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Cure Claims in Bankruptcy - Delphi Bankruptcy Case Raises Issues

Following a recent ruling in the Delphi Corporation bankruptcy case approving cure notices and cure claims procedures, purchasers of unsecured trade claims originating out of executory contracts or unexpired leases should take special precautions to protect their rights or risk impairment or loss of such claims to the extent they become “cure claims”. As further outlined in this memorandum, purchasers of claims should take steps to ensure that (i) they are able to quickly locate and match claim numbers with the underlying contracts and the original claimant, (ii) their purchase agreements clearly assign all cure payments to the purchaser and (iii) the original claimant is obligated to promptly deliver to the purchaser any cure notices received from debtors and follow purchaser’s instruction regarding such cure notices.

How Cure Claims Arise

Under the United States Bankruptcy Code, debtors have the option to (i) reject, (ii) assume or (iii) assume and assign to a third party, executory contracts and unexpired leases.¹ In order to assume or assign a contract or lease, however, the debtor must cure all monetary defaults and give adequate assurance of its ability to perform under the contract. The assumption of a contract or lease thus gives rise to a “cure claim”. All amounts due under the contract or lease as of the petition date must be .cured. by the debtor, generally through an immediate cash payment of such amounts, even if general unsecured creditors receive no distributions until later in the case or receive less than the full amount of their claims or receive consideration other than cash.

In effect, the debtor’s decision to assume an executory contract or unexpired lease elevates the priority of the claim related to the contract.

¹ The Bankruptcy Code does not define “executory contracts” and “unexpired leases”. Generally, a contract is executory if both parties to the contract have material obligations that remain outstanding under the contract. An unexpired lease is a form of an executory contract.

Delphi Cure Claims Procedure

In the Delphi bankruptcy case, the Bankruptcy Court for the Southern District of New York entered a Solicitations Procedures Order² which, among other things, approved the procedures and forms of notices for dealing with cure claims for supply contracts that the debtors intended to assume under their proposed plan of reorganization.

The Solicitations Procedures Order directed the debtors to provide Cure Notices³ to counterparties to supply contracts that the debtors intended to assume. The Cure Notices identified specific contracts to be assumed and the proposed cure amounts, if any,⁴ and provided the contract counterparties (i.e. the original claimholders) an opportunity to accept or reject the proposed cure amount. If they accepted that amount, the counterparties could then elect whether to receive payment of the cure amount in cash or stock. The Solicitations Procedures Order also authorized the debtors to remit payments of cure amounts directly to the contract counterparties whose contracts were being assumed.

In addition, the Solicitations Procedures Order authorized the debtors to send a Generic Notice⁵ to purchasers of these unsecured claims, but unlike the Cure Notices, these Generic Notices did not identify the contract to be assumed, the proposed cure claim or even the contract counterparty whose contract was being assumed. The Generic Notices simply stated, in pertinent part:

[Y]ou are receiving this notice as a courtesy because the claims register . . . indicates that you may hold or may have purchased a claim from one or more of the Counterparties to whom the Cure Notice and election was sent.

If Cure Notices were not returned by the deadline set forth in the notice, the cure amounts proposed by Delphi were deemed to be correct and were to be paid in the stock of reorganized Delphi, rather than in cash, to the contract counterparties.

Although cure claims procedures similar in form to the procedures used by Delphi are frequently used by debtors in bankruptcy to reconcile cure amounts and assume executory contracts, they generally allow for parties in interest, including purchasers of claims, to appear and respond to notices regarding cure amounts and they generally provide more information regarding proposed cure amounts and the corresponding claims and contracts. As discussed below, the Delphi cure claims procedure was more restrictive than such procedures in other cases and presented special difficulties to purchasers of claims. In addition, the Delphi debtors actively opposed efforts by purchasers to enlarge the time within which to respond to the Cure Notice or otherwise modify the terms of the cure claims procedure.

² Order Approving (I) Disclosure Statement, (II) Record Date, Voting Deadline, and Procedures for Temporary Allowance of Certain Claims, (III) Hearing Date to Consider Confirmation of Plan, (IV) Procedures for Filing Objections to Plan, (V) Solicitation Procedures for Voting on Plan, (VI) Cure Claim Procedures, (VII) Procedures for Resolving Disputes Relating to Postpetition Interest, and (VIII) Reclamation Claim Procedures. (Docket No. 11389).

³ Notice of Cure Amount with Respect to Executory Contract to be Assumed or Assumed and Assigned Under Plan of Reorganization (the "Cure Notice").

⁴ Section 365(b) of the Bankruptcy Code requires a debtor to "cure" a default in an executory contract or unexpired lease of the debtor if it seeks to assume such contract or lease.

⁵ Notice to Holders, Assignees, Transferees, and Purchasers of Claims of Cure Procedures Established Under Solicitation Procedures Order (the "Generic Notice").

Problems for Purchasers of Cure Claims

Typical transfer documents for the sale and purchase of unsecured trade claims provide that cure amounts belong to the purchaser and that decisions regarding the treatment of claims are to be made by the purchaser. The following aspects of the Delphi cure claims procedures, however, presented problems to purchasers who attempted to enforce these typical purchaser rights.

The Generic Notices Lacked Critical Information Regarding Cure Claims. The Generic Notices contained no information regarding the identity of the original claimant or the contract being assumed and did not reference a claim number or the proposed cure amount. Thus, the Generic Notices lacked basic information that was necessary for purchasers to track-down the Cure Notices (which contained the proposed cure amount) from the original claimant⁶ so that they could attempt to reconcile the proposed cure amounts with claim numbers or scheduled claims. Without more information, it was practically impossible for a purchaser to determine which or how many of its claims were subject to Cure Notices and to take appropriate action to protect its claims.

Only Original Claimholders Were Authorized to Respond to Cure Notices. Pursuant to the Solicitations Procedures Order, the only party authorized to receive and respond to Cure Notices was the original counterparty to the contract being assumed. Delphi took the position that the obligation to cure a monetary default through payment of a cure amount ran to the contract counterparty and not the purchaser of the claim arising from such contract. This meant that even if a purchaser was able to determine the identity of the original claimholder and the details of the proposed cure, it still had to rely on the original claimholder to make the desired elections on the Cure Notice.

Accordingly, purchasers had to obtain the cooperation of original claimholders, who may have had no direct contractual relationship with or obligation to the purchasers, in order to respond to Cure Notices. To further exacerbate the problem, the Cure Notices identified the cure amounts and contracts by reference to purchase order numbers, which do not appear to have been readily identifiable, even to contract counterparties.

Cure Amounts Paid to the Original Claimholders. The Solicitation Procedures Order authorized the debtors to make distributions on account of cure amounts directly to the original claimholders, even if they no longer are the record or beneficial holders of the cure claims, and further provided that purchasers had no rights or recourse against Delphi with respect to the cure. This payment arrangement thus required purchasers to locate the cure payments and arrange for the transfer of such payments from the original claimholders to the purchasers, exposing purchasers to substantial credit risk of the original claimholders.

Request for Court Intervention

Due to the problems highlighted above and the short time period to coordinate responses, an ad hoc group of claim purchasers filed an emergency motion in the Delphi bankruptcy case on January 9, 2008 which sought (i) an extension of the deadline to submit Cure Notices and (ii) an order authorizing the debtors to make distributions of the cure amounts directly to the purchasers of the claims and not to the contract counterparties.

Delphi filed a response to the motion on January 10, 2008 asserting, among other things, that the claims purchasers did not take an assignment of the underlying contracts and, as such, they had no

⁶ Delphi and its claims agent refused to provide copies of the Cure Notice to anyone other than the original claimholder.

rights with respect to cure decisions or cure amounts. Following an emergency hearing on the motion brought by the ad hoc group of claims purchasers, the Bankruptcy Court denied the motion.

Recommendations

In light of the difficulties faced by purchasers of claims in the Delphi bankruptcy case, and the possibility that in the future other debtors may adopt the procedures used by Delphi, purchasers of claims should consider the following measures when purchasing claims:

- (a) obtaining the name and contact information of the original claimholder for the claim being purchased;
- (b) obtaining and reviewing information regarding the creditworthiness of the original claimholder;
- (c) identifying the underlying contracts or agreements giving rise to the claims and amounts necessary to cure monetary defaults under such contracts or agreements in the event they are assumed by the debtors;
- (d) making sure in the transfer documents that the original claimholder or subsequent seller, as the case may be, is contractually obligated to promptly deliver all notices regarding the claim to the purchaser and to remit directly to the purchaser all payments it receives in respect of the claim;
- (e) making sure the transfer documents provide that the seller and original claimholder will comply with purchaser's instructions regarding the claim;
- (f) making sure that the remedies under the transfer documents provide for appropriate damages in the event original claimholder or seller, as the case may be, fails to comply with purchaser's instructions with respect to claims or fails to take reasonable steps to protect the claims;
- (g) providing in the transfer documents that the default election with respect to a cure amount is receipt of such payment in cash, unless otherwise directed by the purchaser, and that the failure to receive cash on account of a cure claim, if offered by the debtor, would give rise to a damage claim under the transfer agreement; and
- (h) obtaining copies of any and all intervening transfer documents and making sure that such intervening documents contain the provisions described in clauses (d) through (g) above.

In addition, purchasers of trade claims should monitor motions and orders in bankruptcy cases regarding cure procedures and cure notices so as to protect their rights to cure claims. Since cure claims are prepetition unsecured claims and only become cure claims when a debtor elects to assume the underlying contract relating to such claim, it is difficult to predict in advance which claims will ultimately become cure claims. However, taking the recommendations listed above should assist purchasers in responding to issues raised by cure claims.

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