Committees:
Unsecured Trade Creditors

When Worlds Collide: Article 2 of the Uniform Commercial Code and Chapter 11

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11

[1]Picture the scene: A vendor has just received word that its customer has filed chapter 11. The vendor put the customer on a cash-before-delivery basis and demanded assurances of performance. The vendor was successful in reducing the accounts receivable owed and avoiding preference liability in doing so.

The customer, now a chapter 11 debtor, calls and demands that the vendor continue to ship and resume credit terms. Upon the advice of counsel, the customer informs the vendor that it is required under provisions of the U.S. Bankruptcy Code to continue to ship goods and to the extend credit terms set forth in the contract. [2]

The problem is that there is still a pre-petition accounts receivable balance, and the vendor is not certain the debtor will survive in chapter 11. The obvious trend in recent years is that many chapter 11 debtors don't successfully restructure their businesses. Rather, "success" in chapter 11 often means a § 363 sale, where the assets are sold as a going concern. [3] Many view § 363 sales as a tool for lenders to liquidate collateral using the efficiency of the chapter 11 process. All too often, the strike price for the assets is very close to the pre-petition secured debt. Understandably, secured lenders' goals are to recover their loans and to minimize their "transactional" costs in doing so. To lenders, "transactional costs" include chapter 11 professional fees, post-petition administrative claims and whatever they are compelled to pay on general unsecured claims. The latter may be in the form of critical vendor payments, § 503(b)(9) claims (so-called "20-day administrative claims") and a carve-out for dividends on unsecured claims.

Analyzing the risk of extending credit terms outside of chapter 11 is difficult, but analyzing the credit risk of a chapter 11 debtor is a complex calculus at best. Is there debtor-in-possession (DIP) financing? Is it sufficient? Is the budget realistic? Is the financing short-term, largely discretionary and terminable at will by the lender? Can the debtor pay as it goes in chapter 11, or will it become administratively insolvent? Is there a critical vendor order? Will the buyer in the § 363 sale assume the contract? What "outs" does the buyer have on its proposed purchase? Chapter 11 is the ultimate "fluid" situation requiring the consensus of multiple parties. Without certainty on these issues, it is nearly impossible to gauge the risk of post-petition credit extensions. After all, the debtors' professionals obtained retainers to secure payment of their post-petition services, rather than accept the risk of administrative insolvency. Despite this uncertainty, debtors insist that vendors ship goods and extend credit terms — because there is a pre-petition contract that so provides.

The Basis for the Debtor's Demand

Section 365 of the Bankruptcy Code is the basis of the demand. [4] It provides a debtor with the right to assume or reject any executory contract, which is a Code term simply meaning a contract where both sides owe material performance to the other. [5]

A sales or supply contract is clearly an executory contract. [6] Moreover, § 365 provides:

> (e)(1) Notwithstanding a provision in an executory contract ... or in applicable law, an executory contract ... may not be terminated or modified, and any ... obligation under such contract ... may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract ... that is conditioned on —
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title ....

(2) Paragraph (1) ... does not apply to an executory contract ..., if —

(A)

(i) applicable law excuses a party, other than the debtor ... from ... rendering performance ... and

(ii) such party does not consent to such assumption or assignment.... [7]

Translated, if a contract contains terms that provide for the termination of or cash-before-delivery credit terms, upon the insolvency of the customer or upon the filing of chapter 11 such terms (referred to as "*ipso facto*" clauses) are not enforceable. [8] However, this provision does not abrogate rights that exist under nonbankruptcy law, such as the Uniform Commercial Code, in this instance Article 2 relating to the sale of goods.

There is no provision in § 365 that provides that the nondebtor party (the vendor) must perform while the debtor decides whether to assume or reject. [9] In addition, there is no provision in § 365 that actually compels the vendor to perform. Rather, debtors rely on the language above that the contract cannot be terminated or modified after the commencement of the case. [10]

However, this is limited to *contract* provisions that terminate or modify a contract based on insolvency or based on a chapter 11 filing, not applicable nonbankruptcy law — for example, Article 2 of the Uniform Commercial Code. [11]

The Uniform Commercial Code Article 2 Remedies for Vendors

Vendors have two powerful tools in Article 2 of the Uniform Commercial Code governing the sale of goods:

Section 2-609: Anticipatory Breach

When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurances of due performance and, if commercially reasonable, suspend any performance pending such assurances. [12]

Section 2-702(1): Cash Before Delivery upon Buyer's Insolvency

Where the seller discovers the buyer to be insolvent, the seller may refuse delivery except for cash. [13]

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Sections 2-609 and 2-702(1) work well together. The seller's performance obligations, which it may suspend under § 2-609, are shipping goods and providing any credit terms agreed on between the parties. If reasonable grounds for insecurity exist, the seller may suspend its obligation to ship or to provide credit terms, or both. [14] Section 2-702(1) likewise allows the seller to sell goods on a cash basis. [15]

If these provisions control, the vendor has the right to suspend its obligation to "perform," ship goods and extend terms, as well as demand assurances of future performance by the debtor, namely pay within terms. In addition, a chapter 11 filing presumes that the customer is insolvent, in which case the vendor may insist on cash-before-delivery payment terms regardless of what the contract provides.

The Collision of Chapter 11 and the Uniform Commercial Code

Debtors, as well as their lenders, want credit terms from vendors to reduce pressure on and the costs of the DIP working capital facility, and to shift some of the working-capital risk to vendors. To this end, debtors seize upon § 365.

Already facing an accounts receivable write-off and possibly a preference claim down the road, vendors are reluctant to increase the loss, so the vendor may feel some pressure to "work with" the debtor. The same could be true for the debtor, who may need the support of vendors long-term.

This debate normally takes the form of brief, but intense, negotiations over the merits of the positions. Inevitably, debtors roll out the automatic stay violation angle — specifically, that the refusal to do business is a ruse to obtain payment on the pre-petition accounts receivable, particularly when the vendor inquires about critical vendor status. True enough, stay violations can be serious and should be avoided. There is a difference, however, in seeking payment of the pre-petition accounts receivable and not increasing an already-existing loss. The two are not necessarily linked.

When statutes are not clear, legal risk exists, and courts must decide based on cases before them. What have courts ruled?

1. In *JW Aluminum Co.* (M.D. Fla.), the bankruptcy court recognized the creditors' 2-609 demand, and that the debtor's response that it would have an administrative claim was not sufficient as adequate assurances of performance. [16]
2. In *National Sugar Refining Co.* (S.D.N.Y.), the bankruptcy court ruled that vendors may stop delivery of goods in transit, a UCC Article 2 remedy, without violating the automatic stay or § 365. [17]
3. *In re Morrison Indus. L.P.,* (W.D.N.Y.) stands for the proposition that it is illogical to suggest a seller could load a truck, commence delivery, then stop that delivery, all allowed under UCC Article 2, but that it cannot suspend delivery in the first instance, also allowed under UCC Article 2. [18]
4. Bankruptcy courts have enjoined vendors from not providing goods or services, but only if the debtor could prove that the debtor would be irreparably harmed and the vendor was paid in advance. [19]
5. One bankruptcy court ruled that a contract termination or modification by a vendor could violate the automatic stay, but only in the situation where the contract was viewed as property of the estate and the debtor had already filed a motion to assume the contract. [20]

Also, as a practical matter, if a DIP facility extends for only 60 days, extended at the discretion of the lender, it is not reasonable to force a vendor into open-ended credit terms.

Bottom Line

The statutes and case law favor vendors' ability to suspend performance until adequate assurances are provided, and to utilize the UCC remedy of cash-before-delivery terms. If debtors agree to cash-before-delivery terms, shipping goods poses little risk to the vendor and opens the door for a court to conclude that any refusal to ship on cash-before-delivery terms is designed to obtain payment of pre-petition accounts receivable, which is a stay violation.

Vendors should be prepared for the debtor's position that critical-vendor status is not appropriate for vendors with contracts. This is not accurate and pre-supposes the correctness of the position that vendors must ship and extend terms post-petition. If so, by definition, then, the vendor is not "critical."

The interplay between the Uniform Commercial Code and the Bankruptcy Code can create uncertainty for vendors, including creating the specter of a stay violation. To navigate this uncertainty, it is important to understand the intricacies of the rules and how they apply to the circumstances of the particular customer, and to also stand firm on the rights of vendors set forth in Article 2 of the UCC.

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[2] *See* 11 U.S.C. § 365(e); *United States ex rel. Postal Serv. v. Dewey Freight Sys. Inc.,* 31 F.3d 620, 624 (8th Cir. 1994); *In re Nat'l Steel Corp.,* 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) ("[M]ost courts agree that before an executory contract is assumed or rejected under § 365(a), that contract continues to exist, enforceable by the debtor-in-possession, but not enforceable against the debtor-in-possession.").

[3] *See* 11 U.S.C. § 363.

[4] *See* 11 U.S.C. § 365.

[5] *See Matters of Crippin*, 877 F.2d 594, 596 (7th Cir. 1989) ("[A] contract is executory for bankruptcy purposes where 'the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material br excusing the performance of the other.' (internal quotations omitted) (quoting *In re Chicago, Rock Island & Pacific R. Co*., 604 F.2d 1002 (7th Cir. 1979))).

[6] *See In re Carolina Fluid Handling Intermediate Holding Corp.*, 467 B.R. 743, 754 (Bankr. D. Del. 2012), *aff'd.*, No. ADV 11-50393 CSS, 2013 WL 1124064 (D. Del. Mar. 18, 2013) (holding that supply agreement between parties was executory contract).

[7] 11 U.S.C. § 365(e)(1)-(2).

[8] *See, e.g., In re FKA FC LLC*, No. GG 15-00643-JTG, 2016 WL 690854, at *5 (Bankr. W.D. Mich. Feb. 12, 2016) (holding that lease provision providing that bankruptcy filing constituted an event in default was an unenforceable *ipso facto* provision); *In re Wheeling–Pittsburgh Steel Corp.,* 54 B.R. 772, 778 (Bankr. W.D. Pa. 1985). ("The policy underlying the prohibition of bankruptcy termination clauses under § 365(e) is that such clauses restrict the debtor's ability to assume and assign executory contracts and leases where doing so would benefit the [bankruptcy] estate, thereby hampering the Debtors' rehabilitation efforts.").

[9] *In re Nat'l Steel Corp.,* 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (noting that "[t]he Code is silent on the rights and obligations of the parties to an executory contract ... during the limbo period — that is, the period between the filing of the petition and the time of assumption or rejection." (*quoting* G. Treister, J.R. Trost, L. Forman, K. Klee & R. Levin, *Fundamentals of Bankruptcy Law* § 5.04(e) at 247 (5th ed.2004))).

[10] *See In re Nat'l Steel Corp.,* 316 B.R. at 305.

[11] *See In re Pittsburgh-Canfield Corp*., 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002) (holding that state law, specifically the UCC, governed the substantive rights between chapter 11 debtor and its vendor and determined enforceability of the parties' agreement).

[12] *See* U.C.C. § 2-609(1).

[13] *See* U.C.C. § 2-702(1).

[14] *See Universal Builders Corp. v. United Methodist Convalescent Homes of Connecticut Inc.,* 7 Conn. App. 318, 322, 508 A.2d 819 (1986) ("A party's failure to provide such assurance of adequate performance within a reasonable time is a repudiation of the contract." (Citations omitted; internal quotation marks omitted.)).

[15] *In re Prof'l Veterinary Products Ltd.*, 454 B.R. 479, 482 (Bankr. D. Neb. 2011) (discussing vendor's remedies under 2-702 upon discovery of debtor's insolvency).

[16] *See In re JW Aluminum Co.,* 200 B.R. 64, 68 (Bankr. M.D. Fla. 1996).

[17] *In re Nat'l Sugar Ref. Co.,* 27 B.R. 565, 574 (S.D.N.Y. 1983) ("The exercise of the right of stoppage in transit does not abrogate, but merely suspends, the contract at issue. The contract remains in effect and the future course of the parties thereunder is governed under Code § 365 (b).").

[18] *In re Morrison Indus. L.P.*, 175 B.R. 5, 7 (Bankr. W.D.N.Y. 1994) (holding that UCC provision dealing with seller's right to refuse delivery of goods except for cash on discovering buyer's insolvency must be liberally applied in favor of seller).

[19] *See Sportfame of Ohio v. Wilson Sporting Goods Co. (In re Sportfame of Ohio Inc.)*, 40 B.R. 47 (Bankr. N.D. Ohio 1984); *Blackwelder v. Drexel-Heritage Furnishings Inc.* (*In re Blackwelder*), 7 B.R. 328 (Bankr. W.D.N.C. 1980).

[20] *See In re Coast Trading Co. Inc.,* 26 B.R. 737 (Bankr. D. Ore. 1982).

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