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A Warning to Contract Counterparties: A Debtor Can Sell Your Fully Performed Contract Without Curing Defaults and Paying Your Claim in Full

By Andrew M. Troop and Andrew V. Alfano*

A decision by the U.S. Court of Appeals for the Third Circuit serves as a stark reminder that the sale (assignment) of a contract in bankruptcy does not always require full payment of the non-debtor counterparty's claim.

There was no "silver lining" for a producer of the 2012 critically acclaimed film *Silver Linings Playbook* and his $400,000 claim to a portion of the film's profits in a dispute before the U.S. Court of Appeals for the Third Circuit.[1] Notwithstanding the purchase of film and related production/distribution rights and contracts in a bankruptcy sale and the buyer's commitment to cure all defaults on the executory contracts acquired, the Third Circuit held that the producer had only an unsecured claim against the Weinstein Company's estate because the producer's contract was not executory. The decision serves as a stark reminder that contract counterparties do not always receive full payment on their claim when their contract is sold in bankruptcy.

BACKGROUND

In 2011, a producer and an affiliate of the Weinstein Company entered into a "work-made-for-hire" contract for production of the film *Silver Linings Playbook*. The producer received a $250,000 upfront payment for production of the film plus contingent future payments equal to roughly five percent of the film's net profits. None of the intellectual property in the film was owned by the producer. The film's success led to the producer earning approximately $400,000 in additional compensation.

In 2018, after a slew of sexual assault allegations were made against its co-founder, the Weinstein Company and its affiliates (collectively, "TWC")

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[1] *See Spyglass Media Grp., LLC v. Bruce Cohen Prods.*, 997 F.3d 497 (3d Cir. 2021).

filed for bankruptcy to facilitate a sale of its assets to Spyglass Media Group, LLC ("Spyglass"). Spyglass bought substantially all of TWC's assets and a right to designate executory contracts for assumption and assignment. Spyglass desired to buy the *Silver Linings Playbook* producer's contract as part of the sale.

In 2018, Spyglass sued the producer in the U.S. Bankruptcy Court for the District of Delaware seeking a declaration that the contract could be sold without "cure" of the producer's $400,000 claim. The bankruptcy court granted summary judgment in favor of Spyglass. The district court affirmed, and the producer appealed to the Third Circuit.

THE DECISION

The producer's entitlement to receive full payment of his $400,000 claim as a condition to the sale of the contract depended on whether the producer's contract was "executory." Under Bankruptcy Code Section 365, defaults existing under an executory contract must be paid in full (i.e., cured) before a contract can be sold or assigned.[2] If the contract is executory under the Bankruptcy Code, then full payment of the producer's claim for the film's net profits would have been a condition to the contract's sale to Spyglass.

In contrast, non-executory contracts can be sold under Bankruptcy Code Section 363 which does not require cure of existing defaults. The counterparty holds a general unsecured claim in the debtor's bankruptcy case for amounts due when the case commenced, and its claims against the purchaser are limited to obligations arising after the sale.

Not surprisingly, the producer argued that the contract was executory and could only be sold to Spyglass under Bankruptcy Code Section 365, which would require payment in full of the $400,000 claim. Spyglass argued to the contrary that the contract was not executory and it purchased the contract under Bankruptcy Code Section 363, without any obligation to satisfy the $400,000 claim.

Executory contract is not defined in the Bankruptcy Code. As a result, the Third Circuit set out the following paradigm for determining whether this contract was executory. First, the Third Circuit set forth the often-cited definition of an executory contract proposed by Professor Vern Countryman: "[An executory contract is] a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the

[2] *See* 11 U.S.C. § 365(b)(1).

failure of either to complete performance would constitute a material breach excusing performance of the other."[3]

Next, the Third Circuit found that the materiality of unperformed obligations is governed by relevant state law. Finally, the Third Circuit looked to the contract's governing New York law and concluded that "[a] material breach is a failure to do something that is so fundamental to a contract that the failure to perform that obligation defeats the essential purpose of the contract."[4]

Applying the foregoing framework to the producer's contract, the Third Circuit found that, on TWC's side, the obligation to pay the producer contingent compensation was material, and the fact that the contingent compensation was larger than the upfront payment to produce the film clearly demonstrated that those payments were material to the agreement. On the producer's side, however, the obligations were mostly performed. The film had been released for six years and the producer had not done any further work. The Third Circuit found that the existence of ancillary negative covenants (such as an obligation to not bring certain disputes) or indemnification obligations were not material. The essence of the contract was for the producer to produce and deliver the film to TWC. Because that fundamental contractual production and delivery obligation had been performed, a breach of the remaining obligations would not defeat the purpose of the contract.

The Third Circuit acknowledged that parties might be able to contract around the substantial performance rule by agreeing that certain provisions that would otherwise be considered immaterial to a contract are material. However, the Third Circuit rejected the producer's argument that a provision in the contract excusing TWC's performance for mere technical violations by the producer rendered everything in the contract material because the contract "did not clearly and unambiguously avoid the substantial performance rule for evaluating executory contracts."[5]

The Third Circuit also rejected the producer's argument because the obligation relied on as material was not an affirmative covenant requiring the producer to do anything; rather it was a condition (more like a negative covenant) to future payment obligations. The Third Circuit ruled that the producer's contention that the clause was material should be evaluated based on

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[3] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

[4] *Feldmann v. Scepter Grp., Pte. Ltd.*, 128 N.Y.S.3d 13 (N.Y. App. Div. 2020) (quoting *O & G Indus., Inc. v. Nat'l R.R. Passenger Corp.*, 537 F.3d 153, 163 (2d Cir. 2008)).

[5] *Spyglass Media*, 997 F.3d at 508.

a high "clear and unambiguous" standard and not the often-applied evidentiary standard of preponderance of the evidence.

Under the stringent "clear and unambiguous" standard, even though the producer was subject to conditions it has to satisfy in order to continue to collect payments, such conditions did not ripen to the level of "materiality." Therefore, the contract could be sold under Bankruptcy Code Section 363 without cure of the producer's claim (we also note that because Section 363 and Section 365 are intended to let a debtor maximize value, it is unclear whether a court would or should apply this same exacting standard for identifying material contract terms, if doing so would deprive the debtor of some perceived value).

CONCLUSION

The Third Circuit's decision dampens what is conventionally welcome news for vendors and other contract counterparties that their contracts will be sold to a buyer out of bankruptcy and their claims will be paid in full. But the decision is not all bad news. While the difference between assumption under Bankruptcy Code Section 365 and a sale under Section 363 can be full payment of a claim versus no distribution, the buyer's willingness to take over contractual obligations on a go-forward basis can be positive for the counterparty. Continuing performance by a willing and able buyer is perhaps a "silver lining" for the producer and contract counterparties alike that find their non-executory contracts sold out of bankruptcy.

Similarly, the Third Circuit's apparent willingness to consider party-designations of material provisions may also be a "silver lining." Vendors and other contract counterparties should consider whether to designate contract terms as material to force a debtor/purchaser to cure defaults if it wants the future benefits of the contract. In considering whether to designate terms as "material," parties need to evaluate the consequences and benefits of doing so. The breach of a term successfully designated as material would relieve the counterparty of future performance, a result that may not be desired.

For example, if a contract states that all obligations are "material" then an otherwise immaterial brief delay in meeting a delivery deadline would enable the other party to terminate the contract. Thus, an attempt to shape a particular bankruptcy outcome could lead to undesirable outcomes outside of bankruptcy. Also, the act of designating otherwise immaterial contractual terms as material might be viewed by courts as form over substance, and not given effect. This possibility is a real one given the "clear and unambiguous" standard that the non-debtor will face. These considerations and others must be evaluated carefully in drafting a contract.

TAKEAWAYS

- Debtors must only pay in full and otherwise cure defaults on executory contracts (contracts requiring substantial performance on both sides) before selling (assigning) the benefits of the contract and binding the buyer to future performance/payment obligations. Otherwise, if the contract is not executory it can be sold without paying prepetition amounts owed under it by the debtor.
- Parties may be able to "contract around" the substantial performance rule and "override the Bankruptcy Code's intended protections for the debtor" by identifying which obligations are material in the contract.
- Contract counterparties need to consider whether to identify "material obligations" to avoid the Third Circuit's ruling.