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Client Alert: Critical Vendor in Texas: It's a Rodeo

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In Chapter 11 cases, one of a vendor's best shots at getting paid its pre-petition debt is being designated as a "critical vendor".

In connection with the Zachry Holdings Chapter 11 case filed in the Southern District of Texas on May 21, 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 the critical vendor at any time stopped supplying goods to the Debtors. 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:

6. In the event that a Trade Claimant does not maintain or reinstate trade terms at least as favorable as those existing in the twelve months prior to the Petition Date during the pendency of the chapter 11 cases, regardless of whether a Trade Agreement has been executed, any payments made pursuant to this Interim Order after the Petition Date shall be, in the Debtors' reasonable discretion, deemed applied to postpetition amounts payable to such Trade Claimant or treated as an unauthorized postpetition transfer recoverable by the Debtors under section 549 of the Bankruptcy Code or other applicable law.

In essence, the Debtors requested its remedies to be 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:

6. In the event that a Trade Claimant that receives payment pursuant to this Interim Order does not maintain or reinstate trade terms at least as favorable as those existing in the twelve months prior to the Petition Date during the pendency of the chapter 11 cases, regardless of whether a Trade Agreement has been executed, 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.

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.

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 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, the Bankruptcy Code 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, the Bankruptcy Code further provides an exception to the foregoing 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 advance credit terms regardless of a contract term requiring credit terms.

The Zachry Holdings critical vendor ruling arguably eliminates these rights of vendors.

It is routine for critical vendor agreements to be set forth in a written “trade agreement”. Over the years, we have successfully negotiated into critical vendor trade agreement conditions of ongoing shipments and credit terms that allow the vendor to stop shipping or providing credit terms if certain conditions are breached or events occur during the Chapter 11 that indicate lack of working capital, or liquidity to operate and pay invoices in the ordinary course of business. Zachry Holdings will make this more challenging, in the Southern District of Texas.

It is doubtful that Delaware, the Southern District of New York or the District of New Jersey will follow Texas’ extreme approach.

It is important that suppliers (1) object to critical vendor orders that do not recognize the legal rights of creditors, and (2) negotiate “outs” for performance if a debtor breaches or if the Chapter 11 proceeding is failing.

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.