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Must Suppliers Continue to Supply on Credit During the Slide into Bankruptcy? Heck No!

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Feature

Bankruptcy lawyers who represent suppliers know that the relationship between a supplier and customer is not as simple as purchase order plus invoice plus payment. Indeed, supply contracts are typically drafted to be flexible in recognition of the relationship between a supplier and its customer which, by its very nature, must be fluid. Frequently, a supply contract permits buyers and sellers to separately negotiate individual deliveries and the terms. For example, the quantity and kind of goods, price terms, means of delivery and/or warehousing and, of course, the terms for payment may all be subject to separate negotiation and mutual agreement.

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Flexibility is even more essential on the slide into bankruptcy. Once a supplier recognizes that its customer may be in distress, there is a heightened need for a nimble approach. Often, the supplier will request payment in advance, a letter of credit, a purchase-money security interest, cash-on-delivery terms or some other form of security to ensure that it will be paid for its continued supply of goods. On the other side, the already-strapped debtor will be forced to pick and choose which suppliers are absolutely vital to its business enterprise and decide how far it is willing to go to accommodate them. Debtors may or may not agree to continue purchasing on terms that force them to accelerate the payment of cash or to tap into lines of credit. At the same time, there are usually at least a handful (if not a panoply) of suppliers that a debtor must keep in tow in order to sustain its business.

It is against this background that debtors and suppliers must find their way once a debtor files for bankruptcy. The debtor will have to choose which contracts to assume or reject under §365 of the Bankruptcy Code, with its attendant requirements for cure and adequate assurance of future performance. But until assumption or rejection, what is a supplier to do? Must a supplier continue to supply on credit terms postpetition? Does it matter if the debtor is in default? Is it relevant that the debtor cannot provide "adequate assurance" that the supplier will be paid? Does the Uniform Commercial Code play a part? Does it violate the automatic stay to withhold delivery? And what about critical-vendor motions? This article will attempt to provide answers to these questions and more, but be forewarned: This author has an opinion.

Case Law on the Obligations of Nondebtor Parties to Unassumed Executory Contracts

A number of cases interpreting §363 are cited for the general proposition that the nondebtor party to an executory contract is obliged to perform it until the contract is assumed or rejected.[1] Yet most of these cases deal not with the question of whether a nondebtor supplier must continue to supply postpetition, but rather with the determination of claims asserted by the nondebtor creditor against the estate.[2] These cases state the general proposition that nondebtors must perform executory contracts in passing to support decisions made concerning claim disputes.

In fact, there are but a handful of cases that directly confront this issue. These cases ask the question of whether a creditor might be enjoined from discontinuing its performance under an executory contract or violate the automatic stay in refusing to supply. Thus, in *Continental Energy Assocs. Ltd. Partnership,* 178 B.R. 405 (Bankr. M.D. Pa. 1995), the bankruptcy court exercised its powers under §105 of the Code to issue a preliminary injunction requiring a fuel supplier to provide the debtor with a continuous supply of natural gas until the debtor either assumed or rejected the supply contract. Notably, however,

1 *See, e.g., In re Public Service Co. of N.H.,* 884 F.2d 11, 14 (1st Cir. 1989); *In re Rhodes Inc.,* 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005); *In re Nat'l Steel Corp.,* 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004); *In re Pittsburgh-Canfield Corp.,* 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002); *In re El Paso Refinery LP,* 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996). *But see In re Lucre,* 339 B.R. 648, 657 (Bankr. W.D. Mich. 2006) ("[T]here is nothing in §365 that permits the trustee or debtor-in-possession to compel performance from the other party prior to actually assuming that contract pursuant to §365(a).").

2 For example, *In re Public Service, supra,* addressed the right of a creditor to setoff the debtor's obligation to buy excess electricity under an unassumed executory contract. *In re Rhodes, supra,* dealt with the administrative claim of a landlord under §§365(d)(3) and 503. *In re Nat'l Steel, supra,* addressed the ability of a debtor supplier to ship to its creditor customer with an upward adjustment in price. *In re El Paso Refinery, supra,* concerned a trustee's objection to a creditor's claim.

the court's determination was grounded in deference to the Fifth Amendment rights of the supplier to be compensated for property, namely the condition that the debtor would continue to make payments under the contract *in advance*. *Id*. at 407. Further, the court found that under the facts before it, the debtor would be irreparably harmed by the supplier's refusal to supply natural gas to the debtor since it would be "effectively prevented from operating." *Id*. at 408. Similarly, in *Matter of Whitcomb & Keller Mortgage Co.*, 715 F2d 375 (7th Cir. 1983), the Seventh Circuit found that the bankruptcy court did not err in issuing a §105 restraining order prohibiting the creditor from discontinuing essential computer services to a debtor. But again, the services rendered by the creditor had been paid for in full postpetition, and the parties had stipulated that any right, lien or other interest that the creditor might have would attach to the proceeds of a sale of the debtor's assets. As such, the property interests of the creditor were protected.

A couple of cases have considered whether canceling or otherwise altering the terms of an executory contract might violate the automatic stay. *In re Coast Trading Company Inc.,* 26 B.R. 737 (Bankr. D. Or. 1982), opined that cancellation of a contract under which the debtor was to sell corn to its purchaser was prohibited under §362(a) as an "act to obtain possession of property of the estate." Notably, the debtor's *contract to sell* was viewed as property of the estate, and the debtor had filed a motion to assume the contract and provided adequate assurances of performance.

Obviously, these facts are quite distinct from a situation in which a supplier might be forced to continue supplying goods under an unassumed contract, such as was the case in *In re National Steel Corp, supra,* also considered whether the debtor's refusal to continue providing steel to a creditor/manufacturer without an upward price adjustment might violate the automatic stay in the manufacturer's separate bankruptcy case. There, the court determined that the submission of an amended price proposal did not violate the automatic stay.

In reaching this holding, the court's rationale was that the contract at issue had not been assumed and therefore was not unenforceable against National Steel. As such, the amended price proposal "did not constitute an act to obtain possession of property of the creditor's bankruptcy estate or to exercise control over property of its estate in violation of §362(a)(3)." *National Steel, supra,* 316 B.R. 287 at 311.

UCC Cases

This author would unabashedly admonish that it is absurd to force a supplier to continue supplying on credit without assurance that the debtor's case is administratively solvent or that the debtor can pay for the property to be supplied. In a solvent case, suppliers may be able to collect on an administrative claim under §503(b) for goods and services furnished postpetition at the contract rate (assuming at market). In particular, where there has been a prepetition default on the way into bankruptcy, and where the debtor is unable to provide assurances in the form of payment in advance, a letter of credit or other security, suppliers should not be forced to "come out of pocket" on the hope that the debtor will ultimately be able to make good. In these circumstances, the supplier is certainly not trying to obtain possession or control over property of the estate, but rather being forced to provide property *to* the debtor's estate.

> *The problem with these suggested motions is that a hearing before the court may not be granted for at least a month, and this is more often than not much too late for the supplier. Under large supply contracts, a supplier may be providing millions of dollars of goods on a weekly, if not daily, basis. Perhaps the best approach is to make the supply contract as nimble as possible in the first place.*

This rationale underlies the provisions of the UCC that allow commercial sellers to withhold performance upon learning of a buyer's insolvency where the buyer refuses to pay cash. *See* UCC §702(1). Several bankruptcy courts have upheld this provision and allowed sellers to withhold performance to sell to bankrupt buyers. *See In re The National Sugar Refining Co.,* 27 B.R. 565 (S.D.N.Y. 1983) (stoppage of goods in transit did not violate automatic stay, and right of stoppage did not abrogate contract); *In re Trico Steel Company LLC Inc.,* 302 B.R. 489 (Bankr. D. Del. 2003) (under New York law, seller's right to stoppage of delivery of goods in transit upheld and not subject to rights of secured creditor); *In re Kellstrom Indus. Inc.,* 282 B.R. 787 (Bankr. D. Del. 2002) (seller's right to stop delivery of goods still in its possession, upon discovering buyer's insolvency, was not impaired by passage of title to buyer); *In re Morrison Indus. LP,* 175 B.R. 5 (Bankr. W.D.N.Y. 1994) (seller's right to refuse delivery of goods except for cash on discovering buyer's insolvency must be liberally applied in favor of seller).

As previously stated, these cases rely on the provisions of the UCC implicit in every commercial relationship to protect the rights of suppliers. They recognize that forcing a supplier to go deeper into debt in the limbo period before assumption or rejection of an executory contract violates the property interests of nondebtor parties.

Critical-vendor Orders

Perhaps to short-circuit this dilemma, debtors often file so-called "critical-vendor motions" seeking to hold onto critical suppliers and other vendors.[3] Such motions have been offensive to some because they blatantly attempt to favor a certain group of prepetition unsecured creditors over others. Moreover, such motions leapfrog the assumption/rejection process without any transparency about which creditors are to be paid and why.

The typical critical-vendor motion, usually filed together with other first-day motions, asks the bankruptcy court for permission to pay the prepetition

[3] Some courts have allowed debtors to pay vendors asserted to be critical under the "doctrine of necessity" and §105 of the Code. *See, e.g., In re CoServ LLC,* 273 B.R. 487 (Bankr. N.D. Tex 2002). Other courts have ruled that bankruptcy courts have no power to authorize payment of prepetition claims. *See, e.g., Matter of B&W Enterprises Inc.,* 713 F.2d 534 (9th Cir. 1983). Some courts have recognized that §363(b)(1) might serve as a basis for permitting payment in appropriate circumstances, but require a factual record to support a finding that payment to a subclass of unsecured creditors will benefit all creditors. *See, e.g., In re Kmart Corp,* 359 F.3d 866 (7th Cir. 2004).

claims of certain "critical vendors" on the theory that if such vendors are not paid, the debtor's business will not survive. Implicitly, these motions recognize that nondebtor suppliers have the right to stop supplying. They openly acknowledge that vendors are tied by a delicate strand and may turn to other buyers not in bankruptcy for business. The motions typically require that, as a *quid pro quo* in exchange for payment, vendors be locked into postpetition agreements that provide for the continued supply of goods on customary credit terms and be barred from making reclamation claims or other statutory claims that might apply. *See, e.g.,* critical-vendor orders entered in *Buffet Holdings Inc.,* Case No. 08-10141-MFW, filed Jan. 22, 2008, and *Flying J. Inc., et al.,* Case No. 08-13384-MFW, filed on Dec. 22, 2008, both in the District of Delaware. In this way, debtors are assured of stable and continuous postpetition supply on credit and need not deal with the variety of claims that might be asserted by suppliers. If such motions are granted, suppliers must choose whether to continue doing business with debtors on long-term credit terms, knowing that payment of prepetition claims is contingent on extending credit.

Practice Pointers and Observations

In order to be certain that a supplier is legally entitled to stop extending credit under an executory contract, the supplier might seek relief from the automatic stay to terminate the contract for cause under §362(d) of the Code. A court might find "cause" for such relief if the debtor is in prepetition default and cannot provide adequate assurance of payment and may even grant conditional relief from stay to permit termination if the debtor fails to make timely post-petition payments. *See, e.g., In re Lucre Inc.,* 339 B.R. 648 (Bankr. W.D. Mich. 2006) (cause existed to modify stay in order to allow telecommunications provider to dissolve prepetition preliminary injunctions to compel performance). Likewise, the supplier may seek "adequate protection" under §363(e), prohibiting the debtor's use of the supplier's goods without such adequate protection of the supplier's interest.

More to the point, a supplier may file a motion under §365(d)(2), compelling the debtor to assume or reject the executory contract by a certain date and may ask for some assurance of payment before that deadline. *See, e.g., Matter of Travelot Co.,* 286 B.R. 462 (Bankr. S.D. Ga. 2002) (debtor would be required, before expiration of shortended deadline to deposit with court cash sufficient to cure defaults, both pre- and postpetition).

Without such a motion, the debtor generally has until plan confirmation to decide whether to assume or reject a contract, and the court may not grant a request for an earlier deadline. However, bringing this type of motion might at least cause the court to order payment terms that are acceptable to the supplier pending assumption or rejection.

The problem with these suggested motions is that a hearing before the court may not be granted for at least a month, and this is more often than not much too late for the supplier. Under large supply contracts, a supplier may be providing millions of dollars of goods on a weekly, if not daily, basis. Perhaps the best approach is to make the supply contract as nimble as possible in the first place.

If it is clear that each delivery can be separately negotiated, as suggested above, the supplier has a winning argument that it need not supply until its buyer has agreed to terms acceptable to it, such as cash in advance. Moreover, if the contract itself incorporates the provisions of the UCC that allow a supplier to withhold performance without prepayment or some other form of adequate security, the unassumed contract will already provide an out. Careful drafting helps to avoid the problem. But for those suppliers who are not so fortunate, the cases cited above seem to uphold the policy behind the UCC in recognizing that a supplier should not be forced to continue supplying on credit terms. ■

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