

Tale of two courts... Trade creditors take note

David Conaway writes on the critical vendor rodeo in Texas and the McKesson Rite Aid supply contract dispute in New Jersey



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Cross-border insolvency proceedings between the US and other countries are increasing. US companies such as McDermott International are filing proceedings outside the US, and non-US companies (SAs) are seeking Chapter 11 protection. Foreign-based creditor interests need to follow the latest trends in US insolvency cases.

In Chapter 11 cases, particularly, one of the vendor’s best shots at getting paid its pre-petition debt is being designated as a “critical vendor”.

Zachry Holdings

In connection with the Zachry Holdings Chapter 11 case filed in the Southern District of Texas on 21 May 2024, the Bankruptcy Court made disturbing comments regarding treatment of critical vendors. Specifically, the Bankruptcy Court, without prompting, asked the Debtors’ counsel to revise the critical vendor order, to not limit the Debtors’ remedies, if a critical vendor at any time stopped supplying goods to the Debtors. In addition to disgorgement of the critical vendor payment, the court specifically indicated the vendor should be in contempt of court and responsible for all consequential damages caused to the Debtors.

Debtors’ counsel did not request this, and the critical vendor order proposed by the Debtors provided that, if a trade claimant does not maintain or reinstate trade terms at least as favourable as those existing in the twelve months prior to the

Chapter 11 during the chapter 11 cases, the Debtors could demand a return of the payments, or their application to post-petition shipments (instead of payment of pre-petition accounts receivable).

The revised critical vendor order, responding to the Bankruptcy Court’s “too limited” comments, provided that, in addition to the disgorgement of payments, the Debtors shall have all remedies available at law or in equity with respect to such trade claimant and the payment made to such trade claimant, including contempt of court and liability for all of the Debtors’ incidental and consequential damages.

The order arguably eliminates protections afforded to unsecured creditors under contract law including the Uniform Commercial Code regarding the sale of goods, and under the Bankruptcy Code. If a vendor supplies goods or services to a debtor on a purchase order and invoice basis, without a formal sales contract, it has no obligation to continue to supply or provide credit terms (though debtors sometimes assert that an open purchase order constitutes an agreement). If a vendor receives payment in full of its pre-petition debt, fair enough, the appropriate *quid pro quo* is continuing to do business with the debtor, as it was conducting business before the Chapter 11 filing.

Material differences in business dealings

A material difference in business dealings prior to Chapter 11 and in Chapter 11 is that the customer has declared itself insolvent, and,

in many Chapter 11 cases, debtors become “administratively insolvent” (insufficient liquidity to pay their ongoing debts as they become due), or the debtor’s assets are liquidated through a section 363 sale. Buyers of debtors’ assets in section 363 sales never assume unpaid obligations that arose during the Chapter 11 and before closing. Sales to Chapter 11 debtors inherently have more risk. Also, before a Chapter 11 filing, a vendor has legal rights to stop supplying or providing credit terms, if it has reasonable grounds for insecurity regarding the customer’s ability to pay, or if it learns that the customer is insolvent.

If a supplier is selling to a customer/debtor under a written sales or supply contract, Bankruptcy Code section 365(e)(1) prohibits the vendor from terminating or modifying the contract:

“solely based on a contract term regarding the insolvency or financial condition of the debtor or the commencement of a [Chapter] 11”.

However, Bankruptcy Code section 365(e)(2)(A)(i) further provides an exception to section 365(e)(1) if “applicable law” excuses a party from rendering performance. Both common law regarding contracts and the Uniform Commercial Code regarding the sale of goods are such “applicable law”. UCC 2-609 (which codifies contract common law) allows a seller of goods to suspend performance when it has reasonable grounds for insecurity of the customer’s ability to pay. UCC 2-702 allows a vendor to revert to cash in



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advance credit terms regardless of a contract term requiring credit terms, if a customer is insolvent.

Rite Aid

In the Rite Aid Chapter 11, the debtors attempted to compel McKesson, Rite Aid's largest pharmaceutical supplier, to continue to perform under a supply agreement by shipping goods unabated and extending pre-petition credit terms. McKesson refused to increase its USD 720 million pre-petition exposure during the Chapter 11 case, and the debtors responded with a Motion for a Temporary Restraining Order and Preliminary Injunction to compel McKesson to supply goods and extend pre-petition credit terms regardless of the increased risk to McKesson. The debtors did not acknowledge Bankruptcy Code section 365(e)(2), which supported McKesson's right to suspend performance and not increase its risk by requiring cash in advance payments.

Appropriately McKesson responded with the assertion that under section 365(e)(2) and other applicable law, it was entitled to terminate the supply agreement, suspend shipments of goods and require cash before delivery payment terms. Specifically, McKesson relied upon UCC sections 2-609 and 2-702 as other applicable law which allowed it to terminate or modify the contract with Rite Aid. McKesson argued:

"Any attempt by the Debtors to argue that the Bankruptcy Code's prohibition on enforcement of "ipso facto" clauses precludes McKesson from the protections of the California Commercial Code must fail. Section 365(e)(1) only prohibits termination or modification of an executory contract that is based solely on a contractual provision conditioned on insolvency, financial condition, or a bankruptcy filing."

Within 30 days of Rite Aid's strong-arm litigation, the parties settled. Notably, key terms were:

1. 7-day payment terms on McKesson's invoices;
2. McKesson could suspend shipments and change payment terms if Rite Aid failed to pay; and
3. McKesson was granted super-priority administrative priority payment status for all post-petition shipments.

In other words, McKesson won.

Vendors' rights and trade agreements

The Zachry Holdings court's critical vendor comments and the resulting revised critical vendor order undercuts the rights of vendors, such as asserted by McKesson in Rite Aid's Chapter 11.

It is routine for critical vendor agreements to be set forth in a written "trade agreement". Over the years, on behalf of vendors, we have successfully negotiated into critical vendor trade agreements conditions of ongoing shipments and credit terms that allow the vendor to stop shipping or providing credit terms if during the Chapter 11 the debtors fail to pay invoices, have a lack of working capital or liquidity to operate and pay invoices in the ordinary course of business, or become administratively insolvent. The Zachry Holdings critical vendor order will make this more challenging, as it will be cited in future cases.

We do not believe that Delaware, the Southern District of New York or the District of New Jersey would adopt the rationale stated by the Zachry Holdings court.

Takeaways for trade suppliers

Clearly, for Chapter 11 cases in Texas, there is a heightened risk that the Bankruptcy Court may ignore the rights of suppliers under applicable non-bankruptcy law such as provisions of the Uniform Commercial Code Article 2 regarding the sale of goods. If forced to continue shipping and extending credit terms into a potentially

administratively insolvent Chapter 11, a trade supplier's loss may be increased.

In New Jersey Bankruptcy Court, in fighting Rite Aid's motion for a temporary restraining order, McKesson bet that the court would recognize a trade supplier's rights under Article 2 of the Uniform Commercial Code, specifically, the rights to suspend shipping goods and/or revert to cash before delivery payment terms. The parties reached a quick settlement that protected McKesson from undue risk.

While neither the Texas nor the New Jersey Bankruptcy Courts issued opinions on these issues, the outcomes of the Zachry Holdings critical vendor order, and the Rite Aid and McKesson settlement approved by the court, are nevertheless instructive to trade suppliers on protecting their rights in high stakes Chapter 11 cases.

It is essential that suppliers (1) object to critical vendor motions that do not recognize the legal rights of creditors, and (2) in negotiating critical vendor trade agreements, include terms that allow the vendor to suspend performance and revert to cash in advance payment terms if the debtor fails to pay, there is a material adverse change in liquidity, the Chapter 11 case becomes administratively insolvent, or there is a sale of assets that does not assume the vendor's contract or otherwise provide for payment of the vendor's invoice. ■



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