

SDNY Clarifies Availability of Administrative Priority for Postpetition Contract Breaches

By John J. Rapisardi and Matthew Kremer



The District Court’s holding reverses some of the potentially harmful consequences of the lower court’s decision—which, if affirmed, would have undermined the Bankruptcy Code’s statutory protections intended to encourage parties to transact with debtors in bankruptcy.

The U.S. District Court for the Southern District of New York recently provided critical guidance on what the court observed as the “psychedelic confusion” surrounding the intersection of Bankruptcy Code §365, governing the assumption and rejection of executory contracts, and Bankruptcy Code §503, governing administrative priority. (The classification of any claims entitled to administrative priority status would allow for such claims to be paid in full, as opposed to treatment as prepetition unsecured claims which would receive a discounted distribution.) Specifically, in *Finance of America v. Mortgage Winddown (In re Ditech Holding)*, No. 21-cv-10038 (LAK), 2022 WL 4448867 (S.D.N.Y. Sept. 23, 2022), U.S. District Court Judge Lewis A. Kaplan sought to answer the “single question” of in what circumstances (if any) a postpetition breach of an executory contract could give rise to an administrative expense priority claim? (Bankruptcy Code §365(g) provides that rejection of a prepetition contract “constitutes a breach of contract” immediately prior to the debtor’s bankruptcy

filing, meaning the resulting rejection damage claim is a general unsecured claim. See 11 U.S.C. §365(g). As a result, the payment of the claim “can be thought of as being in little tiny Bankruptcy Dollars, which may be worth only ten cents in U.S. dollars.” *Cohen v. Drexel Burnham Lambert Group (In re Drexel Burnham Lambert Group)*, 138 B.R. 687, 706 (Bankr. S.D.N.Y. 1992) (quoting Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 228 (1989)).) The court rejected the Bankruptcy Court’s analysis that focused on whether a contract extension created a new postpetition contract or modified an existing contract under state law. See *Finance of America v. Mortgage Winddown (In re Ditech Holding)*, No. 19-10412 (JLG), 2021 WL 4928724 (Bankr. S.D.N.Y. Oct. 21, 2021). Instead, the court concluded that the appropriate test is whether the postpetition breach was within the parties’ “fair contemplation” at the time they entered the contract. If a postpetition breach was not within the parties’ fair contemplation, then the breach is deemed to arise postpetition and the resulting claims are eligible for administrative expense priority to the extent they constitute “actual, necessary costs and expenses” of preserving the estate.

But even if the breach was foreseeable and the resulting claims arise prepetition, the analysis does not end here. Judge Kaplan recognized the well-established equitable claim of quasi-contract (or quantum meruit)—something the Bankruptcy Court failed to do. That is, where a debtor elects to receive goods or services postpetition the party supplying goods or services is eligible for administrative priority if the estate receives a demonstrable benefit.

This decision should provide some relief to contract counterparties. It clears up the market confusion created by the Bankruptcy Court’s decision and confirms that administrative priority status is available if (1) a contract counterparty is induced to perform and provides a demonstrable benefit to the estate postpetition, or (2) a postpetition breach was not in the fair contemplation of the parties.

Facts

One of the debtors in *Ditech*, Reverse Mortgage Solutions (RMS), was party to several reverse mortgage subservicing agreements with Finance of America Reverse (FoA). From March 2011 to October 2018, FoA and RMS entered into three mortgage subservicing agreements, under which RMS collected and remitted mortgage payments in exchange for subservicing fees. The first agreement was entered in March 2011, and was extended by agreement seven times prior to the bankruptcy filing and four times thereafter. The two other agreements, entered on December 12, 2017 and October 4, 2018, included a one month term, but afforded FoA a unilateral monthly renewal option. Such option was exercised multiple times and the agreements were extended through February 2019 and September 2019, respectively.

RMS filed for Chapter 11 on Feb. 11, 2019. The plan went effective in September 2019 and provided for the sale of the business to a third-party. The purchaser elected not to assume any of the subservicing agreements with FoA.

FoA filed proofs of claims totaling more than \$14 million related to RMS’s alleged contract breaches from the petition date through the plan effective date. FoA claimed that each of the extension agreements created a new postpetition contract under applicable state law, thus entitling FoA to administrative claim priority status (entitled to 100% payment). The administrator of RMS’s reorganization plan objected to the claims. The plan administrator argued that the parties did not enter into new agreements, but merely extended the terms of the existing agreements, thereby rendering the claims general unsecured claims (entitled to an estimated recovery of 13-15%).

Bankruptcy Court’s Decision

The Bankruptcy Court sustained the plan administrator's objection and reclassified the claims as general unsecured claims. The Bankruptcy Court centered its analysis on *Hain v. Bush Indus. (In re Bush Indus.)*, No. 05-CV-119S, 2006 WL 8455682 (W.D.N.Y. March 29, 2006), a Western District of New York decision that addressed whether certain contract modifications created a new agreement arising after a Chapter 11 filing. The Bankruptcy Court summarized *Bush* as standing for the proposition that "an agreement that restates contract provisions with no substantive changes, involves the same relationship among the same parties, contains clauses that state the parties' desire to amend and restate prior agreements, and merely adjusts the term of the agreement or the compensation, does not constitute a new contract." The Bankruptcy Court concluded that FoA and RMS's postpetition extensions were analogous to the modifications in *Bush* because the extensions merely (1) restate the provisions of the applicable subservicing agreements with no substantive changes, (2) involve the same relationship among the same parties, and (3) state the parties' intention to extend the same terms. Consequently, the court determined that the claims arose prepetition as a result of the rejection of the prepetition executory contract and were not entitled to administrative priority treatment as a result of a breach or rejection of a postpetition contract.

District Court's Decision

On appeal, Judge Kaplan rejected the Bankruptcy Court's reliance on *Bush* and the inquiry into whether the extension agreements constitute new contracts as a matter of state law. The court recognized that it is the Bankruptcy Code, not state law, that governs when a claim arises. To address this question, the focus is not on whether a new contract was created, but whether the breach in question was within the "fair contemplation" of the parties at the time they entered into the underlying contract.

March 2011 Agreement. Applying the "fair contemplation" test, the court determined that the March 2011 agreement was distinguishable because the agreement was extended postpetition by mutual agreement between FoA and RMS. Although the "types" of subservicing errors that gave rise to FoA's claims may have been foreseeable, the risk of a postpetition breach was not since the contract by its terms would have expired but for the postpetition extension. In other words, the risk of subservicing errors beyond the contract expiration date was not within the fair contemplation of the parties at the time they entered into the contract.

In reaching this decision, the court focused on certain "troubling" inefficiencies created by the Bankruptcy Court's holding. In particular, the court observed that a rule that postpetition contract extensions with identical substantive terms cannot result in an administrative priority claim would "flip the Bankruptcy Code on its head" because it would disincentivize parties that rendered services to a debtor prepetition from providing those services on the same or similar terms postpetition. This would directly undermine the reason for granting administrative status in the first place: to encourage continued business interactions with the debtor. It would also create unnecessary inefficiencies in the bankruptcy process by forcing a debtor to locate new service providers when parties with preexisting relationship could presumably provide such services more efficiently.

Judge Kaplan was further troubled by how the Bankruptcy Court's decision did not align with the Bankruptcy Code's policy of allowing priority claims to prevent unjust enrichment; if any prepetition agreement that does not require postpetition performance necessarily gives rise to unsecured claims for postpetition breaches (because an extension of the agreement was foreseeable), this would pave the way for debtors to receive services for which they have no intention of paying.

December 2017 and October 2018 Agreements. The District Court concluded that the breaches under the other two subservicing agreements—the December 2017 agreement and October 2018 agreement—arose prepetition because those agreements were extended unilaterally by FoA, not based on the mutual consent of the parties. Applying the "fair contemplation" test, it was foreseeable that

FoA could obligate RMS under these agreements as no agreement or action by any other party was required.

Although the breach of contract claims arising under the December 2017 and October 2018 agreements were not entitled to administrative status, Judge Kaplan acknowledged that other claims may exist if the estate received demonstrable benefits from FoA postpetition. The Bankruptcy Court had failed to consider the equitable claim of quasi-contract; that is where one party has created an expectation inducing another to give new value. To further the Bankruptcy Code's equitable principle of preventing unjust enrichment, it is well-established that an administrative claim may arise in the circumstances where a debtor elects to receive benefits from another. However, the court recognized that because statutory priorities in bankruptcy are narrowly construed, for administrative priority to be available, the claimant must be induced to provide a postpetition benefit to the estate it otherwise would not have provided. As a result, a counterparty may not be eligible for administrative status if the party simply elects to continue to perform under its contract without an affirmative inducement by the debtor. (An example of this distinction was highlighted by this same court in *In re Drexel Burnham Lambert Group*, in which the court denied administrative claim status for a postpetition contract breach due to a lack of inducement. *In re Drexel*, 138 B.R. at 713. Here, the debtor's general counsel, who signed a four-year employment contract approximately 10 months before the corporation filed bankruptcy, sought severance pay under the terms of his contract in the amount of \$3.7 million. The court concluded that any inducement was made prepetition (when the contract was signed) and thus denied administrative status for the claim, particularly since the general counsel only continued in the Debtor's employment two months after the filing.)

Judge Kaplan therefore vacated the Bankruptcy Court's decision for further proceedings consistent with the opinion. FoA's quasi-contract claims may be eligible for administrative priority if the Bankruptcy Court concludes that FoA was induced by RMS to provide a postpetition benefit to the estate it otherwise would not have provided.

Conclusion

The District Court's holding reverses some of the potentially harmful consequences of the lower court's decision—which, if affirmed, would have undermined the Bankruptcy Code's statutory protections intended to encourage parties to transact with debtors in bankruptcy. Contract counterparties should take comfort that under the “fair contemplation” test an agreement to extend contract terms will not be used against such party in determining whether a breach arises postpetition, potentially entitling the party to administrative priority. In addition, even if a breach is deemed to arise prepetition, if a counterparty is induced and provides a demonstrable benefit to the estate postpetition, such party may be entitled to administrative priority under the quasi-contract doctrine.

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