UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW MEXICO

In re:
Patriot Aviation Services, Inc.

No. 11-98-16029 SR

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND MEMORANDUM OPINION IN SUPPORT OF ORDER DENYING DEBTOR'S MOTION TO ASSUME CONTRACT WITH KIWI INTERNATIONAL HOLDINGS, INC. AND ORDERING REJECTION OF CONTRACT

This matter presents the question of when the Court may override the Debtor's business judgment concerning an executory contract by ordering the rejection of that contract despite the Debtor's motion to assume it, even when the Debtor is not in default under the terms of the contract at the time it moves to assume the contract.

On October 29 and 30, 1998, two matters came before the Court for final hearing: Motion by Debtor to Assume Contract with Kiwi International Holdings, Inc., ("Kiwi") and a Motion to Compel Debtor in Possession to Reject Contract with Kiwi[1]. At the conclusion of the hearing the Court orally ruled that the Motion to Assume was denied, and the Motion to Compel Rejection was granted. The Court memorialized this ruling by Order entered November 20, 1998. These Findings of Fact and

[1] The Court earlier treated this motion as a motion to fix deadline for assumption or rejection of the contract under 11 U.S.C. Section 365(d)(2). After hearing on the motion the Court fixed a deadline and debtor responded with this Motion to Assume.

Conclusions of Law and Memorandum Opinion is being entered pursuant to Federal Bankruptcy Rule 9052 in support of that Order.

I. Parties, Subject Matter of Contract, and Brief Summary of Events Leading up to the Motions.

Patriot Aviation Services, Inc. (“Debtor”) is an FAA approved airplane service center located at the Roswell Industrial Airport in Roswell, New Mexico. Direct Jet, Inc., ("Direct Jet") a Virginia corporation, has an irrevocable proxy to vote all of the issued and outstanding stock of Debtor, and is in possession of all the stock which is endorsed in blank. Mr. Fred Olsen, President of Direct Jet, is also the Acting President of the Debtor. Direct Jet became involved with Debtor sometime during the summer of 1998. In September 1998, Debtor called a Board of Directors meeting and started formulating a business plan, during which time the Board also authorized Fred Olsen to file a Chapter 11 proceeding.

Kiwi is a commercial passenger airline that operates 727 aircraft. Kiwi entered into contract number GTA-98006 with Debtor on October 1, 1998 (but under its terms effective September 29, 1998) to service aircraft number N360PA (the “Contract”) to comply with FAA regulations and provide routine maintenance.

Pursuant to the Contract, the work was to be completed by November 3, 1998. The terms called for $125,000 down upon delivery of the aircraft, then $70,000 per week by wire transfer during the next five weeks, with the final balance due (subject to adjustments for extra work or labor or late delivery) upon redelivery of the aircraft.

On October 1, 1998, Kiwi wire transferred $125,000 to Direct Jet and delivered the aircraft. On the evening of October 1, 1998, Debtor found itself evicted from its business premises at the airport by its landlord, the City of Roswell.[2] On October 6 or 7, 1998, Debtor reentered the business premises. Shortly upon regaining the premises Debtor received a letter from Kiwi instructing Debtor to perform no work under the Contract. Debtor complied with the letter. Kiwi made no further payments under the Contract.

Kiwi then filed its motion to compel rejection of the Contract. Initially Debtor stipulated to rejection, and the parties submitted a proposed order granting rejection. The Court, sua sponte conducted a hearing on this settlement,

[2] Debtor filed its voluntary Chapter 11 petition on October 5, 1998 simultaneously with an Adversary Proceeding against the City of Roswell to regain possession. After expedited hearings, the City was ordered to allow reentry. See Patriot Aviation Services, Inc. v. City of Roswell, Adversary 98-1229 S (Bankr. D. N.M. October 6, 1998).

after notice to the United States Trustee[3], and refused to enter the order for two reasons: 1) During the hearing Debtor changed its mind on rejecting the Contract, thinking that if Kiwi were ordered to resume payments it might be able to complete the work, and in any event 2) the parties failed to establish that the settlement was in the best interests of the estate. Debtor then filed its Motion to Assume, and the Court conducted a hearing on an expedited basis.

II. Progress of the Hearing and Oral Ruling.

At the hearing on October 29, 1998, Mr. Fred Olsen, Acting President of Debtor, testified on behalf of the Debtor. Kiwi called Mr. George Mehm of Mehm Co. Consulting, Inc., who appeared as a representative of Kiwi. Mr. Mehm's background includes an MBA in finance and extensive experience in the airline industry and in bankruptcy issues relating to airline reorganizations. Kiwi also called "Jim" Jameson, Jr., the President of Southwest Aero Technologies, Inc. ("SWAT"). Coincidentally SWAT is also in a Chapter 11 reorganization in this District and is also located at the Roswell Airport. SWAT is engaged in substantially the same business as debtor. Finally, Kiwi called Mr. Mark McKenna, the former Manager of

[3] The Debtor had not yet filed its statements or schedules. No committee had been formed. Notice of the settlement had not been provided to creditors.

Planning and Production Control of Debtor, who is now an employee of SWAT.

Upon Kiwi's request, the Court held a supplemental evidentiary hearing on the morning of October 30, at which Olsen testified regarding matters that had not been discovered by Kiwi until late in the afternoon on October 29. This testimony related to Debtor losing, or voluntarily relinquishing, its FAA certification to work on 727 aircraft. The Court took closing argument on the afternoon of October 30 and then ruled orally that the contract could not be assumed, and ordered its rejection.

III. Relevant Law.

Bankruptcy Code Section 365(a) provides that the Trustee[4], subject to Court approval, may assume or reject any executory contract or unexpired lease of the debtor. 11 U.S.C. § 365(a). Court approval is required. In re: Child World, Inc., 147 B.R. 847, 852 (Bankr. S.D. N.Y. 1992) and cases cited therein. See also J. Westbrook, "National Bankruptcy Review Commission: The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts," 5 Am. Bankr. Inst. L. Rev. 463, 467 (Until adoption of the 1978 Code, the trustee's

[4] A debtor in possession has the rights and duties of a Trustee. See 11 U.S.C. § 1107(a).

decision that the estate perform or breach a bankruptcy contract did not require review or approval by the bankruptcy court.) In order to obtain this approval, the Trustee must demonstrate whether the assumption or rejection of a contract would confer a net benefit on the estate. In re: Riodizio, Inc., 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997). If a contract is assumed, any subsequent breach may entitle the other party to the contract to administrative priority treatment for damages suffered as a result of the breach. N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 531-32, 104 S.Ct. 1188, 1199 (1984); In re: El Paso Refinery, L.P., 220 B.R. 37, 41 (Bankr. W.D. Tex. 1998); In re: Spencer, 139 B.R. 562, 564 (Bankr. M.D. Fla. 1992); Westbrook, "Commission's Recommendations" 5 Am. Bankr. Inst. L. Rev. at 465-66; See also 11 U.S.C. § 365(g)(2)(A), § 503(b)(1)(A) and § 507(a)(1). On the other hand, if a contract is rejected, the contract is deemed breached pre-petition, and the other party to the contract is allowed an unsecured claim for its damages. 11 U.S.C. § 365(g) and § 502(g). See generally El Paso Refinery, 220 B.R. at 40.

The often expressed standard for review of a decision to assume or reject is the "business judgment rule." See, e.g., N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 104 S.Ct.

1188, 1190 (1984). However, as 7 Collier on Bankruptcy, ¶1108.07[2] (Lawrence P. King ed., 15th ed. rev. 1998)("Collier") notes, the business judgment rule in bankruptcy is different from the business judgment rule as developed under state law. In the latter cases, the business judgment rule is typically invoked after the fact when a management decision has already been put into effect. Id. The Courts do not concern themselves with the outcome of the decision; rather, they review the process by which the decision was made. In the bankruptcy context, however, the business judgment rule is invoked before the fact when the trustee seeks approval for a transaction. Id. The Bankruptcy Courts are then properly concerned with both how the decision was made and the probable outcome on the chapter 11 process. Id. Citing In re Public Service Co. of New Hampshire, 90 B.R. 575, 581 (Bankr. D. N.H. 1988). Therefore,

> [A] bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine a contract and the surrounding circumstances and apply its best "business judgment" to determine if it would be beneficial or burdensome to the estate to assume it...[T]he process of deciding a motion to assume is one of the bankruptcy court placing itself in the position of the trustee ... and determining whether assuming the contract would be a good business decision or a bad one.

Orion Pictures Corp. v. Showtime Networks, Inc. (In re: Orion Pictures Corp.), 4 F.3d 1095, 1098 (2nd Cir. 1983) cert. dismissed, 114 S.Ct. 1418. (citations omitted). See also Matter of Tilco, 558 F.2d 1369, 1372 (10th Cir. 1977)("The Court, not the Trustee, must apply the 'business judgment' test.")(decided under former law).

Once a decision to assume is made, and approved, the Court must then determine if any of the cure, compensation or adequate assurance requirements of Bankruptcy Code Section 365(b)(1) must be met. From a literal reading of 11 U.S.C. § 365(b)(1), if there has been no default that section does not apply. Accord In re: Commonwealth Mortgage Company, Inc., 149 B.R. 4, 8 at n. 24. In other words, if a contract is not in default, the only hurdle for the Trustee is the business judgment test. If a contract is in the best interests of the estate, the Trustee may assume it.

On the other hand, if there has been a default, the Trustee must at the time of assumption,

> (A) cure[s], or provides adequate assurance that the trustee will promptly cure, such default;
> (B) compensate[s], or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
> (C) provide[s] adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1). In that case the Trustee would have two hurdles, the business judgment test and proof of cure and adequate assurance of future performance.

IV Findings of Fact.

Based on the testimony of the parties, and a review of the documents admitted into evidence, the Court finds as follows:

1) Fred Olsen, the Acting President of Debtor, is the President of Direct Jet, Inc., a Virginia Corporation.

2) Direct Jet has an irrevocable proxy to vote all shares of Debtor and is in possession of all shares of Debtor, which are endorsed in blank.

3) Direct Jet became involved with Debtor during the summer of 1998. At that time Debtor had suffered a loss of approximately $4 million and could not make its payroll or rent payments.

4) Direct Jet brought substantial new business into Debtor.

5) Sometime before mid-September Debtor sent letters to creditors, attempting to work out a payment arrangement with all creditors to avoid bankruptcy. Several secured creditors refused to go along with the proposal.

6) In mid-September, Debtor had a board of directors meeting and authorized Olsen to file a chapter 11 proceeding if necessary.

7) Debtor entered a contract with Kiwi on October 1, 1998, which by its language was effective September 29, 1998. The Contract provides that Debtor will service aircraft number N360PA (Model B727-230, Serial Number 20676), completing the work by November 3, 1998. Kiwi will pay $464,000 plus additional payments for parts and additional work, subject to its approval of submitted invoices. Kiwi was allowed to have inspectors on the premises during the work.

8) Debtor needed to be FAA certified to enter into and to perform this contract.

9) Kiwi wire transferred $125,000 to Direct Jet on October 1, 1998. The Contract also called for weekly payments of $70,000 for five weeks to cash flow the project. The final Contract payment was to occur upon return of the aircraft. Direct Jet paid at least some of the funds to Debtor. No documentary evidence was put in evidence to show that the entire amount was paid. Testimony referred to a $60,000 payment, and to another $26,000 payment. Other testimony said that all funds were paid over.

10) On the evening of October 1, 1998, Debtor was locked out of its premises by its landlord the City of Roswell.

11) Debtor reentered the premises on October 6 or 7, 1998.

12) Kiwi sent Debtor a “cease and desist” request directing that Debtor perform no more work on the aircraft pending receipt and review by Kiwi of certain information that it demanded upon hearing of the Chapter 11 filing.

13) There is conflicting testimony whether any work had been done on the aircraft as of the receipt of the letter. Olsen testified that before October 5 inspections were made and an engine was removed. Later, he testified that as of October 6, because of the eviction, no work had been done.

14) Debtor complied with the “cease and desist” request.

15) Kiwi made no further payments, leaving $338,000 unpaid on the Contract.

16) The Contract provides that Debtor would pay $3,500 per day

for each day delivery is delayed after November 3, 1998.[5] The hearing on the Motion to Assume Contract ended on October 30, 1998.

17) The Contract did not provide that payments under the Contract be held in trust. Debtor spent all or most of the $125,000 on rent, wages, and other items. Nothing in the Contract precluded the Debtor from spending the funds as it did.[6] 18) Nothing in the Contract required the Debtor to provide the additional information and assurances demanded by Kiwi following the filing of the Chapter 11 petition.[7] Kiwi made the demands for the information (financial statements, business plans, etc.) only after it learned of the Chapter 11

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[5] Both sides argued over whether the $3,500 penalty would come into play given the fact that Kiwi had requested Debtor to stop working on the Contract. The Court believes that there is a legitimate issue here, but does not need to decide it because there was insufficient evidence to determine benefit to the estate either with or without this penalty.

[6] Mr. Mehm testified that it was permissible to spend funds on operating expenses such as utilities, payroll and rent. Since apparently Kiwi felt so vehemently that this spending constituted a default under the Contract, it is surprising that there is nothing in the Contract which supports that view, especially in light of the fact that after the Debtor had provided the first draft of the Contract to Kiwi, Kiwi had the owner of the aircraft, outside counsel and Mr. Mehm all review and make changes to the Debtor's initial draft. (For this reason, the Court will not construe any ambiguities in the Contract against the Debtor.)

[7] In any event, the Debtor seems to have provided most of the requested information.

filing. Kiwi explained its demands as simply seeking the assurances that it was entitled to under Section 365 of the Code.[8] While the information sought by Kiwi would have arguably been quite relevant to the decision about whether to enter the Contract to begin with, the only applicable sections of the Code which explicitly require the Debtor to provide such assurances in connection with a typical executory contract such as this are Section 365(b)(1), applicable when the Debtor is in default of the contract at the time of moving to assume it, and Section 365(f)(2), when the Debtor seeks to assign an assumed contract.

19) As of the hearing date Debtor claimed to have "about $15,000 to $20,000" in the bank. No documentary evidence was presented to support this claim. As of the hearing date, the only assets of Direct Jet were the stock in the Debtor (to the extent holding endorsed blank stock is an asset) and "maybe 50 to 100 thousand" in its bank accounts. No documentary evidence was provided to support either of these claims.

20) On October 1, 1998, Debtor had between 75 and 80 employees. During October Debtor terminated many employees,

[8] Mr. Mehm testified that the filing of the bankruptcy petition constituted a breach of the Contract, justifying the demands for the additional information. Kiwi apparently was unaware of the provisions of 11 U.S.C. 365(b)(2)(B).

including several that were key to maintaining FAA certification. As of the hearing, Debtor had 30 to 35 employees.

21) Before Debtor filed its chapter 11, it had entered into a "Memorandum of Understanding" with SWAT to "combine" with SWAT. This combination would share personnel and tools necessary to perform FAA certifiable work on 727 aircraft. Olsen testified that he believed the SWAT agreement was still in place. He also testified that it would be "fair to say" that the SWAT agreement was necessary to complete the Contract.

22) The only pro-forma, financial statement or budget presented to the Court by Debtor was Exhibit 16. This pro-forma was predicated on the SWAT agreement.

23) Olsen testified that there was another financial statement and pro-forma showing income he "guessed" was 400 to 500 thousand over the next month from a contract with Mesa Airlines and from other sources. He had not prepared this pro-forma. It was prepared by John Funkhauser, the Financial Officer of either Direct Jet or Debtor (the testimony was vague on this issue). Mr. Funkhauser did not testify, nor was the pro-forma offered into evidence.

24) The Mesa Airline Contract is a “general terms and conditions” contract. Under its terms, Mesa can, at its option, provide aircraft to the debtor for servicing. There is no minimum level of business required by the Mesa contract.

25) As of the hearing date, no SWAT employees were working for the Debtor. Olsen did not know if any of SWAT’s tools were on Debtor’s premises. McKenna testified that certain tools are essential for 727 maintenance, and that as of October 5 (his last date of employment) Debtor did not possess these required tools.

26) Debtor failed to present any evidence on what profit would result from the Contract. It also failed to predict a delivery date of the Kiwi aircraft, or to predict the impact of the $3,500 per day penalty. The only evidence presented was debtor’s unsupported and self-serving testimony that a $70,000 per week cash flow would benefit the estate. Debtor, however, presented no evidence of what costs would be necessarily associated with that cash flow. The Court cannot find that a profit could be earned.

27) Olsen testified that the profit margin on the Contract was “slim.” “Slim” was not defined by the parties. If “slim” is less than $125,000 on this $464,000 contract, and given that the first $125,000 was received and expended on non-

contract items, the only logical conclusion is that performance of the contract would result in a loss to the estate, and probably a negative cash flow overall. It also raises the question of whether the Debtor could complete the job if the contract were assumed.

28) Debtor failed to provide any credible evidence of other existing or reasonably certain pending contracts that could bring in extra cash to help cash flow the Kiwi contract work.

29) Jameson, the President of SWAT, testified that the Memorandum of Understanding was no longer in effect; it had been canceled; that performance under the memorandum might endanger its FAA certification due to co-mingling of assets and personnel; and that there would be “no circumstances” under which SWAT would work with Debtor at this time. Furthermore, no motion had ever been filed in its Chapter 11 case to enter into this Memorandum of Understanding.

30) Debtor has not filed a motion in its case to approve the Memorandum of Understanding with SWAT.

31) As of the date of the hearing Debtor had not filed its Schedules or Statement of Financial Affairs or Initial Report.

32) As of the date of the hearing Debtor had not filed any motions regarding debtor-in-possession financing nor did it introduce any credible evidence related to negotiations about

financing or documents related to proposed financing (particularly the $2.5 million “RDA” loan mentioned in testimony.)

33) Kiwi presented testimony that it needed the aircraft back before the holiday season. Kiwi pays $95,000 per month rent on this aircraft. Kiwi could lose as much as $33,000 per day in revenues if the plane is not timely returned.

34) Kiwi argued (and the debtor disputed) that it would be entitled to consequential damages in addition to the $3,500 per day late delivery penalty called for by the Contract.[9]

35) At the supplemental evidentiary hearing on October 30, Olsen testified that on October 28 debtor’s agents met with officials from the FAA to notify it that Debtor lacked proper and adequate equipment to service 727 aircraft. Consequently, Debtor had decided to voluntarily relinquish its certification to service model 727 aircraft. It decided to do this because it would be easier to get certification restored, and that certification could be restored if it could prove it had the proper personnel and tooling within 30 days.[10]

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[9] This claim is not before the Court, and the Court specifically makes no ruling on this argument. However, it should be noted that the contract contains what appears to be a liquidated damage provision.

[10] The Court is particularly disturbed that this highly relevant fact was not disclosed to the Court during the full day of testimony on October 29th. If the Debtor were aware that performance of the

36) Debtor failed to show that it could have proper tools on hand within 30 days. Debtor's only testimony regarding tools related to either 1) the SWAT deal, or 2) undocumented testimony regarding a possible lease of tools from a company in Austin, Texas that could possibly be shipped to Roswell.

37) Debtor failed to show that it would have the certification necessary to work on the contract.

V. Conclusions of Law.

1) The expenditure by the Debtor of substantial portions of the $125,000.00 on past due rent, wages, and similar items, and the refusal to provide the information demanded by Kiwi post petition (which information was not required of the Debtor pursuant to the Contract), did not constitute defaults under the Contract. Kiwi failed to demonstrate that the

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contract was about to become improbable, if not impossible, it had a fiduciary duty to its creditors to refrain from committing itself on the contract. See, e.g. Westbrook, "Commission's Recommendations" 5 Am. Bankr. Inst. L. Rev. at 467 ("A decision to perform a contract that turns out to be a bad bargain may divert the remaining assets to the counterparty, leaving nothing for the creditors, or may generate a heavy weight of administration costs sinking a reorganization.") While the Court acknowledges that Debtor's agents may have had a good faith belief that the certification could be restored, the entire facts should have been disclosed at the original hearing and dealt with there, rather than at an emergency supplemental hearing requested by the objecting party. This lack of full disclosure casts serious doubts on the overall credibility of the Debtor's case and justifies an override of the Debtor's business judgment.

Debtor was in default under any provision of the Contract at the time the Debtor sought to assume the Contract. It therefore did not need to address the provisions of 11 U.S.C. Section 365(b)(1).

2) The Debtor has failed to prove that assumption of the Contract would provide a net benefit the estate.

3) The Debtor has failed to prove that it would profit from assumption of the Contract.

4) It would be uneconomical for the Debtor to complete the Contract according to its terms.

5) Assumption of the contract would likely result in a large administrative claim against the estate.

6) Rejection of the contract may likely result, at worst, in a pre-petition claim against the estate of only $125,000.[11]

7) Debtor has failed to prove that it could perform the Contract, because of its lack of personnel, lack of tools, and, at this stage, lack of FAA certification. The Debtor will be unable to perform the Contract in light of the fact that it will shortly lose its Federal Aviation Regulation 145

[11] By making this conclusion, the Court is not ruling on whether the "cease and desist" instruction from Kiwi, which the Debtor voluntarily complied with, prevented the Debtor from being able to complete the work on the aircraft reasonably timely. Nor is it ruling on whether the Debtor might have other claims against Kiwi, so as to reduce or eliminate any administrative or other claims by Kiwi.

certification (a requirement for work on this aircraft), although at the time of the hearing the Debtor had not lost that certification. Even if the Debtor is able to recover the certification shortly, as it asserts, it has not shown that assuming the Contract and attempting to perform would not result in a substantial increase in post petition administrative priority debt with no significant prospect for paying that debt.

8) Assumption of the Contract should be denied.

9) Rejection of the Contract should be ordered.

10) Because the Court finds that the Contract should be rejected, it need not reach the issue of whether the Contract was breached either pre- or post-petition, or whether any of the promises of cure or adequate assurances of future performance offered were satisfactory or necessary.

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James S. Starzynski
United States Bankruptcy Judge

I hereby certify that, on the date file stamped above, a true and correct copy of the foregoing was either electronically transmitted, faxed, mailed, or delivered to the R. Trey Arvizu, William Arland, and the United States Trustee.

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