may reject the contract. Generally, the rejection of a contract constitutes a breach, and the estate should pay damages, if any.<sup>123</sup> In case of rejection, the Code treats a claim for the breach as a prepetition claim, which is not entitled to priority under § 507.<sup>124</sup> The breach neither terminates the contract nor eliminates all the rights and obligations regarding third parties,<sup>125</sup> and the remedies following the § 365 rejection almost always exclude specific performance.<sup>126</sup> Since the rejection costs the estate only pecuniary damages

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<sup>116</sup> See discussion *infra* Part II.B.2 (describing how the Code produces a preference for the assumption of an installment land contract, and the nonbankrupt seller is overly protected from the purchaser's bankruptcy).

<sup>117</sup> 11 U.S.C. § 365(b)(2), (e), (f)(3).

<sup>118</sup> *Id.* § 365(b)(2), (e).

<sup>119</sup> *Id.* § 365(f)(3) (2006); see also 3 COLLIER, *supra* note 65, ¶ 365.09[3].

<sup>120</sup> 11 U.S.C. § 365(e); see also 3 COLLIER, *supra* note 65, ¶ 365.08[1].

<sup>121</sup> See 3 COLLIER, *supra* note 65, ¶ 365.08[1].

<sup>122</sup> See discussion *infra* Part II.B.2 (describing how the Code produces a preference for the assumption of an installment land contract, and the nonbankrupt seller is overly protected from the purchaser's bankruptcy).

<sup>123</sup> 11 U.S.C. § 365(g). The relevant part of § 365(g) provides that "[e]xcept as provided in subsection[] . . . (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease . . . immediately before the date of the filing of the petition." *Id.*

<sup>124</sup> *Id.*; see also 3 COLLIER, *supra* note 65, ¶ 365.10[1]. Section 365(g) provides in detail which date is considered the date of breach in various situations involving post-assumption rejection and conversion to different chapter bankruptcies. 11 U.S.C. § 365(g).

<sup>125</sup> 3 COLLIER, *supra* note 65, ¶ 365.10[3].

<sup>126</sup> *Id.* ¶ 365.10[1]. Often the lack of a specific performance remedy may give the debtor incentive to characterize a contract as executory and reject the contract. See *id.* ¶ 365.10[1]. Some commentators argue that this power is akin to avoidance. Westbrook, *supra* note 79, at 309–10; see Andrew, *supra* note 79, at 901–31; Westbrook, *supra* note 80, at 470–72.

with no priority, it can be a powerful tool for the estate to get out of unfavorable contracts. However, because an installment land contract purchaser's obligation is usually only pecuniary, this limitation to the seller's relief is not useful for the purchaser in bankruptcy.<sup>127</sup>

Although the Code is silent on the case of purchaser bankruptcy, Congress has expressly addressed the case of seller bankruptcy. The power of the bankrupt seller to reject an installment land contract resulted in inequity to the detriment of the non-debtor-purchaser under the Bankruptcy Act of 1938.<sup>128</sup> In light of this inequitable treatment of the non-debtor-purchaser, Congress adopted § 365(i) and (j) in the Code to address the rights of the non-debtor-purchaser in possession of the property.<sup>129</sup> If the purchaser is in possession

<sup>127</sup> See discussion *supra* Part II.B.2.

<sup>128</sup> The relevant parts of the Bankruptcy Act provided that "the trustee shall assume or reject any executory contract, including unexpired leases of real property." Bankruptcy Act of 1938, Pub. L. 75-696, 52 Stat. 840, 880-81. The Bankruptcy Act also provided that "the rejection of an executory contract or unexpired lease . . . shall constitute a breach of such contract or lease as of the date of the filing of the petition." *Id.* at 873-74. Under the Bankruptcy Act, the bankrupt seller of a land sale contract could reject the contract and deprive the buyer of its possession of property without full compensation resulting in a "windfall to an undeserving party"—the bankrupt seller. 3 COLLIER, *supra* note 65, ¶ 365.12.

<sup>129</sup> REPORT OF THE COMM'N ON BANKR. LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 199, 206; *id.* pt. 2, at 157-58, 172-73 (1973). The relevant parts of § 365(i) and (j) provide:

- (i)(1) If the trustee rejects an executory contract of the debtor for the sale of real property . . . under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property . . .
- (2) If such purchaser remains in possession—
  - (A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and
  - (B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.
- (j) A purchaser that treats an executory contract as terminated under subsection (i) of this section, or a party whose executory contract to purchase real property from the debtor is rejected and under which such party is not in possession, has a lien on the interest of the debtor in such property for the recovery of any portion of the purchase price that such purchaser or party has paid.

11 U.S.C. § 365(i), (j). Congress included these provisions in the Code in response to *In re New York Investors Mutual Group* where the court allowed the seller to reject the eighteen-month long contract for sale of land. *In re N.Y. Investors Mut. Grp.* 143 F. Supp. 51 (S.D.N.Y. 1956). Courts have understood that through § 365(i) and (j), Congress intended to protect the purchaser of a "long-term land sale contract not passing title until the full purchase price has been paid." *Summit Land Co. v. Allen (In re Summit Land Co.)*, 13 B.R. 310, 317

when the seller files for bankruptcy, the purchaser can either treat the contract as terminated or remain in possession even after the purchaser rejects the contract.<sup>130</sup> If the purchaser chooses to remain in possession after rejection, the purchaser must complete the future payments, and the seller has to deliver the title to the purchaser on completion of payments.<sup>131</sup> The purchaser may offset any damages due to the seller's rejection of the contract from the purchaser's future payments, but the purchaser cannot file an affirmative claim to get the damages after the rejection.<sup>132</sup> Also, once the seller delivers the title to the purchaser, the seller is relieved of all liabilities.<sup>133</sup> On the other hand, if the purchaser chooses to treat the rejected contract as terminated, or the purchaser is not in possession of the property, the purchaser has a lien on the property for the payment it has already paid.<sup>134</sup> This lien, however, is of the lowest priority relative to the pre-existing encumbrances on the property.<sup>135</sup> These provisions address only seller bankruptcy and the Code is silent on the treatment of the purchaser-in-possession in purchaser bankruptcy.<sup>136</sup>

In summary, an installment land contract, when found to be executory by a court, can be (1) assumed and performed in full ahead of paying the general unsecured creditors; (2) rejected by the trustee with damages paid as an unsecured claim; (3) performed according to the exception provided in § 365(i) for the purchaser-in-possession; or (4) rejected creating a low-priority lien for the purchaser according to § 365(j). In purchaser bankruptcy, the relevant scenarios are (1) and (2).<sup>137</sup>

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(Bankr. D. Utah 1981) (quoting REPORT OF THE COMM'N ON BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2 at 158 (1973)).

<sup>130</sup> 11 U.S.C. § 365(i)(1).

<sup>131</sup> *Id.* § 365(i)(2).

<sup>132</sup> *Id.* § 365(i)(2)(A). Therefore, the recovery for the purchaser who remains in possession is capped at the amount of payments yet to be paid. *See* 3 COLLIER, *supra* note 65, ¶ 365.12[1]. However, if the purchaser is not in possession upon the seller's rejection or the purchaser treats the contract as terminated, there is no limitation for damages. *Id.* ¶ 365.12[2].

<sup>133</sup> *Id.* § 365(i)(2)(B).

<sup>134</sup> *Id.* § 365(j).

<sup>135</sup> 3 COLLIER, *supra* note 65, ¶ 365.12[4].

<sup>136</sup> *See* discussion *infra* Part II.B.4.

<sup>137</sup> The "ride through" may be another option as some courts and commentators have suggested. 3 COLLIER, *supra* note 65, ¶ 365.03[6]. However, the "ride through" is essentially bypassing bankruptcy as if it did not happen and therefore has little relevance to this Comment on how the federal bankruptcy law affects and interacts with the state property laws.

### 3. Secured Claims Under the Code

If a court finds that an installment land contract is not “executory,” the arrangement will be viewed as creating a secured claim on property similar to a mortgage.<sup>138</sup> The seller will have a secured claim on property under § 506,<sup>139</sup> and federal courts should determine the substantive rights of the parties to the secured lien according to the applicable state laws.<sup>140</sup> The purchaser’s biggest advantage is time because the purchaser will be protected by the automatic stay and the payments may be rescheduled.<sup>141</sup> The purchaser will have a chance to cure over time and maintain the premises, and the trustee does not have to make a quick decision either to fully perform or to breach. If the purchaser does not or cannot pay the installments, the court will determine the priority based on the state notice and recording laws and follow the state foreclosure procedure.<sup>142</sup> As a result, the purchaser will get the mortgagor protections set by the state foreclosure laws.

Moreover, the purchaser can take advantage of the state mortgage law as well as federal bankruptcy law without making a drastic decision to “assume or reject” the installment land contract. If the value of the property is greater than the contract price, the purchaser may claim equity in the property even if the purchaser loses the property—i.e., no full performance. Also, depending on the fair market value of the property, federal bankruptcy law may limit state-given rights of the non-debtor party.<sup>143</sup> If the property is not worth as much as the full contract price, the purchaser may reduce the seller’s secured claim to the value of the property, thus leaving the rest of the price as an unsecured claim.<sup>144</sup> An exception to this scenario is a chapter 11 case, in which the seller

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<sup>138</sup> See, e.g., *Mitchell v. Streets (In re Streets & Beard Farm P’ship)*, 882 F.2d 233, 235 (7th Cir. 1989); *Heartline Farms, Inc. v. Daly*, 128 B.R. 246, 248–49 (Bankr. D. Neb. 1990), *aff’d*, 934 F.2d 985 (8th Cir. 1991). In general, a court may find that a contract partially performed is not executory. See *supra* Part I.B.1 (discussing what is “executory”). The trustee may enforce or abandon the debtor’s rights under the non-executory contract, and the non-debtor party can file a proof of claim under § 501. See 11 U.S.C. § 501; 3 COLLIER, *supra* note 65, ¶ 365.LH[1]. Courts have generally found that if an installment land contract is not an executory contract, the installment land contract is not just a partially performed contract but a mortgage. See *In re Streets & Beard Farm*, 882 F.2d at 235.

<sup>139</sup> 11 U.S.C. § 506 (2006); see also 4 COLLIER, *supra* note 65, ¶ 506.01.

<sup>140</sup> See *Butner v. U.S.*, 440 U.S. 48, 54–55 (1979).

<sup>141</sup> 11 U.S.C. § 362(a).

<sup>142</sup> See *Butner*, 440 U.S. at 54–55.

<sup>143</sup> See *Westbrook*, *supra* note 79, at 252–53.

<sup>144</sup> See, e.g., *Fox v. Hill (In re Fox)*, 83 B.R. 290, 294 (Bankr. E.D. Pa. 1988). The purchaser may reduce the amount of the lien depending on the facts of the case. Because home mortgages are exempt from modification, the major advantage of the mortgage characterization of an installment land contract for a home

may elect to keep the full contract price as a secured claim.<sup>145</sup> However, even then, the purchaser may be relieved from paying the installments on time as provided in the contract.<sup>146</sup> Therefore, the purchaser may enjoy the reduction of payments, delay of payments, or both, if the installment land contract is treated as creating a secured claim.

### C. *Judicial Decisions on the Applicability of § 365 to Installment Land Contracts*

Federal courts generally have taken three approaches when asked whether an installment land contract is “executory” in purchaser bankruptcy. Some courts have strictly applied the material breach test of the Countryman Approach to determine whether an installment land contract is executory.<sup>147</sup> Others have reached pro-purchaser results by relying on state laws that treat an installment land contract as a mortgage.<sup>148</sup> Finally, focusing on the benefit to the estate rather than the form of the contract, a few courts have adopted the Functional Approach.<sup>149</sup> The internal logic of each individual case is reasonable; however, the overall installment land contract jurisprudence in purchaser bankruptcy has been inconsistent due to diverse state laws.<sup>150</sup>

Some federal courts have ruled that an installment land contract is not an executory contract for bankruptcy purposes.<sup>151</sup> Two lines of reasoning have supported that conclusion: (1) installment land contracts are security devices, so § 365 is inapplicable;<sup>152</sup> or (2) the seller’s conveyance of title pursuant to an

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would be to cure and maintain. 11 U.S.C. § 1322(b)(5); *see also* Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993).

<sup>145</sup> Even when the fair market value assessed by the court is below the contract price, the seller may elect to keep the full contract price as a secured claim depending on the purchaser’s payment stream in a chapter 11 case. 11 U.S.C. § 1111(b)(2). However, the seller may not make the election because the election is not necessarily advantageous to the seller as the seller has to forego potential unsecured claim payments. 7 COLLIER, *supra* note 65, ¶ 1111.03[4].

<sup>146</sup> *See supra* text accompanying notes 141–42.

<sup>147</sup> *See, e.g.,* Terrell v. Albaugh (*In re Terrell*), 892 F.2d 469, 471–73 (6th Cir. 1989); O’Brien v. Ravenswood Apartments, Ltd. (*In re Ravenswood Apartments, Ltd.*), 338 B.R. 307, 313 (6th Cir. B.A.P. 2006); *In re Speck*, 50 B.R. 307, 308 (Bankr. D.S.D. 1985), *aff’d*, 798 F.2d 279 (8th Cir. 1986); Shaw v. Dawson (*In re Shaw*), 48 B.R. 857, 861–62 (D.N.M. 1985).

<sup>148</sup> *See, e.g.,* Mitchell v. Streets (*In re Streets & Beard Farm P’ship*), 882 F.2d 233, 234 (7th Cir. 1989); Heartline Farms, Inc. v. Daly, 128 B.R. 246, 249, 253 (D. Neb. 1990), *aff’d*, 934 F.2d 985 (8th Cir. 1991).

<sup>149</sup> *See, e.g., In re Adolphsen*, 38 B.R. 776, 779 (Bankr. D. Minn. 1983); *In re Booth*, 19 B.R. 53, 55–57 (Bankr. D. Utah 1982).

<sup>150</sup> *See* discussion *supra* Part I.A.2.

<sup>151</sup> *See, e.g., In re Streets & Beard Farm*, 882 F.2d at 234; *Heartline Farms*, 128 B.R. at 253.

<sup>152</sup> *Heartline Farms*, 128 B.R. at 253.

installment land contract is immaterial under the Countryman Approach.<sup>153</sup> In states that treat an installment land contract as a security device, courts applied reasoning (1) and avoided making the executory contract inquiry.<sup>154</sup> In the states that recognize equitable conversion or otherwise attribute security device-like characteristics to installment land contracts, the courts applied reasoning (2) and avoided the executory characterization.<sup>155</sup>

Other federal courts have treated installment land contracts as executory contracts under the Code.<sup>156</sup> They have argued that in the absence of a state statute declaring an installment land contract to be a mortgage, the functional similarities between an installment land contract and a purchase money mortgage do not render an installment land contract a mortgage for bankruptcy purposes.<sup>157</sup> These courts have strictly followed the Countryman Approach and reasoned that the purchaser had an unperformed material obligation to pay the installments and the seller had an unperformed material obligation to transfer the title upon full payment of the contract.<sup>158</sup> Since the breach of either obligation would excuse the non-breaching party from performing, the courts have found that installment land contracts are executory for bankruptcy purposes.<sup>159</sup>

A few courts have followed the Functional Approach in analyzing installment land contracts in purchaser bankruptcy.<sup>160</sup> In *In re Booth*, the court ruled that an installment land contract is a mortgage in purchaser bankruptcy even in the absence of state law clearly indicating that an installment land contract is a mortgage.<sup>161</sup> The court questioned the applicability of § 365 to

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<sup>153</sup> *In re Streets & Beard Farm*, 882 F.2d at 235.

<sup>154</sup> *Heartline Farms*, 128 B.R. at 249, 251. The court in *Heartline Farms* also noted that Professor Countryman's rationale is not based on installment land contracts. *Id.* at 249–50.

<sup>155</sup> *In re Streets & Beard Farm*, 882 F.2d at 235.

<sup>156</sup> See, e.g., *Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469, 471–73 (6th Cir. 1989); *O'Brien v. Ravenswood Apartments, Ltd. (In re Ravenswood Apartments, Ltd.)*, 338 B.R. 307, 313 (6th Cir. B.A.P. 2006); *In re Speck*, 50 B.R. 307, 308 (Bankr. D.S.D. 1985), *aff'd*, 798 F.2d 279 (8th Cir. 1986); *Shaw v. Dawson (In re Shaw)*, 48 B.R. 857, 861–62 (D.N.M. 1985).

<sup>157</sup> *In re Ravenswood Apartments*, 338 B.R. at 311–12.

<sup>158</sup> *In re Terrell*, 892 F.2d at 472; *In re Ravenswood Apartments*, 338 B.R. at 315; *In re Speck*, 50 B.R. at 308–09; *In re Shaw*, 48 B.R. at 861.

<sup>159</sup> *Supra* note 158.

<sup>160</sup> See, e.g., *In re Adolphsen*, 38 B.R. 776, 778–79 (Bankr. D. Minn. 1983); *In re Booth*, 19 B.R. 53, 54, 56–57 (Bankr. D. Utah 1982).

<sup>161</sup> *In re Booth*, 19 B.R. at 62. Following the Functional Approach, courts may find that characterizing an installment land contract as an executory contract is beneficial to the estate in seller bankruptcy. *Sipes v. Gen. Dev. Corp.*, 17 B.R. 1000, 1012 (S.D. Fla. 1995), *aff'd sub nom.* *Sipes v. Atl. Gulf Comtys. Corp.*, 84 F.3d 1364 (11th Cir. 1996).

installment land contracts and focused on the benefit to the estate.<sup>162</sup> It found that for the purchaser-debtor in the case, it is beneficial to the estate to characterize the installment land contract as a lien, so as to increase the value of the estate and further the rehabilitation of the bankrupt purchaser.<sup>163</sup>

Another small set of courts have held that installment land contracts cannot be categorically characterized as either executory or non-executory for § 365 purposes.<sup>164</sup> These courts noted that installment land contracts are not always executory or non-executory because the characterization of installment land contracts depends on the facts of the case, the terms of the contract, and the rights and obligations of the parties under state law.<sup>165</sup> The courts narrowly held that only in specific instances the installment land contract is not executory because it is essentially a financing device.<sup>166</sup>

Overall, federal courts have reached three general conclusions regarding installment land contracts based on diverse reasoning. As one commentator noted, the current status of installment land contract jurisprudence in purchaser bankruptcy amounts to fifty different laws providing fifty different sets of rights to the parties since there is no uniform federal treatment.<sup>167</sup>

## II. THE MORTGAGE PRESUMPTION OF INSTALLMENT LAND CONTRACTS IN PURCHASER BANKRUPTCY

### A. *Questioning the Applicability of § 365 to Installment Land Contracts in Purchaser Bankruptcy*

Section 365 is incompatible with installment land contracts in purchaser bankruptcy because installment land contracts embody aspects of both a contract and a security device, which the Code treats distinctly. As explored below, applying § 365 to installment land contracts (1) disrupts the purchaser's property rights relative to other device holders within a state; (2) places unwarranted emphasis on the contract aspect of installment land contracts; and

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<sup>162</sup> *In re Booth*, 19 B.R. at 55, 58–59.

<sup>163</sup> *Id.* at 58–60.

<sup>164</sup> *See, e.g.*, *Kane v. Inhabitants of the Town of Harpswell (In re Kane)*, 248 B.R. 216, 223 (1st Cir. B.A.P. 2000), *aff'd*, 254 F.3d 325 (1st Cir. 2001); *Leefers v. Anderson (In re Leefers)*, 101 B.R. 24, 26–27 (C.D. Ill. 1989).

<sup>165</sup> *In re Kane*, 248 B.R. at 223–24; *In re Leefers*, 101 B.R. at 26–27.

<sup>166</sup> *In re Kane*, 248 B.R. at 223–24. The *In re Leefers* court vacated the bankruptcy court's finding of executory contract and remanded. *In re Leefers*, 101 B.R. at 28.

<sup>167</sup> Westbrook, *supra* note 79, at 321.



(3) results in substantively inconsistent application of bankruptcy law across states.

### 1. *Distortion of the Purchaser's Property Rights*

Comparing how an unexpired lease and an installment land contract are treated under § 365 illustrates the distorting effect of applying the executory contract analysis to an installment land contract. Section 365 expressly applies to an unexpired lease agreement.<sup>168</sup> However, courts do not blindly apply § 365 to unexpired leases. When courts analyze an unexpired lease, courts determine if the lease is a “true lease” and not a sale or disguised security device, even though § 365 does not explicitly limit its applicability to true leases.<sup>169</sup> Although state law determines the parties’ substantive rights, some federal courts have even held that the state true lease analysis may not be wholly binding for bankruptcy purposes in light of the congressional intent underlying § 365.<sup>170</sup> Therefore, courts look into the “economic realities” of the unexpired lease and ask whether the unexpired lease is or functions like a security device before applying § 365 to an unexpired lease.<sup>171</sup>

Consider two possible arrangements for identical property between a titleholder and a possessor. One is termed a lease and the other an installment land contract. They both involve identical monthly payments for an identical period of time. The possessor in each arrangement takes possession of the property immediately. In other words, the structures of the two arrangements are the same, and they only differ by name.

Under this scenario, if the possessor who has a “lease” files for bankruptcy, the possessor may argue that the arrangement was a disguised security device and § 365 is inapplicable.<sup>172</sup> The titleholder/lessor has a secured claim on the

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<sup>168</sup> 11 U.S.C. § 365(a) (2006).

<sup>169</sup> Courts have imported the bona fide lease requirement of § 502(b)(6) into § 365. *See, e.g.,* *Liona Corp. v. PCH Assocs.* (*In re PCH Assocs.*), 804 F.2d 193, 199–200 (2d Cir. 1986); *In re Booth*, 19 B.R. 53, 59 (Bankr. D. Utah 1982); 3 COLLIER, *supra* note 65, ¶ 365.02[3]; MICHAEL T. MADISON, ET AL., 2 LAW OF REAL ESTATE FINANCING, *Effect of Bankruptcy of the Mortgagor-Avoiding Powers-Recharacterization* § 13:20 (2011), available at Westlaw, 2 L. Real Est. Financing § 13:20 (discussing sale-leaseback recharacterization in bankruptcy and its implications).

<sup>170</sup> *See, e.g.,* *Moreggia & Sons, Inc. v. Walsh* (*In re Moreggia & Sons, Inc.*), 852 F.2d 1179, 1182–84 (9th Cir. 1988). *But see* 3 COLLIER, *supra* note 65, ¶ 365.02[3] (state law governs the true lease analysis and the burden of proof is on the party who wants to prove that the lease is not a true lease).

<sup>171</sup> *In re Moreggia & Sons*, 852 F.2d at 1182.

<sup>172</sup> *See supra* text accompanying notes 168–71.

property, and the possessor/lessee may cure the arrearage over time and keep the property.<sup>173</sup>

However, the bankrupt possessor who has an “installment land contract” may not make a similar argument when a court performs the § 365 inquiry following the Countryman Approach.<sup>174</sup> Furthermore, if the court finds mutual, unperformed material obligations, the possessor/purchaser must either burden the estate by assuming the entire contract or lose the property—including any possible equity—by rejecting the contract.<sup>175</sup> The assumption would disturb the possessor/purchaser’s creditors’ rights to the estate, and the rejection would disturb the possessor/purchaser’s state-given property rights.<sup>176</sup> The possessor/purchaser must either pay in full on time or lose the property.<sup>177</sup> Unlike the similarly situated lessee, the purchaser is deprived of the chance to cure and maintain over time, and his property rights become inferior to the lessee’s. In other words, the party who paid purported rents for the property pursuant to a lease may be allowed to keep the property; however, the party who paid purported price installments of the property in expectation of obtaining title may not be allowed to keep the property.

## 2. *Misplaced Emphasis on the Contract Aspect of Installment Land Contracts*

Bankruptcy law treats contracts and security arrangements differently.<sup>178</sup> A contract memorializes the parties’ agreed-upon allocation of risks of non-performance or external circumstances.<sup>179</sup> The mutual material obligation test of the Countryman Approach may be necessary to at least filter out contracts with completely unilateral rights or obligations that the trustee should not

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<sup>173</sup> See discussion *supra* Part I.B.3.

<sup>174</sup> If the state law clearly treats installment land contracts as mortgages or if the court applies the Functional Approach, the scenario illustrated in this hypothetical may not happen or may be ameliorated. See discussion *supra* Part I.C. However, given courts’ widespread adherence to the Countryman Approach and many state laws distinguishing installment land contracts from mortgages, this scenario would likely occur in some jurisdictions as long as § 365 inquiry is available for installment land contracts in purchaser bankruptcy.

<sup>175</sup> See discussion *supra* Part I.B.2.

<sup>176</sup> See *supra* text accompanying notes 55–61; discussion *supra* Part I.B.2.

<sup>177</sup> See discussion *supra* Part I.B.2.

<sup>178</sup> See generally, Julis, *supra* note 3. Some commentators have criticized the distinct treatments of a lease, which is a contract, and a security device in bankruptcy law. See, e.g., John D. Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667, 668 (1983).

<sup>179</sup> See RESTATEMENT (SECOND) OF CONTRACTS §§ 154, 225 (1981).

assume or reject at the time of the debtor's bankruptcy.<sup>180</sup> Indeed, the mutuality threshold can serve as a proxy for the benefit to the estate.<sup>181</sup>

For a security device, however, bankruptcy law focuses on secured status, maturity, filing of claims, and priority.<sup>182</sup> A valid and legal contract may be fully assumed or rejected, but a valid and legal security device may not be fully rejected or assumed because the focus is not on the arrangements between the parties but on the value of the security and the amount of debt.<sup>183</sup>

When analyzing installment land contracts, almost all courts start with some version of executory contract inquiry. Some courts follow the straightforward Countryman Approach.<sup>184</sup> The courts that eventually find an installment land contract to be non-executory reach that conclusion either by picking and choosing multiple factors to find the lack of mutual material obligations or by following state law to rule the contract is a security device if the state law clearly treats an installment land contract as a mortgage.<sup>185</sup> However, that initial inquiry highlights only the contract aspect of an installment land contract and compromises the parties' property rights in the process. When courts are analyzing a mortgage agreement, they do not ask if the mortgage agreement is executory.<sup>186</sup> Indeed, courts have squarely rejected very few attempts by parties who argued that a mortgage agreement is an executory contract for bankruptcy purposes, and § 365 is wholly inapplicable to a mortgage agreement.<sup>187</sup>

Rights embodied in a mortgage, true lease, earnest money contract, and installment land contract in various states lie along a spectrum of mixed property and contractual rights.<sup>188</sup> On the one end of the spectrum, the parties' contractual rights primarily control the parties' relationship—a true lease and earnest money contract are near this end of the spectrum. On the other end of the spectrum, the parties' property rights primarily control the parties' relationship—a mortgage is near this end of the spectrum. An installment land

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<sup>180</sup> See *supra* text accompanying notes 67–78.

<sup>181</sup> Pickerill, *supra* note 77, at 104.

<sup>182</sup> 11 U.S.C. §§ 506, 507 (2006).

<sup>183</sup> See discussion *supra* Parts I.B.2–3.

<sup>184</sup> See discussion *supra* Part I.C.

<sup>185</sup> See discussion *supra* Part I.C.

<sup>186</sup> Even if one asks this question, the Countryman Approach easily yields that a mortgage is not executory for bankruptcy purposes even in title jurisdictions because the purchase money mortgagee holds title only as a security, and it would fail the material breach test.

<sup>187</sup> See, e.g., *In re* N. Am. Dealer Grp., Inc., 16 B.R. 996, 1000 (Bankr. E.D.N.Y. 1982).

<sup>188</sup> See discussion *supra* Part I.A.1.

contract is somewhere in the middle of this spectrum where both contractual and property rights of the parties influence the parties' relationship depending on jurisdiction. This middle ground, however, is nonexistent in bankruptcy law, which treats contracts and secured claims distinctly. Therefore, the installment land contract analysis in purchaser bankruptcy must pick one end of the spectrum, but the default position need not be on the earnest money contract and true lease end of the spectrum where the parties' contractual rights may be more controlling than the parties' property rights.

By starting with the executory contract inquiry, courts already have assumed that an installment land contract is closer to a true lease or an earnest money contract than a mortgage. The first question to ask is not whether there are unperformed mutual and material obligations, whether the assumption or rejection would benefit the estate, or whether the contract is "executory" according to any other test. Rather, the first question should be whether the installment land contract functions like a security device to which § 365 is inapplicable. Even if there seems to be material obligations left on both sides of the installment land contract, once it is determined to be a security device, § 365 should not apply. The purchaser's rights may fall short of a mortgagor's, depending on jurisdiction. Nonetheless, such diminished purchaser rights do not imply that the purchaser's rights have been reduced to something equal to or less than those of a lessee. Perhaps due to the name, an installment land contract has been effectively presumed to be primarily a contract for § 365 purposes, and the burden has been on the party who wanted to characterize it otherwise.

### *3. Substantive Inconsistency of the Installment Land Contract Analysis in Purchaser Bankruptcy*

Federal bankruptcy law does not and should not alter substantive rights in state-governed subject areas such as property law.<sup>189</sup> Bankruptcy law should not disregard state property rights and create federal substantive rights for parties to an installment land contract.<sup>190</sup> However, the application of bankruptcy law to states' property law should be consistent, as bankruptcy law provides a consistent mechanism to distribute assets among creditors with

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<sup>189</sup> *Butner v. U.S.*, 440 U.S. 48, 54–55 (1979).

<sup>190</sup> Westbrook, *supra* note 79, at 317–19.

various interests and sets out boundaries of debt collection.<sup>191</sup> If two states have substantively similar property laws regarding installment land contracts, federal courts should reason and rule similarly in bankruptcy cases arising in each of the states.

Inconsistency often occurs in cases involving installment land contracts because the reasoning for finding or not finding an installment land contract executory can be so malleable.<sup>192</sup> Assessing the state law involves several overlapping factors such as the existence of a state statute on point, state courts' enforcement of forfeiture, existence of notice and grace period requirements, existence of foreclosure requirement, and recognition of equitable title.<sup>193</sup> Since states have some mixture of these factors, a bankruptcy court can focus on certain aspects of the state statute or common law to arrive at the conclusion it desires.

For example, a state may have a statute that allows forfeiture after notice and a grace period for a purchaser who paid a certain percentage of the full price.<sup>194</sup> Once the purchaser pays more than a certain percentage, the seller's only remedy is foreclosure. One rationale may be that the state recognizes and enforces forfeiture, albeit with restrictions. The state law, therefore, does not equate an installment land contract to a mortgage, and the court should apply the executory contract analysis of § 365. However, one may argue that by providing limitations to forfeiture, the state recognizes equitable title. Therefore, following that argument, the court may find that an installment land contract should be a mortgage under bankruptcy law.

The cases involving Ohio and Illinois statutes on installment land contracts demonstrate the duality of understanding state statute and common law and the resulting inconsistent bankruptcy law. The Ohio and Illinois statutes provide substantively similar remedies for purchasers: both states allow forfeiture only

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<sup>191</sup> See Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987). But see Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) (arguing for a federal distribution system that disturbs state or nonbankruptcy law as little as possible and against special bankruptcy rules). The discussion of the fundamental purpose of federal bankruptcy law with respect to state law is beyond the scope of this Comment. Regardless of what the fundamental purpose of federal bankruptcy law is, the consistency sought in federal bankruptcy law is not consistent result across the nation, but the consistent application of federal bankruptcy law to state substantive laws. See *Butner*, 440 U.S. at 54–55.

<sup>192</sup> At least one commentator argues that executory contract analysis in general is too malleable. Westbrook, *supra* note 79, at 287.

<sup>193</sup> See *supra* text accompanying notes 55–61.

<sup>194</sup> See *infra* text accompanying notes 195–201.

where the purchaser has not paid a certain percentage of the purchase price.<sup>195</sup> However, the common laws of Illinois and Ohio have developed differently.<sup>196</sup> The Seventh Circuit in *In re Streets & Beard Farm* found that under Illinois law the purchaser became an equitable owner and delivery of title was a mere formality.<sup>197</sup> Therefore, the Seventh Circuit found that the installment land contract was not an executory contract but a security device.<sup>198</sup> On the other hand, in *In re Ravenswood Apartments*, the Sixth Circuit Bankruptcy Appellate Panel applied Ohio law and emphasized the seller's retention of legal title and noted that the restriction on the seller's remedies should not characterize the contract as a mortgage.<sup>199</sup> The court rejected the idea that the resemblance between an installment land contract and a mortgage should determine the executory nature of the installment land contract.<sup>200</sup> The Sixth Circuit Bankruptcy Appellate Panel found that the conveyance of title was a material obligation under the Countryman Approach and concluded that the installment land contract was executory.<sup>201</sup>

From these examples, one can see that the state laws that seem to provide a similar scope of rights often are interpreted differently and result in the lack of

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<sup>195</sup> The *Restatement (Third) of Property* summarizes the Illinois statute as follows:

A vendor must foreclose a contract for deed entered into after November 23, 1987, as a mortgage if the property is residential, the contract period is greater than five years and the amount due under the contract is less than 80 percent of the contract price. As to other contracts, forfeiture is available after notice through a "Forcible Entry and Detainer" proceeding.

RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4 (1997) (summarizing 735 ILL. COMP. STAT. 5/15-1106, 5/9-102). The *Restatement* also summarizes the Ohio statute as follows:

Contracts for deed on "property improved by a dwelling" are categorized in two ways: those that have been in effect less than five years and on which less than 20 percent of the principal amount has been paid; and those which have been in effect five years or more or on which 20 percent or more has been paid. In the former situation, forfeiture is authorized, but subject to a 30-day grace period during which purchaser may avoid forfeiture by payment of arrearages. In the latter setting, the contract must be foreclosed as a mortgage.

*Id.* (summarizing OHIO REV. CODE §§ 5313.01–5313.10).

<sup>196</sup> Compare *Mitchell v. Streets (In re Streets & Beard Farm P'ship)*, 882 F.2d 233, 235 (7th Cir. 1989) (citing *Shay v. Penrose*, 185 N.E.2d 218 (Ill. 1962)), with *O'Brien v. Ravenswood Apartments, Ltd. (In re Ravenswood Apartments, Ltd.)*, 338 B.R. 307, 312–13 (6th Cir. B.A.P. 2006) (citing *Coggshal v. Marine Bank Co.*, 57 N.E. 1086, 1088 (Ohio 1900)).

<sup>197</sup> *In re Streets & Beard Farm*, 882 F.2d at 235 (citing *Shay v. Penrose*, 185 N.E.2d 218 (Ill. 1962)).

<sup>198</sup> *Id.*

<sup>199</sup> *In re Ravenswood Apartments*, 338 B.R. at 311–13 (citing *Coggshal*, 57 N.E. at 1088).

<sup>200</sup> *Id.*, 338 B.R. at 311–13 (citing *Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469 (6th Cir. 1989) (applying Michigan law)).

<sup>201</sup> *In re Ravenswood Apartments*, 338 B.R. at 314–16.

consistency in the application of federal bankruptcy law to state substantive laws. The differences in various state installment land contract laws are a matter of degree of the extent to which state laws focus on the contractual or property aspect of installment land contracts.<sup>202</sup> Even if Illinois gives purchasers a little more rights than does Ohio, that small difference should not be the determining factor of the applicability of § 365. Moreover, ruling one way or another in purchaser bankruptcy for § 365 purposes brings drastically disparate consequences to the parties to the installment land contract, which suggest that a malleable § 365 analysis is not appropriate.<sup>203</sup> The inconsistency issue is most pronounced when courts follow the Countryman Approach, and the Functional Approach would likely provide more consistent results regarding installment land contracts in purchaser bankruptcy.<sup>204</sup> However, courts have not adopted the Functional Approach as the sole test for the applicability of § 365, and many courts still adhere to the Countryman Approach.<sup>205</sup>

### *B. The Mortgage Presumption in Purchaser Bankruptcy*

Although applying § 365 is often incompatible with installment land contracts in purchaser bankruptcy, categorically denying the application of § 365 to installment land contracts would judicially abolish the utility of some installment land contract arrangements. A rebuttable mortgage presumption would preserve the utility of installment land contracts and avoid the uncomfortable feeling of ignoring the word “executory.” The presumption would have the benefit of allowing courts to consistently analyze installment land contracts while still retaining the flexibility to characterize them as executory contracts in certain cases.

Although some commentators argue for the demise of installment land contracts, state laws have not abolished installment land contracts.<sup>206</sup> State legislatures or courts may reduce or even remove the distinction between an installment land contract and a mortgage in the future. However, until then, installment land contracts currently remain a viable alternative to mortgages, even in jurisdictions that do not favor installment land contracts, and

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<sup>202</sup> See discussion *supra* Part I.A.2.

<sup>203</sup> See discussion *supra* Part I.B.2–3.

<sup>204</sup> See generally Westbrook, *supra* note 79.

<sup>205</sup> 3 COLLIER, *supra* note 65, ¶ 365.02[2][a].

<sup>206</sup> See NELSON & WHITMAN, *supra* note 8, § 3.38; see also RESTATEMENT (THIRD) OF PROP. (MORTGAGES) § 3.4 (1997).

bankruptcy courts should find the best way to address them. The mortgage presumption will produce a pro-purchaser result in installment land contracts in purchaser bankruptcy. Considering the functional role of an installment land contract as a mortgage alternative, such a pro-purchaser result is desirable.<sup>207</sup>

The best resolution for the current uncertainty in installment land contract jurisprudence would be for Congress to enact specific provisions addressing the rights of the parties to an installment land contract.<sup>208</sup> Congress could adopt a provision granting more explicit rights to purchasers while keeping the treatment of installment land contracts equitable for the sellers in purchaser bankruptcy.<sup>209</sup> In the meantime, courts should address installment land contracts and the rights of the parties in a consistent manner.

### *1. The Function of Installment Land Contracts*

One of the most important policies underlying bankruptcy law is the choice of substance over form through courts' use of equitable power.<sup>210</sup> Courts should look into the function of an installment land contract just as when courts perform the true lease analysis in bankruptcy<sup>211</sup> to determine if applying the § 365 analysis is appropriate for the contract.

If a court rightly first asks whether an installment land contract functions like a security device, the answer will be yes for the majority of cases in which installment land contracts resemble mortgages. Even in the cases where the courts found the installment land contract was executory, the courts have noted that the installment land contract did function like a security device.<sup>212</sup> The courts just prioritized applying the material breach test over relying on the functionality of the installment land contract.<sup>213</sup> Therefore, the most straightforward reason for the mortgage presumption is that an installment land

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<sup>207</sup> 15 POWELL, *supra* note 7, § 84D.01[1].

<sup>208</sup> Westbrook, *supra* note 79, at 321.

<sup>209</sup> For example, Congress can adopt purchaser remedies similar to what is provided in § 365(i) and (j), where the purchaser can only keep the property if the purchaser is in possession. 11 U.S.C. § 365(i), (j) (2006). Also, similar to some state laws, Congress may distinguish between commercial and residential properties or limit purchaser protections to purchasers who have paid substantial payments. *See supra* note 129.

<sup>210</sup> *In re Booth*, 19 B.R. 53, 58 (Bankr. D. Utah 1982) (noting that a bankruptcy court should choose substance over form as a court of equity).

<sup>211</sup> *See supra* text accompanying notes 169–71.

<sup>212</sup> *O'Brien v. Ravenswood Apartments, Ltd. (In re Ravenswood Apartments, Ltd.)*, 338 B.R. 307, 315 (6th Cir. B.A.P. 2006) (citing *Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469, 472 (6th Cir.1989)).

<sup>213</sup> *Id.* (citing *In re Terrell*, 892 F.2d at 472).



contract functions like a mortgage in terms of the financial arrangement of the parties and the purchaser's control and possession of the property.

## 2. *Lack of Benefit to the Estate in the Executory Contract Characterization*

Generally, § 365 rejection can be a powerful tool for the trustee to pick and choose favorable contracts.<sup>214</sup> Because § 365 rejection can be so powerful, some scholars focus on the abuse of § 365 rejection as a pseudo avoidance power and its inequitable results for non-debtors.<sup>215</sup> The effect of applying § 365 to a contract depends on what the debtor would like to do. If the debtor wants to breach the contract, applying § 365 is better for the debtor since the non-debtor's remedy is generally limited to damages for a rejection under § 365.<sup>216</sup> If the debtor wants to keep the contract, not applying § 365 is better for the debtor because the non-debtor's priority status will not be elevated to administrative status.<sup>217</sup> Often, the estate benefits little by assuming a contract under § 365 because it can be overly burdensome to the estate.<sup>218</sup> The most utility comes from the power to reject unfavorable contracts using § 365.<sup>219</sup>

However, § 365 rejection is not a good tool for an installment land contract purchaser for several reasons. First, § 365 rejection may not allow the purchaser to capture any equity unless state foreclosure law applies to the defaulted installment land contract. If no state law protection exists, the only way to capture any equity is to assume the contract and burden the estate with administrative costs to the unsecured creditors' detriment. Second, even when the contract price exceeds the fair market value of the property, assumption may be better for the estate—depending on the past payments, the extent to which the contract price exceeds the fair market value, and the enforcement of the contract terms in the jurisdiction. Third, since the purchaser's obligations are usually only pecuniary, the exclusion of specific performance in § 365 rejection is not useful for the purchaser in bankruptcy. Thus, characterizing an

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<sup>214</sup> See, e.g., *In re Taylor*, 103 B.R. 511, 516–17 (D.N.J. 1989) (rejection of personal services contract); *In re Trans World Airlines, Inc.*, 261 B.R. 103, 117–18 (Bankr. D. Del. 2001) (“[T]he ability to reject an executory contract is rooted in . . . maximizing the return . . . by permitting the debtor in possession to renounce title to and abandon burdensome property.”).

<sup>215</sup> See, e.g., Andrew, *supra* note 79, at 901–31; Westbrook, *supra* note 80, at 470–72; Westbrook, *supra* note 79, at 309–10.

<sup>216</sup> See 11 U.S.C. § 365(g) (2006); discussion *supra* Part I.B.2.

<sup>217</sup> See 3 COLLIER, *supra* note 65, ¶ 365.03[2]; see discussion *supra* Section I.B.2.

<sup>218</sup> Andrew, *supra* note 79, at 890.

<sup>219</sup> *Supra* note 214.

installment land contract as an executory contract favors the assumption of the contract while the rejection confers little benefit to the estate.

The executory contract inquiry is appropriate for contracts in general because the benefit of the § 365 rejection power makes up for the possibility of having to assume some contracts. Depending on contractual arrangements and facts of the case, some debtor parties may benefit from § 365 rejection, and others may have to burden the estate through § 365 assumption. Overall, the impact of § 365 on debtors in general is net positive or at least net neutral. However, as mentioned above, there is little benefit from applying § 365 to an installment land contract in purchaser bankruptcy because of its nature. Section 365 does not provide a potential upside (i.e., the typical benefits from § 365 rejection) for a typical installment land contract purchaser in bankruptcy, while it puts the bankrupt purchaser in a difficult position. Therefore, applying § 365 to an installment land contract in purchaser bankruptcy when there is a substantively sound rationale to treat the contract as a secured claim would be wholly burdensome to the purchaser. The mortgage presumption would allow the parties to reliably predict their rights and relieve the purchaser-debtor from the burden of proving that an installment land contract is not an executory contract.

### 3. *State Substantive Law Providing the Maximum Limit to the Non-Debtor-Sellers' Rights*

State substantive law should prescribe the maximum rights the non-debtor party has in bankruptcy because the non-debtor party should not enjoy a windfall from the debtor's bankruptcy.<sup>220</sup> Inequitable treatment of purchasers under state law need not result in inequitable application of bankruptcy law.<sup>221</sup> There is one commonality among the various states' installment land contract jurisprudence: installment land contract sellers have rights greater than or equal to the rights of purchase money mortgagees.<sup>222</sup> For the rehabilitation or fresh start of the insolvent debtor, it is inevitable that some state-given rights of the non-debtors would be diminished.<sup>223</sup> By treating installment land contracts as mortgages in purchaser bankruptcy, the seller's rights would be somewhat

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<sup>220</sup> See Westbrook, *supra* note 79, at 249.

<sup>221</sup> Countryman, *supra* note 68, at 473 (noting that the vender-purchaser inequity is not resulting from the bankruptcy law, but the inequitable state law, which may be overcome by the bankruptcy court's equitable power).

<sup>222</sup> See discussion *supra* Part I.A.1.

<sup>223</sup> See Westbrook, *supra* note 79, at 249–52.

diminished. By limiting the seller's rights in the purchaser's bankruptcy, the purchaser incidentally enjoys more rights than he would have outside of bankruptcy because of the complementary nature of the rights and obligations of the sellers and purchasers. However, such result is inevitable because it is the purchaser's bankruptcy after all, and the typical condition of the purchaser to be in bankruptcy is that the purchaser cannot fulfill its obligations or is otherwise distressed.

Pro-seller laws of certain states need not translate to enhanced seller rights in purchaser bankruptcy. State substantive laws may generally grant more rights and protections for installment land contract sellers than mortgagees.<sup>224</sup> However, states do not and cannot grant special protections to non-debtor-sellers—as compared to non-debtor-mortgagees—under federal bankruptcy law.<sup>225</sup> States' property and contract laws may allow for a middle ground between a lease and a mortgage and let sellers enjoy the enhanced status under state law.<sup>226</sup> However, where there is no middle ground between a contract and a mortgage as in purchaser bankruptcy, states cannot extend this enhanced status to sellers.

Treating an installment land contract as an executory contract is problematic because the executory contract treatment favors the assumption of the contract.<sup>227</sup> If an installment land contract is treated as an executory contract under the Code, and that contract is assumed, the seller may enjoy more rights than guaranteed by some state's law.<sup>228</sup> In some instances, the seller may even enjoy more rights than the purported lessor of a lease that is a disguised security device.<sup>229</sup> On the other hand, treating an installment land contract as a mortgage may reduce the seller's state-given rights. However, the seller cannot claim unjust treatment when he is equated to a mortgagee in purchaser bankruptcy, because under state law, he is not entitled to immunity from purchaser bankruptcy or administrative priority status under § 507.<sup>230</sup>

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<sup>224</sup> 15 POWELL, *supra* note 7, § 84D.01[2]; Juliet M. Moringiello, *A Mortgage by Any Other Name: A Plea for the Uniform Treatment of Installment Land Contracts and Mortgages Under the Bankruptcy Code*, 100 DICK. L. REV. 733 (1996).

<sup>225</sup> See U.S. CONST. art. VI, § 2 (the Supremacy Clause).

<sup>226</sup> See *supra* text accompanying notes 38–51.

<sup>227</sup> See discussion *supra* Part II.B.2.

<sup>228</sup> Once the trustee decides to assume the installment land contract, the estate has to pay the full contract payment on time. See 3 COLLIER, *supra* note 65, ¶ 365.03[3]. Outside of bankruptcy, depending on the state's law, the seller may not get full on-time performance if the purchaser defaults on the contract.

<sup>229</sup> See discussion *supra* Part II.A.1.

<sup>230</sup> See 3 COLLIER, *supra* note 65, ¶ 365.LH[1].

Therefore, the seller may enter an installment land contract with the sense of receiving better protection under state law, but such protection need not be recognized under federal bankruptcy law. The non-debtor seller should not assume to enjoy something more than mortgagees in mortgagor bankruptcy because the additional rights the seller may have under state law is only the maximum—not the guarantee—of the rights a non-debtor may get in bankruptcy.

#### 4. *Compatibility with the Provisions in § 365(i) and (j) in Seller Bankruptcy*

There are practical and legal differences between purchaser bankruptcy and seller bankruptcy, and the mortgage presumption would not frustrate the understanding of § 365(i) and (j). The Bankruptcy Act of 1938 treated installment land contracts as executory contracts in seller bankruptcy, and a series of cases allowed the bankrupt sellers to reject the contract.<sup>231</sup> Such inequitable results have prompted active discussions regarding purchaser's rights in seller bankruptcy,<sup>232</sup> and Congress responded by adding § 365(i) and (j) into the Code.<sup>233</sup> Despite the seller's rejection under § 365, the purchaser's possession is protected under those provisions and the purchaser will receive credit for the past payments. However, § 365 does not specifically address the case of purchaser bankruptcy.<sup>234</sup>

If an installment land contract is treated as a mortgage in purchaser bankruptcy, the purchaser would enjoy protections provided to mortgagors under state law, while the seller would not be entitled to forfeiture or liquidated

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<sup>231</sup> See, e.g., *In re* N.Y. Investors Mut. Grp., 143 F. Supp. 51 (S.D.N.Y. 1956).

<sup>232</sup> See generally Lacy, *supra* note 1; Grant S. Nelson & Dale A. Whitman, *The Installment Land Contract—A National Viewpoint*, 1977 BYU L. REV. 541.

<sup>233</sup> 11 U.S.C. § 365(i), (j) (2006).

<sup>234</sup> Some courts have argued that the existence of § 365(i) and (j) should be viewed as congressional acknowledgement that installment land contracts are executory under the Code. *Shaw v. Dawson* (*In re* Shaw), 48 B.R. 857, 860 (Bankr. D.N.M. 1985). *But see In re Booth*, 19 B.R. 53, 62–63 (Bankr. D. Utah 1982). However, that inference fails to acknowledge the language, legislative history, and policy behind § 365. Section 365(i) provides for the purchaser in possession “[i]f the trustee rejects an *executory contract* . . . for the sale of real property.” 11 U.S.C. § 365(i) (emphasis added). By specifying “executory contract,” the language suggests not all sales of real property involve an executory contract. See *In re Booth*, 19 B.R. at 62 n.19. Moreover, Congress's intent was to correct the inequity in *In re New York Investors*, where the bankrupt seller rejected the land sale contract. *Heartline Farms, Inc. v. Daly*, 128 B.R. 246, 251 (Bankr. D. Neb. 1990), *aff'd*, 934 F.2d 985 (8th Cir. 1991); see also *supra* note 129 (describing *In re New York Investors*). To infer that Congress intended all installment land contracts to be treated as executory is reading too much into this provision regarding seller bankruptcy.

damages.<sup>235</sup> However, in seller bankruptcy, the seller has more rights than a mortgagee because it can reject the contract if the purchaser is not in possession.<sup>236</sup> In addition, if the title is encumbered at the time of bankruptcy, the purchaser-in-possession takes the risk of receiving the imperfect title if he decides to complete the installment land contract payments.<sup>237</sup>

Therefore, treating an installment land contract as a mortgage in purchaser bankruptcy may result in apparently inconsistent rights between the parties to an installment land contract. This apparent inconsistency, however, does not present a problem. The seller-debtor only enjoys enhanced rights over a mortgagee-creditor because the seller is in bankruptcy.<sup>238</sup> That the seller-debtor enjoys certain rights in its own bankruptcy does not mean that those same rights should be given to the seller-creditor if the purchaser files bankruptcy. Bankruptcy inherently affords the debtor extra rights and protections. Although bankruptcy should not disturb the state-given substantive rights,<sup>239</sup> if some disturbance is necessary or inevitable, courts should direct any resulting leniency or advantage to the debtor—and in turn, the estate—not a creditor.<sup>240</sup>

Another way to look at the provisions of § 365(i) and (j) is to note that they protect the purchaser of the installment land contract even though he is not the one in bankruptcy and not the subject of the bankruptcy protection. Some courts have interpreted § 365(i) and (j)'s purpose as providing protection to the nonbankrupt purchasers-in-possession, not categorically defining installment land contracts as executory contracts.<sup>241</sup> Indirectly, these provisions show the incompatibility of § 365 and installment land contracts. The fact that Congress provided protections even for non-debtor-purchasers evidences Congress's acknowledgement of the uniquely vulnerable purchaser rights that are subject to analysis under § 365 and in bankruptcy in general.

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<sup>235</sup> 11 U.S.C. § 506; *see also* 4 COLLIER, *supra* note 65, ¶ 506.01.

<sup>236</sup> 11 U.S.C. § 365(i).

<sup>237</sup> The damages to the non-debtor-purchaser can only be offset up to the amount of future payments due under the contract.

<sup>238</sup> *See In re Booth*, 19 B.R. at 62 n.19.

<sup>239</sup> *See Butner v. U.S.*, 440 U.S. 48, 54–55 (1979).

<sup>240</sup> Although § 365(i) and (j) of the Code recognizes the hybrid nature of installment land contracts, this recognition should not be interpreted to the detriment of the bankrupt purchaser when the statute is silent on purchaser bankruptcy. *See supra* text accompanying note 212.

<sup>241</sup> *In re Booth*, 19 B.R. at 56.

### III. POSSIBLE REBUTTAL OF THE MORTGAGE PRESUMPTION

Practically speaking, the mortgage presumption would capture most installment land contract arrangements. However, there can be exceptions. Several state statutes and § 365(i) and (j) provide useful guidance as to when it may be appropriate not to treat an installment land contract as a mortgage. There can be several factors in equity that may rebut the mortgage presumption. For example, if the bankrupt purchaser is not in possession of the property under an installment land contract, the purchaser-debtor may not have sufficient grounds to assert treatment as a mortgage based on equity.

If the presumption is rebutted, although a rebuttal is unlikely in many cases, a court can determine whether the installment land contract is executory according to the executory contract jurisprudence.<sup>242</sup> Rebutting the mortgage presumption would require a highly fact-specific determination based on two considerations: functionality and equity.

#### A. *Functionality Considerations*

The mortgage presumption could be rebutted if the installment land contract does not function as a mortgage at all or the parties' intent against creating a mortgage is clear and express. One of the reasons for the mortgage presumption is that an installment land contract often functionally resembles a seller-financed purchase money mortgage.<sup>243</sup> Because an installment land contract is more analogous to a mortgage than a lease, analyzing an installment land contract should begin from the mortgage end of the spectrum rather than the lease or earnest money contract end.<sup>244</sup> However, if an installment land contract lacks the characteristic functions of a purchase money mortgage, the relative rights of the seller or purchaser may not be similar to a mortgagee or mortgagor, respectively.

There are several factors that may suggest the mortgage presumption of an installment land contract should be rebutted. Some factors may show the installment land contract functions not as a mortgage but as a different device. For example, the purchaser's failure to exercise ownership of the premises or a

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<sup>242</sup> See discussion *supra* Part I.B.2. The general executory contract jurisprudence encompasses a variety of contracts and not just installment land contracts. The analysis of the executory contract jurisprudence with respect to which approach to adopt, Countryman or Functional, is outside the scope of this Comment.

<sup>243</sup> 15 POWELL, *supra* note 7, § 84D.01[2].

<sup>244</sup> See discussion *supra* Part II.A.2.

balloon payment at the end of the contract term may suggest the installment land contract is more akin to a lease or a lease-and-purchase. On the other hand, a substantially short payment term, one or two years as opposed to twenty years, may suggest that the installment land contract functions as an earnest money contract.<sup>245</sup> A lack of immediate possession may suggest the contract does not function as a security device.

Other factors may also suggest that the parties intended the installment land contract to be a strict contractual arrangement. The instrument itself may indicate the parties' intent. For instance, the installment land contract may include the parties' obligation to construct buildings or deliver goods and services not typical of a mortgage arrangement.<sup>246</sup> Or, perhaps the contract reflects detailed negotiations between sophisticated parties whose intent is clearly reflected in the document and should be honored. In those cases, the clear intent of the parties would strengthen the argument for treating the installment land contracts as executory contracts and making the bankrupt purchaser assume or reject the contract as is.

### *B. Equity Considerations*

In certain cases, it may be inequitable for the seller to treat the installment land contract as a mortgage. For example, if the purchaser paid only the first few installments and willfully defaulted to try to take advantage of the mortgage presumption of bankruptcy law in bad faith, it may be equitable to rebut the mortgage presumption and apply § 365. The mortgage treatment would be especially inequitable if the seller has been a party in good faith. Unencumbered title and fair installment land contract price may indicate the seller's genuine and good faith in entering the deal.<sup>247</sup>

Sometimes it may be equitable for the bankrupt purchaser to consider the installment land contract as executory. Although this possibility is not likely, the purchaser may show that it is more beneficial to the estate if the installment land contract is treated as an executory contract. Perhaps the fair market value of the property has risen, and assuming the contract may result in benefit to the estate that somehow outweighs the burden of the contract's elevated

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<sup>245</sup> *Id.*

<sup>246</sup> *See, e.g., Sipes v. Atl. Gulf Cmty. (In re Gen. Dev. Corp.)* 84 F.3d 1364 (11th Cir. 1996) (seller bankruptcy).

<sup>247</sup> Due to the financial risk the seller takes, property under an installment land contract may be overpriced.

administrative status. In such case, a court can exercise its discretion to find that the mortgage presumption is rebutted.

In sum, although there should be a strong presumption that an installment land contract is a mortgage in purchaser bankruptcy, courts, using their equitable powers, may decide that the presumption has been rebutted. A rebuttal would be appropriate if the installment land contract does not function like a mortgage at all, the mortgage presumption would be highly inequitable for the seller, or the executory contract characterization would greatly benefit the purchaser's bankruptcy estate.

### CONCLUSION

An installment land contract by its nature is a hybrid instrument embodying unclear state-given contractual and property rights. In addressing installment land contracts in purchaser bankruptcy, courts have asked whether installment land contracts are executory contracts under § 365.<sup>248</sup> To determine whether § 365 applies to installment land contracts, courts have consulted state property laws in conjunction with the executory contract inquiry—either the Countryman Approach (the material breach test) or the Functional Approach (the benefit to the estate). However, the “executory contract” inquiry has resulted in distortion of the parties' property rights and inconsistent applications of bankruptcy law by courts, and has illustrated the lack of utility of § 365 for installment land contract purchasers. Therefore, instead of applying § 365, courts should presume that an installment land contract in purchaser bankruptcy is a mortgage. The presumption may be rebutted when the installment land contract does not function as a mortgage or when it is inequitable to characterize the installment land contract as a mortgage.

The best way to resolve the ambiguities in installment land contract jurisprudence would be for Congress to directly address installment land contracts in purchaser bankruptcy in the Code. Some commentators argue that installment land contracts should be abolished since they have few independent

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<sup>248</sup> Terrell v. Albaugh (*In re Terrell*), 892 F.2d 469 (6th Cir.1989) (finding the contract executory); Mitchell v. Streets (*In re Streets & Beard Farm P'ship*), 882 F.2d 233 (7th Cir. 1989) (finding the contract not executory); O'Brien v. Ravenswood Apartments, Ltd. (*In re Ravenswood Apartments, Ltd.*), 338 B.R. 307 (6th Cir. B.A.P. 2006) (finding the contract executory); Heartline Farms, Inc. v. Daly, 128 B.R. 246 (Bankr. D. Neb. 1990) (finding the contract not executory), *aff'd*, 934 F.2d 985 (8th Cir. 1991); *In re Speck*, 50 B.R. 307 (Bankr. D.S.D. 1985) (finding the contract executory), *aff'd*, 798 F.2d 279 (8th Cir. 1986); Shaw v. Dawson (*In re Shaw*), 48 B.R. 857 (D.N.M. 1985) (finding the contract executory).



merits.<sup>249</sup> However, without clear congressional action or changes in state property laws regarding installment land contracts, courts and practitioners are left with the current state of the law. The rebuttable mortgage presumption would not offend state property laws and would provide clarity and consistency in analyzing installment land contracts in purchaser bankruptcy.

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<sup>249</sup> See discussion *supra* Part I.A.

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