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Ride-through Revisited (Again)

The Strategic Use of the Ride-through Doctrine in the Post-*Catapult* Era

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The so-called "hypothetical test" adopted in cases such as *Catapult*[1] and *Sunterra*[2] has been widely criticized as potentially preventing a debtor-in-possession (DIP) from continuing to use certain unassignable contracts, such as its own patent and copyright licenses. This assumes that a debtor must elect either to assume or to reject its executory contracts at or before plan confirmation. If so, then an executory contract that is unassignable, and that is therefore unassumable under *Catapult,* can only be rejected.

There is, however, a third possibility. A debtor may permit an executory contract to "ride through" its bankruptcy case unaffected.[3] In an article published by the *ABI Journal* in 2000,[4] Mark R. Campbell and Robert C. Hastie explored the 80-year history of the ride-through doctrine, and in 2002 the U.S. Bankruptcy Court for the District of Arizona in *In re Hernandez*[5] acknowledged the doctrine's continuing validity. Nevertheless, debtors have continued to lose valuable property rights when their contracts have been deemed to be unassumable under *Catapult* and its progeny.[6] Can these property rights be preserved by resorting to the ride-through doctrine? To answer that question, this article again examines the ride-through doctrine, this time focusing not on its historic roots but on its strategic application and on the statutory provisions supporting its use in a reorganization setting.

Preservation of Value vs. Assumption of Contract


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Lawyers are trained to think in terms of preserving contract rights, and in the bankruptcy context, that typically means the debtor's assumption of key contracts. The effect of assumption is that the debtor agrees to undertake all of its pre-petition obligations under the contract on a post-petition, administrative basis and likewise to continue receiving all benefits due to it under the contract. But this sort of legalistic thinking loses sight of the big picture. What the debtor and its creditors generally want is to preserve the debtor's going-concern value. And where the debtor is a party to a valuable contract, this requires only that the benefits of the contract continue to be available to the reorganized entity, regardless of the legal vehicle used to achieve this result.

Catapult, Sunterra and their progeny have become entangled in a painstaking linguistic analysis of a single section of the Bankruptcy Code, §365(c).[7] Contrary to well-established rules of statutory construction that call for courts to give meaning to an entire statutory scheme, these decisions ignore the clear language and meaning of the Code's many other reorganization provisions, such as §§101(5), 365(a), 365(d), 1123, 1124 and 1129, some of which are more directly pertinent. These sections permit—but do not require—chapter 11 debtors to make certain elections. Nothing in these sections grants a nondebtor the power to terminate a contract merely because the debtor commenced a bankruptcy case, and the courts need not find for parties remedies not prescribed in the statute.[8]


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The ride-through doctrine arises from the absence of any Code provision requiring that a chapter 11 debtor assume or reject all executory contracts.[9] Section 365(a) is permissive, stating that a chapter 11 debtor "*may* assume or reject any executory contract."[10] The practical effect of this provision is to permit the trustee or DIP to elect to undertake the debtor's obligations under an executory contract and to compel performance by the nondebtor party. Alternatively, the trustee or DIP may elect not to undertake these contractual obligations, leaving the nondebtor party with a pre-petition damage claim for the debtor's breach of contract. With certain enumerated exceptions,[11] §365(d)(2) similarly states that "the trustee *may* assume or reject an executory contract."[12] These sections deal with the powers of the chapter 11 debtor, not with remedies available to creditors, and nowhere do they either grant to nondebtor parties the right to terminate a debtor's executory contracts or require a chapter 11 debtor to make an election.

Section 1123(b)(2) is similarly permissive, stating that a plan may, subject to §365, provide for the assumption or rejection of any executory contract."[13] Section 1129, which governs plan confirmation, likewise

1 *Perlman v. Catapult Entertainment Inc. (In re Catapult Entertainment Inc.),* 165 F.3d 747 (9th Cir. 1999).
2 *In re Sunterra Corp.,* 361 F.3d 257 (4th Cir. 2004).
3 *See Consol. Gas, Electric Light and Power Co. v. United Rys. and Electric Co.,* 85 F.2d 799 (4th Cir. 1936).
4 *See* Campbell, Mark R. and Hastie, Robert, "Executory Contracts: Retention without Assumption in Chapter 11—'Ride-through' Revisited," *ABI Journal* (March 2000).
5 *In re Hernandez,* 297 B.R. 795 (Bankr. D. Ariz. 2002).
6 *Id. See, generally, In re Access Beyond Technologies Inc.,* 237 B.R. 32, 48 (D. Del. 1999) (noting in *dicta* that an unassumed executory contract is "deemed rejected" and "disappears").
7 *See* Bussel, Daniel J. and Friedler, Edward A., "The Limits on Assuming and Assigning Executory Contracts," 74 Am. Bank. L.J. 321 (2000).
8 *Griffin v. Oceanic Contractors Inc.,* 458 U.S. 564, 571 (1982) (a statute's plain meaning should be conclusive except in those rare instances where a literal interpretation would produce "a result demonstrably at odds with the intentions of its drafters").
9 *See In re Hernandez,* 287 B.R. at 799; *see, also, Stumpf v. McGee (In re O'Conner),* 258 F.3d 392 (5th Cir. 2001); *United Food & Commercial Worker Union v. Family Snacks Inc. (In re Family Snacks Inc.),* 257 B.R. 884 (8th Cir. B.A.P. 2001). *See, generally, N.L.R.B. v. Bildisco & Bildisco,* 465 U.S. 513, 546, n.12 (1984).
10 11 U.S.C. §365(a) (emphasis added).
11 *See* 11 U.S.C. §365(d)(1)-(2); *see, also,* 11 U.S.C. §§365(d)(2), 365(e)(1) and 365(e). That one category of contracts, such as real estate leases, requires a "timely" decision creates a negative implication that other categories of contracts are not subject to such restrictions.
12 11 U.S.C. §365(d)(2) (emphasis added).
13 11 U.S.C. §1123(b)(2).

does not require assumption or rejection. In fact, §1129 does not refer to the assumption or rejection of executory contracts. Section 1129(a) merely allows for plan confirmation where certain requirements are satisfied, including that each class of claims has either accepted the plan or is "unimpaired," or alternatively, that the cramdown requirements of §1129(b) are met.

Contract rights fall within the scope of the broad definition of a "claim."[14] When a debtor intends to operate its reorganized business using an executory contract, it can cure defaults,[15] provide adequate assurance of future performance and assume the contract. But if the debtor cures defaults and leaves unaltered the legal, equitable and contractual rights of the nondebtor party to the contract, the claim associated with the contract is unimpaired under §1124.[16] And if a class of claims is unimpaired, the debtor's plan can be confirmed, and the unimpaired class of claims will be unaffected.

Preservation of Ride-through: Procedural Concerns

Ride-through cases typically arise when a court must grapple with the status of an executory contract that for some reason was not assumed or rejected pursuant to §365 before or at confirmation.[17] But there is no statutory requirement that a debtor must elect either to assume or to reject an executory contract. As recognized in *Hernandez,* the debtor may, as a strategic decision, elect not to address an executory contract.[18] As the *Hernandez* court noted, a forced rejection could require debtors to forfeit contract rights simply because of a pending bankruptcy case and regardless of whether they had actually breached the contract. Such a result—which would leave debtors with fewer rights in bankruptcy than outside bankruptcy—would be inconsistent with chapter 11's reorganization principles.[19]

For a contract to ride through, the chapter 11 plan must provide for neither assumption nor rejection of the agreement, and it must leave all claims thereunder unimpaired and unaffected by the bankruptcy. As stated in *Hernandez*: "[A]n executory contract may not be addressed in a chapter 11 plan and simultaneously ride through the bankruptcy unaffected."[20] For a class of claims to be unimpaired under §1124(2)(a), the debtor must leave unaltered the legal, equitable and contractual rights of the claim-holders. In the case of an unimpaired executory contract treated under §1124(a)(2), the debtor must cure defaults (except certain *ipso facto* clauses), must provide adequate assurance of future performance and may not violate any contractual clauses. The class of claims including the unimpaired contract claim will then be deemed to accept the plan in accordance with §1129(a)(7).

While a debtor that wishes to retain the benefits of a key contract could seek to assume the contract by separate motion prior to confirmation, this approach places the debtor at risk by requiring it to commit to assumption before knowing whether its chapter 11 plan will otherwise be confirmed. Alternatively, a debtor may propose a reorganization plan based on the premise that a key contract is assumable, preserving ride-through as a fallback position under the plan. But this approach could embroil the parties in litigation regarding the contract's assumability. Moreover, it is unclear whether such a plan—absent amendment—would satisfy *Hernandez*'s requirement that an executory contract that is to ride through not be "addressed." It is also unclear whether a plan that is silent regarding assumption or rejection, but that provides for cure of defaults and other matters related to the treatment of claims arising under the executory contract, will be found not to "address" the executory contract for purposes of application of the ride-through doctrine.

Obstacles for the Unwary Debtor

Permitting a contract to ride through a bankruptcy case without assumption creates potential pitfalls for the debtor. Where reorganization is contingent on the *assignment* of a key contract to a third party, ride-through will not resolve the problems created by *Catapult.*[21] This is likely to be a significant problem whenever the debtor intends to sell all or substantially all of its assets under §363. Likewise, when the debtor is unable to cure defaults, ride-through will not permit an end-run around §365's cure requirements.

Some defaults, however, need not be cured in either an assumption or a ride-through scenario. Section 365(b)(2) specifically excludes from cure those defaults that arise under *ipso facto* provisions relating to a debtor's financial condition, the commencement of a bankruptcy case or the appointment of a trustee. In addition, §1124(2) invokes §365(b)(2) when determining whether a class of claims is impaired notwithstanding any contractual provision or applicable law that entitles the claimant "to demand or receive accelerated payment" following a default.

Nevertheless, debtor's counsel should tread cautiously. Where an *ipso facto* clause has been breached and the breach does not fall under §1124(2) and cannot be cured, ride-through may not be viable.[22] Similarly, where a class is unimpaired notwithstanding a default under an *ipso facto* clause, the debtor should consider whether the *ipso facto* clause will survive and be enforced after plan confirmation. The answer may be "no,"[23] but debtor's counsel should consider including in the confirmation order a finding that the class is unimpaired and that the *ipso facto* clause is unenforceable.

Other potential problems have ready solutions. For example, some commentators have expressed concern that where defaults are an issue, ride-through does not offer the same certainties the debtor would obtain through assumption. One solution would be to request that the court make a determination that the claims associated with the contract in question are unimpaired under §1124. Commentators have also cautioned that the executory contract itself may satisfy the very broad definition of "claim,"[24] in which case it may be extinguished or discharged under §1141 if it is not dealt with under the plan. To avoid this result, debtor's counsel should consider including in any chapter 11 plan a provision excluding the executory contract from discharge.[25]

Protections for Licensors and Other Nondebtor Parties

Nondebtors have several tools with which to contest ride-through. First, §365(d)(2) permits nondebtor parties to request that the court establish a deadline by which the debtor must elect to assume or reject an executory contract. In *Hernandez,* the court rejected the nondebtor party's assertion that merely because it had filed a motion under §365(d)(2) with respect to a nonassumable contract, that contract must be *de facto* rejected.[26]

However, the nondebtor party might be able to compel rejection in appropriate circumstances. The *Hernandez* court looked to the four-part test established in *Theatre*

14 *See* 11 U.S.C. §101(5) (claim means "(a) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or (b) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment...").

15 Bankruptcy Code §1124(2)(a) requires that a debtor cure any default occurring prior to or after commencement of the bankruptcy case in order for a claim to be unimpaired. However, *ipso facto* clauses are specifically exonerated from this section under §365(b)(2) (which excludes provisions relating to the insolvency or financial condition of the debtor, the commencement of a bankruptcy case, or the appointment of a trustee).

16 *See* 11 U.S.C. §1124 ("A class of claims...is impaired under a plan unless...the plan (1) leaves unaltered the legal, equitable, and contractual rights to which such claim...entitles the holder of such claim...").

17 *In re Hernandez,* 287 B.R. at 801.

18 *Id.* at 802-03.

19 *Id.* at 798-99.

20 *Id.* at 802.

21 *See* Campbell and Hastie, *supra* note 4.

22 *See Id.*

23 *See Levy v. Cohen,* 19 Cal. 3d 165 (1977) (plaintiff was barred by *res judicata* from relitigating a debt discharged in the bankruptcy proceeding).

24 *See* 11 U.S.C. §101(5).

25 *See* Campbell and Hastie, *supra* note 4.

26 *In re Hernandez,* 287 B.R. at 805.

Holding Corp. v. Mauro to determine whether a deadline for assumption or rejection should be imposed. Those factors are (1) the damage that the nondebtor party would suffer; (2) the contract's importance to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation, value its assets and form a plan; and (4) whether exclusivity has terminated.[27] Because the license agreements were critical to the debtor's reorganization effort, the court declined to fix a deadline, which would have effectively compelled rejection in that case.[28] In contrast, in *In re Cajun Electric Power Cooperative,*[29] the court held that where the debtor had proposed a liquidating plan and the nondebtor party would be immediately affected because it would be without a source of electricity, a deadline would be imposed and the contract would be *de facto* rejected. A debtor facing a motion to compel assumption or rejection might therefore consider presenting evidence that the claims arising under the executory contract can be unimpaired under §1124.

Nondebtors may also seek relief from the automatic stay to enforce their rights under applicable nonbankruptcy law. Numerous courts have held that if a contact is nonassumable, this alone constitutes grounds to modify the automatic stay and permit the contract's termination since there is "no reason to allow the [contract] to remain in place,"[30] an approach that overlooks the possibility of ride-through. Even the *Hernandez* court granted the nondebtor party's relief-from-stay motion with little analysis, noting merely that cause for the relief existed since the debtors could not assume the contract or otherwise treat it under their plan.[31] The court may have been influenced by the nondebtor's assertion that there were breaches that could neither be cured nor exempted from cure under the Code's *ipso facto* provisions and that the agreement could therefore be terminated under applicable nonbankruptcy law.[32] If a breach of an *ipso facto* provision had been at issue, it is unclear whether relief from stay would have been granted. Faced with a relief-from-stay motion, a debtor might therefore do well to present evidence of its ability to cure defaults pursuant to §1124 and the importance of the contract to the debtor's chapter 11 plan.

A nondebtor party, even if it is deemed to accept the debtor's plan, may object to the plan's confirmation. For example, it may assert that an unassumable contract is not estate property and that the debtor has the burden of demonstrating that any plan premised on the use of nonestate assets—such as income derived from the nonassumable contract—is not confirmable. The nondebtor might also challenge the plan's feasibility. Where significant issues exist regarding the parties' respective rights under a critical contract, such as the existence and cure of defaults or the nondebtor's ability to terminate the contract, those issues will be beyond the reach of the bankruptcy court in a ride-through scenario.

Venue Choices

If there a question regarding a key contract's assignability, one consideration is whether it is feasible to file the debtor's chapter 11 petition in a venue that has adopted the "actual test" regarding assumption (such as the First Circuit) or that has at least not adopted the "hypothetical test" espoused in the Third, Fourth, Ninth and Eleventh Circuits. Where these venue choices are not available, a ride-through strategy may provide an alternate means of preserving valuable contract rights, especially in the First, Second, Third, Fourth, Fifth and Ninth Circuits, which have expressly recognized the ride-through doctrine.

Conclusion

While the ride-through doctrine has a long history, it is no panacea. In many situations, ride-through will not be a viable option, and the nondebtor party to a nonassignable contract has numerous tools with which it may seek to have such a contract deemed rejected or terminated. But where ride-through is recognized, debtors who could otherwise lose their ability to use a key contract may be able to preserve valuable contract rights. ■

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27 *Theatre Holding Corp. v. Mauro,* 681 F.2d 102 (2d Cir. 1982).
28 *Id.* at 807.
29 *In re Cajun Electric Power Coop.*, 230 B.R. 715 (M.D. La. 1999).
30 *See, generally,* Hesse, Gregory G., "The Risk of an Offensive Use of Catapult," *ABI Journal* (April 2001).
31 *See In re Hernandez,* 287 B.R. at 807.
32 *Id.* at 807-08.