

Second Circuit: Not a Party to an Assumed Unexpired Lease? No Cure Claim for You!

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Financial Restructuring and Bankruptcy Alert

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On April 10, 2023, the United States Court of Appeals for the Second Circuit (the “Court”) held that a non-party to an unexpired lease assumed by a debtor in bankruptcy was not entitled to assert a “cure claim” under section 365(b)(1)(A) of title 11 of the United States Code (the “Bankruptcy Code”) based on a purported default under the subject lease. In *Tutor Perini Bldg. Corp. v. New York City Reg’l Ctr. George Wash. Bridge Bust Station & Infrastructure Dev’t Fund, LLC (In re George Wash. Bridge Bus Stations Dev. Venture LLC)*,^[1] the Court affirmed the decision of the United States District Court for the Southern District of New York (the “District Court”), which, in turn, had previously affirmed the decision of the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”).

Factual Background and Procedural History

George Washington Bridge Bus Station Development Venture LLC (the “Debtor”) was the redeveloper of the bus station (the “Bus Station”) of the Port Authority of New York and New Jersey (the “Port Authority”) located in New York City. In July of 2011, the Debtor and Port Authority entered into an agreement (the “Ground Lease”) under which the Debtor would manage the approximately \$183 million redevelopment of the Bus Station.

The Debtor was required under the Ground Lease to hire contractors to complete the redevelopment of the Bus Station. Additionally, the Ground Lease explicitly provided that the Debtor “shall pay all claims lawfully made against it by its contractors, subcontractors, material-men and workmen and all claims lawfully made against it by other third persons arising out of or in connection with or because of the performance” of the construction work required of the redevelopment project (*i.e.*, the Ground Lease required the Debtor, rather than the Port Authority, to pay the contractors).^[1]

The Debtor subsequently hired Tutor Perini Building Corp. (“Tutor”) as general contractor for the project. The Debtor and Tutor quickly became embroiled in conflict over, among other things, the Debtor’s failure to pay certain bills issued to it by Tutor. The Debtor commenced an arbitration proceeding against Tutor over the disputed bills, and Tutor counterclaimed with evidence of approximately \$113 million in damages arising from the Debtor’s failure to pay the disputed bills.

During arbitration, the Debtor filed for chapter 11 protection. The Debtor then sought authority from the Bankruptcy Court to sell its assets, including its rights in the Ground Lease, to which Tutor objected.^[2] Tutor, a non-party to the Ground Lease, argued that the Debtor was required to satisfy the outstanding \$113 million in order to cure the defaults under the Ground Lease as required by Bankruptcy Code section 365. Thus, Tutor argued, the Debtor could not assume and sell the Ground Lease.

The Bankruptcy Court rejected Tutor’s arguments that: (i) Bankruptcy Code Section 365 does not limit who may assert a “cure claim”; and (ii) Tutor was a third-party beneficiary under the Ground Lease, which entitled it to assert a cure claim. The District Court affirmed, and appeal to the Court followed.

Applicable Bankruptcy Law

Bankruptcy Code section 365(a) allows a debtor to assume an unexpired lease. Furthermore, under section 365(b)(1)(A), if a debtor has previously defaulted on its obligations under the subject lease (*i.e.*, a payment default), the debtor must first cure any such defaults (or provide adequate assurance that it will cure the defaults) before it may assume the unexpired lease.

"Under the classification scheme enacted by Congress, the Bankruptcy Code sets up three broad classes of claims: secured, priority unsecured and general unsecured."^[3] Sections 503 and 507 of the Bankruptcy Code, among others, determine the priority of distribution to creditors in a bankruptcy case. Section 503(b) establishes what claims against a debtor are afforded "administrative" priority. Pursuant to section 507(a)(2), classification of a claim as "administrative" allows the holder of such claim to receive a distribution from a debtor's estate ahead of many other of the debtor's creditors.

Finally, a "cure claim" under Bankruptcy Code section 365(b)(1)(A), is afforded administrative priority status pursuant to section 503(b)(1)(A), thus requiring such claim to be satisfied prior to general unsecured claims. As the District Court noted, "the Code . . . provides for superior priority for such a cure claim, even where a breach-of-contract claim by the counterparty in the event of the debtor's breach would otherwise have been treated as unsecured."^[4]

The Court's Rationale

On appeal, the Court affirmed the decisions of the District Court and the Bankruptcy Court. As noted, Tutor advanced two (2) arguments in support of its assertion that the Debtor could not assume the Ground Lease: (i) Tutor was entitled to receive all outstanding amounts owed by the Debtor as a cure claim under Bankruptcy Code section 365(b)(1)(A), as the ground lease required the Debtor to pay its contractors; and (ii) Tutor was a third-party beneficiary under the Ground Lease entitled it to assert a cure claim.

Tutor's primary argument hinged on the assertion that Bankruptcy Code does not limit who may assert a cure claim against the Debtor. Specifically, that section "does not state that only a party to the assumed contract may do so."^[5] The Court quickly dispensed with Tutor's reasoning, holding that a creditor asserting a cure claim "must have some right to pursue a breach of contract claim" under a contract or lease being assumed, which Tutor did not.^[6] The Court's rationale was based on the fact that: (i) statutory priorities are narrowly construed in order to facilitate equitable distribution of a debtor's resources; and (ii) reading section 365(b)(1)(A) to restrict cure claims to contract counterparties "make[s] the most sense of § 365 and the 'Bankruptcy Code as a whole.'"^[7]

The Court further expounded that such a holding enforces the statutory purpose of section 365(b), which is to guarantee that the non-debtor counterparty receives the benefit of its bargain if required to continue performance under the assumed contract or lease. In contrast, granting administrative priority to a creditor whose claim does *not* arise from an assumed contract or lease does not further any statutory purpose. Furthermore, reading section 365(b)(1)(A) to restrict administrative priority to non-debtor contract counterparties falls squarely in line with other subsections of section 365 that explicitly apply to, or inure to the benefit of, the counterparty; specifically sections 365(b)(1)(B) (regarding trustee's additional responsibilities with regard to assumed contracts or lease) and 365(g) (noting that rejection of a contract or lease gives rise to a breach of contract claim, which is a lower priority general unsecured claim).

As to Tutor's argument that it is entitled to a cure claim as a third-party beneficiary, the Court stated, "Tutor Perini's claim fails because it is not a third-party beneficiary."^[8] Specifically, under New York law, Tutor was an incidental beneficiary rather than an "intended" third-party beneficiary.^[9] Indeed, New York law generally requires that a construction contract clearly state that the contracting parties intended to benefit third parties, which was not the case under the ground lease. As such, Tutor was not a third-party beneficiary, had no right to enforce the contract, and was not entitled to administrative priority for the amounts owed to it by the Debtor.

If you have questions or would like additional information, please contact Travis Powers (powerst@whiteandwilliams.com; 212.868.4837).

[1] 2023 U.S. App. LEXIS 8428, at *5-6.

[2] The Debtor's case was converted to chapter 7 on October 1, 2021.

[3] *In re Senise*, 202 B.R. 403, 407 (Bankr. D.S.C. 1996).

[4] *Tutor Perini Bldg. Corp. v. New York City Reg'l Ctr. George Wash. Bridge Bust Station & Infrastructure Dev't Fund, LLC (In re George Wash. Bridge Bus Stations Dev. Venture LLC)*, No. 20-cv-7433 (JSR), 2021 U.S. Dist. LEXIS 146040, at *15-16 (S.D.N.Y. Aug. 4, 2021).

[5] *Tutor Perini*, 2023 U.S. App. LEXIS 8428, at *12.

[6] *Id.*

[7] *Id.* at *15 (quoting *Smart World Techs., LLC v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 183 (2d Cir. 2005)).

[8] *Id.* at *20.

[9] *Id.*

[i] No. 21-2050-bk, 2023 U.S. App. LEXIS 8428 (Apr. 10, 2023).

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