Are §§ 1129(a)(1) and (3) Dead? Erosion of Contract Counterparty's Rights in Chapter 11

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I thought I had "seen it all" in an article I wrote last year[1] where I warned contract counterparties that when the chapter 11 plan contemplates a sale of the debtor's assets, some debtors lure them into complacency by including them on the "assumed contracts" list—only to amend that list and reject most or all of the executory contracts on the eve of the sale's closing. However, in the past year, I have seen chapter 11 debtors and their counsel use new tactics to deprive these creditors of the protections that § 365 of the Bankruptcy Code affords them. The Seventh Circuit's recent decision in *In re UAL Corp.*[2] signals the continuing erosion of the contract counterparty's rights in chapter 11.

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Pursuant to 11 U.S.C. § 365(d)(2), a chapter 11 debtor may assume or reject an executory contract at any time before confirmation of a plan. However, the bankruptcy court may grant a creditor's request to set a different deadline. Many chapter 11 debtors want maximum flexibility for as long as possible and, consequently, prefer to deal with their executory contracts as part of the plan-confirmation process. Frequently, the debtor's disclosure statement (or the order approving it) requires the debtor to file (and serve on contract counterparties) a so-called "plan supplement" before the confirmation hearing, itemizing which contracts will be rejected and assumed (and, perhaps, assigned)—along with the debtor's calculation of cure amount owing on each contract to be assumed. The plan supplement, the order approving the disclosure statement or some other paper sets a deadline for contract counterparties to object to the debtor's version of the cure amount.

Theoretically, this procedure should work if the affected creditors receive notice of the plan supplement and the proposed cure amount in time to file objections. Historically, the deadline for objections to the cure amount seemed to coincide with the deadline for objections to plan confirmation—so the contract counterparty's objection could be filed as both an objection to the cure amount and objection to plan confirmation.[3] From a tactical standpoint, the savvy creditor wants to file its objection to the cure amount as an objection to plan confirmation in order to obtain maximum leverage from a debtor who is anxious to resolve plan objections before the confirmation hearing.

Increasingly, debtors are "gerrymandering" deadlines and procedures so that the deadline for contract counterparty objections is *after* the deadline for objections to plan confirmation. This has the effect of "bifurcating" the subject matter of objections and giving debtors the upper hand in negotiations to resolve them. For example, if the contract counterparty misses the deadline to object to plan confirmation, the debtor's attempts to resolve any objection likely will begin with the assertion that the contract counterparty's only timely objection pertains to the cure amount. Consequently, the creditor will have less leverage with the debtor than if it had objected to confirmation. While a debtor anxious for plan confirmation might be concerned about a plan objection, that same debtor is generally less concerned with objections to the cure amount because they do not often get heard by the bankruptcy judge as part of the plan-confirmation process. Instead, cure-amount objections are usually diverted to the "cure claim reconciliation" process, during which the debtor (or the disbursing agent) retains the money (or the disputed portion thereof) until the debtor and the creditor agree on the figure for the cure amount.

Worse yet, debtors and their counsel are increasingly cutting procedural corners in an effort to effectively silence contract counterparties and make it nearly impossible for them to file objections to plan confirmation. Bankruptcy courts appear to be condoning this, which is even more disturbing. On Feb. 17, 2011, I received an urgent call from a new client who was a contract counterparty in a large chapter 11 case. The plan confirmation hearing was set for Feb. 24, and objections to plan confirmation were due on Feb. 17—which is why the call was urgent. The debtor had been permitted to wait until Feb. 14—just three days before the plan objection deadline—to file the plan supplement containing the list of executory contracts to be assumed, assigned or rejected. The debtor filed the plan supplement on Feb. 14 stating that the list of contracts being assigned was too voluminous—and if a contract or lease was not included in one notice, then the contract is being assumed and assigned and the cure amount is "-0-." Contract counterparties were given until Feb. 22 to object to the cure amount, but the Feb. 17 deadline for plan objections meant that they had only three days between the filing of the plan supplement date and the deadline for filing objections to the plan.

The procedure was very confusing to creditors. First, they had to figure out which list their contract was on. Then, if their contract was on the list of assigned contracts, they were puzzled as to *how* the cure amount could be "-0-." The answer, of course, was in the fine print. The "notes" admitted that the cure amount listed was what the debtor *proposed* to pay as a condition to assumption and/or assignment, *and that it might not reflect what the debtor's books and records showed as the*

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[1] Lisa S. Gretchko, "Beware the Executory Contract Bait and Switch," XXIX *ABI Journal* 7, 42-43, 79, September 2010.

[2] 635 F.3d 312 (7th Cir. 2011).

[3] Because § 1129(a)(1) of the Bankruptcy Code requires that the chapter 11 plan comply with applicable provisions of the Code (including § 365(b), which requires payment of the cure amount, or adequate assurance that it will be promptly paid, as a condition to assumption or assignment of an executory contract), it is appropriate for a contract counterparty to file an objection to the cure amount as a plan objection.

actual pre-petition amount owing to the contract counterparty.

The Feb. 14 notice of the plan supplement was mailed to creditors, so many of them did not receive it for several days. My new client received it on Feb. 17—the due date of plan objections. I had four hours to file a plan objection in bankruptcy court in a distant state. It was a mad dash to meet that deadline!

This scenario is wrong on many levels, and bankruptcy courts should not condone it. First, there are the procedural problems, which can be easily remedied by bankruptcy judges requiring strict adherence to the notice provisions inherent in the Bankruptcy Code and Rules. If a debtor seeks to assume an executory contract by motion, Rule 9014(a) of the Federal Rules of Bankruptcy Procedure requires that the debtor give the contract counterparty reasonable notice and opportunity for hearing. Why should there be a different standard for "reasonable notice" to contract counterparties when the debtor seeks to assume contracts as part of the plan confirmation process?

The more serious problem is a debtor's practice of filing an assumed/assigned contract list that proposes to pay a "-0-" cure amount on many or most of the debtor's executory contracts, and then putting the burden on the contract counterparty to timely file an objection to the "-0-" cure amount. A debtor's admission that the "-0-" cure amount is a *proposed* cure figure (and that it might not reflect what the debtor's own books and records show as the true cure amounts owed to contract counterparties) means that the debtor and its counsel have knowingly proposed a plan that violates § 365(b)(1). This is wrong. It might be a new scheme that debtors' counsel invented in order to get chapter 11 plans confirmed, but it is also a perversion of the Code that effectively throws contract counterparties under the bus. Section 1129(a)(3) of the Code requires that any plan be proposed in good faith, and § 1129(a)(1) requires a plan to comply with the applicable provisions of title 11. A debtor's proposing "-0-" cure amounts when its own books and records show that there are amounts owing to contract counterparties seems to violate both of the foregoing Code sections.

The participation of debtor's counsel in this "-0-" cure amount scheme, while knowing and admitting that the debtor's books and records show pre-petition amounts owing to contract counterparties, would seem to constitute a violation of Rule 9011 of the Federal Rules of Bankruptcy Procedure. However, debtors' counsel are likely to argue that the "notes" constituted adequate disclosure and that they were merely "shifting the burden" to the contract counterparties to object to the "-0-" cure amount. While reasonable minds may differ on whether the participation of debtor's counsel constitutes a Rule 9011 violation, the practice of a debtor proposing "-0-" cure amount to try to "flush away" known cure claims would end if bankruptcy judges would simply deny plan confirmation because this scheme violates §§ 1129(a)(1) and (3).

In order for a bankruptcy court to deal with the "-0-" cure claim scheme, the court would need to *find out* about it—most likely from a contract counterparty's objection. Perhaps this is *why* debtors' counsel seeks to have the court set the deadline for the plan supplement so close to the confirmation hearing—so that contract counterparties will not receive the plan supplement in time to file an object to plan confirmation based on the debtor's violations of §§ 1129(a)(1) and (3). Viewed through this prism, a debtor's request for a late deadline for the plan supplement appears to be designed to silence the objections of contract counterparties (who might not be able to "connect the dots" in time to file an objection to plan confirmation) while at the same time "flushing away" the cure claim that even the debtor's books and records show is owed.

Sadly, it appears that bankruptcy courts are not inclined to protect contract counterparties. In *In re UAL Corp. (ReGen Capital I Inc. v. UAL Corp.)*,[4] the Seventh Circuit basically held that contract counterparties are "on their own" when it comes to protecting themselves. Despite the language of § 365(d)(2), which permits assumption or rejection of executory contracts or unexpired leases at any time *before* the confirmation of a plan, the Seventh Circuit recently affirmed the bankruptcy court's approval of a reorganization plan that proposed to assume the executory contracts that were listed on an exhibit to the plan—even though no cure amount was listed on that exhibit. Instead, the plan included a so-called "reservation of rights" that enabled the debtor to reject any executory contract on the list within 15 days after the debtor and contract counterparty agree to the cure amount or an order establishing the cure amount. Obviously, this "reservation of rights" was designed to coerce creditors to agree to a smaller cure amount in order to avoid rejection of their executory contracts, but because the assumption or rejection likely would not occur before plan confirmation, the procedure and its timing seem to violate § 365(d)(2).

The Seventh Circuit expressly declined to address the "broader issues posed by such post-confirmation assumption or rejection arrangements."[5] Instead, the court found that the plan became binding on all creditors upon confirmation. The court observed that one contract counterparty had timely filed a plan objection alleging that the post-confirmation contract assumption/rejection procedure violated § 365(d)(2), and that this objection was resolved by exempting that creditor from the debtor's reserved right to reject that contract. Because the appellant in *UAL* failed to file a similar objection to plan confirmation and failed to appeal the confirmation order, the Seventh Circuit simply held that the appellant was bound by the confirmation order.

The Seventh Circuit's refusal to address the propriety of post-confirmation assumption or rejection arrangements does not bode well for the non-debtor parties to executory contracts. In the aftermath of the *UAL* decision, this class of creditors and their counsel should be much more proactive. Creditors' counsel should carefully monitor the chapter 11 case and object to a debtor's request to file the plan supplement as close as possible to the confirmation hearing, or any other maneuver that impairs the procedural due process to which contract counterparties are entitled. This likely requires a limited objection to the debtor's disclosure statement (or to the proposed order granting it) and/or an objection to any order establishing deadlines and procedures regarding plan

4 635 F.3d 312 (7th Cir. 2011).

5 *Id.* at 321.

confirmation. Bankruptcy courts should also recognize that a late deadline for the debtor to file the plan supplement means that contract counterparties will not have sufficient notice to timely file a plan objection—including objections identifying the violations of §§ 1129(a)(1) and (3) inherent in the debtor's proposing to pay "-0-" on known cure claims reflected in the debtor's own books and records. Indeed, a late plan supplement deadline has the effect of keeping contract counterparties (and the bankruptcy court) "in the dark" until it is too late.

Creditors' counsel should be especially alert to the fact that the deadline for plan objections is increasingly set to expire *before* the deadline for objections to cure amounts. In order to gain leverage, counsel would be well advised to file any objection to the cure amount as an objection to plan confirmation, which is appropriate because § 1129(a)(1) requires that a plan comply with the Code, which elsewhere requires that a contract counterparty be paid the cure amount actually owing as a condition to assumption or assignment of the executory contract (or provided with adequate assurance that it will be promptly paid.) Such an objection to plan confirmation should also highlight any defects in the timing or procedures regarding the plan's efforts to assume, assign or reject executory contracts, especially any "-0-" cure claim proposal when the debtor's own books and records *show* a cure amount owing. According to the Seventh Circuit's decision in *UAL*, if the debtor intends to assume, assign or reject executory contracts as part of its plan-confirmation process but the procedure or timing is flawed, then the contract counterparty should timely file an objection to plan confirmation. Otherwise, entry of the confirmation order could leave that contract counterparty unexpectedly last in line. ■