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Alert

Connecticut Supreme Court Defines Bankruptcy Effect on Contracts

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"[B]ankruptcy 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, 153 A.3d 1249 (2017). Reversing the trial court, granting the plaintiff's motion for en banc reconsideration of its earlier Feb. 21, 2017 opinion and superseding that earlier opinion, 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," the debtor 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 enforcement of an "ipso facto" bankruptcy termination clause, reasoning that the contractual language in this case "only" gave the non-debtor 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. Still, the Supreme Court questioned "why the parties did not seek to resolve the questions of federal law" before it in the underlying bankruptcy case. *Id.*, at n.7.

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 non-debtor contracting party do when its counterparty seeks Chapter 11 relief?

Facts
CCT, a Delaware corporation based in Connecticut, 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 had sent a letter 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. Zone did nothing further to implement its termination letter. The bankruptcy court later dismissed CCT's Chapter 11 case on Nov. 25, 2009 when CCT was unable to have the court confirm a reorganization plan.

CCT then promptly sued Zone in the Connecticut state court on December 2009, claiming Zone's nonpayment. Zone counterclaimed, alleging (a) CCT's failure to provide services and (b) termination of the parties' contract because of its Feb. 5, 2007 purported termination letter. After trial, the lower court ruled for Zone, awarding damages, costs and attorney fees, plus a declaratory judgment that the parties' contract had been terminated under the bankruptcy termination clause.

The Connecticut Supreme Court
The Supreme Court, after agreeing to rehear the case 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 "breached the purchase agreement by failing to provide adequate service." *Id*., at *10.

1. *Bankruptcy Filing NOT a Breach.* Zone significantly conceded on appeal 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 that CCT had breached.

Despite early cases holding bankruptcy to constitute a breach, 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, Inc.*, 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 . . .

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

2. *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.

3. *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.

4. *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 pre-Code 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, 861 n.1 (Bnkr. D. Nev. 1984). In *CCT* though, the Connecticut Supreme Court held that 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 the almost three years of the pending CCT Chapter 11 case, but, more significant, Zone "also never requested that the bankruptcy court order [CCT] to make" a decision on whether to assume or reject the contract. The court thus found that the "ride-through doctrine did not create an exception to [Code] § 365(e) under the circumstances of" this case. *Id*. at n.20.

The Supreme Court stressed that 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 it found no court applying 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 Dehon, Inc.*, 352 B.R. 546, 565 n. 20 (Bankr. D. Mass 2006). Also, explained the Supreme Court, Code § 349(b)(3) "automatically revests the property of the estate, including contract rights, in the debtor upon dismissal." *Id*. It thus held that "the ride-through doctrine does not apply in the context of" this case. *Id.*

Moreover, reasoned the Supreme Court, "[e]ven if the ride-through doctrine did apply, . . . the doctrine [did not] create . . . an exception to the prohibition against ipso facto clauses contained in" Code § 365(e). *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 may not rely on protection of Code § 365(e) "[u]nless and until an executory contract is assumed . . . "). 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, 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 non-debtor 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, revests 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.

5. *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.* It also cited the unpredictability, the inconsistency ("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?") and the unfairness of applying the "judicially made" ride-through doctrine in the context of statutory remedies available to Zone, the non-debtor party (e.g., stay modification; availability of judicial deadline for assumption or rejection; and possible judicial annulment of contract).

Zone's critical error, said the Supreme 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."). Thus, concluded the Supreme Court, Code § 365(e) "rendered [Zone's] purported termination of the . . . agreement ineffective, and . . . the trial court incorrectly [applied] the ride-through doctrine so as to retroactively validate the termination." *Id*.

6. *No Forward Contract*. Finally, the Supreme Court devoted many unnecessary pages in 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 noncommodity, namely, . . . digital signal circuits to [Zone]." *Id*., at *25. Because Code § 365(e) applied, therefore, 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.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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