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Determining whether a claim is entitled to administrative expense priority in bankruptcy

By Schuyler G. Carroll, Esq., Bethany D. Simmons, Esq., and Noah Weingarten, Esq., Loeb & Loeb LLP

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In *Finance of America LLC v. Mortgage Winddown LLC (In re Ditech Holding Corp.)*, No. 21-cv-10038 (LAK) (S.D.N.Y. Sept. 23, 2022), District Court Judge Lewis Kaplan answered the following question: "[I]n what circumstances, if any, will a post-petition breach of an executory contract give rise to an administrative expense priority claim under section 503(b) of the Bankruptcy Court?"

In answering the question, Judge Kaplan reversed, in part, the decision of Bankruptcy Judge James Garrity in *In re Ditech Holding Corp.*, No. 19-10412 (JLG) (Bankr. S.D.N.Y. Oct. 21, 2021), which we wrote about in March 2022 (https://reut.rs/3DjKmJo). Judge Kaplan held that non-debtor contract counterparties may receive administrative expense claim priority for a post-petition breach on a pre-petition contract when the post-petition breach was not within the parties' "fair contemplation" at the time they entered the contract. However, if the breach was within the parties' fair contemplation, the post-petition breach yields a contingent pre-petition claim not entitled to administrative expense priority. This reverses the finding by Judge Garrity that administrative expense priority turned on whether the Debtor breached a pre- versus post-petition contract as determined by state law.

Facts

Debtor Reverse Mortgage Solutions, Inc. ("Debtor") was a party to three reverse mortgage subservicing agreements (the "Agreements") with Finance of America Reverse LLC (the "Claimant"). Under these Agreements, the Debtor serviced reverse mortgage loans for the Claimant in exchange for servicing fees.

One of the Agreements was scheduled to expire pre-petition, and the parties entered into a series of extensions that did not alter any of the other provisions of the Agreement (as extended, the "Extended Agreement"). Post-petition, the Debtor and Claimant entered into further extensions of the Extended Agreement's term, again without otherwise altering any other provisions. The Debtor performed under the Extended Agreement post-petition and received fees for doing so.

The two other subservicing agreements each had a one-month term before the subservicing agreement automatically renewed at Claimant's option (the "Renewed Agreements"). Pre-petition, Claimant exercised its option to renew the Renewed Agreements through February 2019 and September 2019 for the Renewed Agreements, respectively.

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

Creditors who perform under a pre-petition contract in the post-petition period may be entitled to an administrative expense claim for a post-petition breach of the agreement by the debtor in some, but not all, circumstances.

Claimant filed a proof of claim seeking administrative expense priority in excess of $375,000 resulting from the Debtor's alleged post-petition breaches of the Agreements. Claimant later amended its claim to assert over $14 million in damages.

The plan administrator filed an objection, which the bankruptcy court sustained. The bankruptcy court reclassified the Claimant's claims as general unsecured claims.

Parties' arguments

The Claimant argued that each term extension was a new Agreement under applicable state law that superseded and replaced the existing Agreements, and thus the breaches that occurred were breaches of post-petition agreements with the Debtor.

Alternatively, Claimant asserted that it was 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.

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The administrator of the Debtor's plan objected and sought to reclassify Claimant's administrative expense claims as general unsecured claims, claiming that they were rejection damages. The plan administrator also asserted that the face of the Agreements demonstrated that the parties did not intend to enter into new Agreements each time the term was extended.

The 'fair contemplation' test

The district court found that the Bankruptcy Code governs when a claim arises and rejected the bankruptcy court's analysis, which turned on whether a "new" contract was formed post-petition under state law.

The district court concluded that, even though the type of breach may be foreseeable at the time of the initial contract, it did not mean that post-petition breach *claims arising from that type of breach were within the fair contemplation of the parties.*

The district court observed that under Bankruptcy Code section 365, a debtor's rejection of an executory contract, such as the Agreements, is deemed to occur immediately before the petition date and results in a general unsecured claim, even where a breach occurred post-petition. Post-petition breaches of rejected executory contracts yield contingent pre-petition claims — not entitled to administrative priority — where the risk of that future breach was within the "fair contemplation" of the parties at the time they entered into the contract.

The district court concluded that, even though the type of breach may be foreseeable at the time of the initial contract, it did not mean that *post-petition breach* claims arising from that type of breach were within the fair contemplation of the parties.

The district court recognized that holding, as a matter of law, that a post-petition contract extension of identical substantive terms never can result in an administrative expense priority would "flip the Bankruptcy Code on its head," disincentivize parties from continuing to do business with a debtor post-petition, and could also lead to the unjust enrichment of the bankruptcy estate.

Application of the fair contemplation test to the agreements

As to the Extended Agreement, the district court found that although the "types" of subservicing errors giving rise to Claimant's claim may have been foreseeable at the time that the parties entered into the original agreement, the parties did not fairly contemplate the risk of a *post-petition breach* by the Debtor since the contract by its terms would have expired but for the post-petition extension.

Specifically, because all of the performance obligations in the Extended Agreement would have ended but for the parties' mutual post-petition agreement to extend it, the risk of the subservicing errors after the petition date was not in the fair contemplation of the parties at the time they entered into the Agreement and the claims were entitled to administrative expense priority to the extent the bankruptcy court determined they comprised the actual, necessary costs and expenses of preserving the bankruptcy estate.

As to the Renewed Agreements, the district court came to a different result. The district court found that a post-petition breach by the Debtor was within the fair contemplation of the parties' because it was foreseeable that Claimant could obligate the Debtor under the Agreements through the post-petition period without any supplemental agreement or action by either party. Accordingly, Claimant's breach of contract claims under the Renewed Agreements were not entitled to administrative expense priority.

Administrative expense priority may be available under a quasi-contract theory

The district court did not end its analysis with the "fair contemplation" test. Rather, Judge Kaplan found that administrative priority may be available if a debtor's estate receives post-petition benefit under a quasi-contract theory.

The district court remanded to the bankruptcy court to determine whether Claimant was entitled to administrative expense priority under a quasi-contract theory based on the benefits the Debtor received under the Renewed Agreements post-petition.

Conclusion

Creditors who perform under a pre-petition contract in the post-petition period may be entitled to an administrative expense claim for a post-petition breach of the agreement by the debtor in some, but not all, circumstances.

If the parties affirmatively extend or renew the executory contract post-petition, claims for breach of the contract are more likely to be entitled to administrative expense priority. However, breaches of contracts that automatically renew post-petition unless a party opts out or that renew at the option of one party, are less likely to be entitled to administrative expense priority.

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About the authors



Schuyler G. Carroll (L) is a partner in **Loeb & Loeb LLP**'s restructuring and bankruptcy practice. His practice focuses primarily on Chapter 11, 15 and 7 bankruptcy proceedings; distressed acquisitions; creditors' rights enforcement; and litigation and advisory work. He can be reached at scarroll@loeb.com. **Bethany D. Simmons** (C), a partner with the firm's restructuring and bankruptcy practice, focuses her practice on bankruptcy reorganization and commercial litigation, and has experience guiding debtors in health care and oil and gas industries through the stages of Chapter 11. She can be reached at bsimmons@loeb.com. **Noah Weingarten** (R), an associate in the firm's restructuring and bankruptcy practice, provides advice on complex bankruptcy and restructuring matters. He maintains a commercial and bankruptcy litigation practice with an emphasis on bankruptcy avoidance litigation and media and entertainment disputes. He can be reached at nweingarten@loeb.com. The authors are based in New York.

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