

# Bankruptcy Ruling Provides Clarity On Administrative Priority

By **Jonah Wacholder and Daniel Lowenthal** (October 28, 2022)

In nonindividual bankruptcies, administrative expense claims rank higher in priority than general unsecured claims, making the determination of whether a claim is an administrative expense often a highly significant one for parties involved in a bankruptcy case.

To enable a business to continue operating for the benefit of creditors as a whole, the U.S. Bankruptcy Code extends this benefit to counterparties who transact with the post-petition debtor, who otherwise may have no assurance of getting paid.

But where a debtor has a preexisting contractual relationship with another party that continues post-petition, it can be tricky to determine when claims arising out of that relationship are entitled to administrative expense priority and when they are not, posing uncertainties both for debtors in possession and for those who do business with them.

A recent U.S. District Court for the Southern District of New York decision, *Finance of America LLC v. Mortgage Winddown LLC*, provides new guidance on this question.[1]

*Finance of America* occurs at the intersection of the Bankruptcy Code's administrative expense provisions with its provisions governing the assumption or rejection of executory contracts.

Section 365 of the Bankruptcy Code permits the assumption or rejection of any executory contract — a contract in which the parties have ongoing duties of performance to each other when a bankruptcy case is filed — and provides that if the debtor rejects the contract, such rejection is treated as a breach occurring "immediately before the date of the filing of the petition."

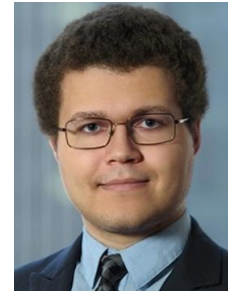
Because Section 365 treats liability from such a breach as arising prepetition, any damages are not treated as an administrative expense and are usually a general unsecured claim. Debtors in bankruptcy use Section 365 to shed obligations that no longer make sense for the reorganized company and limit their counterparties to recovery as a prepetition claimant.

Section 365 also provides that ordinarily a bankruptcy trustee or debtor in possession has until the confirmation of a plan to assume or reject executory contracts, other than those involving leases of nonresidential real property.

This raises the prospect of an extended period of performance post-petition on a contract that is ultimately rejected — precisely the scenario at issue in *Finance of America*.

## The Facts

*Finance of America* is a reverse mortgage lender. It retained Reverse Mortgage Solutions Inc., a mortgage servicer, to subservice certain loans, under the terms of three agreements.



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The first agreement was entered in March 2011, and expired on March 19, 2018, but the parties executed a series of successive extension agreements, extending the first agreement through March 31, 2019.

The other two agreements gave Finance of America a monthly renewal option, which it exercised through February 2019 for the second agreement and through September 2019 for the third agreement.

Reverse Mortgage Solutions filed a Chapter 11 petition on Feb. 11, 2019. After the petition was filed, Finance of America and Reverse Mortgage Solutions entered into several more extensions of the March 2011 agreement.

The last of these extensions expired on Sept. 30, 2019, when Reverse Mortgage Solutions' Chapter 11 plan of reorganization took effect.

On Nov. 11, 2019, Finance of America filed a proof of claim seeking administrative expense priority for damages allegedly resulting from Reverse Mortgage Solutions' breaches of the agreements between the date of Reverse Mortgage Solutions' bankruptcy petition and the date the plan became effective.

The plan administrator filed an objection, and the bankruptcy court granted the objection, finding that the post-petition extensions were not new contracts as a matter of New York law, holding that claims based on rejected prepetition contracts arise prepetition, and the alleged breaches at issue were within Finance of America's fair contemplation at the time of the contracts.

Finance of America appealed.

## **The Decision**

The district court vacated the U.S. Bankruptcy Court for the Southern District of New York's ruling. The district court rejected the bankruptcy court's reliance on state law to determine whether the extensions were new contracts.

The district court held that when the claim arose was governed by federal law, and the appropriate federal-law test was whether the breaches were within the parties' fair contemplation when they entered the underlying subservicing agreements.

As to the first agreement, the district court held that the risk of breaches after April 1, 2019, was not within the fair contemplation of the parties at the time of contract in March 2011, because the performance obligations under the first agreement would have expired on March 31, 2019, were it not for the post-petition extensions.

The court reasoned that excluding claims for breaches after April 1, 2019, would contravene the purpose of Section 503(b) — the section of the Bankruptcy Code that governs administrative expense claims — because it would remove the incentive for a debtor's counterparties to extend a contract benefiting the estate after a bankruptcy petition is filed.

As such, the court held that Finance of America's breach of contract claim for breach of the first agreement was eligible for administrative priority to the extent it constitutes "actual, necessary costs and expenses of preserving the estate."

The court applied a different analysis to the second and third agreements, which were not

extended by mutual agreement but by the exercise of Finance of America's unilateral rights under the agreements.

As to these, the court held that it was foreseeable at the time of contracting that Finance of America could extend Reverse Mortgage Solutions' obligations through the post-petition period. Therefore, Finance of America's breach of contract claims under these two agreements were not eligible for administrative priority.

However, the court further held that Finance of America's quasi-contract claims may be eligible for administrative priority, relying on a line of cases holding that administrative priority is available for claims arising from a debtor's election to receive a claimant's goods or services under a contract post-petition.

The court clarified that in light of the general principle that statutory priorities in bankruptcy are narrowly construed, for administrative priority to be available the claimant must be induced to provide a benefit it would not otherwise have provided.

Mere receipt of benefits is insufficient, even though this might suffice in some circumstances for a quasi-contract claim outside of bankruptcy.

The court left it to the bankruptcy court on remand to determine whether any of Finance of America's claims have administrative priority under this standard.

## **Implications**

Finance of America provides for two ways a participant in a prepetition contractual relationship with a debtor may nonetheless be entitled to administrative expense priority for a claim arising from that relationship.

First, and most straightforwardly, a contract extension by mutual agreement taking place post-petition can give rise to administrative expense priority just like any other post-petition transaction.

Second, even where a prepetition contract applies by its terms post-petition, performance under that contract might still be a basis for a quasi-contract claim entitled to administrative expense priority.

For bankruptcy trustees or debtors in possession, the decision is a caution about how to handle a contract that has neither been assumed nor rejected without giving rise to an unwanted administrative expense claim.

Post-petition contract extensions have the potential to give rise to claims with administrative expense priority — and even continuing with business as usual on an existing contract may give rise to an administrative expense claim in quasi contract.

For an entity transacting with a debtor in bankruptcy, correspondingly, this decision may provide helpful authority to facilitate getting paid on the portion of a preexisting contractual relationship that extends post-petition.

Even so, Finance of America's provision for administrative expense priority in these circumstances remains limited.

Absent a post-petition contract extension, a claimant must show inducement, so under the

ruling's standard a counterparty cannot simply continue performing unilaterally and expect to get priority — even if performance is not rejected.

And for any claim to receive administrative expense priority, it must meet the Bankruptcy Code's standard of being among "the actual, necessary costs and expenses of preserving the estate."

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[1] 21-cv-10038 (LAK), 2022 U.S. Dist. LEXIS 172793 (S.D.N.Y. Sept. 23, 2022).