

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

Compelling Postpetition Trade Credit: Navigating Uncharted Waters

Contributing Editor:

Bruce S. Nathan
Lowenstein Sandler PC; New York
bnathan@lowenstein.com

Also Written by:

Scott Cargill
Lowenstein Sandler PC; Roseland, N.J.
scargill@lowenstein.com

The limits of a vendor's obligation to continue to provide goods or services on credit to a customer that files for chapter 11 has been the subject of debate since the enactment of the Bankruptcy Code. Unfortunately, the sweeping changes to chapter 11 that were part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) failed to address this unsettled area. Vendors should consider the interplay among the protections afforded to a debtor under the automatic stay arising under §362 of the Code, the status of executory contracts between the vendor and a debtor under §365, and a vendor's Uniform Commercial Code (UCC) and other state law remedies. This article examines these related, and sometimes conflicting, rights and how courts have attempted to balance a debtor's need to obtain a vendor's goods and/or services on credit terms against a vendor's right to be reasonably assured that it will be compensated by the debtor.

Vendors that Are Parties to Executory Contracts



Bruce S. Nathan

Under many supply and services agreements, there remains an obligation on the vendor's part to continue to perform, and a corresponding obligation by the debtor to compensate the

About the Authors

Bruce Nathan is a partner in the Bankruptcy, Financial Reorganization and Creditors' Rights Group at Lowenstein Sandler PC in New York. Scott Cargill is a partner in the Bankruptcy, Financial Reorganization & Creditors' Rights Group in the firm's Roseland, N.J., office.



Scott Cargill

The automatic-stay provisions of §362(a)(3) prohibit a vendor that has a prepetition claim from taking action to obtain possession of property of a debtor's estate or property from the debtor's estate.

vendor for performance, thus satisfying the generally accepted definition of an "executory contract" (i.e., contracts on which performance remains due to some extent on both sides). See Countryman, "Executory Contracts in Bankruptcy," 57 Minn. L. Rev. 439 (1973). See also *In re Texscan Corp.*, 976 F.2d 1269, 1271-72 (9th Cir. 1992); *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3d Cir. 1989). It is well-settled that in the period between

Similarly, §362(a)(6) prevents a creditor from taking action to collect or recover its prepetition claim against the debtor. The courts have generally found that executory contracts, such as supply and services agreements, are property of the debtor's estate, entitled to the protection of the automatic stay and cannot be terminated by the creditor without first obtaining relief from the stay. See *In re Computer Communications*, 824 F.2d 725 (9th Cir. 1987) (relying, in part, on legislative history of §362 that stay should

Last in Line

the filing of a bankruptcy case and a debtor's decision to assume or reject an executory contract, the contract is enforceable by the debtor against the vendor, but is not enforceable against the debtor to the extent that the debtor has the right to reject the contract at any time, subject to bankruptcy court approval. See *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 531 (1984). If the vendor provides goods and/or services to the debtor under the contract, the debtor has an obligation to pay for the reasonable value of these services or goods, which is generally afforded an unsecured administrative priority claim pursuant to §503(b). *Id.*

be broad in scope and that "[j]udicial toleration of an alternative procedure of self-help and post hoc justification would defeat the purpose of the automatic stay"). See also *In re West Electronics Inc.*, 852 F.2d 79, 82 (3d Cir. 1988).

The bankruptcy court in *In re Lucre*, 339 B.R. 648 (Bankr. W.D. Mich. 2006), appeal dismissed on other grounds, 471 F.Supp. 845 (W.D. Mich. 2007), recognized that *Computer Communications* held that the automatic stay prohibits a nondebtor party to an executory contract from taking affirmative steps to terminate the contract. *Id.* at 660. However, the *Lucre* court held that the automatic stay does

not preclude the nondebtor from refusing to perform postpetition where the debtor had breached the contract *prior* to the bankruptcy. *Id.* The court relied on state contract law principles that prevent the party in default of a contract from enforcing the contract against the nondefaulting party, unless such contract is assumed pursuant to the requirements of §365. *See Lucre*, 339 B.R. at 656-57.

Extending Credit under Executory Contracts

The supply and services agreements that vendors negotiate with customers frequently require the vendor to extend unsecured credit to its customer so that payment is not due until after the goods are delivered or services performed. The risk profile, and a vendor's reasonable belief that it will be compensated by the customer, is usually materially different when the agreement is negotiated than it is after a customer has filed for chapter 11 protection. If a vendor has a significant unpaid prepetition claim against a debtor and is doubtful of a debtor's ability to reorganize, a vendor may understandably be concerned about continuing to extend credit to its customer (now a chapter 11 debtor).

In such a situation, the debtor will typically assert that the vendor is protected by the liquidity provided by the debtor's court-approved financing arrangement with its secured lender and the §503(b) administrative priority claim that the vendor is afforded on account of the postpetition goods provided and/or services rendered by the vendor. Unfortunately, chapter 11 debtors frequently fail and are forced to liquidate assets either in the chapter 11 case or a converted chapter 7 case. Depending on the amount of the debtor's secured debt and other administrative claims, the vendor may have a very good basis to be concerned that the debtor will not have sufficient assets to pay all administrative claims fully and timely. It would clearly be inequitable to force the vendor to continue to extend postpetition credit terms when there is a significant risk of nonpayment due to the debtor's administrative insolvency. Significantly, there is no reported decision requiring a vendor to continue to extend credit terms on a postpetition basis pursuant to an executory contract requiring the vendor's extension of credit.

A debtor may also threaten to sue the vendor for breach of contract, violation of the automatic stay and/or for injunctive relief where the vendor

refuses to continue to sell goods or provide services on credit. The debtor may argue that because a supply or services agreement is an executory contract that constitutes property of the debtor's estate, the creditor is precluded by the automatic stay from altering the terms of the agreement, including modifying credit terms or switching to cash-in-advance terms. The debtor may then seek to hold the creditor that refuses to perform under the exact terms of the agreement to be in willful violation of the automatic stay and responsible for actual and punitive damages, sanctions and costs.

In response to, or in anticipation of, such an argument by a debtor, the vendor may demand adequate protection of the vendor's interest in the debtor's property (*i.e.*, the supply or services contract that constitutes property of the estate) for the vendor's continued performance under the supply or services agreement. Section 363(e) allows any party with an interest in, among other things, property used, sold or leased by the debtor at any time to request that such use, sale or lease to be prohibited or conditioned on the debtor providing adequate protection of the requesting party's interest. A vendor could also seek to lift the automatic stay and terminate the contract to the extent that the debtor refuses to furnish adequate protection. Notably, §361 states that when a court finds adequate protection to a creditor to be warranted, such adequate protection requires cash payment, a replacement lien or providing the indubitable equivalent of the creditor's interest. However, such protection *cannot* be furnished by providing a creditor with an administrative claim (which would be granted in any event pursuant to §503(b) on account of continued postpetition extensions of credit under a vendor's executory contract).

In *Visteon Corp.*, a case pending in the U.S. Bankruptcy Court in Delaware,¹ vendors that had entered into contracts for the sale of goods to Visteon on credit terms prior to its chapter 11 filing responded to these threats by seeking court approval that would authorize them to switch to cash-in-advance terms. They invoked their UCC rights of adequate assurance and stoppage of delivery, as well as their adequate bankruptcy protection rights in support of this relief. Interestingly, they have appeared to have settled with Visteon.

¹ *In re Visteon Corp.*, Case No. 09-11786 (CSS) (Bankr. D. Del.).

Vendors can also couple the argument of an unreasonable risk of nonpayment with the companion argument that the vendor should not be compelled to extend credit under a supply or services agreement because §365(c)(2) does not permit a debtor to assume an executory contract if "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." While the language of §365(c)(2) suggests that a supply or services agreement with credit terms fits neatly in the statutory framework, some courts that have considered the issue have narrowly construed §365(c)(2) to apply only to contracts in which the principal purpose of the agreement was to loan money or provide a financial accommodation.²

In re Thomas B. Hamilton Co. Inc., 969 F.2d 1013, 1018-19 (11th Cir. 1992). These courts have held that §365(c)(2) should not be extended to a contract with a primary purpose of supplying goods or services with incidental financial accommodations or extensions of credit by the nondebtor party. *In re Neuhoff Farms Inc.*, 258 B.R. 343 (Bankr. E.D.N.C. 2000); *In re UAL Corp.*, 293 B.R. 183, 189 (N.D. Ill. 2003); *but see In re Cole Bros. Inc.*, 154 B.R. 689 (W.D. Mich. 1992) (finding that extension of credit was integral part of dealership agreement where manufacturer provided inventory and floor plan financing); *In re Sun Runner Marine Inc.*, 945 F.2d 1089, 1092 (9th Cir. 1991) (same).

Adequate Assurance under the UCC

The UCC provides vendors that supply goods (not services) with certain additional protections that courts have generally found supplement the rights a supplier has under the Bankruptcy Code.³ Principal among these state law rights is UCC §2-609, which provides that when

² This interpretation appears to be consistent with the legislative history of §365(c)(2) ("Characterization of contracts to make a loan, or extend other debt financing or financial accommodations, is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods and services with payments to be made over time." 124 Cong. Rec. H11089 (Daily Ed. Sept. 28, 1978) (Statement of Rep. Edwards)).

³ Many states have recognized that the doctrine of adequate assurance applies to contracts not governed by the UCC, such as service contracts. For instance, the New York Court of Appeals found that rights of adequate assurance apply to long-term commercial contracts between commercial entities that are "complex and not easily susceptible of all security features being anticipated, bargained for and incorporated in the original contract." *Norcon v. Power Partners LP v. Niagara Mohawk Power Corp.*, 705 N.E.2d 656, 662 (1998) (applying doctrine to electricity purchase agreement). *See also Carfield & Sons Inc. v. Cowling*, 616 P.2d 1008, 1010 (Colo. 1980) (applying doctrine to construction contracts); *Lo Re v. Tel-Air Communications Inc.*, 490 A.2d 344, 349-50 (N.J. Super. Ct. App. Div. 1985) (applying doctrine to contract for purchase of radio station). Many of the courts expanding the doctrine have relied on Restatement (Second) of Contracts, §251.

a party to a sales contract has reasonable grounds for insecurity about the counterparty's ability to perform, it has the right to send a written demand to the counterparty (such as a buyer) to provide adequate assurance of the counterparty's ability to perform its obligations under the contract. The counterparty must respond with adequate assurance of its ability to perform within a reasonable time of the demand, not to exceed 30 days. The demanding party can suspend performance under the contract until it receives adequate assurance. However, the suspension of performance must be "commercially reasonable." If the counterparty does not timely respond, or fails to provide adequate assurance of its ability to perform, the insecure party has the right to treat the contract as repudiated by the counterparty and may proceed to commence an action for breach of contract.

The statutory terms used in the UCC to determine when a party may demand adequate assurance are undefined and vague. Comment 3 of the commentary to UCC §2-609 states that a "buyer who falls behind in 'his account' with the seller, even though the items involved have to do with separate and legally distinct contracts, impairs the seller's expectation of due performance." A debtor's prepetition payment default of its obligations to a creditor has been found to provide reasonable grounds for insecurity that justified the creditor's invocation of its adequate assurance rights. *Reich v. Republic of Ghana*, 2002 WL 142610, at *4 (S.D.N.Y. Jan. 31, 2002); *Hornell Brewing Co. Inc. v. Spry*, 664 N.Y.S.2d 698, 703 (N.Y. Sup.Ct. 1997). A vendor may also be considered reasonably insecure where the buyer is indebted to the vendor and the vendor becomes aware of the buyer's financial difficulties. See *In re JW Aluminum Co.*, 200 B.R. 64 (Bankr. M.D. Fla. 1996). Similarly, a vendor may be considered reasonably insecure if the buyer is in substantial arrears with a supplier, lacks sufficient financing, bounces checks and fails to sell even a small fraction of the product supplied. *Hornell Brewing*, 664 N.Y.S.2d at 702-3. Other potential circumstances that, in combination with other factors, may lead a vendor to be reasonably insecure include a sudden expansion of a customer's credit line,⁴ or suspicious activity by a buyer in suddenly stopping utilization of price discount for early payments.⁵ However,

a vendor cannot use UCC §2-609 unreasonably or as "a weapon to avoid unprofitable contracts."⁶

The actions that a buyer must take to address a vendor's reasonable grounds for insecurity are determined according to commercial standards and will depend on the circumstances. For instance, a buyer's agreement to switch from credit terms to cash-in-advance, or to provide a letter of credit or other collateral to secure payment, would, under many circumstances, be found to constitute adequate assurance. See *In re JW Aluminum Co.*, 200 B.R. 64 (Bankr. M.D. Fla. 1996). Lesser actions that a buyer may be able to justify as adequate assurance also include providing the vendor with the buyer's financial information (e.g., audited financials, cash-flow projections, availability under credit lines) to demonstrate its financial ability to pay for the goods.

The trade creditors in *Visteon* that moved in the bankruptcy court to switch to cash terms invoked their adequate assurance rights. Among the grounds that one of the trade creditors asserted as a basis for Visteon's inability to pay the creditor's claim for postpetition sales were: (1) Visteon's large unpaid prepetition debts to creditors; (2) the lack of a postpetition working capital facility; (3) Visteon's administrative insolvency; and (4) Visteon's agreement for use of cash collateral that was for a very limited duration and contained onerous terms. The creditor argued that these grounds for insecurity required Visteon to provide adequate assurance of its performance by purchasing goods on cash-in-advance terms or providing a letter of credit in an amount acceptable to the creditor.

The seller's right to stop delivery of goods has been found to exist even after title to the goods and risk of loss has passed to the buyer.

Stoppage of Delivery under the UCC

The UCC also affords a vendor of goods the right to stop shipment to a buyer if certain conditions are met pursuant to UCC §§2-702, 2-703 and 2-705. One of the principal requirements for an unpaid vendor's exercise of stoppage-of-delivery right is that the

buyer is either insolvent or has failed to timely pay its obligations to the vendor. According to UCC §1-201(23), the buyer's insolvency can be premised upon either an equity definition or a balance-sheet definition. A buyer is equitably insolvent when the buyer is unable to pay its debts in the ordinary course of business or as they become due. A buyer is considered insolvent under the balance-sheet test when its liabilities exceed its assets.

Through UCC §2-702(1), a vendor can refuse delivery of goods to an insolvent buyer on any terms other than cash-in-advance or cash-on-delivery. The seller's right to stop delivery of goods has been found to exist even after title to the goods and risk of loss has passed to the buyer.⁷ In addition, under UCC §2-705, the buyer can stop delivery of goods in the possession of a common carrier or other third party, so long as the seller complies with the specific requirements for stoppage of goods in transit, as set forth in the UCC.

The moving trade creditors in the *Visteon* case also invoked their rights of stoppage of delivery with respect to future sales to further justify their right to switch to cash-in-advance terms. They relied on several bankruptcy court decisions that denied relief to a debtor seeking to compel the creditor's delivery of goods on credit terms pursuant to an existing pre-petition contract. For instance, in *In re Kellstrom Indus. Inc.*, 282 B.R. 787 (Bankr. D. Del. 2002), a creditor sold goods to the debtor, but retained possession of the goods prior to the debtor's bankruptcy filing.

Following the filing, the debtor sought to sell all of its assets, including the goods still being held by the creditor. The creditor opposed the sale, invoking its adequate-protection rights based on its right to stop delivery under the UCC. The bankruptcy court held that the seller was entitled to adequate protection on account of its stoppage-of-delivery rights by the debtor's prior cash payment for goods in the seller's possession. *Id.* at 790-91. See also *In re Sportfame of Ohio Inc.*, 40 B.R. 47, 53 (Bankr. N.D. Ohio 1984); *In re Ike Kempner & Bros. Inc.*, 4 B.R. 31 (Bankr. E.D. Ark. 1980); *In re Blackwelder Furniture Co. Inc.*, 7 B.R. 328, 337-38 (Bankr. W.D.N.C. 1980).

Other bankruptcy courts have ruled that a seller can invoke its UCC stoppage of delivery rights without violating the automatic stay or otherwise without

⁴ U.C.C. §2-609, comment 4.

⁵ U.C.C. §2-609, comment 4.

⁶ See *Baill Banking Corp. v. UPG Inc.*, 985 F.2d 685, 704 (2d Cir. 1993).

⁷ *In re Kellstrom Indus. Inc.*, 282 B.R. 787, 791 (Bankr. D. Del. 2002).

regard to a debtor's bankruptcy filing. *See National Sugar Refining Co.*, 27 B.R. 565 (S.D.N.Y. 1983); *In re Fabric Buys*, 34 B.R. 471 (Bankr. S.D.N.Y. 1983) (creditor's stoppage of delivery rights upheld in debtor's bankruptcy case and deemed not voidable preference); *In re Coast Trading Co. Inc.*, 744 F.2d 686, 693 (9th Cir. 1984).

Conclusion

There is surprising little statutory or case law guidance concerning whether a trade creditor that is a party to an executory contract with a debtor is required to continue extending postpetition credit to the debtor. The lack of case law may be attributed to the decision by debtors and creditors to settle disputes rather than taking the risk of litigating this issue. However, creditors should be aware of the various arguments that could be raised in opposition to a debtor's demand that credit must continue to be supplied on the same terms as prior to the bankruptcy filing. Consideration of bankruptcy law protections, as well as state law rights, is necessary for a proper assessment and response to such debtor demands. ■

Reprinted with permission from the ABI Journal, Vol. XXVIII, No. 8, October 2009.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 12,300 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.