

POST-PETITION ENFORCEMENT OF EXECUTORY CONTRACTS

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INTRODUCTION

The Bankruptcy Code provides little guidance on the rights of parties to executory contracts prior to assumption or rejection, and the case law addressing executory contracts is often inconsistent and confusing. These materials focus on selected issues involving executory contracts in this limbo period, with special emphasis on issues involving automotive supply contracts.

A. Post-Petition Termination and Expiration Issues.

1. Contract rights are property of the estate, regardless of whether the contract at issue is executory, and those rights are protected by the automatic stay. *In re Elder-Beerman Stores, Corp.*, 195 B.R. 1019, 1023 (Bankr. S.D. Ohio 1996). *See also In re Plastech Engineered Products, Inc.*, 382 B.R. 90, 2008 Bankr. LEXIS 422, *37 (Bankr. E.D. Mich. 2008) (“every conceivable interest of the debtor, future, non-possessory, contingent, speculative, and derivative, is within the reach of Section 541” and, therefore, sufficient to invoke the provisions of the automatic stay.)
2. It is well-established that, once a bankruptcy petition is filed, the non-debtor party cannot terminate an executory contract without first obtaining relief from the automatic stay. *Plastech, supra* at *38; *Elder-Beerman, supra* at 1024. However, a contract that expires by its own terms, even after the petition date, or which was validly terminated prior to the petition date cannot be resurrected and/or assumed by the debtor. *See Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1214 (7th Cir. 1984), *cert. denied*, 469 U.S. 982 (1984) (“Where a contract has been validly terminated pre-bankruptcy, the debtors' rights to continued performance under the contract have expired. The filing of a petition under chapter 11

cannot resuscitate those rights.”) In light of these principles, it follows that once a contract has expired or been properly terminated, the non-debtor party can no longer be compelled to perform. As discussed below, however, logic plays a subservient role in the analysis of executory contracts.

3. Automotive supply contracts create special difficulties in the application of these principles. Typically, automotive supply contracts consist of a blanket purchase order issued by the customer for a particular part and subsequently issued releases. The purchase order incorporates by reference the customer’s general terms and conditions. Blanket purchase orders are for an unspecified or uncertain duration (e.g., life of program, life of part, annually renewed) and an unspecified quantity of parts. The purchase order and/or terms and conditions provide that the customer has no obligation to purchase parts unless those parts were manufactured in accordance with an individual release. *See generally, Advanced Plastics Corporation v. White Consolidated Industries, Inc.*, 828 F. Supp. 484, 486-489 (E.D. Mich. 1993); *In re Dana Corporation*, 2007 Bankr. LEXIS 3927, *3-*8 (Bankr. S.D.N.Y., November 14, 2007). In short, a “blanket” purchase order is neither a contract for a specified number of parts, nor a requirements contract. *Dana Corporation* at *7-*8.
4. According to the *Dana* court, “each time a specific release under a blanket purchase order is fulfilled by the supplier and paid by the purchaser, the contractual relationship in essence ends unless the purchaser issues another release.” *Id.* at *8. *See also Advanced Plastics Corp., supra* at 488 (“Defendant [customer] stopped issuing releases, and it no longer had a contractual obligation to purchase parts from plaintiff. The contract expired; defendant did not terminate it.”) Alternatively, under UCC 2-309, a contract of indefinite duration is terminable at will by either party. *See Advanced Plastics Corp., supra* at 488-490.; *Dana Corp., supra* at *8.
5. If each release is, in essence, a separate contract, the question becomes whether a blanket purchase order can truly be considered an executory contract since, under the most common definitions of executory contracts, future performance is, in some fashion, required. Presumably, if the customer has the right to refuse to issue future releases, the supplier has a corresponding right to refuse to accept future releases. While this may be strictly correct, it does not account for the fact that, in the automotive industry, most

suppliers are the sole source of supply on most parts and, therefore, if the release is not accepted, the customer has no alternative source of supply. This would be enormously problematic in any industry. However, given the automotive industry's reliance on "just in time" inventory, the results can be catastrophic. *In re Meridian Automotive Systems-Composites Operations, Inc.*, 372 B.R. 710 (Bankr. D. Del. 2007).

6. After Meridian filed bankruptcy, Plastech, a major supplier of component parts, demanded certain price increases. When Meridian rejected Plastech's request, Plastech refused to deliver parts, arguing that it had no obligation to fulfill a release until it accepted that release by beginning performance. Ultimately, production was moved away from Plastech, and the court was not required to decide whether Plastech could be compelled to perform under releases it had not "accepted." Subsequently, Meridian instituted an action to recover payments made to Plastech under a critical vendor trade agreement. *Id.*
7. If each release is a separate contract, as the *Dana* court held, there would not appear to be any way for the court to compel Plastech's post-petition performance. However, the *Meridian* court held that, because there were outstanding releases as of the petition date, the purchase order was executory, at least with respect to those releases. *Meridian, supra* at 721-722. Of course, even if the *Meridian* court was correct that the outstanding releases were executory as of the petition date, once those specific releases were fulfilled, the contract again expired. In the absence of a trade or critical vendor agreement, performance could not be compelled if new releases were not accepted.
8. The use of blanket purchase orders and releases gives the customer tremendous flexibility. At any time, and for any reason, or for no reason whatsoever, a customer can simply stop issuing releases causing the contract to expire. *Advanced Plastic, supra* at *8. Similarly, a supplier can refuse to accept a newly issued release. However, unless the supplier is, itself, in extreme financial circumstances, the economic consequences of refusing performance would militate against such conduct, further favoring the customer. For these reasons, a myopic focus on individual releases fails to account for the nature of automotive supply contracts generally, where the supplier is frequently the sole source of supply. Where a supplier is the sole source of a particular part, a customer is unlikely to refuse to issue new releases and a supplier is equally unlikely to refuse them. Future

performance is, therefore, an inherent aspect of automotive supply contracts, regardless of how the purchase order is drafted. In these circumstances, treating the issuance and acceptance of a specific release as the full extent of the “contract” seems analytically deficient and at odds with the definition of executory contracts under either the Countryman definition or the functional approach utilized in the Sixth Circuit. *See In re Cardinal Industries, Inc.*, 146 B.R. 720, 729 (Bankr. S.D. Ohio 1992).

9. Because material future performance is an essential aspect of automotive supply contracts, it may make more sense to treat them as executory contracts of indefinite duration. Under the Uniform Commercial Code, a “where the contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party.” UCC § 2-309(2). At the time of filing, the contract would remain executory and, therefore, the non-debtor party could not terminate the contract without first obtaining relief from the automatic stay. Conversely, the debtor could not unilaterally terminate the contract without first obtaining bankruptcy court approval after demonstrating that rejection was a proper exercise of the debtor’s business judgment. *In re Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In either event, bankruptcy court supervision over the treatment of a highly significant asset of the estate is assured.

B. Performance Issues Pending Assumption or Rejection

10. As previously noted, every conceivable interest of a debtor in property, whether future, non-possessory, contingent, speculative, and derivative, falls within the definition of “property of the estate,” and, therefore, is sufficient to invoke the protections of the automatic stay. The fact that the automatic stay applies, however, does little to resolve the more pressing question; what is the non-debtor party required to do or prohibited from doing under the contract once bankruptcy ensues?
11. The Bankruptcy Code is generally silent on the rights and obligations of the parties to an executory contract during the “limbo period” from the filing of the case to the assumption or rejection of the contract. *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004). According to the Supreme Court, prior to assumption or rejection, the contract

is enforceable against the non-debtor party, even though the contract may ultimately be rejected by and, therefore, unenforceable against the debtor. *See NLRB v. Bildisco & Bildisco*, 104 S.Ct. 1188, 1199 (1984) (“But the filing of the petition in bankruptcy means that the collective bargaining agreement is no longer immediately enforceable, and may never be enforceable again.”) It is not at all clear what the Supreme Court meant, but this language has since found its way into virtually every executory contract opinion.

12. Nevertheless, a debtor in possession that elects to receive the benefits of the contract during the limbo period must pay for the *reasonable* value of the goods or services provided. *Bildisco*, supra at 1199. *See generally In re Tabernash Meadows, LLC*, 2005 Bankr. LEXIS 210, *28-*31 (Bankr. D. Colo. February 15, 2005). Prior to recent Code amendments, the reasonable value of the goods and services provided was determined by reference to Section 503(b), and did not necessarily equate to the contract price. Now, however, Sections 365(d)(3) and (5) provides that a debtor is obligated to pay the rate set forth in the real or personal property lease “notwithstanding section 503(b)(1)” As for executory contracts other than real or personal property leases, the contract price is not conclusive. Moreover, the language of Section 365(d)(3) and (5) implies that, after rejection, the lease rate is not conclusive as to value either.
13. Stating that a contract is enforceable against the non-debtor party or that a debtor must pay for the reasonable value of the goods or services provided post-petition does little to address what the scope of permissible conduct is by the non-debtor party short of termination. *See generally, In re Lucre*, 339 B.R. 648,657, n.6 (Bankr. W.D. Mich. 2006) (“A more interesting question arises when the other party has already withheld performance because of a material breach when the debtor files its Chapter 11 petition. The question then is what authority is there under the Bankruptcy Code for the newly-minted debtor-in-possession to compel the other party to resume performance when the other party was justified in withholding that performance only the day before?”)
14. In *Lucre*, Judge Hughes answered this question by holding that nothing in the Bankruptcy Code requires performance by the non-debtor party where a debtor has materially breached the contract prior to the petition date. Rather, state contract law, not the Bankruptcy Code, answers that question. According to Judge Hughes, “the mere commencement of the bankruptcy case and the attendant imposition of the automatic stay

do not by themselves empower a debtor, as debtor-in-possession, to compel from the other party to an executory contract performance the day after the commencement of the bankruptcy case when the debtor had no right to compel that performance the day before. Consequently, it is illogical to contend that the non-debtor party's justifiable refusal to perform under an executory contract post-petition is somehow a violation of the automatic stay." 339 B.R. at 660-661.

15. What is most interesting about *Lucre* is that, due to a state court injunction, the non-debtor party to the contract was unable to terminate the contract, or to suspend performance due to the debtor's pre-petition material breach. Even here, where the contract had not been suspended or terminated, Judge Hughes concluded that nothing in the Bankruptcy Code, including the automatic stay provisions of Section 362, allowed the debtor in possession to compel performance post-petition. The refusal to perform was not an "act," let alone an act in violation of the automatic stay. The debtor in possession's only recourse was to assume the contract and cure any defaults. According to Judge Hughes, "it is not enough for the trustee or debtor in possession to adequately provide for whatever post-petition performance the other party is to furnish under the executory contract if there is also a material pre-petition breach by the debtor, for the pre-petition breach in and of itself justifies continued non-performance by the other party regardless of what the debtor may offer as post-petition 'adequate protection.' The trustee or the debtor-in-possession must also cure the pre-petition default as part of a Section 365 assumption of the executory contract if it is to regain its right to demand performance from the other party." *Lucre, supra* at *30-*31. Presumably, only where the debtor is not in default at the time of filing can a court compel continued performance by the non-debtor party because the non-debtor party had no state law right to suspend performance in the absence of a material breach. So much for the so-called "breathing spell" afforded by the filing of chapter 11.
16. Although one can appreciate Judge Hughes' efforts to completely rewrite a confusing area of law, the *Lucre* decision remains an aberration. Moreover, given the potentially significant damage claims that can be imposed for stay violations, few bankruptcy lawyers would counsel their clients to pursue such a course of action.

17. Had *Lucre* simply held that a debtor in possession cannot compel the non-debtor party to resume performance if the non-debtor party actually (and justifiably) ceased performing prior to the petition date, then perhaps its conclusions would be more credible. However, even this limited conclusion is questionable. In the case *In re Pacific Gas and Electric Company*, 2004 U.S. Dist. LEXIS 22023 (D.N.D. Cal., September 30, 2004), the debtor sought to compel certain “qualifying facilities” (the “QFs”) to resume performance under their respective executory contracts without any offer of adequate protection or adequate assurance going forward, and after conceding that the QFs had justifiably suspended performance prior to the petition date. The bankruptcy court disagreed and refused to order the QFs to resume performance.
18. On appeal to the district court, the debtor argued that, once bankruptcy was filed, the QFs were obligated to resume performance, even without any assurance of payment going forward. *Id.* at *11 (“PG&E asserts that the protections of the Bankruptcy Code not only stay lawsuits against the debtor, but also other rights, such as demanding assurances, that may exist in state law, in order that the debtor may obtain “breathing space” while reorganizing.”) In contrast, the QFs argued that the Bankruptcy Code only required maintenance of the status quo – i.e., what the parties were doing at the time the petition was filed. As it was undisputed that the QFs had properly suspended performance prior to the petition date, the QFs argued that suspended performance was now the status quo.
19. In an opinion that makes one long for an expanded use of bankruptcy appellate panels, the district court held that, once a bankruptcy petition is filed, state law, including the Uniform Commercial Code, is no longer controlling. The QFs were obligated to resume performance under their executory contracts regardless of the debtor’s ability to perform post-petition. If the QFs were concerned about the debtor’s ability to perform post-petition, their only remedy was to seek relief from the automatic stay to terminate the contract or, alternatively, seek to compel the debtor to assume or reject the contract within a reasonable time. In direct contrast to *Lucre*, the court held that *continuing* to withhold performance, even if performance was properly suspended pre-petition, constituted an impermissible exercise of “unilateral self-help” in violation of the automatic stay. *Id.* at *22-*25.

20. *Lucre* and *Pacific Gas & Electric Co.* bookend the most extreme positions regarding post-petition performance prior to assumption and rejection. Interestingly, both courts conclude that the *only* source of available relief is the assumption or rejection of the contract. In *Lucre*, performance can be compelled only if and when the debtor in possession assumes the contract and cure all defaults, an unfeasible option, particularly at the inception of a case when financing is restricted or unavailable. In contrast, in *Pacific Gas*, the non-debtor party must perform and, therefore, bears all of the economic risk going forward. The non-debtor party must convince the court to lift the stay or immediately compel assumption or rejection, equally unfeasible alternatives at the inception of the case, and contrary to the Bankruptcy Code's policy of granting the debtor a "breathing spell" in order to facilitate a successful restructuring. *In re Plastech Engineering, supra* at *68.

C. Payment Terms Pending Assumption or Rejection

21. Any sane non-debtor party to an executory contract will not relish having to choose between the possibility of violating the automatic stay (and risk large monetary sanctions) or extending significant additional credit pending assumption or rejection that may never get repaid. Nor should the non-debtor party be placed in such a "Catch-22" position. If a non-debtor party to an executory contract can be compelled to continue performance post-petition, certainly the non-debtor party is entitled to be protected against the risk of being an involuntary lender. However denominated, the non-debtor party is entitled to something more than the ephemeral promise of an administrative claim. *In re JW Aluminum Co.*, 200 B.R. 64, 67 (Bankr. M.D. Fla. 1996):

Anyone who is remotely familiar with Chapter 11 cases and the Debtor-in-Possession post-commencement status frequently is painfully aware that the recognition of a postpetition claim as a cost of administration is a pyrrhic [sic] victory, if a victory at all. It is a well-known fact that the mortality rate in Chapter 11 cases is quite high and in an aborted Chapter 11 case, which is later converted to a Chapter 7 case, the cost of administrative items incurred in the Chapter 11 case are [sic] subordinated to the costs of administration items incurred in the liquidation phase of the case.

22. There is any number of ways a non-debtor party can be adequately protected against “the prospect of throwing good money after bad,” *In the Matter of Kmart Corp.*, 359 F.3d 866, 873 (7th Cir. 2004), including cash in advance or cash on delivery payment terms, the posting of letters of credit or security deposits, third party guarantees, and the like. *See e.g., In re Coserv, LLC*, 273 B.R. 487, 499 (Bankr. N.D. Tex. 2002). Particularly in the early stages of a bankruptcy case, wire transfers for future shipments are becoming increasingly common.
23. To my knowledge, no court has held that requiring payment in advance for post-petition shipments under an executory contract constitutes a violation of the automatic stay. To the contrary, courts denying critical vendor payments to parties with executory contracts have done so largely on the ground that the non-debtor party can only be compelled to perform under the contract as long as the debtor is able to ensure against additional losses by making cash in advance payments or providing other equally secure arrangements. *See In the Matter of Kmart*, supra at 873-874; *In re Coserv*, supra at 498-499.
24. Several courts have also recognized that a non-debtor party’s interest in an executory contract or lease is “an interest of an entity in property” entitled to adequate protection under Section 361 of the Bankruptcy Code. *In the Matter of Braniff Airways, Inc.*, 783 F.2d 1283, 1286 (5th Cir. 1986); *In the Matter of Whitcomb & Keller Mort. Co.*, 715 F.2d 375, 379 (7th Cir. 1983); *In re Attorneys Office Management, Inc.*, 29 B.R. 96, 98-99 (Bankr. C.D. Cal. 1983); *In re Castle Tool Specialty Co.*, 22 B.R. 44, 45-46 (E.D. Penn. 1982). *Contra, In re Wheeling-Pittsburgh Steel Corp.*, 54 B.R. 385, 390-391 (W.D. Penn. 1985); *In re Café Partners/Washington 1983 L.P.*, 81 B.R. 175, 179-181 (Bankr. D.D.C. 1988). If adequate protection is required, Section 361(3) specifically provides that an administrative expense claim under Section 503(b)(1) of the Code is *not* adequate protection.
25. Those courts rejecting the notion that a non-debtor party’s interest in an executory contract is “an interest of an entity in property” entitled to adequate protection have done so largely because Section 365 of the Code is not referred in the introductory sentence to Section 361 (“When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property . . .”). However, Section 365 does not address, and was not intended to override Section 363(e), which *requires* a court to “prohibit or

condition such use, sale or lease of property as is necessary to provide adequate protection of such interest.” If the debtor has a sufficient interest in a contract or lease justifying the application of the automatic stay, it is anomalous to hold that the non-debtor party to that same contract or lease does not have a corresponding interest entitled to adequate protection.

D. Compelling Shipments in the Absence of an Enforceable Contract

26. In the absence of an enforceable contract, can a bankruptcy court compel a non-debtor party to ship critical goods? This issue goes to the heart of “critical vendor” payments on account of pre-petition unsecured claims. To justify making a critical vendor payment, the debtor must show, *inter alia*, that there is no practical or legal alternative. “This means that the vendors’ goods or services are essential and that the critical vendor will, in fact, not provide them without exceptional treatment.” *In re United American, Inc.*, 327 B.R. 776, 782-783 (Bankr. E.D. VA. 2005). *See also In re Coserv, supra* at 498 (“there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim”); *In re Kmart, supra* at 873 (“They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries.”) Without an enforceable long-term agreement, however, it is generally thought that a bankruptcy court is powerless to order a non-debtor to do business with the debtor in possession.
27. Where a non-debtor does not have a pre-petition claim against or ongoing contract with the debtor, a bankruptcy court cannot compel that entity to do business with the debtor. However, even in the absence of a long-term contract, courts have been willing to compel parties to sell goods for cash where the refusal was deemed to be a coercive attempt to obtain payment of a pre-petition claim. *In re Sportfame of Ohio, Inc.*, 40 B.R. 47 (Bankr. N.D. Ohio 1984); *In re Ike Kempner & Bros., Inc.*, 4 B.R. 31 (Bankr. E.D. Ark. 1980). *Cf., In re Continental Energy Assoc. L.P.*, 178 B.R. 405 (Bankr. M.D. Penn. 1995).
28. In the *Sportfame of Ohio* case, the debtor, a sporting goods retailer regularly purchased goods at wholesale from Wilson Sporting Goods for resale at its stores. The parties had been doing business for almost 10 years without any formal long-term agreement. Due to

an unpaid invoice, Wilson stopped shipping goods to the debtor prior to the petition date. After the chapter 11 filing, Wilson refused to sell any goods to the debtor, even for cash, allegedly to force the debtor to pay Wilson's pre-petition invoice. The debtor sought injunctive relief to require Wilson to resume shipments, arguing that Wilson's refusal to ship was a violation of Section 362(a)(6). Wilson argued that "instead of asking for repayment of its [pre-petition] debt, it only sought to encourage the debtor to submit a plan calling for 100% repayment of its claim." *Id.* at 49. The court found that Wilson's "sole animus in refusing to ship goods to debtor for cash was its desire to coerce debtor's repayment of its prepetition indebtedness and that this act, albeit a passive one, was an 'act to collect, assess, or recover a claim against the debtor' in contravention of 11 U.S.C. § 362(a)(6)."

29. The *Sportfame* court placed emphasis on the hearsay testimony of the debtor's principal, the sole witness at trial, that Wilson's sole reason for refusing to sell goods was to coerce payment of its pre-petition invoice. In *Ike Kempner*, however, evidence regarding motivation or reasons for refusing to sell for cash were unnecessary. According to the court, a reasonable inference to be drawn from a refusal to sell for cash is that the refusal is an effort to coerce payment of a pre-petition claim "which is tantamount to harassment prohibited by Chapter 11." 4 B.R. at 32.
30. To come full circle, compare *Sportfame* and *Ike Kempner*, where the courts compelled performance in the absence of an enforceable contract, with *Lucre, supra*, where the court refused to compel performance despite the presence of an enforceable contract.