Shumaker, Loop & Kendrick, LLP

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

Business Information for Clients and Friends of Shumaker, Loop & Kendrick, LLP

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Manufacturing • Customers • Vendors • Supply Chain
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Picture the scene: You have just received word that your customer has filed Chapter 11. You had followed my advice (see article Reducing a Customer's Accounts Receivable in the Zone of Insolvency), and put the customer on a cash-before-delivery basis and demanded assurances of performance. You were 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 you continue to ship, and resume credit terms.

The customer tells you its lawyers have advised you are required under provisions of the U.S. Bankruptcy Code to continue to ship goods and to extend credit terms set forth in the contract. The problem is there is still a prepetition accounts receivable balance and you are not certain the debtor will survive in Chapter 11. You are certainly aware that in recent years many Chapter 11 debtors don't successfully restructure their business. Rather, "success" in Chapter 11 often means a Section 363 sale, where the assets are sold as a going concern. Many view Section 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 prepetition secured debt. Understandably, secured lenders' goals are to recover their loan, and 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, Section 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 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, or will it become administratively insolvent? Is there a critical vendor order? Will the buyer in the Section 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 administratively insolvency.

Despite this uncertainty, debtors insist you ship goods and extend credit terms … because there is a prepetition contract that so provides.

The Basis for the Debtor's Demand

Section 365 of the Bankruptcy Code is the basis of the demand. Section 365 provides a debtor the right to assume or reject any executory contract, which is a Bankruptcy Code term meaning simply a contract where both sides owe material performance to the other. A sales or supply contract is clearly an executory contract. Moreover, Section 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 ….

Translated, if a contract contains terms that provide for 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. **However, this provision does not abrogate rights that exist under non-bankruptcy law, such as the Uniform Commercial Code, in this instance Article 2 relating to the sale of goods.**

There is no provision in Section 365 that provides the non-debtor party (the vendor) must perform while the debtor decides whether to assume or reject. In addition, there is no provision in Section 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.

But, this is limited to ***contract*** provisions that terminate or modify a contract based on insolvency or based on a Chapter 11 filing, not applicable non-bankruptcy law, Article 2 of the Uniform Commercial Code for example.

If the debtor's position were correct (which it's not), then any non-bankruptcy law on the subject would be inapplicable.

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.

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.

Section 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. Section 2-702(1) likewise allows the seller to sell goods on a cash basis.

If these provisions control, the vendor has the right to suspend its obligation to "perform", ship goods and extend terms, and demand assurances of future performance by the debtor, namely pay within terms.

In addition, a Chapter 11 filing presumes 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, and their lenders, want credit terms from vendors to reduce pressure on and costs of the DIP working capital facility, and to shift some of the working capital risk to vendors. To this end, Debtors seize on Section 365.

Vendors, already facing an accounts receivable write-off and possibly a preference claim down the road, are reluctant to increase the loss. 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 prepetition accounts receivable. Particularly when the vendor inquires about critical vendor status. Fair enough, stay violations can be serious, and should be avoided. There is a difference, however, in seeking payment of the prepetition accounts receivable, and not increasing an already existing loss. The two are not necessarily linked. But expect debtors to up the ante to achieve a result.

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. Florida), **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**.

2. In National Sugar Refining Co. (S.D.N.Y.), the Bankruptcy Court ruled vendors may stop delivery of goods in transit, a UCC Article 2 remedy, without violating the automatic stay, or Section 365.

   It is illogical to suggest a seller could load a truck, commence delivery, then stop that delivery, all allowed under UCC Article 2, but cannot suspend delivery in the first instance, also allowed under UCC Article 2 (Morrison Industries, L.P., W.D.N.Y.).

3. Bankruptcy Courts have enjoined vendors from not providing goods or services, but only if the debtor could prove the debtor would be irreparably harmed, and the vendor was paid in advance.

4. 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.

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 prepetition 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, the vendor is not "critical".

The interplay between the Uniform Commercial Code and the Bankruptcy Code can create uncertainty for vendors. 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.

Given the specter of a stay violation, advice of counsel is prudent.

We hope you found this useful and informative, and feel free to share this with others in your company. Please contact us if you have any questions about this, or any other matter.

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