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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN RE:	)	CASE NO. 01-51117
	)	
REPUBLIC TECHNOLOGIES INTERNATIONAL, LLC,	)	CHAPTER 11
	)	
	)	JUDGE MARILYN SHEA-STONUM
DEBTOR(S)	)	

MEMORANDUM OPINION RE: MOTION OF REPUBLIC TECHNOLOGIES INTERNATIONAL, LLC TO REJECT CONTRACT WITH INDUSTRIAL RAILWAY SWITCHING & SERVICES, INC. PURSUANT TO 11 U.S.C. §365(C) AND ORDER SCHEDULING FURTHER STATUS CONFERENCE

This matter comes before the Court on the "Motion for Republic Technologies International, LLC for an Order Approving the Rejection of an 'In-Plant Rail Transportation Services Agreement'" **[docket #351]**, "Industrial Railway Switching & Services, Inc.'s Opposition to Debtor's Requested Rejection of the 'In-Plant Rail Transportation Services Agreement'" **[docket #392]** and the "Response of Debtor . . . to Industrial Railway Switching & Services, Inc.'s Opposition to Debtor's Requested Rejection of the 'In-Plant Rail Transportation Services Agreement'" **[docket #424]**. Counsel represented to the Court that an evidentiary hearing was not necessary and that this matter could be decided upon the pleadings and oral argument. After oral argument, the parties were given time in which to file additional memoranda in support of their respective positions. Those memoranda were timely

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filed **[docket #693 and docket #694]** and the matter was then taken under advisement.

This proceeding arises in a case referred to this Court by the Standing Order of Reference entered in this District on July 16, 1984. It is determined to be a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A) and (O) over which this Court has jurisdiction pursuant to 28 U.S.C. §§1334(b), 157(a) and 157(b). The following constitutes this Court's findings of fact and conclusions of law.

BACKGROUND

In August 1998, USS/Kobe Steel Company ("USS/Kobe") and Industrial Railway Switching & Services, Inc. ("IRSS") entered into an "In-Plant Rail Transportation Services Agreement" (the "Initial Agreement"). Pursuant to the Initial Agreement, IRSS was to provide rail transportation services, equipment repairs, equipment rental and other miscellaneous services to USS/Kobe. *See* Initial Agreement at pgs. 2-3 (attached to RTI's Motion [docket #351] as Exhibit A). Sometime in the year 2000, Republic Technologies International, LLC ("RTI") and IRSS entered into an amendment to the Initial Agreement (the "Amendment"). *See* Amendment (attached to RTI's Motion [docket #351] as Exhibit B).[1]

[1] The copy of the Amendment attached to RTI's motion to reject the Agreement was neither dated nor signed. In its response to RTI's motion, IRSS seems to raise this as an issue. *See* IRSS's Opposition Response [docket #392] at pg. 1, footnote 1 ("[p]ursuant to a purported, but unattached, Amendment to the Agreement, Debtor alleges to have become the successor-in-interest to USS/Kobe under the Agreement"). However, at the beginning of the oral argument on this matter, counsel for both parties stipulated that the Initial Agreement and the Amendment (as attached to RTI's Motion [docket #351]) were valid and enforceable agreements between RTI and

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Pursuant to the Amendment, RTI (as successor in interest to USS/Kobe) was substituted as a party to the Initial Agreement, the term of the Initial Agreement was extended and certain payment amounts and terms of the Initial Agreement were modified. (The Initial Agreement and the Amendment shall hereinafter be referred to collectively as the "Agreement"). In the Agreement, the term "Owner" is defined as USS/Kobe Steel Company and its successors, nominees and assigns and the term "Contractor" is defined as IRSS, together with its employees, agents and representatives. *See* Initial Agreement at pgs. 1-2 (attached to RTI's Motion [docket #351] as Exhibit A).

On April 2, 2001, RTI and several subsidiaries commenced their reorganization cases by filing voluntary petitions for relief under chapter 11 of the Bankruptcy Code. RTI and its filing subsidiaries are continuing in possession of their property and are operating and managing their businesses, as debtors in possession, pursuant to §§1107 and 1108 of the Bankruptcy Code.

Pursuant to the operation and management of its business, RTI filed a motion seeking authority to reject the Agreement pursuant to §365 of the Bankruptcy Code. Through that motion, RTI contends that the Agreement is an executory contract, the retention of which would be burdensome to its bankruptcy estate:

IRSS.

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> In exercising its business judgment, the Debtor has weighed the costs and benefits of assuming the Agreement and continuing its relationship with IRSS against the costs and benefits of rejecting the Agreement and finding an alternative provider of rail services. The Debtor has determined that it can obtain the same services form [sic] a related entity – its subsidiary, [Nimishillen and Tuscarawas] – at a substantially lower price. Moreover, replacing IRSS with Nimishillen and Tuscarawas will eliminate the significant costs of curing any defaults under the Agreement.

See RTI's Motion [docket #351] at pg. 3, ¶7. Through its opposition to RTI's motion, IRSS does not dispute RTI's business judgment as to rejection of the Agreement. What IRSS does dispute is the characterization of the Agreement as an executory contract that can be rejected pursuant to §365 of the Bankruptcy Code. However, as discussed more fully below, exactly how IRSS would characterize the Agreement is not entirely clear.

DISCUSSION

Through their pleadings and during oral argument, the parties focused primarily on whether or not the Agreement should be characterized as an "executory" contract for services which could be rejected by RTI pursuant to §365 of the Bankruptcy Code. However, in its pleadings and also during oral argument, IRSS also contended that the Agreement could be characterized as a financing arrangement between the parties:

> While the Agreement was terminable at will by USS/Kobe, IRSSI and USS/Kobe negotiated very stringent termination fees in order to protect IRSSI's investment in its construction of the facility should USS/Kobe terminate the Agreement. In large part, the Agreement could be considered a financing agreement setting forth the terms by which IRSSI agreed to finance the construction of the railway yard facility.

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See IRSS's Opposition to RTI's Motion [docket #392] at pg. 2.[2] Because the characterization of the Agreement will prescribe the parties' rights in this bankruptcy proceeding, both of the potential characterizations that were raised in the pleadings and during oral argument must be addressed.

THE AGREEMENT AS AN EXECUTORY CONTRACT

Section 365(a) of the Bankruptcy Code sets forth that a debtor in possession, subject to court approval, may assume or reject any executory contract. The term "executory contract" is not, however, defined in the Bankruptcy Code. In *Sloan v. Hicks (In re Becknell & Crace Coal Co., Inc.)*, 761 F.2d 319 (6th Cir. 1985), the Sixth Circuit of Appeals set forth a "functional approach" to determining what is or what is not an executory contract:

> The key, it seems, to deciphering the meaning of the executory contract rejection provision is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, then the contact is not executory . . . .

Sloan v. Hicks (In re Becknell & Crace Coal Co., Inc.), 761 F.2d 319, 322 (6th Cir. 1985), *citing Chattanooga Mem'l Park v. Still (In re Jolly)*, 574 F.2d 349, 350-51 (6th Cir. 1978) (other citations omitted). *See also Phar-Mor, Inc. V. Strouss Bldg. Assocs. (In re Phar-Mor,*

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[2] RTI did not address this contention by IRSS in either its pleadings or during the oral argument on this matter.

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Inc.), 204 B.R. 948, 952 (N.D. Ohio 1997).[3] This approach to the determination of what is an executory contracts has been described as follows:

> [U]nder the functional approach the purpose for allowing the debtor in possession to reject or assume an executory contract 'is to enable . . . a troubled debtor to take advantage of a contract that will benefit the estate by assuming it or alternatively, to relieve the estate of a burdensome contract by rejecting it.' Thus, even though there may be material obligations outstanding on the part of only one of the parties to the contract, it may nevertheless be deemed executory under the functional approach if its assumption or rejection would ultimately benefit the estate and it creditors.

Arrow Air, Inc. v. The Port Auth. of New York and New Jersey (In re Arrow Air, Inc.), 60 B.R. 117, 122 (Bankr. S.D. Fla. 1986), *citing In re Norquist*, 43 B.R. 224, 225 (Bankr. E.D. Wash. 1984).[4]

During the term of the Agreement, IRSS is the sole contractor permitted to perform

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[3] The parties agreed that for the purpose of resolving the issue of whether the Agreement is executory, the Sixth Circuit's decision in *Sloan v. Hicks (In re Becknell & Crace Coal Co., Inc.)*, 761 F.2d 319 (6th Cir. 1985) is controlling. *See* IRSS's Supplemental Opposition to RTI's Motion [docket #693] at pg. 2.

[4] In opposing RTI's motion to reject the Agreement, IRSS relies upon a definition of executory contracts originated by Professor Vern Countryman of Harvard University. Such definition describes an executory contract as one "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." Countryman, *Executory Contracts in Bankruptcy: Part I;* 57 MINN. L. REV. 439, 460 (1973). Although the Sixth Circuit Court of Appeals indicated that it found Professor Countryman's definition "helpful," it did not utilize that definition to determine whether a contract is executory but instead developed the "functional approach." *Chattanooga Mem'l Park v. Still (In re Jolly)*, 574 F.2d 349, 350-51 (6th Cir. 1978). Given that the Sixth Circuit in *Sloan v. Hicks (In re Becknell & Crace Coal Co., Inc.)*, 761 F.2d 319 (6th Cir. 1985), a case commenced under the Bankruptcy Reform Act of 1978, reiterated its adherence to the "functional approach" and given that the parties agreed that *Becknell* is controlling in this case, *see* footnote 2, *supra*, the Court will not discuss the Countryman definition any further in this Opinion.

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the work provided for in the Agreement. *See* Initial Agreement at pg.12, Art. 12 (attached to RTI's Motion [docket #351] as Exhibit A). For its performance of that work RTI is required to compensate IRSS through various payments ranging from those due on a lump sum per month basis (i.e. for "routine track inspections including maintenance and lubrication of switches") to those due on a per service basis (i.e. "furnish[ing] and install[ing] wheel stops"). *See* Initial Agreement at Exhibit "B" - Price Terms, pgs. 4 and 5 (attached to RTI's Motion [docket #351] as Exhibit A).

RTI is permitted to terminate the Agreement, in whole or in part and with or without cause, "upon thirty (30) days prior written notice to [IRSS]." *See* Initial Agreement at pg. 12, Art. 12 (attached to RTI's Motion [docket #351] as Exhibit A). RTI is also permitted to terminate the Agreement, with or without notice to IRSS, upon the occurrence of certain specified events such as IRSS's failure to timely cure a material breach. *See* Initial Agreement at pgs. 12-14, Art. 12 (attached to RTI's Motion [docket #351] as Exhibit A).[5] If RTI terminates the Agreement solely for its convenience, RTI becomes obligated to pay IRSS a termination fee that, based upon the circumstances in this case, would equal $2,752,500.00. *See* Initial Agreement at Exhibit "G" - Termination Fee Schedule (attached to RTI's Motion [docket #351] as Exhibit A).

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[5] There have been no allegations in this matter that either party is in breach of their respective obligations under the Agreement.

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IRSS argues that the aforementioned termination provisions remove the Agreement from the realm of executory contracts within the meaning of §365(a) of the Bankruptcy Code because RTI (as a debtor in possession) is not obligated to do anything in the future under the Agreement. In the Sixth Circuit, however, the focus when determining if a contract is executory is not on whether there are outstanding material obligations on the part of both parties to the contract but is instead on whether the purposes rejection is expected to accomplish will be achieved. Two purposes that are served by rejection of executory contracts are (1) to clear the contractual path to permit the debtor to accept services from its subsidiary rather that IRSS and (2) to create a breach of contract which makes the other party to the contract (in this case IRSS) a creditor with a claim that may be incorporated into a plan and ultimately discharged. *The Huntington Nat'l Bank Co. v. Alix (In re Cardinal Indus., Inc.),* 146 B.R. 720, 728 (Bankr. S.D. Ohio 1992), *citing Chattanooga Mem'l Park v. Still (In re Jolly)*, 574 F.2d 349, 351 (6th Cir. 1978).

As set forth in RTI's pleadings and not disputed by IRSS, RTI can obtain the same services from a subsidiary at a substantially lower price. Accordingly, if the Agreement were to remain in effect it would be financially burdensome to RTI. Even if RTI were to exercise the termination provisions of the Agreement, its obligations thereunder would not cease for

at least 30 days. During those 30 days, RTI would have to pay IRSS for services that it could undisputedly obtain for a lower price. Such a cost savings would clearly benefit RTI during a time when it faces financial obstacles on a daily basis. Additionally, rejection of the Agreement by RTI would create a breach of contract and make IRSS a creditor with a claim that may be incorporated into a plan or reorganization and ultimately discharged. *Compare Chattanooga Mem'l Park v. Still (In re Jolly)*, 574 F.2d 349 (6th Cir. 1978) (where contract was not found to be executory because, in part, a breach of the contract had occurred pre-petition).

THE AGREEMENT AS A FINANCING DOCUMENT

In the Agreement, the term Facility is defined only as "a facility to be erected, operated and maintained by Contractor as part of, and in connection with the ongoing performance of, the Work." *See* Initial Agreement at pg. 2 (attached to RTI's Motion [docket #351] as Exhibit A). Who holds or will hold title to the Facility is addressed in various portions of the Agreement including the following:

> 5.5 To the extent of any payment made by Owner to Contractor pursuant to this Agreement, Contractor hereby pledges, assigns and grants to Owner, as security for performance by Contractor of its obligations hereunder, a first priority continuing security interest, second in priority only to Contractor's principal lender, in all Contractor's right, title and interest in and to the Facility . . . .

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> 12.3 Contractor hereby grants to Owner an irrevocable and exclusive option, to be exercised by Owner in its sole and exclusive discretion, on or before January 31, 2004, to purchase the Facility and/or other property relating to the Work. In order to exercise this option, Owner shall (i) provide Contractor with written notice of the exercise and (ii) make payment to Contractor in an amount equal to the difference between $750,000.00 and $12,500.00 per month for each month elapsed under the Agreement. The parties agree and understand that the option granted by Contractor to Owner creates no obligation or requirement for Owner to exercise or to purchase any or all of the property that it subject to this option.
>
> 12.4 In the event that Owner terminates the Agreement for its convenience, Contractor's sole and exclusive remedy shall be payment of amounts provided for in Exhibit "G" attached hereto. Owner shall make such payments within thirty (30) days of the exercise of this termination and Contractor shall not be required to remove the Facility. Provided, however, that nothing contained in this Section 12.4 shall affect the option established under Section 12.3 of this Agreement.
>
> 32.1 Subject to Section 32.2 below, title in and to the Facility and to all Contractor's tools, equipment, supplies, materials, facilities and structures not furnished by Owner and not incorporated into the Work but used in performance of this Agreement, shall remain in Contractor at all times . . . .
>
> 32.2 Title to the Facility and to materials, equipment, facilities, structures and supplies provided by Contractor . . . and incorporated in the Work shall pass to Owner only upon a completed transfer pursuant to Article 8 or Article 12 hereof . . . .

See Initial Agreement at pgs. 8, 15, 37 (attached to RTI's Motion [docket #351] as Exhibit A). In the event of a breach by IRSS, the Agreement provides that IRSS shall remove the Facility at its sole cost and expense. *See* Initial Agreement at pg. 14 (attached to RTI's

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Motion [docket #351] as Exhibit A). The Agreement does not appear, however, to address what happens to the Facility upon a breach by RTI.[6]

Despite IRSS's contention that the Agreement could be characterized as a financing agreement, it did not address, let alone analyze any of the provisions of the Agreement addressing title to the Facility nor did it provide any information as to whether Uniform Commercial Code filings regarding the Facility were ever made. Because the parties chose to prosecute this matter on only briefs and oral argument, the Court is without any information regarding exactly what comprises the "Facility" as well as whether or not the parties intended the Agreement to somehow serve as a way to enable RTI to finance acquisition of title to the Facility. In short, IRSS's argument that the Agreement could be characterized as a financing document raises far too many questions that are not answerable on the record now before the Court for the matter to be decided upon the pleadings alone.

CONCLUSION

Based upon the foregoing, the Court finds that the Agreement could be characterized as an executory contract which RTI would be entitled to reject pursuant to §365 of the Bankruptcy Code. However, because the characterization of the Agreement will dictate

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[6] Interestingly, there does not appear to be any direct provision in the Agreement addressing a breach by RTI.

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IRSS's rights in this bankruptcy proceeding and because IRSS chose to raise an argument that the Agreement could be characterized as a financing agreement, the Court cannot decide this matter without additional information. Accordingly, a status conference on this matter shall be held on **March 19, 2002 at 10:00 a.m.** at which counsel for IRSS shall address whether or not his client wants to further prosecute its argument that the Agreement could be characterized as a financing document. If IRSS does choose to prosecute that argument, the Court will then schedule an evidentiary hearing on the matter. Counsel may appear telephonically at the status conference provided that they inform the Court of their desire to do so by not later than **March 18, 2002** and are in compliance with all the provisions set forth in Judge Shea-Stonum's memorandum regarding telephonic participation at pre-trial conferences (found on the Court's web site www.ohnb.uscourts.gov).

IT IS SO ORDERED.

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MARILYN SHEA-STONUM
Bankruptcy Judge

DATED: 3/5/02