

Connecticut Supreme Court Defines Bankruptcy Effect on Contracts

By Michael L. Cook

Bankruptcy “does not constitute a per se breach of contract and does not excuse performance by the other party in the absence of some further indication that the [debtor] either cannot, or does not, intend to perform,” held the Supreme Court of Connecticut in a lengthy opinion on Nov. 21, 2017. *CCT Communications, Inc. v. Zone Telecom, Inc.*, 2017 WL 5477540, *13 (Ct. Nov. 21, 2017) (en banc), superseding 324 Conn. 654, 153A.3d 1249 (2017).

The supreme court rejected the trial court’s erroneous finding that the plaintiff debtor’s bankruptcy petition “constituted a breach of [contract, permitting] the defendant to terminate that agreement.” *Id.* at *2. Because the trial court never found that the debtor (CCT) “either could not or did not intend to perform its obligations as a result of its bankruptcy filing”, it had not “breached the... agreement by filing for bankruptcy protection.” *Id.* at *13. Nothing in the contract itself supported the trial court’s “conclusion that filing the [bankruptcy] petition constituted a breach by [CCT].” *Id.*

Equally important, the Supreme Court rejected the lower court’s en-

forcement of an “*ipso-facto*” bankruptcy termination clause, reasoning that the contractual language in this case “only” gave the nondebtor defendant (“Zone”) “the option to terminate.” *Id.* at *12. Nor, on the facts of this case, could Zone rely on the so-called judicially created “ride-through” exception to evade the Bankruptcy Code’s invalidation of *ipso-facto* termination clauses (§ 365(e)(1)).

A New York bankruptcy court had dismissed CCT’s Chapter 11 case one month before the commencement of the suit in the Connecticut state court. Although CCT had originally sued Zone in the bankruptcy court, that court “declined to retain jurisdiction” after dismissal of the Chapter 11 case because, among other things, the CCT suit “primarily involved questions of state contract law.” *Id.* at *6.

RELEVANCE

The federal bankruptcy issues in *CCT*, a routine contract dispute, were significant:

- Does the filing of a bankruptcy petition constitute a breach of contract?
- Is an *ipso-facto* bankruptcy termination clause effective? Useful?
- What happens when a trustee or Chapter 11 debtor-in-possession neither assumes nor rejects an executory contract during the pendency of a Chapter 11 case?
- Does the unassumed or unrejected contract “ride through”

the dismissal of the Chapter 11 case?

- What should a nondebtor contracting party do when its counterparty seeks Chapter 11 relief?

FACTS

CCT bought telecommunication services and resold those services to third parties such as Zone. After contractual disputes with Zone (its customer) and a supplier, CCT filed a Chapter 11 petition in the Southern District of New York on Jan. 29, 2007. It later sued Zone for breach of contract in the bankruptcy court on Jan. 27, 2009.

Zone wrote to CCT on Feb. 5, 2007, during the pending of the Chapter 11 case, “purport[ing] to terminate [its agreement with CCT, relying on a clause], which provides ... that either party may terminate upon 30 days written notice” in the event of a party’s bankruptcy. *Id.* at *5. But Zone did nothing further to implement its termination letter.

CCT promptly sued Zone in the Connecticut state court in December 2009, claiming Zone’s nonpayment, after the bankruptcy court’s dismissal of the Chapter 11 case. Zone counterclaimed, alleging: 1) CCT’s failure to provide services; and 2) termination of the parties’ contract because of its Feb. 5, 2007, purported termination letter. The lower court ruled for Zone, awarding damages, costs, and attorneys’ fees plus a declaratory judgment that the parties’ contract had been terminated under the bankruptcy termination clause.

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THE CONNECTICUT SUPREME COURT

The supreme court, *en banc*, found that the trial court held for Zone solely on the basis of CCT's bankruptcy filing. *Id.* at *8, *9, and *10. In fact, the trial court cited Zone's Feb. 5, 2007, termination letter and its reliance on the contractual bankruptcy termination clause. The lower court, said the supreme court, never held that CCT failed "to provide adequate service." *Id.* at *10.

Bankruptcy Filing NOT a Breach

Zone conceded that it "never alleged ... [CCT's] bankruptcy filing constituted a breach" *Id.* at *12 n. 16. Because of the trial court's reliance on the bankruptcy filing, though, the supreme court parsed the following language in the bankruptcy termination clause: "... this [a]greement may be terminated by either party upon thirty ... days ... notice of such termination to the other party in the event that [nonterminating] party has ... filed a voluntary petition in bankruptcy" *Id.* at *12.

First, stressed the court, the quoted language does not even "suggest that a bankruptcy filing will constitute a material breach of the ... agreement." *Id.* Instead, it means "only that a bankruptcy affords the other party the option to terminate if it desires." *Id.* Thus, "the plain language of the [contract] itself does not support" the lower court's finding of a breach by CCT.

Despite early cases to the contrary, a bankruptcy filing, "without more, [is no longer] a material breach." *Id.* at *13, citing *Central States, Southeast & Southwest Areas Pension Fund v. Basic American Industries*, 252 F.3d 911, 917 (7th Cir. 2001) (Posner, J.) ("Merely filing for the protection of the bankruptcy court is not a repudiation of obligations or a cessation of operations. ... An insolvent firm is not necessarily out of business, and the parties with which it has contracts cannot automatically assume that the firm will default. ... "); 2 *E. Farnsworth, Contracts* (3d Ed. 2004) § 8.21. Because the lower court in *CCT* never found that CCT "either could not or did not intend to

perform," it "incorrectly determined that [CCT] breached the ... agreement by filing for bankruptcy protection." 2017 WL 5477540, at *13.

Ipso-Facto Bankruptcy Termination Clause Not Enforceable

Code § 365(e) provides that a debtor's executory contracts may not be terminated solely as a result "of a bankruptcy filing." *Id.* at *13. Thus, the Code invalidates *ipso-facto* provisions such as the bankruptcy termination clause in the Zone/CCT agreement.

Assumption or Rejection Flexible In Chapter 11 Cases

The supreme court first explained the difference between assumption (*i.e.*, adoption) and rejection (*i.e.*, statutory breach) of an executory contract in bankruptcy cases, noting that either choice is within the trustee's discretion. Although contracts are ordinarily rejected in a Chapter 7 bankruptcy case if they are not "expressly assumed or rejected" within 60 days, "that default rule does not apply to Chapter 11 [cases]." *Id.* at *14. A Chapter 11 trustee or debtor in possession may assume or reject an executory contract "at any time prior to the confirmation of a reorganization plan," unless the bankruptcy court orders an earlier decision. *Id.* Thus, a Chapter 11 debtor in possession "should be granted more latitude in deciding whether to reject a contract than should a trustee in liquidation." *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 529 (1984). But the Code "does not specify the legal status of an executory contract that is *never* expressly assumed or rejected during a Chapter 11 [case]," as happened in *CCT*. 2017 WL 5477540, at *15.

No Ride-Through Exception to Invalidation of Ipso-Facto Clause

Courts had "applied a rule predating adoption of the [Code], namely, the ride-through doctrine." *Id.* Under that doctrine, when a contract is neither assumed nor rejected during a Chapter 11 case, said the court in *CCT*, it will "pass through the reorganization unaffected and become an obligation of the reorganized debtor."

Id., citing *In re Nevada Emergency Services, Inc.*, 39 B.R. 859, 861n.1 (Bankr. D. Nev. 1984). In *CCT*, though, the trial court had improperly applied the "ride-through doctrine" in order to "circumvent the protections embodied in [Code] §365(e)." *Id.* CCT had failed to assume or reject its contract with Zone during its Chapter 11 case, but, more significantly, Zone "also never" asked the bankruptcy court to force CCT to decide on whether to assume or reject the contract. Thus, said the supreme court, the "ride-through doctrine did not create an exception to [Code] §365(e) under the circumstances of" this case. *Id.* at n.20.

The ride-through doctrine "generally ha[d] been applied when a plan of reorganization is confirmed without specifying whether a particular executory contract is assumed or rejected." *Id.* at *16. Although no court had applied the doctrine when a Chapter 11 case had been dismissed prior to confirmation of a reorganization plan, as happened in *CCT*, one court suggested that because "there is no reorganized debtor, there is no [new] entity for the contract to ride-through to." *Id.*, citing *In re Debon, Inc.*, 352 B.R. 546, 565 n. 20 (Bankr. D. Mass 2006). Also, explained the supreme court, Code § 349(b)(3) "automatically reverts the property of the estate, including contract rights, in the debtor upon dismissal." *Id.* Thus, "the ride-through doctrine does not apply in the context of" this case. *Id.*

"Even if the rider-through doctrine did apply, ... the doctrine [did not] create ... an exception to the prohibition against *ipso-facto* clauses contained in" Code § 365(e), said the court. *Id.* at 16. "Nothing in the plain language of the [Code says] that the protections of ... §365(e)(1) are available to the debtor only upon the assumption of an executory contract ... [Code] §365(e)(2) lists various conditions under which ... §365(e)(1) does not apply, but makes no mention of the need to assume the contract." *Id.* at *19, rejecting *In re Hernandez*, 287 B.R. 795, 800-801 (Bankr. D. Ariz. 2002) (Chapter 11 debtor must

assume contract to get protection of Code § 365(e)).

Indeed, a Chapter 11 debtor has a “paramount” right to a reasonable period of time “to appraise its financial situation and the potential value of its assets in ... the formulation of a plan” before having to assume or reject an executory contract. *Theatre Holding Corp. v. Mauro*, 681 F.2d 102, 106 (2d Cir. 1982); 3 Collier on Bankruptcy ¶365.05[5], at 365-52 (16th ed. 2017) (“decision[s] to assume a long-term contract usually should be delayed until confirmation.”). Therefore, “[o]nce the bankruptcy case is filed, the [non-debtor] is required to perform its obligations ... even though the debtor’s performance obligation is suspended and the [non-debtor] is stayed from exercising its remedies and rights [while] the debtor decides whether to assume or reject the contract.” 2017 WL5477540, at *18, quoting J. Daniel, “Lawyering on Behalf of the Non-Debtor Party in Anticipation, and During the Course, of an Executory Contract Counterparty’s Chapter 11 Bankruptcy Case,” 14. *Hous. Bus & Tax L.J.* 230, 238 (2014).

The Code’s “protections from *ipso facto* clauses” prevented “a nondebtor party [Zone]” from “circumventing those protections by ... terminating [its] contract” with CCT, the Chapter 11 debtor. *Id.* at 18. Still, reasoned the supreme court, “a contract that rides through bankruptcy remains binding on all parties, and ... [after bankruptcy], redress for any alleged defaults may be pursued in state court if such remedy is not otherwise precluded by law ... [T]he rationales that led Congress to bar the enforcement of [*ipso-facto*] clauses cease to apply after the reorganization process has been completed. The same is presumably true of a contract that does not ride through but that, instead, reverts in the debtor upon dismissal” of the case under Code § 349(b)(3). *Id.* at *19, citing H.R. Rep. No. 95-595 p. 349 (1977), reprinted in 1998 U.S.C.C.A.N. 5963, 6305.

No Resurrection of Zone’s Barred Contract Termination

The supreme court rejected the trial court’s “resurrection” of Zone’s asserted termination of its contract with CCT. *Id.* No court had ever “revived a termination in this manner,” somehow “validat[ing] and reinstat[ing] ... a termination that was barred by Code §365(e) during a bankruptcy [case].” *Id.* “How [could Zone] terminate the ... agreement on the basis of [CCT’s] bankruptcy ... and simultaneously contend the agreement should be applied as if the petition had never been filed?” It was simply unfair to apply the “judicially made” ride-through doctrine in the context of statutory remedies available to Zone, the nondebtor (e.g., stay modification; availability of judicial deadline for assumption or rejection; possible judicial annulment of contract).

Zone’s critical error, said the court, was its “opt[ing] not to pursue any of [its] statutory remedies in the bankruptcy court. Instead, it chose to unilaterally terminate the [CCT] agreement. That decision ... was ‘fraught with peril,’ ... because [a]n injured party that chooses to exercise a right of self-help ... by electing to terminate takes the risk that a court may later regard the exercise as precipitous.” *Id.* at *20, quoting 2 E. Farnsworth, *Contracts* (3d ed. 2004), §8.15, p. 511. See *In re Computer Communications, Inc.*, 824 F.2d 725, 731 (9th Cir. 1987) (“Judicial toleration of ... self-help and post-hoc justification would defeat the purpose of the automatic stay.”).

No Forward Contract

Finally, the supreme court devoted many unnecessary pages to affirming the trial court’s finding that the CCT/Zone agreement was not a “commodity forward contract” under Code § 556, “which carves out an exception to [Code] §365(e).” First, Zone was admittedly “not a commodity broker or financial participant.” *Id.* at *21. Also, the agreement here, said the court, was “a multifaceted agreement [involving] ... [CCT’s] sale of a non-commodity, namely, ... digital signal

circuits to [Zone].” *Id.* at *25. Because Code § 365(e) applied, Zone’s “purported termination” under the contract’s *ipso-facto* termination clause “was invalid.” *Id.*

COMMENT

The lesson from CCT for a non-debtor contracting party: Move in the bankruptcy court for appropriate relief.

- A modification of the automatic stay to permit litigation of any contract dispute outside the bankruptcy court; or
- An order directing the debtor-in-possession to assume or reject the contract by a fixed deadline; or
- A declaratory judgment that the debtor-in-possession has effectively terminated the agreement.

The threshold issue for any non-debtor is whether it wants to retain the contract with the debtor. If so, it should seek payment for any post-bankruptcy services. If not, seek rejection or termination of the contract.

Zone simply did not want to pay CCT for services it received, merely sent an ineffectual termination letter, did nothing until sued, and ultimately lost. Zone apparently wanted to end its contract with CCT but was either reluctant or afraid to seek relief in the bankruptcy court.



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