

So Ordered.

Dated: March 24th, 2017



Frederick P. Corbit

Frederick P. Corbit
Bankruptcy Judge

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WASHINGTON

In re:

TERELL W. EUSTLER,¹

Debtor.

Case No. 15-00870-FPC13

NOT FOR PUBLICATION

MEMORANDUM DECISION

INTRODUCTION

Parties-in-interest, Brady F. Carruth and William Leslie Doggett (collectively, the “Complaining Shareholders”) filed a motion for relief from the automatic stay to exercise their rights through the Stock Restriction/Buy-Sell Agreement (“Agreement”) to purchase debtor Terell W. Eutsler’s shares in a jointly held software company called Softbase Development, Inc. [ECF No. 48]. Debtor objected. [ECF No. 51]. On January 24, 2017, the court held a preliminary hearing. [ECF Nos. 62 & 63]. At the conclusion of the hearing, the court set a final hearing and requested additional briefing on two issues: (1) whether the Agreement between

¹ The correct spelling of debtor’s last name is Eutsler.

1 the parties constituted an executory contract; and (2) when the Complaining
2 Shareholders first received notice of Mr. Eutsler's Chapter 13 bankruptcy. At the
3 final hearing, the court heard argument of Andrew W. Zeve, attorney for the
4 Complaining Shareholders, Anastasia L. Karson, attorney for the debtor, Melissa
5 Williams, attorney for the Chapter 13 Trustee, and creditor/attorney Julie C. Watts.
6 The court has jurisdiction over this proceeding pursuant to 28 U.S.C. § 1334. The
7 court has reviewed the evidence and testimony presented and the matter is ready for
8 decision.²

9 FACTUAL BACKGROUND

10 Terell Eutsler, Stephen J. Dorr, and the two Complaining Shareholders are the
11 sole shareholders in Softbase Development, Inc., a Texas corporation which was
12 formed on June 5, 1995. [ECF No. 48, Ex. 1]. The corporation's primary business is
13 the creation, sale and service of enterprise software for industrial equipment dealers.
14 [ECF No. 48]. Shareholders, Mr. Eutsler and Mr. Dorr, are also employees of the
15 corporation and involved in the corporation's day-to-day operations. The
16 Complaining Shareholders on the other hand, are not employees of the corporation
17 and do not take an active role in the management of the company. [ECF Nos. 71 &
18 72]. Indeed, the only evidence presented of the Complaining Shareholders'

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20 ² Unless otherwise indicated, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

1 involvement was their request in June of 2016 (about 20 years after the company
2 was formed) to examine the company's books and records to assess the financial
3 condition of the company. [ECF No. 70].

4 The Agreement at issue sets forth various "terminating" events, including a
5 shareholder filing bankruptcy. [See ECF No. 48, Ex. 6; Articles I-III]. Once a
6 terminating event occurs, it triggers an option allowing the corporation or the
7 remaining shareholders to purchase the terminated shareholder's stocks.³ *See id.* The
8 option must be exercised within a thirty-day window or it expires. *See id.*

9 Mr. Eutsler filed for bankruptcy on March 12, 2015. [ECF No. 1].

10 Accordingly, the Complaining Shareholders argue that they have the right to
11 exercise their purchase option of Mr. Eutsler's stock pursuant to the terms of the
12 Agreement. Mr. Eutsler argues that his bankruptcy should not, as a matter of law,
13 trigger the option and that even if the Complaining Shareholders did have an option
14 to buy his shares that option expired because the Complaining Shareholders did not
15 exercise their option within thirty days of learning about his bankruptcy. [ECF No.
16 61]. The Complaining Shareholders disagree, arguing that the thirty-day window to
17 exercise the option has not expired because, although Mr. Eutsler filed for
18 bankruptcy in March of 2015, they did not learn of the bankruptcy filing until
19 November 18, 2016. [ECF No. 48]. The parties do not dispute that shareholder

20 ³ See Stock Restriction/Buy-Sell Agreement dated September 23, 1998 [ECF No. 48, Ex. 6].

1 Mr. Dorr, who also serves as the corporation's treasurer, knew about Mr. Eutsler's
2 bankruptcy filing as early as March 19, 2015, when the Chapter 13 Trustee issued a
3 wage directive to the corporation. [ECF No. 70].

4 The Complaining Shareholders now seek relief from the automatic to proceed
5 with exercising their option rights under the Agreement. In the alternative, the
6 Complaining Shareholders argue that Mr. Eutsler's stock is not property of the estate
7 and therefore, not subject to the automatic stay. Mr. Eutsler argues that his stock is
8 not an executory contract, it is merely an asset of the estate and necessary for his
9 reorganization

10 DISCUSSION

11 **I. The Agreement is not an executory contract.**

12 A chapter 13 plan may provide for the assumption or rejection of any
13 executory contract of the debtor not previously rejected under section 365 of title 11.
14 11 U.S.C. § 1322(b)(7). Whether a contract is executory within the meaning of the
15 Bankruptcy Code is a question of federal law. *See Benevides v. Alexander (In re*
16 *Alexander)*, 670 F.2d 885, 888 (9th Cir. 1982). Additionally, whether a contract is
17 executory is “a factual question to be determined by the bankruptcy court.” *In re*
18 *Robert L. Helms Constr. & Dev. Co., Inc.*, 139 F.3d 702, 705 n.13 (9th Cir. 1998).
19 Although the Code does not define “executory contract,” the Ninth Circuit and most
20 other courts have adopted the “Countryman” definition. According to Professor

1 Countryman, an executory contract is a contract under which the obligation of both
2 the bankrupt and the other party to the contract are so far unperformed that the
3 failure of either to complete performance would constitute a material breach
4 excusing the performance of the other. *Pacific Express, Inc. v. Teknekron Infoswitch*
5 *Corp. (In re Pacific Exp., Inc.)*, 780 F.2d 1482, 1487 (9th Cir. 1986). The Ninth
6 Circuit has further clarified that a contract will only be determined to be executory
7 if, on the date of filing the bankruptcy petition, there exist obligations of both parties
8 that are so far unperformed that the failure of either party to complete performance
9 would constitute a *material breach* and thus excuse the performance of the other.
10 *See id.*

11 Thus, even if the court agrees with the Complaining Shareholders' premise;
12 that there are continuing obligations of both parties, the court must then determine
13 whether a party's failure to comply with those obligations would constitute a
14 material breach. To determine this, the court must look to state law to determine the
15 significance of the remaining obligations, as state law controls with regard to
16 property rights in assets of a debtor's estate. *See Hall v. Perry (In re Cochise*
17 *College Park, Inc.)*, 703 F.2d 1339, 1348 n.4 (9th Cir. 1983) (explaining the
18 question of the legal consequence of one party's failure to perform its remaining
19 obligations under a contract and whether one of the parties' failure to perform its
20 remaining obligations would give rise to a material breach is an issue of state

1 contract law). In this case, the Agreement in question was signed and executed in
2 Texas. Therefore, this court will look to Texas state law to determine whether any
3 remaining obligations rise to the level such that a failure to perform any of those
4 obligations would give rise to a material breach.⁴

5 Texas courts follow the framework outlined in the Restatement of Contracts to
6 determine whether a breach is material.⁵ *Mustang Pipeline Co., Inc. v. Driver*
7 *Pipeline Co.*, 134 S.W.3d 195, 199 (Tex. 2004). Generally however, under Texas
8 law a breach of contract is material if it is so substantial as to defeat the purpose of
9 the transaction or so severe as to justify the other party's suspension of performance.
10 *Id.*

11 The Complaining Shareholders argue that the Agreement contains several
12 ongoing obligations and that those obligations are sufficient to render the Agreement
13 executory. Therefore, a court must, as this court has done here, conduct a factual
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15 ⁴ The court notes that neither party cited Texas law to support whether the alleged obligations rise
to the level such that a failure to perform would give rise to a material breach.

16 ⁵ In determining whether a breach of contract is material, the following factors are significant:
17 (1) the extent to which the injured party will be deprived of the benefit which he reasonably
18 expected; (2) the extent to which the injured party can be adequately compensated for the breach;
19 (3) the extent to which the party failing to perform will suffer forfeiture; (4) the likelihood that the
breaching party will cure its breach, taking into account all of the circumstances including any
reasonable assurances; and (5) the extent to which the behavior of the breaching party comports
with standards of good faith and fair dealing. *Hernandez*, 875 S.W.2d at 693 n.2 (Tex. 1994)
20 (citing Restatement (Second) of Contracts § 241 (Am. Law Inst. 1981)). “The less the non-
breaching party is deprived of the expected benefit, the less material the breach.” *Hernandez*, 875
S.W.2d at 693. Whether a breach is material is a question of fact. *Hudson v. Wakefield*, 645
S.W.2d 427, 430 (Tex. 1983).

1 inquiry to determine whether, on the date the petition was filed, *see Collingwood*
2 *Grain, Inc. v. Coast Trading Co., Inc. (In re Coast Trading Co.)*, 744 F.2d 686, 692
3 (9th Cir. 1984), either party's failure to perform its remaining obligations would give
4 rise to a material breach and excuse performance. *In re Wegner*, 839 F.2d 533, 536
5 (9th Cir. 1988). If either "party has substantially performed its side of the bargain,
6 such that the party's failure to perform further would not constitute a material breach
7 excusing performance by the other party, [then] a contract is not executory." *In re*
8 *Munple, Ltd.*, 868 F.2d 1129, 1130 (9th Cir. 1989) (internal quotation marks and
9 citation omitted).

10 Specifically, the Complaining Shareholders argued the following on-going
11 mutual obligations and negative covenants are sufficient to render the Agreement
12 executory: the right of first refusal as to selling shares; obligation to give written
13 notice of involuntary assignment; anti-competition clause; non-disparagement
14 clause; and covenant against encumbrances. The court disagrees. The court notes
15 that the case law on this issue is far from clear or consistent. Although the briefing
16 by the attorney for the Complaining Shareholders was well-written and his oral
17 argument clear and cogent, the court finds that restrictive covenants, such as non-
18 compete, confidentiality, and non-interference, are not sufficiently material to render
19 the Agreement executory under the Countryman test. *See In re Robert L. Helms*
20 *Constr.*, 139 F.3d 702 (en banc panel concluded that if an option was not in the

1 process of being exercised at the time of the bankruptcy, it was not an executory
2 contract).⁶

3 Contrary to the Complaining Shareholders assertions, the mere fact that the
4 Agreement contains several negative covenants does not persuade this court that the
5 Agreement is executory for purposes of 11 U.S.C. § 365. Rather, based on the facts
6 presented, the court concludes that the remaining obligations on the part of the
7 debtor to comply with the restrictive covenants do not rise to the requisite level of
8 materiality necessary for the Agreement to be considered executory. Indeed, there
9 was no evidence presented that the debtor's breach of one of these covenants would
10 be deemed a material breach of the Agreement thus relieving the remaining
11 shareholders of their obligations. Rather than being a material breach excusing
12 future performance, the court finds that a failure to comply with one of the negative
13 covenants might entitle the remaining shareholders, at most, to injunctive relief or an

14 ⁶ See also *In re Munple*, 868 F.2d at 1130-31 (finding commission agreements are executory even
15 though may contain a provision conditioning payment on closing the sale); *Employees Retirement*
16 *System of Hawaii v. Osborne (In re THC Financial Corp.)*, 686 F.2d 799, 804 (9th Cir. 1982)
17 (indemnification obligation did not render the agreement not executory); *In re Alexander*, 670 F.2d
18 885 (mortgage agreement not executory); *Shults & Tamm v. Brown (In re Hawaiian Telecom*
19 *Communs., Inc.)*, 2012 WL 273614 (Bankr. D. Haw. Jan. 30, 2012) (collecting cases and
20 concluding that the “majority of cases examining non-competition and non-solicitation obligations
hold that these provisions are not sufficiently material under the Countryman test.”); *In re Bergt*,
241 B.R. 17 (Bankr. D. Alaska 1999) (a right of first refusal possessed by another owner of lots in
a subdivision was not an executory contract, and therefore could not be rejected, where no sale of
the property was pending at the time the bankruptcy petition was filed); *In re Spectrum Info.*
Technologies, 190 B.R. 741, 749-50 (Bankr. E.D. N.Y. 1996) (non-debtor employees’ duties of
non-competition, confidentiality, public statement and non-interference insufficient); see *contra In*
re III Enterprises, Inc. V, 163 B.R. 453 (Bankr. E.D. Pa. 1994) (collecting cases and concluding
that most courts applying the Countryman definition find option contracts to be executory).

1 award of damages. *See Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 571 (Tex.
2 1981); *Zachry Const. Corp. v. Port of Houston Auth. of Harris Cty.*, 449 S.W.3d 98
3 (Tex. 2014).

4 At the hearing, it was stated that the Complaining Shareholders want to
5 purchase Mr. Eutsler's stock in order to have more control of the company. This is
6 despite evidence, that since the beginning of the company, the Controlling
7 Shareholders have not taken any type of active role in managing or controlling the
8 company. Evidence was not presented indicating that Mr. Eutsler is failing to
9 perform. Indeed, counsel for the Complaining Shareholders repeatedly stated that the
10 debtor is the only one who writes the software and knows how to run it and that the
11 company continues to need him. Thus, from the evidence presented, it appears that
12 the Complaining Shareholders are getting the benefit of the bargain. *See Hernandez*
13 *v. Gulf Group Lloyds*, 875 S.W.2d 691, 693 (Tex. 1994) (explaining that “[i]n
14 determining the materiality of a breach, courts...consider...the extent to which the
15 nonbreaching party will be deprived of the benefit that it could have reasonably
16 anticipated from full performance”). Such evidence weighs against finding a failure
17 to comply with one of the negative covenants, a material breach.

18 Therefore, this court finds that the Agreement was not an executory contract
19 within the meaning of section 365 of the Bankruptcy Code on the date the
20 bankruptcy was filed. Consequently, 11 U.S.C. § 365 is inapplicable in this case.

1 **II. The Agreement is subject to the automatic stay.**

2 The court finds that regardless of when the Complaining Shareholders found
3 out about the debtor’s bankruptcy, they are not entitled to enforce the stock purchase
4 provision because the triggering/terminating event was the debtor’s filing of
5 bankruptcy. The Bankruptcy Code protects debtors from such ipso facto provisions.
6 *See* Bankruptcy Code §§ 365(e)(1) and 541(c)(1)(B). Ipso facto provisions are those
7 provisions that allow the discretionary or automatic termination of the debtor’s
8 contract and property rights merely because the debtor filed a bankruptcy petition or
9 becomes insolvent.⁷ *See In re Cole*, 226 B.R. 647 (B.A.P. 9th Cir. 1998). Because
10 ipso facto clauses are unenforceable as to Mr. Eutsler’s economic interests in the
11 company, any provision that requires the transfer of such economic interests is
12 unenforceable. The court is also concerned that Mr. Eutsler’s employment may be in
13 jeopardy if he was forced to sell his interest in the company. Mr. Eutsler
14 employment income is necessary to make his Chapter 13 Plan payments.

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17 ⁷ Bankruptcy Code § 541, in addition to describing what constitutes property of the bankruptcy
18 estate, also invalidates ipso facto clauses, providing that a debtor's interest “in property becomes
19 property of the estate...notwithstanding any provision in an agreement, transfer instrument, or
20 applicable nonbankruptcy law...that is conditioned on...the commencement of a case under this
title...and that effects or gives an option to effect a forfeiture, modification, or termination of the
debtor's interest in property.” 11 U.S.C. § 541(c)(1)(B). Additionally Black’ Law Dictionary
describes an ipso facto clause as a contractual or other provision that results in a loss of property
rights or the elimination or limitation of obligations that existed prior to the commencement of a
bankruptcy which loss, elimination or limitation occurs by reason of the debtor’s bankruptcy (or a
debtor’s insolvency or financial condition or the appointment for a debtor of a custodian-triggers
not relevant to the motions). *See* Black's Law Dictionary 834 (7th ed. 1999).

1 Therefore, this court will enter an order denying the Complaining
2 Shareholders' motion for relief from the automatic stay.

3 ///END OF MEMORANDUM DECISION///
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