WHAT IS THE CURE?: NONMONETARY DEFAULTS UNDER EXECUTORY CONTRACTS

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I. ASSUMPTION OF EXECUTORY CONTRACTS

The Bankruptcy Code (the "Code") provides that, subject to court approval, a bankruptcy estate representative (trustee or debtor in possession—the "Estate Representative") "may assume or reject any executory contract or unexpired lease of the debtor."[1] The Code was designed to allow a debtor to elect to discontinue performance under a burdensome contract, while permitting the debtor to force the other party to the contract to continue performance under a contract valuable to the bankruptcy estate.[2] When a debtor is in default under an executory contract, the Estate Representative may nonetheless assume the contract if it cures (or provides adequate assurance that it will promptly cure) such default, compensates (or provides adequate assurance of prompt compensation) for any pecuniary loss of the other party resulting from such default, and provides adequate assurance of future performance under the contract.[3] The power to assume a contract in default is not dependent upon language in the contract allowing for the cure of a default, because "if the trustee has power to assume the contract, he or she must also have power to cure or the assumption of a contract is futile."[4] Further, the power to provide assurance of a prompt cure is an extraordinary power under the Code.[5]

II. NONMONETARY DEFAULTS

If the Estate Representative has reasonably exercised its business judgment in determining whether to reject or assume an executory contract, the decision will generally be approved by the bankruptcy court.[6] However, courts have found assumption of an executory contract to be more complicated when nonmonetary defaults are involved. The First Circuit Court of Appeals, in *Newark Ins. Co. v. BankVest Capital Corp. (In re BankVest Capital Corp.)*,[7] addressed what it characterized as "an exception to an exception to the usual rule"[8] governing assumption of executory contracts under section 365 of the Code. Ordinarily, an execu-

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tory contract can be assumed (or rejected), subject to court approval. Further, if a default exists under the executory contract, the default must be cured (or adequate assurance of cure must be provided) in accordance with section 365(b)(1) of the Code. In *BankVest*, the First Circuit recognized that "the requirement in § 365(b)(1) that the debtor cure defaults prior to assumption itself has exceptions."[9]

III. THE CONFLICTING RULES OF *CLAREMONT* AND *BANKVEST*

The scope of the exception under section 365(b)(2)(D) of the Code to the cure requirement was at issue in *BankVest*. Section 365(b)(2)(D) provides:

> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
>
> . . .
>
> (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.[10]

Courts interpreting the language of section 365(b)(2)(D) have split in two general ways. In *In re Claremont Acquisition Corp.*,[11] the Ninth Circuit Court of Appeals essentially read subparagraph (D) as follows:

> (D) the satisfaction of any penalty rate or [any other penalty] provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

Under this interpretation, the word "penalty" in subparagraph (2)(D) describes both "rate" and "provision" (the "*Claremont* Rule").

In contrast, in *BankVest*, the First Circuit concluded that the word "penalty" in section 365(b)(2)(D) describes only the term "rate," and that the second half of subparagraph (2)(D) creates a distinct exception for nonmonetary defaults (the "*BankVest* Rule"). Under this view, the language of the statute can be read as follows:

> (D) the satisfaction of any penalty rate[,] or [any] provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

In *BankVest*, the debtor was in the business of originating, securitizing, selling, and servicing equipment leases. Under the contract at issue, the debtor agreed to lease specified computer equipment and the lessees were obligated to make monthly rental payments. Further, the debtor agreed to arrange for delivery of the equipment directly to the lessees from the manufacturer. Certain of the specified equipment was not available at the time of the commencement of the lease and it was agreed that

the manufacturer would provide the lessees with substitute "loaner" equipment pending completion and delivery of the balance of the equipment identified under the lease. Following confirmation of the debtor's chapter 11 plan and pursuant to a provision in the plan providing for the determination of cure costs pursuant to section 365(b)(1) for all executory contracts to be assumed, the lessees asserted that the debtor had defaulted on the subject contract by failing to replace the loaner equipment with the balance of the items identified in the lease. "Further, they contended that this non-monetary default was a historical fact not susceptible to cure (i.e., nothing BankVest could do would remedy its historical failure to deliver the equipment on time)."[12]

In *Claremont*, the executory contracts at issue involved automobile dealer franchise agreements. The franchise agreements provide that the manufacturer could terminate the franchise for the dealer's failure to operate the business for seven consecutive business days. The debtors in that case had ceased operating their automobile dealerships 13 days prior to filing their chapter 11 petitions. The Ninth Circuit concluded that the "Debtors' failure to operate the dealership for two weeks preceding the bankruptcy filing constituted a nonmonetary default. Moreover, this default is a 'historical fact' and, by definition, cannot be cured."[13] This precluded assumption of the franchise agreements.

In reaching its conclusion in *Claremont,* the Ninth Circuit determined that the construction of section 365(b)(2)(D) in a manner where the word "or" operates to create two distinct and independent exceptions to the cure requirements would be "both grammatically incorrect and nonsensical."[14] Moreover, the Ninth Circuit found the "proper construction" of section 365(b)(2)(D) to be "readily apparent," stating:

> A proper reading of subsection (D) requires that the adjective "penalty" modify *both* the words "rate" and "provision," not just the word "rate." Furthermore, like the word "penalty," the word "satisfaction" must also define both "rate" and "provision." Stated differently, subsection (D) provides an exception from cure for satisfaction of "penalty rates" and "penalty provisions." When construed in this manner, the clause following the word "or" is not a catch-all exception to paragraph (1), but instead an exception concerning those provisions of a contract which impose a penalty for a debtor's failure to perform a nonmonetary obligation.[15]

In *BankVest*, the First Circuit recognized that if the plain language of section 365(b)(2)(D) dictated a conclusion there would be no need to go any further. However, unlike the Ninth Circuit in *Claremont*, the First Circuit did not find that the proper construction of the statute was readily apparent by reviewing the language. The First Circuit stated:

> [W]e see no textual basis for preferring appellants' interpretation to the one adopted by the bankruptcy court, which strikes us as equally consistent with the text. Nothing in the language or syntax of § 365(b)(2)(D) unambiguously requires either outcome. Indeed, we are hard-pressed to endorse any "plain meaning" argument where, as here, other federal courts have reached conflicting answers to the same question based on the same "plain" language.[16]

The First Circuit rejected the reasoning underlying the Ninth Circuit's construction of subparagraph (2)(D), finding that the text of section 365(b)(2)(D) is awkward and ungrammatical on any reading. The First Circuit stated:

> [I]t proves nothing to say that the statute remains syntactically flawed when whole clauses are omitted. In any event, 'the task of statutory interpretation involves more than the application of syntactic symmantic rules to isolated sentences.' . . . The wiser methodology, and the one that we employ here, is to interpret Congress's words in light of the goals and underlying policies of the statute as a whole.[17]

Finding the language of section 365(b)(2)(D) to be ambiguous, the First Circuit sought to derive congressional intent from other sources. The First Circuit did not find the legislative history of section 365(b)(2)(D) to be helpful. Rejecting the view of the Ninth Circuit expressed in *Claremont* that the limited legislative history of the section suggests that Congress only intended to relieve debtors of the obligation to pay penalties and not to free debtors from the cure requirement with respect to nonmonetary defaults, the First Circuit stated:

> At best, the legislative history indicates that Congress intended § 365(b)(2)(D) to free debtors from lease provisions requiring the payment of penalty rates. . . But subparagraph (2)(D) also refers to non-monetary defaults, and the legislative history does not indicate what Congress intended by that reference. To interpret the House Report's explanation of one clause of subparagraph (2)(D) as a limitation on the scope of a different, unmentioned clause would 'overstate the inferences that can be drawn from an ambiguous act of legislative drafting. . . .'[18]

Accordingly, the First Circuit concluded that the legislative history was not helpful with regard to interpreting the scope of subparagraph (2)(D).

The First Circuit, in *BankVest*, carefully considered the purposes and policies underlying section 365. "The best approach to interpreting § 365(b)(2)(D) focuses on practical considerations of bankruptcy policy and Congress's overarching purposes in the Bankruptcy Code."[19] The First Circuit discussed criticism of the *Claremont* decision by bankruptcy commentators viewing that case as an obstacle to the successful reorganization of many debtors. Frequently, nonmonetary defaults are "histori-

cal" facts that are not possible to cure after the fact. "Requiring a debtor to cure such incurable defaults is tantamount to barring the debtor from assuming any lease or contract in which such a default has occurred—no matter how essential that contract might be to the debtor's reorganization in bankruptcy."[20] Rejecting the Claremont Rule, the First Circuit found that this could not be what Congress intended since it would severely undermine: (i) the basic purpose of section 365 to advance the successful rehabilitation of the debtor for the benefit of both the debtor and its creditors; and (ii) the overarching goal of the Code of maximizing the value of the estate for all creditors.[21]

In concluding that section 365(b)(2)(D) is intended to allow debtors to assume executory contracts without being obliged to cure nonmonetary defaults, the First Circuit found its interpretation to be consistent with the remaining subparagraphs in section 365(b)(2), "which are directed to so-called ipso facto clauses (for instance, contract provisions that force debtors into default merely for becoming insolvent or seeking bankruptcy protection),"[22] stating:

> Like defaults based on breaches of ipso facto clauses, non-monetary defaults are often a product of the debtor's very financial distress. In Claremont itself, for example, the non-monetary default that prevented the debtors from assuming their franchise agreement was their decision to close their automobile dealership for the two weeks immediately prior to their bankruptcy petition . . . So in the end, they were denied a valuable asset in their chapter 11 reorganization because the same financial hardship that drove them into bankruptcy also forced them to default on their dealership agreement. This, we conclude is among the ipso facto harms that Congress intended § 365(b)(2)(D) to prevent.[23]

The First Circuit further pointed out that, like with respect to direct ipso facto provisions (forfeiture provisions based on bankruptcy, insolvency, financial condition, or the appointment of a receiver or other custodian), a potential creditor could draft a contract in a manner designed to prevent assumption of the contract post-bankruptcy by specifically defining nonmonetary defaults.

> This creates the risk that a potential creditor can effectively 'bankruptcy-proof' its contract with a financially troubled company by making the deal contingent on the achievement of stringent performance or quality benchmarks. One recognized purpose of the ipso facto clauses in § 365(b)(2) is to prevent creditors from opting out of the bankruptcy process in this manner.[24]

The First Circuit explained that since ipso facto defaults "are not necessarily non-monetary," the interpretation of section 365(b)(2)(D) as relieving the Estate Representative from the obligation to cure nonmon-

etary defaults is not redundant with the relief from ipso facto provisions provided in subparagraphs (2)(A) to (C).[25]

IV. MATERIAL DEFAULTS

Some courts have attempted to soften the impact of the *Claremont* Rule by limiting the types of nonmonetary defaults they find to be incurable. In *In re New Breed Realty Enterprises, Inc.*,[26] the court held that "[w]here the default is non-monetary and is not curable, the debtor is precluded from assuming an executory contract only if the default was material or if the default caused 'substantial economic detriment."[27] In *New Breed*, the court nonetheless found the debtor could not cure under subparagraph (2)(D) what it characterized as a nonmonetary default arising from its failure to close a transaction "by the time of the essence closing date."[28] The court found that allowing the debtor to assume the contract would circumvent the effect of a material provision. The *New* Breed court precluded the debtor from assuming the contract since it found that the default went to "the fundamental right to remain in or end a contractual relationship."[29]

In *In re Walden Ridge Development, LLC*,[30] the court addressed a situation involving essentially the same facts as were present in *New Breed* and reached an opposite conclusion:

> This Court does not follow the lead of *New Breed* in characterizing the failure of a buyer to pay the purchase price under an executory contract as a non-monetary default. Such default simply does not equate to the "historical fact" default in the automobile franchise cases which may be characterized as non-monetary. Here, the failure to close was occasioned by the failure to pay the purchase price and thus constitutes a monetary default which is curable through the payment of the purchase price together with fair compensation as provided in § 365(b)(1)(A) and (B).[31]

Like the court in *New Breed*, the court in *Walden Ridge*, purported to follow the Third Circuit's view in *Joshua Slocum* that the Estate Representative need not cure a nonmonetary default unless the default was material or caused substantial economic detriment. The approach of the court in *Walden Ridge* further limited the scope of the *Claremont* Rule by finding that it applied only to franchise cases and certain other material nonmonetary defaults causing substantial economic detriment and not to an Estate Representative's failure to pay the purchase price and close a transaction regardless of whether there was a time-of-the-essence closing date requirement in the contract.

V. EFFECT OF 2005 AMENDMENTS TO THE BANKRUPTCY CODE

In the course of its analysis of section 365(b)(2)(D) in *BankVest*, the First Circuit considered the then-pending legislation to amend section 365(b)(2)(D) by striking the phrase "penalty rate or provision" and replacing it with "penalty rate or penalty provision" and also amending section 365(b)(1) by modifying the cure requirement for certain nonmonetary defaults. At the time of the *BankVest* decision, the First Circuit found that "[t]he most that can be gleaned from this unenacted legislation is that at least some members of Congress are aware that § 365(b)(2)(D) is a problem. It does not tell us how Congress in 1994 [the time that the then-existing version of Section 365(b)(2)(D) was enacted] intended the present version of subparagraph (2)(D) to operate in cases like the one at bar."[32]

With the adoption of the 2005 amendments to the Code,[33] the language of subparagraph (2)(D) is now clearer and will be applied with respect to cases commenced 180 days or more following the enactment of the new legislation. Subparagraph (2)(D) has been amended by adding the word "penalty" prior to the word "provision" and, as amended, reads as follows:

> (D) 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.

Accordingly, under subparagraph (2)(D), penalty rates and other penalty provisions arising from a nonmonetary default do not need to be cured in order for assumption of the executory contract. This would seem to reflect an adoption of the *Claremont* Rule, at least as far as subparagraph (2)(D) is concerned. However, section 365(b)(1)(A) has also been amended in a manner that impacts the Estate Representative's obligation to cure nonmonetary defaults.

Prior to the 2005 amendments, subparagraph (1)(A) of section 365(b) of the Code simply provided the requirement that the Estate Representative could not assume an executory contract unless it "(A) cures, or provides adequate assurance that the trustee will promptly cure such default". Under the 2005 amendments, subparagraph (b)(1)(A) now provides that, with respect to assumption of an executory contract where a default exists, the Estate Representative cannot assume the contract unless it:

> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossi-

> ble for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such defaults arises from a failure to operate in accordance with the nonresidential real property lease, then such default shall 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.[34]

In order to fit within the new exception to the cure requirement under amended subparagraph (1)(A), it appears that the following elements need to be present: (1) the default must be a nonmonetary default (but not a related penalty rate or penalty provision); (2) the default must occur under a real property lease; and (3) it must be impossible for the Estate Representative to cure the nonmonetary default. However, if the default involves failure to operate under a nonresidential real property lease, that nonmonetary default can and must be cured by performance at and after the time of assumption. It is unclear why this amendment is limited to nonmonetary defaults under real property leases, instead of applying to all executory contracts. Moreover, it is unclear why the "failure to operate" provision only applies to nonresidential real property leases. The amendment, presumably would not change the result in *Claremont* where the contracts at issue were dealership franchise agreements and not simply real property leases. Further, the question of what it means to be "impossible" for the Estate Representative to cure the nonmonetary default may, in some instances, result in uncertainty and disagreement. Additionally, it may be uncertain whether particular defaults are truly nonmonetary in nature. For example, it is the view of the court in *New Breed* that the failure to close a time-of-the-essence transaction by paying the purchase price is a nonmonetary, historical default that cannot be cured. The court in *Walden* Ridge rejected this approach. However, if the subject contract is not a real estate lease, the nonmonetary default cure exception will not apply in any event. If a contract is titled as a real estate lease, but also includes, attaches, references or otherwise is connected with other agreements, do nonmonetary defaults under the "lease of real property" or under the connected agreements come within the cure exception of subparagraph (b)(1)(A)?

VI. CONCLUSION

While likely to spawn uncertainty in litigation connected with the curing of defaults in the process of assuming real property leases, the 2005 amendments to section 365 do at least attempt to address the *Claremont* problem when the historical, incurable default situation arises in the context of a real property lease. However, the problem continues to exist and is likely to hamper reorganization efforts when nonmonetary

defaults are present in other types of executory contracts. Moreover, it would appear that in cases governed by the 2005 amendments, the *Claremont* Rule, as codified in amended section 365(b)(2)(D), will apply to executory contracts that are not real property leases.

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1. 11 U.S.C.A. § 365(a). While the Bankruptcy Code does not define the term "executory contract," the United States Supreme Court has defined contracts as executory when "performance remains due to some extent on both sides." N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 522 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984) (citation omitted).

2. See Bildisco, 465 U.S. 513, 528 ("The authority to reject an executory contract is vital to the basic purpose of a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization.").

3. See 11 U.S.C.A. § 365(b)(1). Compensation for pecuniary loss includes reasonable attorney's fees incurred as a result of the default if provided for in the contract. See In re Child World, Inc., 161 B.R. 349, 353-55, 24 Bankr. Ct. Dec. (CRR) 1450 (Bankr. S.D. N.Y. 1993).

4. Post v. Sigel & Co. (In re Sigel & Co., Ltd.), 923 F.2d 142, 145, 21 Bankr. Ct. Dec. (CRR) 375, 24 Collier Bankr. Cas. 2d (MB) 869, Bankr. L. Rep. (CCH) P 73780 (9th Cir. 1991).

5. Sigel & Co., 923 F.2d 142. (["N]ormally if a contract is breached, the breach cannot be cured by an assurance that it will be cured. The statute [11 U.S.C.A. § 365(b)(1)] gives the trustee a power that in this respect goes beyond the contract.").

6. See Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046-47, 12 Bankr. Ct. Dec. (CRR) 1281, 12 Collier Bankr. Cas. 2d (MB) 310, 226 U.S.P.Q. (BNA) 961, Bankr. L. Rep. (CCH) P 70311 (4th Cir. 1985).

7. In re BankVest Capital Corp., 360 F.3d 291, 42 Bankr. Ct. Dec. (CRR) 210, Bankr. L. Rep. (CCH) P 80062 (1st Cir. 2004), cert. denied, 124 S. Ct. 2874, 159 L. Ed. 2d 776 (U.S. 2004).

8. In re BankVest Capital Corp., 360 F.3d 291, 295.

9. In re BankVest Capital Corp., 360 F.3d 291, 296. For example, as an exception to the general rule, the Estate Representative is not required to cure nonmonetary defaults under provisions of an executory contract relating to the insolvency or financial condition of the debtor, the commencement of the debtor's bankruptcy case, or the appointment of or taking possession by a bankruptcy trustee or a pre-bankruptcy custodian. See 11 U.S.C.A. § 365(e)(1).

10. 11 U.S.C.A. § 365(b)(2)(D).

11. In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 30 Bankr. Ct. Dec. (CRR) 1045, Bankr. L. Rep. (CCH) P 77469 (9th Cir. 1997).

12. In re BankVest Capital Corp., 360 F.3d 291, 295.

13. In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1033, citing In re Lee West Enterprises, Inc., 179 B.R. 204, 208, 26 Bankr. Ct. Dec. (CRR) 1102 (Bankr. C.D. Cal. 1995).

14. In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1034.

15. In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1034, see also In re Williams, 299 B.R. 684, 686 (Bankr. S.D. Ga. 2003).

16. In re BankVest Capital Corp., 360 F.3d 291, 297, citing In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1034, In re Williams, 299 B.R. 684, 686, In re BankVest Capital Corp., 290 B.R. 443, 447, 41 Bankr. Ct. Dec. (CRR) 14 (B.A.P. 1st Cir. 2003), judgment aff'd, 360 F.3d 291, 42 Bankr. Ct. Dec. (CRR) 210, Bankr. L. Rep. (CCH) P 80062 (1st Cir. 2004), cert. denied, 124 S. Ct. 2874, 159 L. Ed. 2d 776 (U.S. 2004), In re Claremont Acquisition Corp., Inc., 186 B.R. 977, 990 n. 11 (C.D. Cal. 1995), aff'd, 113 F.3d 1029, 30 Bankr. Ct. Dec. (CRR) 1045, Bankr. L. Rep. (CCH) P 77469 (9th Cir. 1997); see also In re Mirant Corp., 2004 Bankr. LEXIS 1377, (Bankr. N.D. Tex. 2004).

17. In re BankVest Capital Corp., 360 F.3d 291, 297 (citations omitted).

18. In re BankVest Capital Corp., 360 F.3d 291, 298 (citations omitted).

19. In re BankVest Capital Corp., 360 F.3d 291, 299.

20. In re BankVest Capital Corp., 360 F.3d 291, 299.

21. In re BankVest Capital Corp., 360 F.3d 291, 300.

22. In re BankVest Capital Corp., 360 F.3d 291, 301, citing 11 U.S.C.A. 365(b)(2)(A) to (C).

23. In re BankVest Capital Corp., 360 F.3d 291, 301 (citations omitted).

24. In re BankVest Capital Corp., 360 F.3d 291, 301 (citations omitted).

25. In re BankVest Capital Corp., 360 F.3d 291, 301 (citations omitted).

26. In re New Breed Realty Enterprises, Inc., 278 B.R. 314 (Bankr. E.D. N.Y. 2002).

27. In re New Breed Realty Enterprises, Inc., 278 B.R. 314, 321, citing and quoting In re Joshua Slocum Ltd., 922 F.2d 1081, 1092, 21 Bankr. Ct. Dec. (CRR) 361, 24 Collier Bankr. Cas. 2d (MB) 581, Bankr. L. Rep. (CCH) P 73769, 117 A.L.R. Fed. 725 (3d Cir. 1990); see also Beckett v. Coatesville Housing Associates, 2001 WL 767601 (E.D. Pa. 2001) ("[M]aterial breaches of a non-monetary nature are not curable under § 365.").

28. In re New Breed Realty Enterprises, Inc., 278 B.R. 314, 325.

29. In re New Breed Realty Enterprises, Inc., 278 B.R. 314, 325, quoting In re Joshua Slocum Ltd., 922 F.2d 1081, 1092.

30. In re Walden Ridge Development, LLC, 292 B.R. 58, 41 Bankr. Ct. Dec. (CRR) 69, Bankr. L. Rep. (CCH) P 78847 (Bankr. D. N.J. 2003).

31. In re Walden Ridge Development, LLC, 292 B.R. 58, 67.

32. In re BankVest Capital Corp., 360 F.3d 291, 298-99.

33. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, § 328 (as passed by the U.S. Senate on March 10, 2005).

34. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, § 328 (as passed by the U.S. Senate on March 10, 2005).