US Column: The Impact of "Applicable Non-Bankruptcy Law" in Chapter 11 Proceedings

David Conaway discusses the interplay between the U.S. Bankruptcy Code and the Uniform Commercial Code (UCC) in Chapter 11 cases



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Seasoned global insolvency professionals are aware that the Bankruptcy Code is the governing law of Chapter 11 cases. The US Bankruptcy Code contains the phrase "unless applicable non-bankruptcy law provides otherwise" in many instances. Thus, the Bankruptcy Code incorporates substantive law on many issues including lien rights, commercial contracts, employment law, environmental law and the list goes on.

One pervasive example is the US Uniform Commercial Code ("UCC"), which includes statutes on commercial contracts, secured transactions, negotiable instruments, letters of credit, bank deposits etc. Technically, the UCC is a uniform law proposed for adoption by each US state. The UCC has been adopted by virtually every US state with few variations. As a result, the UCC is functionally "federal" law, pretty much the same throughout the US.

As a global insolvency attorney, your European client with subsidiaries in the US ("Seller") contacts you, regarding an important US customer ("Debtor") with whom the Seller has a written supply contract. The Debtor has filed Chapter 11 in the US. The Seller's team in the US has been watching the customer and has put the Debtor on a cash-before-delivery basis and demanded assurances of future performance. The accounts receivable balance is significant, and the client is concerned about a substantial loss.

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The Debtor contacts the Seller and demands that it continue to ship goods, and resume the pre-Chapter 11 credit terms.

The Debtor's position is that the Seller is required under provisions of the US Bankruptcy Code to continue to ship goods and to extend credit terms set forth in the parties' contract for the duration of the Chapter 11 proceeding. The problem is the Seller has doubts whether the Debtor will survive in Chapter 11. You are aware that, in recent years, many Chapter 11 debtors do not successfully restructure their business. Rather, "success" in Chapter 11 often means a Section 363 sale, where the assets are sold, hopefully 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 close to the pre-petition secured debt. Understandably, secured lenders' goals are to recover their loan, and minimize their Chapter 11 "transactional" costs in doing so. To lenders, "transactional costs" include Chapter 11 professional fees, post-petition administrative claims (which includes obligations to post-petition suppliers) and whatever lenders may be 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 selling to a Chapter 11 debtor is a complex calculus at best:

- Is there DIP financing?
- Is there sufficient liquidity?
- 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 Section 363 sale assume the contract?
- What "outs" does the buyer have under the proposed asset purchase agreement?

Chapter 11 is the ultimate "fluid" situation requiring the consensus of multiple parties. Without certainty on these issues, it is difficult 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, the Debtor insists that the Seller 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 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 prohibits the vendor from termination or modification of a contract "*solely based on a contract term regarding the insolvency or financial condition of the debtor or the commencement of a [Chapter] 11*", known as "*ipso facto*" clauses. However, Section 365 further provides an exception to the foregoing if "*applicable non-bankruptcy law*" excuses a party from rendering performance. Both the common law regarding contracts and the UCC regarding the sale of goods are such "applicable law".

Debtors routinely ignore that their Section 365 rights are 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, such as the UCC, for example.

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.

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. Section 2-702(1) likewise allows the seller to sell goods on a cash basis. Also, the vendor has the right to demand assurances of future performance by the debtor, not later than within 30 days.

The collision of Chapter 11 and the UCC

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 *ipso facto* clauses under Section 365.

Vendors, already facing an accounts receivable loss and possibly a preference claim in the future, are reluctant to increase the loss by extending credit terms in risky circumstances. 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 will assert that the refusal to ship goods and extend credit terms is a violation of the Section 362 automatic stay, as a disguised attempt to obtain payment on the prepetition accounts receivable.

US Bankruptcy and Federal courts have addressed this issue.

1. In one case, a Bankruptcy Court recognized the creditors' UCC Section 2-609 demand, and that the creditor having an administrative claim was not sufficient as adequate assurances of performance.
2. Another court ruled vendors may stop delivery of goods in transit, a UCC Article 2 remedy, without violating the Section 362 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.
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.

Also, as a practical matter, if a DIP facility extends for only 60 days, to be 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 support 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 an automatic 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 UCC 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. ■

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