AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

Legislative Update

This month's Update continues to focus on the significant changes made by the new amendments to the Code (Pub. Law 109-8).

Bankruptcy Reform and Nonmonetary Defaults—What Have They Done Now?

Written by:
Risa Lynn Wolf-Smith
Holland & Hart LLP; Denver
rwolf@hollandhart.com

Bankruptcy specialists know that debtors must cure contractual defaults before assuming any executory contract or lease. But changes made in the Bankruptcy Reform Act of 1994 left practitioners unsure about whether debtors' obligations to cure non-monetary defaults had been eliminated. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) has finally answered some of the questions, though the language is murky. Except for leases of real property and "penalties" relating to nonmonetary breaches, the new language of §365(b)(1) requires that nonmonetary defaults be cured.

Background

The Bankruptcy Reform Act of 1994 excepted from a debtor's cure obligations "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." 11 U.S.C. §365(b)(2)(D). Courts disagreed about how to interpret this provision. Some read it in the disjunctive, as excusing the debtor's obligation to cure *either* a penalty rate *or* a provision relating to a default arising from a breach of a nonmonetary obligation. These courts construed subsection (b)(2)(D) to relieve debtors of the obligation to cure nonmonetary defaults altogether. *See In re BankVest Capital Corp.,* 360 F.3d 291 (1st Cir. 2004); *In re Walden Ridge Development LLC,* 292 B.R. 58 (Bankr. D. N.J. 2003); *In the Matter of GP Express Airlines Inc.,* 200 B.R. 222, 233-34 (Bankr. D. Neb. 1996).

Risa Lynn Wolf-Smith

Other courts read it in the conjunctive, as excusing the debtor's obligation to cure penalty rates and penalty provisions arising from a nonmonetary default. *See In re Claremont Acquisition Corp. Inc.,* 113 F.3d 1029, 1034 (9th Cir. 1997); *Three Sisters Partners LLC,* 167 F.3d 843, 848 n.3 (4th Cir. 1999); *In re New Breed Realty Enterprises Inc.,* 278 B.R. 314, 320-21 (Bankr. E.D.N.Y. 2002); *In re Vitanza,* 1998 WL 808629 at *21 (Bankr. E.D. Pa. 1998). These courts interpreted subsection (b)(2)(D) to relieve debtors of their obligation to pay penalties only, but not of their obligation to cure nonmonetary defaults.

To better appreciate the competing interpretations and their results, one must first consider what might constitute a "nonmonetary" default. Breaches such as the failure to maintain certifications or licenses, to maintain specified quality or qualification standards, to provide information and to operate continuously without closure—all of these would constitute nonmonetary breaches. Thus, in *Claremont, supra,* the debtor had ceased operating pre-petition in breach of its obligation not to close its GM dealership for more than seven consecutive days. In *GP Express Airlines, supra,* the debtor airline had failed to meet performance standards relating to the completion of flights, the timely arrival of flights and the use of standardized accounting services.

In many cases, the nonmonetary defaults are incurable because they are "historical facts" that cannot be cured. For this reason, many have observed that requiring the cure of nonmonetary defaults would be an obstacle to the successful reorganization of debtors. Debtors would not be able to assume valuable contracts because they could not turn back the clock. Others have argued that third-party contracting parties should not be held hostage under contracts that would otherwise be terminated for breach of nonmonetary clauses. These proponents reasoned that permitting assumption without the cure of nonmonetary defaults expanded debtors' rights beyond what they would be under the applicable contracts and state law. Still others have suggested that debtors should be able to cure nonmonetary obligations by compensating for "pecuniary losses" that flow from the breach of nonmonetary covenants. Unfortunately, pecuniary loss from a nonmonetary default is often more difficult to measure than for a monetary default.

Directives from Congress

Congress has finally made some decisions on the question of what a debtor must do to assume an executory contract or lease under which nonmonetary breach has occurred, but its directives are far from clear. First, §365(b)(2)(D) has been amended to read as follows:

> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
>
> > (D) the satisfaction of any penalty rate or *penalty* [new word added] provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

Presumably, this small addition resolves the dilemma: Debtors must cure nonmonetary defaults except for penalty rates or penalty provisions relating to nonmonetary breaches. The conjunctive interpretation has apparently been adopted.

However, BAPCPA adds a new part to subsection (b)(1)(A), which reads as follows:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph* [new language italicized].

Thus, leases of real property are treated differently. If it is impossible to cure a nonmonetary default under a real property lease at and after the time of assumption (*e.g.,* "historical facts"), the breach need not be cured. But if the default arises from a failure to operate under a *nonresidential real property lease,* the default must be cured upon assumption, and all pecuniary losses resulting from such default must be compensated.

In essence, Congress has created special rules for leases of real property, and in particular, nonresidential real property leases are singled out for special treatment. Debtor lessees need not cure nonmonetary defaults if performance is impossible, and if the lessee has failed to operate under a nonresidential lease, the lessee must provide compensatory payment. One cannot help but note that lessors would be well-advised to include liquidated damages clauses in their leases quantifying the damages that would flow from the failure to operate under their nonresidential real property leases.

Conclusion

While it may be difficult to decipher the policy behind the significant changes to §365, those changes will hopefully clarify the intent of Congress with respect to nonmonetary defaults. Debtors will now have to find a way to satisfy nonmonetary obligations. Under nonresidential real property leases, the cure will be paid in dollars. Time will tell how other executory contracts will be cured. ■

Reprinted with permission from the ABI Journal, *Vol. XXIV, No. 6, July/August 2005.*