# Administrative expense priority is not guaranteed for post-petition breaches by debtors

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Parties to contracts with a company that files for Chapter 11 bankruptcy are often urged to continue doing business with the debtor after its case is filed to avoid disruption of business for all parties. In doing so, contract counterparties often assume that they will be entitled to an administrative expense claim for any post-petition breach of the agreement by the debtor. However, the decision by Judge James Garrity in *In re Ditech Holding Corp.*, No. 19-10412 (JLG) (Bankr. S.D.N.Y. Oct. 21, 2021) provides a cautionary tale that well-informed companies should bear in mind when engaging in business with debtors in bankruptcy.

## Facts

One of the debtors in *Ditech*, Reverse Mortgage Solutions, Inc. (Debtor), was a party to reverse mortgage subservicing agreements (the Agreements) with Liberty Home Equity Solutions, Inc. and Finance of America Reverse LLC (the Claimants). Under these agreements, the Debtor serviced reverse mortgage loans for the Claimants in exchange for servicing fees.

While the Agreements were scheduled to expire before the Debtor's bankruptcy filing, the Debtor and each of the Claimants entered into a series of agreements to extend the term without otherwise altering the other terms or conditions of the Agreements (the Prepetition Extension Agreements). As a result of the Prepetition Extension Agreements, the Agreements were still in place when the Debtor filed for Chapter 11 in February 2019.

The Debtor and the Claimants also entered into a series of agreements post-petition to further extend the term of the Agreements, ultimately through Sept. 30, 2019, (the Post-Petition Extension Agreements and with the Prepetition Extension Agreements, the Extension Agreements). Like the Prepetition Extension Agreements, the Post-Petition Extension Agreements extended the terms without otherwise altering the other terms or conditions of the Agreements. The Debtor performed under the Extension Agreements and received servicing fees for doing so.

The Debtor sold its reverse mortgage business under its confirmed plan, and the sale was consummated on Sept. 30, 2019. The Agreements expired by their own terms before the effective date of the Debtor's plan, and the Debtor did not assign the Agreements to the buyer. The Debtor's plan provided that any executory contracts not assumed were rejected.

## Claimants' arguments

The Claimants subsequently filed claims seeking payment of administrative expenses. They argued that the Debtor had breached the Agreements post-petition by committing various servicing errors and other material breaches of the agreements. The Claimants argued that each Extension Agreement was a new Agreement under applicable state law that superseded and replaced the existing Agreements; thus, the breaches that occurred were breaches of post-petition agreements with the Debtor.

*Since the Extension Agreements were not new, post-petition agreements, the court held that claims under them were not entitled to administrative expense priority.*

As support for their argument, the Claimants asserted that the Debtor received substantial consideration for entering into the Extension Agreements, including servicing fees. They further argued that their claims were not in the nature of rejection damages claims since the Debtor could not reject the Extension Agreements, which were entered into post-petition.

Alternatively, Claimants asserted that they were entitled to administrative expense priority payment for the Debtor's post-petition breach of the Agreements because, even though the Debtor had neither assumed nor rejected the Agreements, the Debtor continued to perform under those agreements post-petition and received the benefits thereunder.

## Plan administrator's arguments

The administrator of the Debtor's plan objected to the administrative expense claims and sought to reclassify them as general unsecured claims, arguing that they were, in fact, claims for rejection of the Agreements. The plan administrator also asserted that it was clear on the face of the Extension Agreements that the parties did not intend to enter into new Agreements, but only to extend the term of the existing Agreements while the parties negotiated the terms of new agreements.

## Court's decision

The court agreed with the plan administrator, sustained the objection, and reclassified the claims as general unsecured claims. The court first found that, in executing the post-petition Extension Agreements, the Debtor was not entering into new agreements with the Claimants and that the Extension Agreements did not supersede or replace the Agreements.

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Instead, the plain terms of the Extension Agreements provided that the Debtor was only extending the original Agreements on the same terms and conditions while the parties attempted to reach a new agreement. Accordingly, since the Extension Agreements were not new, post-petition agreements, the court held that claims under them were not entitled to administrative expense priority.

The court next considered whether the damages claims resulting from the Debtor's post-petition breach of the Agreements were nevertheless entitled to administrative expense priority. The court held that they were not. The court started with the premise that the Bankruptcy Code determines when a claim arises and defines a claim to include a *possible* right to payment. Building upon this basic premise, the court noted that where parties contemplate the possibility of a future breach in their contracts, such breaches are treated as contingent prepetition claims rather than post-petition claims.

As a result, the court found that, since the Agreements contemplated the possibility of servicing errors and established procedures for dealing with such errors, the claims were contingent prepetition claims rather than post-petition claims, irrespective of whether the Debtor rejected the Agreements or they expired by their terms. The fact that the Debtor received post-petition compensation for its services did not transform the claims into administrative expense priority claims.

## Practice pointers

It is widely accepted that a debtor-in-possession's breach of an agreement entered into post-petition gives rise to an administrative expense priority claim for the full amount of damages provided for in the contract. This is because operation of the debtor's business during the bankruptcy case benefits prepetition creditors and, therefore, any claims that result from the operations are entitled to priority payment.

However, the *Ditech* decision seems to reverse what was accepted as black letter law and suggests that a debtor's post-petition breach of a contract may never create an administrative expense priority claim if the terms of the contract contemplated a potential breach. Contract counterparties should not assume that they will be entitled to administrative expense priority for their claims if the debtor continues to perform post-petition, but nevertheless breaches the contract. Under *Ditech*, there is a real risk that such claims will be treated as general unsecured claims.

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