
Trading Away Priority? Implications of Seventh Circuit Decision in *United Air Lines* on Bankruptcy Claims Trading & Contract Assumption

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Claims trading is common in most larger bankruptcy cases, with financial institutions closely monitoring the cases and pricing the value of potential distributions to creditors. But as the Seventh Circuit's recent decision in *United Air Lines* reminds us,¹ the amount ultimately distributed to creditors is not always the only variable affecting the value of bankruptcy claims, especially when those claims arise from on-going contracts between the debtor and its creditors. Buyers and sellers of bankruptcy claims should take note of this new decision and its potential implications on the claims trading market and on the assumption of executory contracts by debtors.

Purchasing Priority?

The initial question addressed by the Seventh Circuit Court of Appeals in the *United Air Lines* decision is whether ReGen Capital, a bankruptcy claims purchaser, bought from a telecommunications provider servicing United *both* the provider's general unsecured claim *and* any right that the provider may have had to a priority cure claim, or whether ReGen bought *only* the provider's general unsecured claim.

The provider's claims against United arose out of contracts between the two parties, in this case contracts for on-going telecommunications services. When United filed its bankruptcy petition, the provider was owed over \$4 million for accrued and unpaid charges under the contracts. In the first instance, that \$4 million pre-petition claim would be classified as a "general unsecured claim" without any priority of distribution over claims of other creditors, because the claim arose prior to the bankruptcy filing and was afforded no statutory priority under the Bankruptcy Code. However, if United wanted to "assume" the still-active underlying contracts² and enjoy the benefits of those contracts during and following the bankruptcy case, it would be required to "cure" the nonpayment of the \$4 million by paying the provider that amount at the time of assumption, essentially granting that claim a priority of distribution. Alternatively, United could "reject" the underlying contracts, giving up its entitlements under those contracts, and could thereby maintain the general unsecured status of the provider's pre-petition claims.

A crucial fact in the recent Seventh Circuit decision was that, before United made any decision to assume or reject the telecommunications provider's contracts, the provider sold its \$4 million claim to ReGen. This crucial fact gave rise to a crucial question: when ReGen bought that claim, did it also buy any right to cure payments if United assumed the contracts?

The Legal Answer: ReGen Bought Both the Provider's General Unsecured Claim and Any Cure Claim

After reviewing the claim assignment agreement between the provider and ReGen, both the bankruptcy court and, on initial appeal, the district court³ found that ReGen had only bought the provider's general unsecured claim and not any right to a cure payment. The district court agreed with the bankruptcy court that "the right to a cure does not arise out of a claim" and that, instead, a cure right "arises out of a contract." The lower courts ruled that, because the ReGen assignment only covered the provider's claims and did not effect an assignment of the underlying contracts, ReGen did not acquire any cure rights.

The Seventh Circuit disagreed with the lower courts. It held that the claim assignment agreement was broad enough to cover both the provider's claims and any right to cure. The Seventh Circuit focused on language in the assignment agreement referring to the transfer of all rights "arising out of or in connection with the claim." In further support of its decision, the Seventh Circuit cited precedent from the Second Circuit, which required a claims purchaser to file a cure claim to preserve any cure right and which therefore placed the cure rights in the hands of the purchaser,⁴ as well as older Seventh Circuit and Supreme Court precedent, which held that a right of priority attaches to the corresponding claim and survives a transfer of the claim, and that priority of a claim is not specific to the creditor holding the claim at the time the claim originates.⁵

Accordingly, the Seventh Circuit reversed the decisions of the lower courts that denied ReGen's cure claim. But does that mean ReGen was entitled to be paid over \$4 million on a priority basis as a cure claim?

The Practical Answer: Where There is No Assumption, There is No Cure

Although ReGen prevailed in its appeal on the issue of whether, as a purchaser of the provider's claims, it had a right to seek cure amounts under the provider's contracts, ReGen ultimately lost its bid for payment of cure amounts. On its face, the reason for this loss appears simple: because cure amounts are only due in connection with assumption of contracts by a debtor, and because United did not assume the provider's contracts, ReGen was not entitled to any cure payments.

However, the facts surrounding United's decisions to assume or reject executory contracts were somewhat complex. United's Chapter 11 plan of reorganization, the roadmap for its exit from bankruptcy, deferred its ability to decide whether to assume or reject a contract until after its bankruptcy exit. And while other filings in the bankruptcy case created some uncertainty, the Seventh

Circuit found that United had not assumed the provider's contracts through the mechanism provided in the Chapter 11 plan, leaving those contracts in a state of limbo. In some cases, this type of deferral of the decision to assume or reject until after a debtor's bankruptcy exit has been controversial, and indeed it was challenged by a different creditor in the United bankruptcy. But neither the provider nor ReGen challenged this aspect of United's Chapter 11 plan.

The Follow-Up Question: Why Would a Debtor Elect Not to Assume a Provider's Contracts?

Although the Seventh Circuit discusses at some length its determination that United did, in fact, elect not to assume the provider's telecommunications contracts, the Seventh Circuit's decision does not reveal why United made that decision. As a general matter, it seems fair to presume that a debtor's decision not to assume an executory contract with a services provider following a sale by the provider of its pre-petition claim could be based, in part, on the same issue that troubled the lower courts: the sale of the provider's claims may effectively sever the provider's pre-petition claim against the debtor from the contractual relationship of the provider and the debtor during and following the bankruptcy case.

In most circumstances, a debtor will assume a contract—and pay the cure amount—because the contract is valuable to the debtor and because the counterparty will not continue to do business under the contract without receiving the cure payment. Simply put, assumption and cure is the only way a debtor can compel a counterparty to perform under the contract moving forward. But under the Seventh Circuit's decision in *United Air Lines*, after a services provider sells its claims (and its right to cure amounts) to a claims buyer, it would be the claims buyer, not the services provider, who would be paid the cure amount upon any assumption. The provider itself would not be entitled to any cure of past defaults in exchange for providing services to the debtor in the future, and the provider would therefore have no incentive to push for assumption of its contracts. Why would a debtor assume a contract and pay a potentially large cure amount, when it could instead strike a new deal with the pre-petition services provider (or another provider) on mutually acceptable terms, unencumbered by any cure amount?

Certainly there are some circumstances, even after a sale of a services provider's pre-petition claims, under which it may be advantageous for a debtor to assume the provider's contracts and pay the claims buyer a cure amount. For example, a debtor might make such a decision if the contracts are priced well below market, even taking into account the cure payment. In that scenario, following assumption, the provider would be stuck providing services for less compensation than it might have been able to demand under new contracts. Having not itself received the cure payment, the provider might both go unpaid for some past services, and at the same time realize less profit on the contract moving forward.

But even in that scenario, why wouldn't the debtor and the provider try to cut out the claims buyer as the "middle man"? Instead of the debtor assuming the existing contracts and paying the cure amount to the claims buyer, the debtor might enter into new, higher-priced contracts and essentially

pay the services provider some or all of the cure amount through the alternate means of the new contract pricing. Such an "end run" around the assumption process would leave the claims buyer without recourse for cure amounts as against the debtor. However, it might also give rise to a dispute between the services provider and the claims buyer, under their claim assignment agreement, as to whether this "end run" would make the provider liable to the claims buyer.

We hasten to add that all the speculation above is just that: speculation illustrating how the parties' strategic interests can change because of the assignment of a claim related to an on-going contractual relationship.

The Bottom Line

The new decision of the Seventh Circuit in *United Air Lines* addresses the novel issue of whether the purchase of a pre-petition bankruptcy claim can sever that claim from the executory contract under which it arose. If the claim and contract are truly severed, the claims purchaser may not have any legal right to seek a cure payment. But even where the claim and contract are not severed, parties to a claims purchase transaction should be aware that the sale of a claim based on an executory contract may change the incentive of a debtor to assume the contract and pay the cure amount. In all events, the trading of bankruptcy claims arising from executory contracts can be more complex and more risky than the trading of claims based on more straightforward arrangements, such as claims based on stand-alone invoices for delivered goods.

¹*In the Matter of UAL Corporation (ReGen Capital I, Inc. v. UAL Corporation, et. al.)*, 2011 WL 559702 (7th. 2011), decided February 18, 2011.

² Contracts that involve on-going obligations by both the debtor and non-debtor parties following a bankruptcy filing are referred to as "executory contracts," and the rules regarding these contracts are found primarily in Section 365 of the Bankruptcy Code (11 U.S.C. § 365).

³ The district court decision is found at *In the Matter of UAL Corporation (ReGen Capital I, Inc. v. UAL Corporation, et. al.)*, 2010 WL 375201 (7th. 2011), and was decided February 2, 2010. The bankruptcy court's unpublished decision was entered on July 30, 2009.

⁴*In re U.S. Wireless Data, Inc. (ReGen Capital I, Inc. v. Halperin)*, 547 F.3d 484 (2d Cir. 2008).

⁵ These decisions arose in the context of wage claims, which enjoy a statutory priority under the Bankruptcy Code. In those cases, claims were bought from wage earners, and the question was whether the statutory priority could be enforced by the purchasers who did not themselves earn the wages. See *Shropshire, Woodliff & Co. v. Bush*, 204 U.S. 186 (1907), and *In re Dorr Pump & Manufacturing Co.*, 125 F.2d 610 (7th Cir. 1942). Although not discussed by the Seventh Circuit in the *United Air Lines* decision, a key distinction between these wage claim cases and the *United Air*

Lines contract claim case is that wage priority is dependent only upon the wage earners' prior work, and not upon any future events, while contract claim priority is dependent upon the assumption of the contract (and presumes future performance under the contract by the parties following assumption).

Authors



**George W. Shuster
Jr.**

PARTNER

✉ george.shuster@wilmerhale.com

☎ +1 212 937 7232



John D. Sigel

RETIRED PARTNER

☎ +1 617 526 6000