Bankruptcy Claims Traders Beware: Ensure That the Cure Comes With the Claim

May/June 2011

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Over the past five years, courts have issued rulings of potential concern to buyers of distressed debt. Courts have addressed, among other things, "loan to own" acquisition strategies resulting in vote designation; equitable subordination, disallowance, and other lender liability exposure based upon the claim seller's misconduct; disclosure requirements for ad hoc committees of debtholders; the adequacy of standardized claims-trading agreements; and claim-filing requirements in the era of computerized records. One of the latest developments in the growing body of bankruptcy jurisprudence affecting this area was contributed recently by the Seventh Circuit Court of Appeals. In *In re UAL Corp.*, the court affirmed a ruling below that the purchaser of a claim based upon an executory contract which was ultimately rejected by a chapter 11 debtor in possession ("DIP") is not entitled to cure amounts as part of its allowed claim.

Assumption and Rejection of Executory Contracts and Unexpired Leases

Section 365(a) of the Bankruptcy Code allows a DIP or bankruptcy trustee, subject to court approval, to "assume" (reaffirm) or "reject" (disavow) almost any "executory contract or unexpired lease" to which the debtor was a party prior to filing for bankruptcy. Although the term is not defined in the statute, "executory" is generally understood to mean that performance remains due to some extent on both sides of an agreement as of the bankruptcy petition date,

such that the failure to perform would constitute a breach-excusing performance by the other contract party.

In a chapter 11 case, the DIP or trustee may make the decision to assume or reject such agreements (other than unexpired leases of nonresidential real property) at any time prior to confirmation of a chapter 11 plan, unless the court orders otherwise upon request of the nondebtor contracting party. This latitude affords the DIP an opportunity to determine which of its executory contracts should be retained as part of its overall restructuring strategy and which should be discarded because they are burdensome or unnecessary.

Assumption is subject to certain restrictions and conditions. For example, if a contract or lease is in default, section 365(b) of the Bankruptcy Code provides that it can be assumed only if the DIP or trustee cures the default, compensates the other party for any pecuniary loss resulting from the default, and provides adequate assurance of future performance under the agreement. Rejection of an executory contract or unexpired lease amounts to a court-authorized breach of the agreement. In most cases, the claim resulting from rejection will be treated as a prepetition claim against the estate on a par with the claims of the debtor's other general unsecured creditors.

Whether the buyer of a claim based upon an executory contract is entitled to cure amounts that would be payable upon assumption of the contract was the subject of the Seventh Circuit's ruling in *UAL Corp.*

UAL Corp.

Prior to filing for chapter 11 protection in Illinois in 2002, air carrier holding company UAL Corporation ("United") entered into various contracts for telecommunications services with AT&T Corporation ("AT&T"). Because United defaulted on the contracts, AT&T filed a proof of claim in the bankruptcy case alleging that it held a general unsecured claim in the amount of approximately $5 million arising from breach of the contracts. Shortly afterward, ReGen Capital I ("ReGen"), a financial firm that operates as a claims trader, filed a claim-transfer notice with the court indicating that ReGen had acquired AT&T's claims against United pursuant to a January 2002 assignment agreement. That agreement defined a "claim" as:

> any general pre-petition unsecured claim of AT&T against a debtor together with interest, if any, payable thereon from and after the Effective Date [of the assignment agreement], and any actions, claims, lawsuits or rights of any nature whatsoever, whether against a debtor or any other party, arising out of or in connection with the Claim, including, Assignor's right to receive, from and after the Effective Date, any cash, securities, instruments, and/or other property as distributions on the Claim.

United filed a chapter 11 plan in 2005. Among other things, the plan contained the following reservation-of-rights clause:

> The Debtors and Reorganized Debtors reserve the right to reject any executory contract or unexpired lease no later than fifteen (15) days after the later of (i) the Debtors or Reorganized Debtors and the counterparty to such executory contract or unexpired lease agree in writing to the amount of the Cure, or (ii) the entry of a Final Order establishing the Cure.

Annexed to the plan was a list of "Assumed Executory Contracts and Unexpired Leases," which included the contracts between United and AT&T but did not set forth any approved or agreed cure amounts for those contracts. The plan provided that confirmation "constitute[d] the Bankruptcy Court's approval of the proposed treatment of executory contracts" as well as a "determination that the Debtors have exercised reasonable business judgment in determining

whether to assume or reject each of their executory contracts." Finally, the plan established a "cure bar date" for parties to submit claims for cure amounts due under assumed contracts.

Sabre, Inc. ("Sabre"), another contract party unrelated to United, ReGen, or AT&T, objected to the reservation-of-rights clause, claiming that it violated section 365(d)(2)'s dictate that the decision to assume or reject be exercised prior to plan confirmation. Sabre and United settled the dispute by exempting Sabre's claim from the scope of the reservation clause. ReGen, however, raised no such objection and voted in favor of the plan, which was confirmed by the court and became effective on February 1, 2006. ReGen received its pro rata share of new common stock under the plan, but only with respect to ReGen's general unsecured claim for damages arising from breach of the contracts.

ReGen then timely filed a claim for cure amounts allegedly due under the contracts. United responded by objecting to the claim and filing a notice on June 4, 2008—more than two years after the effective date of the plan—of its intent to reject the contracts. The bankruptcy court ruled that ReGen's general unsecured prepetition claim did not carry with it the right to receive a cure payment in connection with assumption of the underlying contract. It also held that United had properly rejected the AT&T contracts in accordance with the reservation-of-rights clause in the plan.

"[T]he right to cure does not arise out of a claim," the court wrote; rather, "[i]t arises out of a contract." According to the bankruptcy court, the general prepetition unsecured claim referred to in the assignment agreement between AT&T and ReGen could not become a cure claim. The

district court affirmed on appeal, observing that "the only reasonable interpretation" of the assignment agreement was that ReGen purchased "general prepetition unsecured claims and the right to recover any distribution made on account of those general prepetition unsecured claims," but not the right to recover the full amount of the default.

The Seventh Circuit's Ruling

The Seventh Circuit affirmed. Because United rejected the underlying contracts in accordance with the express provisions of its confirmed chapter 11 plan, the court of appeals explained, no cure amounts were payable in respect of either such contracts or the claim acquired by ReGen from AT&T. According to the Seventh Circuit, regardless of whether the underlying contracts appeared on the list of contracts to be assumed upon confirmation, no assumption could have taken place until "cure or adequate assurance of prompt cure," as required by section 365(b)(1).

The court specifically declined to rule on the propriety of the rights-reservation clause, which effectively provided for the post-confirmation assumption or rejection of contracts. If ReGen wished to object to this aspect of the plan on the basis of section 365(d)(2) or otherwise, the Seventh Circuit emphasized, it could have done so prior to confirmation, as Sabre in fact did:

> We do not have occasion to decide here whether a timely challenge to United's reservation of the right to postpone the assumption decision would have been successful under section 365. Nevertheless, we can appreciate that such a reservation can make sound business sense in the context of the Code's balancing of the rights of debtors and creditors. The reservation gave the debtor protection from the risk that a creditor's demand for a cure could be more expensive than expected, and it gave the debtor the opportunity to continue to do business with AT&T without making a final decision to assume or reject that would affect ReGen rather than AT&T.

However, the court of appeals faulted the lower courts' reasoning regarding the scope of the assignment agreement. According to the Seventh Circuit, the agreement's definition of "claim" was broad enough to include the right to collect a cure amount arising from AT&T's original contracts. The court rejected United's argument that, because a separate filing is required to seek a cure claim, the cure claim "is disconnected from the general unsecured claim." The claims, the Seventh Circuit wrote, "stem from the same transaction giving rise to a single right to payment." The court explained that this conclusion is supported by rulings handed down by the Second Circuit (on nearly identical facts) and, more generally, by long-standing U.S. Supreme Court and Seventh Circuit precedent.

Outlook

UAL Corp. is a cautionary tale for claims traders, particularly those seeking to obtain payments on account of cure claims. As a contractual matter, claim-transfer documents should be drafted carefully to ensure that all rights and remedies appurtenant to a claim, including cure amounts payable upon assumption of the contract in bankruptcy, are expressly made part of the transaction if the parties intend to transfer cure claims. But even if a claim buyer purchases the right to a cure claim, there can be no assurance that the underlying contract will be assumed such that a cure claim becomes payable.

By the same token, although the parties to a sale transaction of the kind involved in *UAL Corp.* might ordinarily anticipate that the underlying contract would be rejected, this may not always be the case. As a consequence, claim-transfer agreements should expressly spell out the rights and obligations of the buyer and the seller in the eventuality that the underlying contract is in fact assumed, including which party is entitled to cure payments.

The ruling may result in more challenges to plan provisions providing for post-confirmation assumption or rejection decisions, especially if a reservation-of-rights clause is open-ended. Absent a court determination that such provisions violate section 365(d)(2) or a specific exemption from such a provision, an assignee may not know whether it will have a cure claim until after the debtor has gone through the cure claims reconciliation process.

UAL Corp. represents only one of the latest case developments affecting claims trading. Another interesting development on that front earlier this year came in the chapter 11 cases of Mesa Air Group, Inc., and its affiliates. In that case, the court entered an order restricting the trading of large claims to protect the debtor's ability to use its net operating losses. A New York bankruptcy court ruled on January 20, 2011, that creditor BF Claims Holdings I LLC, which had acquired its claims in violation of the trading order, lacked standing to object to confirmation of the debtors' chapter 11 plan. Among other things, the decision emphasizes the importance of complying with court-established procedures for acquiring claims and properly documenting claims transfers.

Regan Capital I, Inc. v. UAL Corp. (In re UAL Corp.), 635 F.3d 312 (7th Cir. 2011).

ReGen Capital I, Inc. v. Halperin (In re U.S. Wireless Data), 547 F.3d 484 (2d Cir. 2008).

Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186 (1907).

Dorr Pump & Manufacturing Co. v. Heath (In re Dorr Pump & Manufacturing Co.), 125 F.2d 610 (7th Cir. 1942).

In re Mesa Air Group, Inc., 2011 WL 320466 (Bankr. S.D.N.Y. Jan. 20, 2011).