History Matters: Historical Breaches May Undermine Assumption of Executory Contracts

Lance E. Miller

One of the primary fights underlying assumption of an unexpired lease or executory contract has long been over whether any debtor breaches under the agreement are "curable." Before the 2005 amendments to the Bankruptcy Code, courts were split over whether historic nonmonetary breaches (such as a failure to maintain cash reserves or prescribed hours of operation) undermined a debtor's ability to assume the lease or contract. By the 2005 amendments, however, Congress apparently took the position that—at least for contracts other than nonresidential real property leases—historic nonmonetary breaches do in fact generally preclude assumption of an executory contract or unexpired lease. A recent case from the Fifth Circuit Court of Appeals implicitly confirms that interpretation.

Nonmonetary Breaches Before the 2005 Amendments

Section 365(a) of the Bankruptcy Code generally permits a debtor to assume an executory contract or unexpired lease. If the contract or lease is subject to prepetition defaults, section 365(b)(1) requires the debtor to first "cure" those defaults. A breach caused by a failure to pay money is "cured" by paying the unpaid amount owed. A breach of nonmonetary covenants, however, may not be as simple. Some terms require performance at a specific time period or interval, so performance at some point in the future may not remedy the past breach.

When dealing with these nonmonetary provisions, courts generally hold that the default is not curable as a matter of law. For example, courts have prohibited assumption where breaches related to, among other things, requirements to maintain continuous operations, promises not to

use leased equipment for work with parties other than the lessor, promises not to place licensed software on third-party computers, and obligations to consummate a transaction by a specified closing date.

The cure requirements under section 365(b)(1) are somewhat moderated by section 365(b)(2), which enumerates a series of exceptions to the requirement for curing prepetition defaults. Prior to the 2005 amendments to the Bankruptcy Code, section 365(b)(2) provided:

> Paragraph (1) of this subsection [requiring cure of any defaults] does not apply to a default that is a breach of a provision relating to—
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> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
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> (B) the commencement of a case under this title;
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> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
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> (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

Notably, the first three enumerated exceptions to the cure requirements under the preamendment version of section 365(b)(2) relate to "*ipso facto*" clauses that trigger default upon a bankruptcy event. Subsection (b)(2)(D), however, addressed something other than *ipso facto* clauses, referring to "penalty rate[s] or provision[s] relating to . . . nonmonetary obligations." Before the 2005 amendments, courts were divided over whether this exception applied to penalty provisions only, or whether the reference to "provision[s] relating to . . . nonmonetary obligations" was a catchall that relieved a debtor from having to cure all nonmonetary breaches.

Under one view, exemplified by the Ninth Circuit Court of Appeals' ruling in *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997), subsection (b)(2)(D) related only to penalty provisions, such that a prepetition breach of a material nonmonetary obligation could preclude any attempted assumption of the contract or lease. For example, in *In re Williams*, 299 B.R. 684 (Bankr. S.D. Ga. 2003), the court ruled that an unexpired truck lease was unassumable where the debtor had violated prepetition a covenant under the lease to refrain from using the vehicle to do work for any company other than the lessor. Opposite this view, other courts, including the First Circuit Court of Appeals in *In re Bankvest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004), held that section 365(b)(2)(D) spoke to two different types of default provisions—penalty provisions as well as a more general provision providing for default upon a failure to perform nonmonetary obligations. Under this interpretation, nonmonetary defaults were generally not grounds to thwart assumption of an executory contract or unexpired lease.

Consider a debtor who, before filing for bankruptcy relief, breached a material covenant in a franchise agreement that required the debtor to operate its business continuously without interruption. Under the view advocated by the Ninth Circuit before the 2005 amendments, the franchise agreement would be considered unassumable because the breach of a "going dark" clause would be considered a nonmonetary default not subject to any exception enumerated under section 365(b)(2). Under the view advocated by the First Circuit, however, the agreement would be assumable without regard to the debtor's prepetition closure of business operations, because nonmonetary breaches would be deemed irrelevant to the debtor's cure obligations pursuant to section 365(b)(2)(D).

The 2005 Amendments

As part of the 2005 amendments to the Bankruptcy Code, Congress amended section 365(b)(2)(D) to provide that a debtor's cure obligations do not apply to "the satisfaction of any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease" (emphasis added). Lawmakers also amended section 365(b)(1)(A) to treat unexpired leases of nonresidential real property differently; for such leases, any breach "that arises from a failure to operate in accordance with . . . [the] lease" may be cured "by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."

In amending section 365(b)(2)(D), Congress appeared to take the position that historic and material nonmonetary breaches relating to nonpenalty provisions should generally be a bar to assumption for contracts and leases other than unexpired leases of nonresidential real property. The import of the changes to section 365(b)(2)(D) remain relatively untested, but a recent unreported decision from the Fifth Circuit Court of Appeals implicitly acknowledges that Congress effectively resolved the previously competing interpretations.

Escarent Entities

In re Escarent Entities, L.P., 2011 WL 1659512 (5th Cir. Apr. 28, 2011), involved a single-asset real estate debtor that entered into a prepetition contract to sell its ranch property to Quantum Diversified Holdings, Inc. ("Quantum"), subject to partial seller financing. The debtor filed for chapter 11 relief in Texas in January 2009, seven days before the closing date established in the purchase contract. It then filed a motion requesting authority to seek better sale terms through an

auction process. The debtor proposed that, if it was unable to obtain a better purchase offer, it would assume the purchase contract and force Quantum to close on the original terms of sale, with a rescheduled closing date. The bankruptcy court approved the assumption motion over Quantum's objection and, when the debtor failed to locate another bidder for the property, ordered that the transaction be closed "after a reasonable time."

On appeal to the district court, Quantum argued that the purchase agreement could not be assumed because the debtor's failure to consummate the sale by the original closing date was a material nonmonetary default that could not be cured by future performance. The district court affirmed the order approving the debtor's assumption of the purchase agreement, and Quantum pursued its arguments before the Fifth Circuit Court of Appeals. Curiously, whereas Quantum's arguments mirrored the terminology underlying section 362(b)(2)(D), neither party actually cited that provision in its briefing before the district court or the Fifth Circuit.

The Fifth Circuit's Ruling

Without actually citing section 362(b)(2)(D), the Fifth Circuit reversed the decisions of the courts below, reasoning that the debtor's failure to consummate the sale on the closing date was "not only a material default, but effectively an incurable one, as the parties are unable to return to January 12, 2009, when Escarent's performance was originally due." In so holding, the Fifth Circuit appears to have implicitly confirmed the prevailing view among commentators and practitioners—that following the 2005 amendments, contracts other than nonresidential property leases which are the subject of material, nonmonetary breaches may simply be unassumable.

Outlook

Although the Fifth Circuit did not cite section 365(b)(2)(D) specifically, *Escarent Entities* seems to confirm that, at least in that circuit, any fight over interpreting the provision is over. Courts in the future may adopt the Fifth Circuit's view that prior nonmonetary breaches of executory contracts and unexpired leases (other than nonresidential real property leases) must be "cured" before they can be assumed. In some cases, this "cure" requirement will simply preclude assumption as a matter of law.