



## A New Twist on the Contract Assumption Defense to Preference Claims

A recent decision by the United States Bankruptcy Court for the District of Delaware, in *Pirinate Consulting Group, LLC v. Avoca Bement Corp. and Knight Hawk Coal, LLC (In re: NewPage Corporation, et al.)*, dismissing a preference action has opened another door for trade creditors to assert a complete defense to a preference claim that might otherwise not appear to be so obvious. The *NewPage* court ruled that preference targets have a complete defense to a preference claim based on payments made under an executory contract that the debtor had assumed. This contract assumption defense has been invoked where the executory contract the debtor had assumed was identified in a schedule of assumed contracts filed as part of a Chapter 11 plan or was otherwise assumed earlier in the bankruptcy case. The *NewPage* court took this a step further and applied the contract assumption defense to a debtor's blanket assumption of all executory contracts not otherwise rejected under a court-approved Chapter 11 plan.

### The Elements of a Preference Claim

According to Bankruptcy Code Section 547(b), a trustee can avoid a preference by proving that: (1) the debtor transferred its property, such as by making a payment to the creditor (Section 547(b)); (2) the payment or other transfer was to or for the creditor's benefit (Section 547(b)(1)); (3) the transfer was made on account of antecedent or existing indebtedness that the debtor

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owed a creditor (Section 547(b)(2)); (4) the debtor was insolvent when the payment or other transfer was made, based on a balance sheet definition of insolvency (liabilities exceeding assets), which Section 547 makes easier to prove by creating a presumption of the debtor's insolvency during the 90-day preference period (Section 547(b)(3)); (5) the payment or other transfer was made within 90 days of the bankruptcy filing in the case of payments to non-insider trade creditors, and within one year of the filing for payments to insider creditors,



such as a debtor's officers, directors, controlling persons and certain affiliated companies (Section 547(b)(4)); and (6) the creditor obtained a greater recovery from the payment or other transfer than the creditor would have received in a Chapter 7 liquidation of the debtor in the absence of the payment. The last requirement for proving an avoidable preference, contained in Section 547(b)(5), is generally known as the "greater than Chapter 7 liquidation recovery" requirement.

A trustee cannot prevail on a preference claim if he or she fails to prove *any* of these requirements. The *NewPage* court dismissed the preference complaint because the trustee could not satisfy the greater than Chapter 7 liquidation requirement for payments made under a supply agreement the debtor had assumed.

### Executory Contracts and the Contract Assumption Defense

Section 365 of the Bankruptcy Code governs the debtor's and creditor's rights under an executory contract. Neither Section 365, nor any other section of the Bankruptcy Code, defines an executory contract. Congress has left it to the courts to develop a definition. Most courts define an executory contract as an agreement under which both parties remain obligated to perform their obligations under the contract, and any party's failure to perform excuses the other party from continuing to perform its remaining duties under the contract. Examples of executory contracts, according to recent case law, include long-term supply agreements where there is an ongoing requirement for the supply and purchase of goods, and where the buyer is required

to purchase a certain minimum quantity of goods. Other executory contracts include purchase orders, consignment agreements and service agreements (such as advertising and subscription fulfillment contracts).

Section 365(a) of the Bankruptcy Code permits a Chapter 11 debtor to assume or reject an unexpired executory contract or lease, subject to court approval. This provision enables a debtor to retain, and allows the bankruptcy estate to reap the benefits of, valuable contracts by assuming these contracts, and jettison, and relieve the bankruptcy estate from, burdensome unprofitable contracts by rejecting those contracts.

A debtor that decides to assume an executory contract or lease must satisfy Bankruptcy Code Section 365(b)'s requirements. They include curing all payment and other defaults under the contract, including fully paying the creditor's pre-petition and post-petition claims, and providing adequate assurance of the debtor's ability to fully perform all of its future obligations under the contract.

### The NewPage Case

Prior to NewPage's September, 2011 Chapter 11 filing, Knight Hawk Coal, LLC (the "seller") and Avoca Bement Corp. (collectively the "defendants") were parties to a coal supply agreement dated July 6, 2010, with NewPage. Knight Hawk, as seller, had agreed to sell, and NewPage had agreed to buy coal under the coal supply agreement for a two-year term beginning January 1, 2011 and expiring on December 31, 2012. While the coal supply agreement did not expressly require that NewPage purchase a fixed quantity of coal, the agreement stated that the "[a]nnual volume will be approximately 105,000 tons to be shipped at approximately 2,000 to 2,200 tons per week."

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At the inception of its Chapter 11 case, NewPage filed several "first-day" motions, including a motion seeking authority to pay the pre-petition claims of certain "critical vendors." The order approving the critical vendor motion conditioned NewPage's payment of a critical vendor's pre-petition claim on the vendor's continuing to provide goods and services to NewPage on customary trade terms.

NewPage and the defendants entered into a critical vendor agreement under which NewPage had agreed to grant the defendants an administrative claim in the amount of \$128,565.92, that was owing under the coal supply agreement pursuant to Section 503(b)(9) of the Bankruptcy Code.<sup>1</sup> In return, the defendants had agreed to extend to NewPage all customary trade terms that were included in the coal supply

agreement. Additionally, according to the critical vendor agreement, the defendants reserved the right to pursue claims relating to the assumption and rejection of executory contracts under Section 365 of the Bankruptcy Code.

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On December 14, 2012, the bankruptcy court approved NewPage's Chapter 11 plan of reorganization and the plan went effective on December 21, 2012. The plan included the appointment of a liquidating trustee to, among their other duties, pursue preference claims. The plan also stated that NewPage had assumed all executory contracts not specifically identified on a list of rejected contracts (included as part of a plan supplement). NewPage did not want to risk inadvertently rejecting contracts that it had failed to expressly assume. The coal supply agreement was listed on NewPage's amended bankruptcy schedules as an executory contract and was not included on the list of executory contracts to be rejected under the plan. Interestingly, the coal supply agreement expired by its own terms on December 31, 2012, a little over two weeks after confirmation of NewPage's plan.

The trustee sued the defendants for the avoidance and recovery of an alleged preference claim totaling approximately \$2.8 million. Thereafter, the defendants moved for summary judgment seeking dismissal of the complaint based on the trustee's failure to satisfy all of the requirements of a preference claim under Section 547(b) of the Bankruptcy Code and, in particular, Section 547(b)(5)'s greater than liquidation recovery requirement.

The defendants denied any liability on the preference claim because NewPage had assumed the coal supply agreement in its Chapter 11 plan. As a result, NewPage was required to fully pay all unpaid amounts owing to the defendants in order to comply with Section 365's requirements for NewPage's assumption of the coal supply agreement. The trustee's recovery of NewPage's payments to the defendants under the assumed coal supply agreement would contradict Section 365's requirement of full payment of the defendants' claim and full performance of all of NewPage's obligations to the defendants under the assumed coal supply agreement. In short, the defendants were no better off receiving the alleged preference payments where NewPage would have otherwise been forced to pay the same amounts as part of its assumption of the coal supply agreement.

The trustee countered that the coal supply agreement was not an executory contract, and, therefore, could not be assumed. The trustee asserted that: (a) NewPage had no material performance obligations under the coal supply agreement (one of the prerequisites for an executory contract) because NewPage

did not have to purchase a specific or minimum amount of coal, and, therefore, was not at risk of breaching the contract if it had failed to make such purchases;<sup>2</sup> (b) the critical vendor agreement replaced and superseded the coal supply agreement prior to approval of the plan; (c) the defendants were bound by NewPage's statement in the critical vendor motion that parties to executory contracts were not critical vendors; and (d) the coal supply agreement could not be assumed because NewPage did not benefit from assumption in light of the imminent expiration of the coal supply agreement and the existence of a new coal supply agreement governing the parties' post-Chapter 11 business relationship that was poised to become effective on January 1, 2013.

## The trustee sued the defendants for the avoidance and recovery of an alleged preference claim totaling approximately \$2.8 million.

### The *NewPage* Court's Decision

The *NewPage* court granted summary judgment in the defendants' favor, finding that they had no preference liability. The court ruled that the trustee could not satisfy Section 547(b)(5)'s greater than liquidation recovery requirement because the coal supply agreement was an executory contract that NewPage had assumed under its plan.

The *NewPage* court relied on the *Kiwi Int'l Air Lines* decision by the United States Court of Appeals for the Third Circuit (whose decisions are binding on the Bankruptcy Court for the District of Delaware, where the *NewPage* case is pending). The Third Circuit held that a trustee may not avoid payments made pursuant to an executory contract that was assumed post-petition. The court observed that a trustee or debtor in possession must "cure all defaults, assure future performance, and make the other contracting party whole" prior to assuming a contract pursuant to Section 365 of the Bankruptcy Code. As a result, a trustee seeking to avoid pre-petition transfers made under an assumed contract cannot satisfy Section 547(b)(5)'s greater than liquidation recovery requirement.

The *NewPage* court rejected the Trustee's argument that the coal supply agreement was not executory, and, therefore, could not be assumed, because NewPage had no material performance obligations under the agreement. The court relied on a recent ruling by Bankruptcy Judge Sontchi, also in a case pending in the Bankruptcy Court for the District of Delaware, *In re Carolina Fluid Handling Intermediate Holding Corp.*, that a supply agreement was an executory contract where the defendant had agreed to supply parts to the debtors based on the debtors' requirements, and the debtors had agreed to buy the parts required in quantities specified in the supply contract. Judge Sontchi concluded that the supply agreement evidenced an on-going requirement for the supply and purchase of parts and was, therefore, executory and subject to assumption. The *NewPage* court also relied on the United

States Third Circuit Court of Appeals holding, in *Sharon Steel Corp. v. Nat'l Fuel Gas Distribution Corp.*, that an agreement characterized by reciprocal obligations continuing into the future was executory, where the supplier had promised to provide natural gas to the debtor and the debtor had promised to purchase the gas at a certain price under a rate schedule.

The *NewPage* court also rejected the trustee's argument that the *NewPage* coal supply agreement did not include any obligation on the part of NewPage to purchase a minimum quantity of goods (in contrast to the supply agreements in *Carolina Fluid* and *Sharon Steel*). The court concluded that NewPage was obligated to purchase a minimum amount of coal under the coal supply agreement. Although the agreement did not specify an exact minimum quantity of coal that Newpage was required to purchase, NewPage would have been in breach of the agreement if NewPage had not purchased any coal from the seller. The court also noted that NewPage and the defendants had continuing obligations to purchase and supply approximately 105,000 tons per year, or approximately 2,000 to 2,200 tons per week, as evidenced by NewPage's purchase of several thousand tons of coal pursuant to the coal supply agreement from the date of approval of the plan on December 14, 2012 through December 31, 2012. There were, therefore, material performance obligations required by both sides that justified characterizing the coal supply agreement as an executory contract subject to assumption.

## In short, the defendants were no better off receiving the alleged preference payments.

Next, the *NewPage* court rejected the trustee's arguments that the critical vendor agreement replaced and superseded the coal supply agreement prior to approval of the plan and the critical vendor order was not meant to apply to creditors who were already parties to executory contracts with NewPage. The *NewPage* court, once again citing *Carolina Fluid*, held that the basis and point of a critical vendor order is to authorize a debtor to pay for pre-petition services or goods subsequent to a bankruptcy filing (including from vendors that are parties to an executory contract) when necessary to preserve the debtor's estate. Indeed, one of the primary reasons for approving critical vendor relief is to avoid having to inquire or litigate the details of the parties' relationship, such as whether they are parties to an executory contract, because there is no time to do so. The court also noted that the critical vendor order provided that "nothing in the [Critical Vendor] Motion or this Order shall be deemed to constitute the post-petition assumption of an executory contract between the Debtors and any third party." Additionally, according to the critical vendor agreement, the defendants had reserved their right to pursue a claim under Section 365 of the Bankruptcy Code as a party to an executory contract, such as the coal supply agreement. The clear implication of this language was that the defendants, as critical vendors, could also be a party to an executory contract.

The *NewPage* court also held that the critical vendor agreement was a separate agreement that did not supersede or replace the coal supply agreement. The critical vendor agreement was not a new standalone supply agreement, but was merely a confirmation that *NewPage* and the defendants would continue to operate under the terms of the coal supply agreement during *NewPage*'s Chapter 11 case.

Finally, the court rejected the trustee's argument that *NewPage* could not assume the coal supply agreement under its Chapter 11 plan because *NewPage* did not benefit from assumption where the agreement continued for only two weeks after approval of the plan. The court concluded that *NewPage* had benefitted from its assumption of the coal supply agreement because the agreement was still in effect when the plan was approved on December 14, 2012, and the parties continued to be obligated to supply and purchase under the agreement following court approval of the plan. In fact, during the approximately two-week period thereafter through the agreement's expiration on December 31, 2012, *NewPage* had purchased coal at an invoice price in excess of \$300,000.

## Conclusion

Trade creditors sued for the recovery of preference claims should be cognizant of whether they are parties to a pre-petition contract with a debtor and whether the debtor treated the agreement as an executory contract. Creditors should review the debtor's schedules, review motions to assume or reject various executory contracts (to confirm whether their contracts are mentioned), and most importantly, review the plan provision regarding the treatment of executory contracts. In a case like *NewPage*, where the debtor had assumed contracts that were not expressly rejected, the door was left wide open for savvy preference defendants to contest preference liability by arguing that the alleged preference payments were made under executory contracts, to which they were parties, that *NewPage* had assumed. ■

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1. Section 503(b)(9) of the Bankruptcy Code grants goods sellers an administrative priority claim for goods sold to and received by a debtor within 20 days of its bankruptcy filing.

2. The coal supply agreement in question also differed from a later supply agreement between the parties that governed their post-petition business relationship and required *NewPage*'s purchase of a clear minimum amount of coal from the Seller.

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