UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE:	:	CASE NO. 00 B 71919 (N.D. ILL.)
KRAUSE, INC.,	:	CHAPTER 7
Debtor.	:	JUDGE MASSEY
BERNARD J. NATALE, Chapter 7 Trustee for the Estate of KRAUSE, INC., an Illinois Corporation,	:	
Plaintiff,	:	
v.	:	ADVERSARY NO. 01-6574
THE HOME DEPOT U.S.A., INC.,	:	
Defendant.	:	

ORDER DENYING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Krause, Inc., a manufacturer of ladders, filed a Chapter 11 bankruptcy case in 2000 in the Northern District of Illinois. Its financial problems stemmed from product liability litigation. The Home Depot U.S.A., Inc. purchased ladders from Krause and sold them in its stores before and after Krause filed bankruptcy. During the Chapter 11 case, Home Depot remitted payments to Krause, some of which Krause applied to outstanding prepetition invoices. Ultimately, the effort to reorganize failed, and the case was converted to one under Chapter 7. Bernard J. Natale, Krause's Chapter 7 Trustee, brought this adversary proceeding against Home Depot to recover

the amounts due to Krause for ladders sold to Home Depot as reflected on unpaid invoices, including a few prepetition invoices.

Home Depot does not deny that it has not paid certain postpetition invoices rendered by Krause (although the exact amount unpaid may be in dispute), but it counterclaims for breach of contract and for statutory indemnity and breach of implied warranty with respect to product liability actions brought against Home Depot. It contends that its claims against Krause may be recouped or set off against Plaintiff's claims. Home Depot moves for summary judgment. The Court heard oral argument on the motion on February 15, 2005.

The following facts are not in dispute, except as noted. Home Depot purchased ladders from Krause pursuant to a contract made prior to Krause's bankruptcy filing. The contract, titled the Vendor's Buying Agreement ("VBA"), is a standard master contract used by Home Depot.

The VBA includes a Purchase Order Agreement which specifies the terms for filling and invoicing purchase orders from Home Depot's stores. It requires Krause (1) to indemnify Home Depot in the event Home Depot is sued for injuries related to Krause's ladders and (2) to carry an occurrence-based liability insurance policy protecting Home Depot.

Krause sold ladders to Home Depot pursuant to the VBA for many years. In July of 2000, tort liability forced Krause to file bankruptcy in the Northern District of Illinois. At that time, Home Depot owed Krause approximately $1 million for ladders shipped and invoiced prepetition. The parties do not agree on the exact amount of Home Depot's prepetition claim.

Home Depot continued to do business with Krause from the petition date until December of 2000. Home Depot remitted funds to Krause postpetition, and Krause applied some of those payments to prepetition invoices. Home Depot has not paid Krause enough to satisfy all unpaid

invoices at the petition and all postpetition invoices issued to it by Krause for ladder purchases; the net difference between the aggregate amount invoiced and the aggregate amount paid is over $1 million. The total amount sought by Plaintiff from Home Depot is approximately $1,161,500.00.

On March 21, 2001, the Bankruptcy Court for the Northern District of Illinois entered an order holding that the VBA was an executory contract and approving its rejection by the Debtor, effective as of December 1, 2000. Home Depot appealed that order. While the appeal was pending in the District Court, the case was converted to one under Chapter 7. On June 3, 2002, the District Court affirmed the Bankruptcy Court's March 21, 2001 Order.

In Krause's main bankruptcy case, Home Depot filed an application for payment of administrative expenses based on its indemnity and insurance claims, to which the Trustee objected. The Bankruptcy Court for the Northern District of Illinois has not yet ruled on that application.

Krause contends in its brief that there is no dispute that the ladders giving rise to Home Depot's claims were manufactured and sold by Krause to Home Depot prepetition. *Plaintiff's Response to Defendant's Motion for Summary Judgment*, p. 24 ("[A]ny claims that the Defendant has for breach of an implied warranty of merchantability arise solely prepetition."). Home Depot's brief neither disputes nor admits this contention. At oral argument, Krause's counsel again asserted that the ladders involved in injuries were sold to Home Depot prepetition. Home Depot's counsel asserted that it purchased allegedly defective ladders postpetition as well as prepetition.

Pursuant to Fed. R. Civ. P. 56(c), made applicable by Fed. R. Bankr. P. 7056, a party moving for summary judgment is entitled to prevail if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). The moving party carries the initial burden of proof and must establish that no genuine factual issue exists. *Celotex*, 477 U.S. at 323; *Clark v. Coats & Clark, Inc.*, 929 F.2d 604, 608 (11th Cir. 1991). The moving party must point to the pleadings, discovery responses or supporting affidavits which tend to show the absence of a genuine issue of material fact. *Celotex*, 477 U.S. at 323. The court will construe the evidence in the light most favorable to the non-moving party. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986); *Rollins v. TechSouth, Inc.*, 833 F.2d 1525, 1528 (11th Cir. 1987).

As a preliminary matter, the facts on which the parties appear to agree as set forth in Defendant's Statement of Undisputed Facts and Plaintiff's response are not sufficient to show that there is no material fact in dispute. In particular, neither party has shown that there is no dispute as to when allegedly defective ladders were sold to Home Depot. For this reason alone, the motion must be denied. The Court will nonetheless discuss the legal issues presented with some factual assumptions in the hope that this discussion may facilitate the resolution of this dispute.

The Recoupment Defense. The Bankruptcy Code does not mention recoupment. *See, e.g., Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1079 (3rd Cir. 1992). Nevertheless, the doctrine is well established as an exception to the Bankruptcy Code's general prohibition against off-setting postpetition debts against prepetition debts. *See Reiter v. Cooper,*

507 U.S. 258, 265 n.2 (1993); *Smith v. Am. Fin. Sys.*, 737 F.2d 1549, 1553 (11th Cir. 1984). Often compared with its cousin, the set-off, recoupment is a defense involving the adjustment of a plaintiff's claim based on amounts owed by the plaintiff to the defendant arising out of the same integrated transaction. The rationale is that "it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *Malinowski v. N.Y. State Dep't of Labor (In re Malinowski),* 156 F.3d 131, 133 (2nd Cir.1998).

In determining whether a right of recoupment exists, courts apply nonbankruptcy law, often common law. *See, e.g., Westinghouse Credit Corp. v. D'Urso,* 278 F.3d 138, 146 (2nd Cir. 2002). Georgia law governs this dispute pursuant to a choice of law clause in the VBA. In Georgia, the right of recoupment is a creature of statute. "Recoupment is a right of the defendant to have a deduction from the amount of the plaintiff's damages for the reason that the plaintiff has not complied with the cross-obligations or independent covenants arising under the contract upon which suit is brought." GA. CODE ANN. § 13-7-2 (2004). "Recoupment differs from setoff in this respect: Any claim or demand the defendant may have against the plaintiff may be used as a setoff, while only a claim or demand arising out of the same transaction as that sued on by the plaintiff may be used as a recoupment." GA. CODE ANN. § 13-7-3. "Recoupment lies for overpayments by the defendant or for payments by fraud, accident, or mistake." GA. CODE ANN. § 13-7-12. "Recoupment may be pleaded in all actions ex contractu where the plaintiff is liable to the defendant under the same contract. If the damages of the defendant exceed those of the plaintiff, the defendant shall be awarded the amount of such excess from the plaintiff." GA. CODE ANN. § 13-7-13.

"The purpose of the defense of recoupment is to show that the amount claimed is not due the plaintiff." *Kuhlke Constr. Co. v. Mobley, Inc.*, 159 Ga. App. 777, 781, 285 S.E.2d 236, 240 (Ga. Ct. App. 1981). Courts in Georgia require that the claim the defendant seeks to recoup arises under the same contract upon which the plaintiff sues. GA. CODE ANN. § 13-7-2; *Aetna Ins. Co. v. Lunsford*, 179 Ga. 716, 721, 17 S.E. 727, 730 (Ga. 1934) (holding defendant could not recoup with a claim from a second contract related to the contract sued upon by plaintiff and involving the same transaction); *Gillespie v. Georgian Fin. & Inv. Corp.*, 113 Ga. App. 134, 147 S.E.2d 465 (Ga. Ct. App. 1996) (holding defendant could not recoup with tort action absent an equitable reason such as insolvency or the non-residence of the plaintiff). Georgia law differs in this respect from the general rule for recoupment which does not require the claims to arise from the same contract. *See, e.g., In re Univ. Med. Ctr.,* 973 F.2d at 1080.

Home Depot contends that its claims and those of Krause arise from one master contract, the VBA. Krause argues that each purchase order constitutes a separate contract. The parties previously litigated the issue of whether the purchase orders are separate contracts or are part of the VBA. In *Home Depot USA, Inc. v. Krause, Inc.*, 2002 WL 1264001 (N.D. Ill. 2002) ("Krause I"), the district court, in affirming the order approving rejection of the VBA, agreed with the bankruptcy court that the purchase orders and the Purchase Order Agreement (which expressly incorporates the purchase orders) were part of the VBA and constituted one contract. The doctrine of issue preclusion prevents Krause from rearguing this issue. *Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.),* 898 F.2d 1544, 1550 n.3 (11th Cir. 1990). Home Depot has therefore satisfied the requirement that the claims of each party must arise from the same contract.

In addition to requiring that both claims arise under the same contract, Georgia law requires that both claims arise from the same subject matter or transaction in order for recoupment to be available. GA. CODE ANN. § 13-7-3. In *Dailey v. Cotton States Mut. Ins. Co.*, 207 Ga. App. 139, 140, 427 S.E.2d 109 (1993), the plaintiff sued to recover unpaid premiums on an insurance policy, and the defendant counterclaimed for damages allegedly suffered years earlier for failing to investigate a loss allegedly insured under the same policy. The Court of Appeals held that the defendant's defense of recoupment failed because his claim was "totally unrelated to the action brought by [the plaintiff] for non-payment of premiums and bears no direct relationship to [the defendant's] obligation to pay the premiums due on the policies . . . ." *Id.* at 140. Recoupment has been permitted where the claims asserted arise out of the same portion of the contract. *See, e.g., Hodges v. Cmty. Loan & Inv. Corp. of North Ga.*, 133 Ga. App. 336, 210 S.E.2d 826 (1974); *Allied Enters., Inc. v. Brooks*, 93 Ga. App. 832, 93 S.E.2d 392 (1956) (defendant permitted to recoup damages arising from faulty construction against contractor's claim for payment based on that construction); *Byrom v. Ringe*, 83 Ga. App. 234, 241, 63 S.E.2d 235, 240 (1951); *Alpharetta Feed & Poultry Co. v. Cocke*, 82 Ga. App. 718, 727, 62 S.E.2d 642, 648 (1950); *Biggs v. McBrayer*, 174 Ga. 244, 162 S.E. 787 (1932) (recoupment permitted where plaintiff's contractual claim was for the purchase price of goods and defendant's claim was for damages because those goods did not meet contract specifications).

Home Depot relies on such cases as *In re Communication Dynamics, Inc.*, 300 B.R. 220 (Bankr. D. Del. 2003) and *In re Telephone Warehouse, Inc*., 259 B.R. 64 (Bankr. D. Del. 2001) in which the bankruptcy court permitted recoupment on facts totally different from the facts here. In the *Communications Dynamics* case, the court permitted a seller of equipment to recoup

against its prepetition claim for equipment sold to the debtor, the debtor's postpetition claim against the seller for credits due under the contract, notwithstanding the fact that equipment sales giving rise to the seller's claims was not the same equipment that gave rise to the debtor's right to a credit. The court noted that "[t]he credits were an integral part of the parties' overall relationship under the Agreement and the parties certainly intended that they be applied against future sales of equipment." *In re Communication Dynamics, Inc.*, 300 B.R. at 227. In other words, to compute the amount owed, the credits and the debits were always intended to be a part of a running total.

In the *Telephone Warehouse* case, the debtors contracted with suppliers of cellular telephones, at least one of which also provided telephone service to debtors' customers. When debtors filed bankruptcy, they owed the suppliers for telephones and the suppliers owed the debtors for commissions earned when customers activated the phone service provided by the suppliers. The bankruptcy court permitted the suppliers to recoup against what they owed debtors for commissions, the amount the debtors owed them for purchases of telephones. In doing so, the court rejected the debtors' contention that the transaction involving the telephone purchases was not the same transaction as that involving the sale of telephone services, holding that "the commissions and equipment purchases are part of a single integrated business transaction." *In re Telephone Warehouse, Inc.*, 259 B.R. at 68. A telephone could not be used without activation of service, and the sales of telephones to the debtors would always be followed by sales of service provided by the suppliers.

The *Communication Dynamics* case and the *Telephone Warehouse* case are easily distinguishable from this case. In neither case was Georgia law applicable. In those cases the

parties regularly netted out the debits and credits for sales and/or commissions to determine the amount owed by the debtors. Here, Home Depot has not shown that in order to calculate what Home Depot owed or owes Krause for ladders purchased for any invoice or set of invoices, one must take into account what Krause owes Home Depot for its failure to provide insurance coverage to indemnify. It was not necessary for Krause to provide insurance coverage or to indemnity Home Depot in order for Home Depot to sell ladders or for its customers to use ladders. The VBA, including each of its constituent parts, does not tie the calculation of what Home Depot owes for a ladder purchase to a breach of the provisions requiring Krause to provide insurance or indemnity against third-party product liability claims. In short, Home Depot has not shown that Krause's failure to provide insurance or to indemnify Home Depot "bears [any] relationship" to its obligation to pay outstanding invoices when those payments were due. *See Dailey v. Cotton States Mut. Ins. Co.*, *supra.* Thus, Krause's claim for the price of ladders sold and Home Depot's claims arising from the failure to indemnify and to provide insurance do not arise from the same transaction, even though they arise from the same contract.

Home Depot contends, without analysis, that the district court in Krause I determined that claims of Krause and the claims of Home Depot arose from the same transaction in deciding that the VBA was an executory contract. There, the district court observed that Krause had a continuing obligation to maintain product liability insurance and Home Depot had a continuing obligation to pay for products delivered. It concluded based on its view of the obligations each party had that the contract was executory.

Nothing in that decision addresses the issue of whether the obligation to pay for ladders is part of the same transaction as the obligation to provide insurance and to indemnify Home Depot.

No part of the district court's decision to affirm the Bankruptcy Court's order authorizing the rejection of the VBA depended on a determination that Home Depot's claims arose from the same transaction as Krause's claims. The district court concluded only that the obligation to maintain insurance was part of the same contract obligating Home Depot to pay for ladders and that both obligations were continuing so as to make the VBA an executory contract. All unfulfilled promises in contracts are continuing. Under Home Depot's view, recoupment would always be available if the parties had continuing obligations to one another, thereby writing out of Georgia law the requirement that the claims arise from the same transaction. Hence, the Court must deny Home Depot's motion for summary judgment to the extent it is based on the doctrine of recoupment.

The Setoff Defense. Home Depot's second defense is that it is entitled to a setoff against Krause's claims. "The right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.' *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L.Ed. 1313 (1913)." *Citizens Bank of Maryland v. Strumpf,* 516 U.S. 16, 18, 116 S.Ct. 286, 289 (1995). Setoff is not a right created by the Bankruptcy Code. *Id*. Georgia law permits setoff. GA. CODE ANN. § 13-7-1 ("Setoff does not operate as a denial of the plaintiff's claim; rather it allows the defendant to set off a debt owed him by the plaintiff against the claim of the plaintiff.") Unlike a recoupment, "[any claim or demand the defendant may have against the plaintiff may be used as a setoff," GA. CODE ANN. § 13-7-3; hence, the offsetting obligations may arise from different contracts and transactions.

Section 553 of the Bankruptcy Code deals with the right of setoff and provides in part: "This title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ." Although section 553 does not address the setoff of postpetition debts against other postpetition debts, courts generally permit such setoffs in bankruptcy. *See, e.g.*, *Gordon Sel-Way Inc. v. United States (In re Gordon Sel-Way, Inc.)*, 270 F.3d 280, 289-292 (6th Cir. 2001); *Southeast Bank, N.A. v. Grant (In re Apex Int'l Mgmt. Servs.)*, 155 B.R. 591, 594-95 (Bankr. M.D. Fla. 1993); *Palm Beach County Bd. of Pub. Instruction v. Alfar Dairy, Inc. (In re Alfar Dairy, Inc.)*, 458 F.2d 1258, 1262 (5th Cir. 1972) (permitting setoff of two post-petition debts in a case under former Chapter XI of the Bankruptcy Act).

A creditor of a bankrupt debtor may not offset its prepetition claim against a postpetition debt it owes to the debtor. *See, e.g., In re Express Parts Warehouse, Inc*., 230 B.R. 526, 528 (Bankr. E.D.N.C.1999) ("Clearly, a creditor should not be permitted to offset the creditor's prepetition claim against the creditor's postpetition obligation to the debtor . . . ."); *In re Charter Co.,* 86 B.R. 280, 284 (Bankr. M.D.Fla. 1988) ("[P]re-petition debts may not be setoff against post-petition obligations.")

Home Depot makes four arguments in an unsuccessful attempt to show either that the claim asserted by Plaintiff is a prepetition debt owed by Home Depot (which could be offset against the prepetition obligation of Krause arising from rejection of the VBA) or that it holds a postpetition claim against Krause (which could be offset against the postpetition claim asserted by Plaintiff). Plaintiff contends that the obligations owed by Home Depot to the Krause estate

arose postpetition, with a minor exception, and that all of the obligations Krause owes Home Depot arose prepetition.

Home Depot's first argument is that it may reallocate or reapply the postpetition payments it made to Krause solely to postpetition invoices, including those that Plaintiff says remain unpaid, so as to leave Krause's prepetition invoices unpaid, thereby enabling it to offset its prepetition debt to Krause against Krause's prepetition debt to it. Its remaining arguments are alternatives to the first argument. Its second argument is that because Krause ceased paying insurance premiums on a date after it rejected the VBA, Home Depot has a postpetition claim for breach of the VBA. Third, Home Depot contends that it has a right to indemnity under state law that arose postpetition because it cannot assert such an indemnity claim until after it pays a judgment or funds a settlement. Finally, it contends that it has a postpetition claim for breach of the implied warranty of merchantability.

<u>1. Reallocation of Invoice Payments.</u> Home Depot asserts that it has a unilateral right to apply its postpetition payments to Krause to postpetition purchases of ladders. Specifically, it contends:

> Post-petition, Home Depot paid Krause at least $1,034,213 on pre-petition invoices. Rutherford Declaration, paragraph 5. Home Depot has elected to reapply these payments to postpetition invoices to protect its setoff rights. Rutherford Declaration, paragraph 9. When these payments are applied postpetition, they offset the Trustee's post-petition claim.

Home Depot's Memorandum of Law in Support of Motion for Summary Judgment, p. 14 (doc. no. 97). Attached to the Rutherford Declaration, submitted under seal, pursuant to an Order entered on July 8, 2004 (doc. no. 102), is a letter from counsel for Home Depot to counsel for Plaintiff, in which Home Depot's counsel explains that "HD contends that it has a right to apply

the post-petition payments to post-petition purchases only, or that the HD post-petition payments should be 'equitably appropriated' to preserve HD's rights of offset."

There appears to be no dispute that the Purchase Order Agreement, a copy of which is part of the VBA is a form prepared by Home Depot. Paragraph 9 of the Purchase Order Agreement provides in part that "[t]he Home Depot pays from invoice only." Paragraph 10 states "[p]ayment will be made per the terms stated on the Order." The term "Order" is short for "Purchase Order," as set forth in the first line of the Purchase Order Agreement. A part of the Purchase Order Agreement is the Master Purchase Order, the terms and conditions of which contain terms and conditions identical to those in paragraphs 9 and 10 in the Purchase Order Agreement.

Home Depot presumably followed its own procedures and paid by invoice. At oral argument of the motion, the Court inquired of Home Depot's counsel whether Home Depot owed Krause on the petition date for ladders purchased. Counsel responded in the affirmative and said that Home Depot owed about $1,030,000. The Court then asked, "And it paid those invoices?" Counsel replied, "yes sir."

Home Depot has articulated no factual or legal basis to support its alleged "right" to direct application of payments to invoices of its choosing long after it made those payments. In absence of such a showing, Home Depot is barred from any attempt to reallocate those payments to postpetition debt by the automatic stay imposed by 11 U.S.C. § 362(a), including subsection (6) which forbids "any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case under this title."

2. PostPetition Breach of Contract. Home Depot asserts that its "claim for breach of the insurance covenant in the VBA is a postpetition claim since it did not arise until February 1, 2002, when the Trustee did not renew the products liability insurance policy which afforded coverage to Home Depot." Memorandum of Law in Support of Motion for Summary Judgment, p. 15 (doc. no. 97).

Section 365(g)(1) of the Bankruptcy Code relegates to prepetition status any claim arising out of the rejection of an executory contract. That section provides:

> (g) Except as provided in subsections (h)(2) and (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-
>
> > (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition[.]

Krause rejected the VBA as of December 1, 2000. Any failure of Krause to perform that contract, whether the breach occurred before bankruptcy or during the case before or after rejection, was due to Krause's rejection of the VBA. *GATX Leasing Corp. v. Airlift Intern., Inc. (In re Airlift Intern., Inc.),* 761 F.2d 1503, 1508-09 (11th Cir. 1985) ("[W]here the contract is not assumed prior to confirmation, the breach of the executory contract or unexpired lease is deemed to have occurred pre-petition, giving rise to a pre-petition claim under section 502(g), but not an administrative expense under section 503(b)."). All obligations under a contract that come due after that contract is rejected are deemed to arise prepetition. Otherwise, there would be no point in rejecting an executory contract or unexpired lease, and section 365 would in large part be meaningless. (It is true that a non-debtor party to a rejected contract that continues after rejection to render services or provide other value to the estate requested by the estate may be entitled to

reimbursement of an administrative expense, as, for example, when a tenant debtor holds over in the premises a short time after rejection of a lease. But Home Depot does not contend here that it provided any value to Krause that it or the Trustee demanded after the rejection of the VBA. If Home Depot is entitled to an administrative expense, it must pursue that course in the Illinois bankruptcy court.) Thus, all of Home Depot's claims for breach of the VBA are prepetition claims.

3. State Law Indemnity. In its counterclaims that were a part of its answer to the amended complaint, Home Depot asserted that it has a statutory right to contribution or indemnity that arose postpetition. In its memorandum of law, it argued:

> Under Georgia law an indemnity claim does not arise until the payment of the settlement or judgment. Auto-Owners Insurance Co. v. Anderson, 252 Ga. App. 361, 364, 556 S.E.2d 465, 467 (2001) ("[W]here no funds have yet been expended, a party's right to seek indemnification has not yet actualized.") (quoting Davis v. Southern Exposition Management Co., 232 Ga. App. 773, 775(2), 503 S.E.2d 649 (1998)).

Home Depot's Memorandum of Law, p. 15. The Georgia law delaying the "actualization" of right to indemnity until after the party seeking indemnity pays a judgment or settlement amount effectuates the policies of avoiding duplicative litigation and of preventing unjust enrichment of the party seeking indemnity that never pays a third party. Home Depot reasons that it cannot assert a claim for indemnity against Krause under state law (apart from its contractual claims) until after it pays a judgment or settlement. Based on this reasoning, it concludes that its common law right to assert an indemnity claim must arise postpetition with respect to any such judgment or settlement it pays postpetition.

Plaintiff contends that Home Depot holds a claim against Krause with respect to damages arising from its prepetition purchases of ladders from Krause, regardless of when Home Depot pays a judgment or settlement to a party injured by a defective ladder.

Section 101(5) of the Bankruptcy defines that the term “claim” as follows:

> (5) “claim” means -
>
> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured[.]

When a “claim” as defined in section 101(5) of the Bankruptcy Code arises is an issue of federal law. Section 101(5) is to be read broadly. As the U.S. Supreme Court has stated:

> We have previously explained that Congress intended by this language [section 101(5)] to adopt the broadest available definition of "claim." *See Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 558, 563-564, 110 S.Ct. 2126, 2130- 2131, 2133-2134, 109 L.Ed.2d 588 (1990); *see also Ohio v. Kovacs*, 469 U.S. 274, 279, 105 S.Ct. 705, 707, 83 L.Ed.2d 649 (1985). In *Davenport*, we concluded that " 'right to payment' [means] nothing more nor less than an enforceable obligation...." 495 U.S., at 559, 110 S.Ct., at 2131.

Johnson v. Home State Bank, 501 U.S. 78, 83, 111 S.Ct. 2150, 2154 (1991).

Thus, the issue is whether Home Depot had a “contingent” right to payment, within the meaning of section 101(5), as of the petition date with respect to postpetition damages it has incurred or will incur or whether it could not have filed a proof of claim in Krause’s bankruptcy case because its right to indemnity under state law would not be “actualized” until it pays a judgment or settlement postpetition.

Several Courts of Appeal have addressed the issue of when a contingent claim arises within the meaning of section 101(5). Most courts have embraced a rule that for bankruptcy purposes a contingent claim arises when the conduct giving rise to the claim occurs, though sometimes with the caveat that the debtor and the creditor must have had some kind of prepetition relationship. Only one circuit has held that a claim arises for bankruptcy purposes when it accrues under state law.

In the Fourth Circuit, a contingent claim arises when the conduct it is based on occurs, apparently without regard to any relationship between the parties. *Grady v. A.H. Robbins Co.*, 839 F.2d 198, 202-03 (4th Cir. 1988). Claims for environmental clean-up costs incurred postpetition are prepetition claims if the debtor caused the hazardous waste to be released prepetition. *United States v. The LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997, 1005 (2nd Cir. 1991); *Cal. Dep't. of Health Servs. v. Jensen (In re Jensen)*, 995 F.2d 925, 930-31 (9th Cir. 1993). In *In re Parker*, 313 F.3d 1267, 1269 (10th Cir. 2002), the Court held that a malpractice claim arose prepetition because the conduct occurred prepetition but did not have to decide whether there had to be a prepetition relationship between the debtor and the claimant because in that case such a relationship existed.

The Seventh Circuit has permitted "products-liability and nuisance claims to be filed in bankruptcy as long as the conduct giving rise to the claim (the manufacture or sale of the defective product, in the case of products liability) had occurred before the petition in bankruptcy had been filed. E.g., *In re UNR Industries, Inc.*, 20 F.3d 766, 770-71 (7th Cir.1994); *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 974 F.2d 775, 782-86 (7th Cir.1992) . . . ." *Fogel v. Zell,* 221 F.3d 955, 961 (7th Cir. 2000).

The Eleventh Circuit has opined that an individual injured by a defective product would have a claim in bankruptcy if (a) it had a relationship with the debtor, defined broadly to include privity or contact with the debtor's products, and (b) the basis for the future lawsuit was the prepetition conduct of the debtor. *Epstein v. Official Comm. of Unsecured Creditors of the Estate of Piper Aircraft (In re Piper Aircraft)*, 58 F.3d 1573, 1577 (11th Cir. 1995). The Fifth Circuit is in the same camp. *See Lemelle v. Universal MFG. Corp.*, 18 F.3d 1268, 1277-78 (5th Cir. 1994) (holding that where the injury resulting in death and the manifestation of that injury occurred long after the petition was filed and the party asserting that a claim existed had to prove that "there must be evidence that would permit the debtor to identify, during the course of the bankruptcy proceedings, potential victims and thereby permit notice to these potential victims of the pendency of the proceedings." *Id.* at 1277).

Only the Third Circuit has held that a party does not have a claim in bankruptcy until that claim accrues for state law purposes. *Frenville v. Frenville Co. (In re Frenville Co.)*, 744 F.2d 332, 337-38 (3rd Cir. 1984), *cert. denied*, 469 U.S. 1160, 105 S.Ct. 911, 83 L.Ed.2d 925 (1985). There, the accounting firm that had represented the debtor prior to its bankruptcy had been sued by lenders to the debtor in state court. The accounting firm sought relief from the automatic stay to file a third party complaint against the debtor and one of its principals, who was also in bankruptcy, in order to seek indemnity under a state law. The lower courts held that the accounting firm had a claim against the debtors and denied the motion. Reversing, the Court of Appeals held that the indemnity claim arose postpetition because it did not accrue until the lenders filed suit. *Id*. at 337.

The *Frenville* case is distinguishable from the present case on two important factual grounds. First, it did not involve a product-liability claim. Second, the parties in *Frenville*, unlike Krause and Home Depot, were not parties to a contract that included an indemnity provision. Several courts have opined, including the Third Circuit in *Frenville*, that contractual indemnity claims arise for bankruptcy purposes at the time the contract is signed. *See, e.g., Frenville*, 744 F.2d at 336; *In re Hemingway Transport, Inc.*, 954 F.2d 1, 9 (1st Circuit 1992); *Olin Corp. v. Riverwood Int'l Corp. (In re Manville Forest Products Corp.)*, 209 F.3d 125, 129 (2nd Cir. 2000). Because an indemnity claim under a rejected executory contract is a prepetition claim, it would be odd indeed to conclude that a virtually identical claim under a state statute is a postpetition claim.

The Eleventh Circuit in particular has rejected the *Frenville* approach, stating:

> The accrued state law claim theory states that there is no claim for bankruptcy purposes until a claim has accrued under state law. The most notable case adopting this approach is the Third Circuit's decision in *In re: M. Frenville Co.*, 744 F.2d 332 (3d Cir.1984), cert. denied, 469 U.S. 1160, 105 S.Ct. 911, 83 L.Ed.2d 925 (1985). This test since has been rejected by a majority of courts as imposing too narrow an interpretation on the term claim. *See e.g., Grady v. A.H. Robins Co.*, 839 F.2d 198, 201 (4th Cir.), cert. denied, 487 U.S. 1260, 109 S.Ct. 201, 101 L.Ed.2d 972 (1988); *In re: Black*, 70 B.R. 645 (Bankr.D.Utah 1986); *Acevedo v. Van Dorn Plastic Machinery Co.,* 68 B.R. 495 (Bankr.E.D.N.Y.1986); *In re: Edge*, 60 B.R. 690 (Bankr.M.D.Tenn.1986); *In re: Johns-Manville Corp.*, 57 B.R. 680 (Bankr.S.D.N.Y.1986); *In re: Yanks*, 49 B.R. 56 (Bankr.S.D.Fla.1985). We agree with these courts and decline to employ the state law claim theory.

Piper, 58 F.3d at 1576 n.2. This Court follows the lead of the Eleventh Circuit in rejecting the accrual approach.

Home Depot had a prepetition relationship with Krause involving the purchase and sale of ladders, some of which were defective. Home Depot argues that such a relationship would be established only when a person injured by a ladder makes a claim against Home Depot. This

argument is spurious and misses the point that it and Krause had a relationship prior to Krause's bankruptcy during which it purchased from Krause defective ladders manufactured by Krause. To the extent that damages suffered by Home Depot are attributable to such ladders, even if those damages were incurred after Krause filed bankruptcy, the *Piper* test is met.

From the moment it purchased a defective ladder from Krause, Home Depot, for bankruptcy purposes, had a claim – a right to payment – against Krause for any losses it might thereafter incur based on its contractual and common law rights to indemnity from Krause. It has conceded as much in its reply brief: "On the date Krause filed bankruptcy, Home Depot had a multi-million dollar indemnity claim against Krause which offset Krause's $1 million receivable owed by Home Depot for pre-petition ladder deliveries." Reply Brief in Support of Motion for Summary Judgment (document no. 107), p. 8. Even under the VBA, Home Depot could not recover from Krause until it had paid a judgment or otherwise incurred an expense. See ¶17 of Purchase Order Agreement attached as part of Exhibit A to Complaint (document no. 1). The claim Home Depot had against Krause on the petition date was contingent to the extent it had yet to incur an expense or to suffer a loss entitling it to indemnity, regardless of whether Home Depot based the claim on the breach of the VBA or on an independent right of indemnity under Georgia law.

Thus, Home Depot right against Krause under Georgia's indemnity law constitutes a claim within the meaning of 11 U.S.C. § 101(5) that arose prepetition, thereby precluding any right of set off against Plaintiff's claim.

<u>4, Breach of Implied Warranty of Merchantability.</u> Finally, in its answer to the amended complaint, Home Depot asserts it has postpetition claims for breach of the implied warranty of

merchantability, a statutory state law cause of action, *citing* GA. CODE ANN. § 11-2-314. Any claim that Home Depot holds for breach of an implied warranty of merchantability arose at the time of sale. *McDonald v. Mazda Motors of Americas, Inc.,* 269 Ga. App. 67, 68, 603 S.E.2d 456 (Ga. App. 2001). The same analysis set forth above with respect to state law indemnity rights applies to any claim that Home Depot has for breach of an implied warranty of merchantability imposed by state law. Because there is no evidence in the record to show when the ladders giving rise to Home Depot's breach of warranty claims were shipped, summary judgment on this breach of implied warranty has to be denied.

For these reasons, it is

ORDERED that Home Depot's motion for summary judgment is DENIED.

Dated: July 11, 2005.