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A rose by another name has its thorns[1]

David Conaway advises not to get stuck in Chapter 11 when a sales contract is deemed to be an executory contract

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SALES AND SUPPLY AGREEMENTS ARE TREATED AS "EXECUTORY CONTRACTS" UNDER THE BANKRUPTCY CODE

In 2017, the U.S.'s largest trading partner was the European Union at $717 billion.[2] Also in 2017, EU countries represented approximately 43% of foreign direct investment in the U.S.

This trade is memorialised by a variety of contracts including sales contracts, joint venture agreements, technology and licensing agreements, financing agreements, agency and distribution agreements, and real and personal property leases. With the growth of cross-border insolvencies by companies with operations and assets in multiple countries, and acknowledging that the U.S.'s Chapter 11 is an often utilised as a strategic business tool, it is likely that such contracts will be impacted by Chapter 11.

Foreign companies doing business in the U.S. should understand the legal and economic impact of Chapter 11. This impact on sales and supply contracts allows proactive advance planning to avoid or minimise risk of loss. The following insights are based on advising numerous clients regarding multi-year and multi-million or billion dollar sales and supply agreements that have been subjected to the Chapter 11 process.

Companies sell goods or provide services to customers usually on two bases:

(1) purchase orders and invoices with references to terms and conditions, or
(2) a written sales or supply agreement.

A formal sales or supply agreement is normally indicative of a more material and longer term commitment by the parties. Beyond the parties' performance obligations set forth in the contract, agreements are the culmination of significant negotiation of the terms and conditions of the contract, and a business decision to dedicate capacity and provide commitments on pricing, terms of payment and customer service, all of which are significant economic investments. In the event of a problem, the risk of loss is far greater than unpaid invoices.

Executory contracts

Sales and supply agreements are treated as "executory contracts" under the Bankruptcy Code, which is the statutory framework for Chapter 11 cases.

Debtors are provided the right to decide to assume, to assume and assign, or to reject executory contracts. This decision is required as part of the plan of reorganisation process, which normally occurs at the end of the Chapter 11 process. Pending a debtor's decision, the parties are generally obligated to continue performing.

In Chapter 11 cases where the "main event" is a Section 363 sale of all of the assets of the debtor to a third party, the outcome for material contracts is usually resolved as part of the sale process. The relevant pleadings and documents regarding the sale include a sale motion, the stalking horse asset purchase agreement (addressing assumed obligations and contracts), the proposed bidding procedures for a sale auction, and a proposed sale order, all of which are subject to objection by any stakeholder. As such, a Section 363 sale is both a "contested matter" (litigation) and a complex M&A transaction. Accordingly, suppliers must engage in the nuances of the Section 363 process to protect their contract rights.

If a debtor seeks to assume, or to assume and assign, the contract, he or she is obligated to:

(1) Cure pre-petition arrearages, meaning paying outstanding pre-petition accounts receivable balances, and
(2) Provide to the supplier "adequate assurances of future performance."

In the case of an assumption and assignment, the debtor as a practical matter delegates the adequate assurances obligation to the buyer.

If a contract is assumed, and arrearages are paid and adequate assurances are provided, the supplier should have successfully avoided the risk of economic loss.

If the debtor elects to reject a contract, any outstanding pre-petition balances will likely not be paid. Rejection is deemed a pre-petition breach of the contract, and the breach of contract damage claim (under Article 2 of the Uniform Commercial Code) is a pre-petition general unsecured claim. Such claims unfortunately rarely receive any meaningful value. Clearly, rejection of a material contract results in losses regarding the current obligations owed under the contract and regarding damages for breach of future performance.

In a recent matter we handled, the supplier invested in the development of plant capacity to support a customer's new product. The customer was unable to contribute to the

investment. Instead, the contract provided for minimum purchases, and for a payment to the supplier calculated on the basis of purchasing shortfalls, meant to compensate for the customer's share of the investment. Generally, such investment losses are greater than the loss arising from non-payment of current invoices.

There are also a number of complexities of the assumption or rejection process that impact the supplier's risk.

1. Post-petition sales to an at-risk customer/debtor.

Generally, the parties must continue performing post-petition, and debtors (and lenders and/or buyers behind the scenes) certainly seek to enforce performance through the terms of the contract, which usually requires additional shipments of goods and credit extensions. Such obligations may well increase the supplier's risk due to the financial condition of the customer and the uncertainty of outcome in Chapter 11.

Suppliers should be aware of significant protections that mitigate this risk, under Article 2 of the U.C.C., particularly U.C.C. Sections 2-609 and 2-702 regarding anticipatory breach and cash before delivery shipments, which can relieve obligations to ship or to extend credit. Suppliers can anticipate that debtors will assert that the Bankruptcy Code trumps Article 2, but case law supports Article 2 as "applicable non-bankruptcy law" that governs the parties' rights and obligations.

Often the most important risk-assessment factor is the sufficiency and the terms and conditions of post-petition (DIP) financing. For example, DIP financing orders usually require modification (or objection) to carve-out any ownership or security interests of a supplier, as well as protect any intellectual property rights.

2. Critical vendor

Depending on the particular Chapter 11 case, essential vendors doing business on a purchase order and invoice basis can receive payment of some or all of their pre-petition claims in exchange for an agreement by that vendor to continue uninterrupted shipments and extensions of credit. Suppliers should be aware that performance obligations required by the Bankruptcy Code under a sales or supply agreement may limit this "remedy".

3. Anti-assignment clauses

Provisions in sales and supply agreements that require consent as a condition of an assignment are generally not enforceable in Chapter 11. However, courts have held that assignment provisions that are "material and economically significant" are enforceable. Suppliers are well-advised to include in the material contracts specific economic requirements of any assignee, rather than defer this analysis to a general "consent" provision.

4. Integration of related agreements

Often in the context of sales and supply agreements, there are related agreements such as security or other credit enhancement agreements or intellectual property agreements. Such agreements should be clear that they are integrated and interdependent contracts that must be assumed (or rejected) in toto. Otherwise, there is the risk that a debtor could attempt to assume a favourable supply agreement, but reject a security agreement that was essential to the supplier when entering into the sales contract.

5. Cure of pre-petition arrearages

In cases of related or integrated contracts, there may be pre-petition obligations owed under more than one contract. It is prudent for the obligations owed under integrated contracts to be "cross-defaulted" in order to achieve maximum benefit of the cure requirement.

A sales and supply agreement generally indicates a material economic commitment or investment by the parties. To avoid or manage the risk of economic loss, companies should understand the impact of Chapter 11 on such contracts and the preventative measures that can be implemented at the outset, thus avoiding the uncertainties of the Chapter 11 process. ■

PROVISIONS IN SALES AND SUPPLY AGREEMENTS THAT REQUIRE CONSENT AS A CONDITION OF AN ASSIGNMENT ARE GENERALLY NOT ENFORCEABLE IN CHAPTER 11

Footnotes:

1 Likely the first fused "quote" of Shakespeare and the rock group Poison.
2 2017 U.S. Census Bureau.