

Bound to Sell: Wrestling With Pre-Bankruptcy Supply Agreements

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Trade creditors that are parties to a supply agreement entered into with a chapter 11 debtor prior to the commencement of the case are in a unique position compared to the rest of the general unsecured creditor body. If they can convince the debtor to assume the supply agreement, they will be able to collect the full amount of damages accruing pre-petition rather than being placed in the pool of those creditors receiving pennies on the dollar, as exists in most cases. At the same time, they are in the unenviable position (in most jurisdictions) of having to perform under the contract during a limbo period between the date the case is commenced and the date that the debtor assumes or rejects the contract. This article will focus on that unenviable position.

Section 365 Overview

Section 365 of the Bankruptcy Code gives the debtor-in-possession¹ in a chapter 11 case the right to assume a pre-petition executory contract or to reject it. If the contract is assumed, the debtor becomes bound by all of its provisions and, as a condition to assumption, must cure all monetary defaults under the contract and compensate the non-debtor party for any actual pecuniary loss resulting from a default by the debtor. 11 U.S.C. § 365(b)(1). If the debtor rejects the contract, the contract is deemed breached as of the date immediately before the filing of the petition and any damages suffered by the creditor are treated as pre-petition general unsecured claims. 11 U.S.C. § 365(g)(1). Unless otherwise ordered by the court, the debtor has until confirmation of the plan to decide whether to assume or reject the contract. 11 U.S.C. § 365(d)(2).

¹ For purposes of simplicity, these materials will refer to the debtor-in-possession or simply “debtor”. However, this discussion applies equally to a chapter 11 trustee. See 11 U.S.C. § 1107.

The Supplier's Dilemma

The supply agreement is often driven by economic considerations that go beyond the mere desire by the seller to attempt to secure guaranteed sales to a customer over a period of time. Often, these contracts are driven by demands made by the purchaser for a long-term supply commitment, either in order to obtain price stability or to ensure an adequate supply of product for the purchaser to fulfill its commitments to its customers. Likewise, sellers of goods may need commitments from their customers to purchase a specified amount of product in order for the seller to be able to plan adequately with its own suppliers to obtain the materials needed to manufacture product for its customers. Or, the seller may need a minimum commitment from its customer in order to guarantee a certain price. Whatever the reason, supply agreements are often less a matter of choice and more a matter of economic necessity. And, because a supply agreement could span a number of years, the economics of the transaction are also usually calculated on that basis. For example, a seller may need to purchase new equipment or invest in other capital improvements and, based on the purchaser's five-year commitment, spreads these costs over the contract's five years. The seller may make other commitments. For example, in order to fulfill the purchaser's orders, the seller may need to enter into its own commitments to purchase raw materials over the life of the contract or at least significant portions of it.

Unlike the typical supplier who sells to its customers as orders are placed with it without any commitment on either party to enter into future transactions, the non-debtor seller under a supply agreement normally remains contractually bound to the debtor to sell goods pursuant to the terms of the contract. So, where there is no supply agreement the supplier, subject to compliance with antitrust and other laws regulating trade, can refuse to sell to the debtor for any reason and can set the terms upon which it is willing to deal with the debtor. This is so, even if

the debtor files a chapter 11 petition. Indeed, it is common for trade creditors selling to the debtor pre-petition on credit terms (*e.g.*, 30 days past invoice), to demand payment in advance or upon delivery once chapter 11 proceedings are commenced. As is discussed below, the seller that is bound by a supply agreement may be required to sell to the debtor on the very terms set forth in the contract and, in fact, on terms more favorable to the debtor than set forth in the contract.

The Non-Debtor's Obligation to Perform Prior to Assumption

When it comes to executory contracts, the filing of the chapter 11 petition dramatically tilts the playing field in the debtor's favor. Almost without exception,² the courts that have addressed the issue have held that the debtor is not bound to perform under the contract prior to assumption, but the supplier is. *In re FBI Distribution Corp.*, 330 F.3d 36 (1st Cir. 2003); *In re Public Service Company of New Hampshire*, 884 F.2d 11 (1st Cir. 1989); *In re Pacific Gas and Electric Company*, 2004 U.S. Dist. LEXIS 22023 (N.D. Cal. 2004); *In re Enron Corp.*, 330 B.R. 387 (Bankr. S.D.N.Y. 2005); *In re Continental Energy Associates Limited Partnership*, 178 B.R. 405 (Bankr. M.D. Pa. 1995); *In re Monarch Capital Corporation*, 163 B.R. 899, 907 (Bankr. D. Mass. 1994). As the First Circuit has observed:

Although during the Chapter 11 proceeding a prepetition executory contract remains in effect and enforceable against the nondebtor

² A case out of the Western District of Michigan makes a forceful argument that section 365 does not compel the result that the non-debtor party is required to perform prior to assumption. Instead, it argues that the parties are left to their state law rights prior to assumption, meaning that as long as the debtor is in material default under the contract the non-debtor party is excused from performing. The court concluded that the only way the debtor can force the non-debtor party to perform is by assuming the contract and curing the defaults. *In re Lucre, Inc.*, 339 B.R. 648 (Bankr. W.D. Mich. 2006). In so holding, the court also observed that language in the Supreme Court's decision in *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 531, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 497 (1984), does not compel a different result. In this regard, some courts have read language in *Bildisco* referring to the debtor's election to resume ("[i]f the debtor in possession elects to continue to receive benefits ...") as mandating that the debtor can elect to receive benefits prior to assumption over the objection of the non-debtor party. The language in *Bildisco* does not go that far, but the courts nevertheless are overwhelmingly on the side of requiring the non-debtor party to perform.

party to the contract, the contract is unenforceable against the debtor in possession unless and until the contract is assumed.”

In re FBI Distribution Corp., 330 F.3d at 43.

Even where the seller has been excused from performance pre-petition, it still can be required to sell post-petition pending the assumption or rejection of the supply agreement. In *In re Pacific Gas and Electric Company*, 2004 U.S. Dist. LEXIS 22023 (N.D. Cal. 2004), for example, sellers of electricity had exercised their rights under section 2-609 of the Uniform Commercial Code³ pre-petition to suspend shipments to the debtor pending receipt of adequate assurance of future performance. They argued that the filing of the chapter 11 petition merely required the maintenance of the status quo, meaning that they were entitled to withhold shipments pending the debtor providing them with adequate assurance of future performance.

The court rejected the argument, stating:

According to the legislative history, the purpose of Chapter 11 of the Bankruptcy Code is to give the debtor a “breathing spell” from creditors, to stop all collection efforts, and to permit the debtor to attempt repayment or reorganization. ... The Bankruptcy Code further seeks to “suspend the normal operation of rights and obligations between the debtor and his creditors,” and to “prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.” ...

In light of the rehabilitative purpose behind the Bankruptcy Code, courts and legal treatises have consistently opined that creditors are responsible for the continuation of performance under the terms of an executory contract upon the debtor’s filing of petition for bankruptcy but before the affirmative assumption or rejection of the contract. ...

³ UCC § 2-609 provides:

A contract for sale imposes an obligation on each party that the other’s expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arises with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance . . .

The QFs correctly point out that these cases involved the non-debtor party's unilateral suspension of its performance under the contract *after* the debtor's filing of the Chapter 11 petition for bankruptcy, whereas here the QFs had already ceased their services in March *before* PG&E's filing of bankruptcy in April. The QFs argue that this difference makes the cases inapplicable; the Court disagrees. While the parties have not cited, and the Court has not found, any case that addresses the specific facts present here, a holding that the QFs were entitled to withhold their performance until PG&E had provided sufficient assurances of financial recovery would vitiate the clear legislative purpose to provide the debtor with "breathing space" while the contract is pending assumption or rejection.

Id. at *15-*16 (emphasis in original) (citations omitted). The court also held that the burden was on the suppliers to seek protection from further performance under the contract that their failure to do so exposed them to liability to the debtor.

The risks to the non-debtor party are quite significant. First, while the courts universally recognize the right to an administrative claim for any unpaid post-petition accruals under the contract it is not so clear that the debtor is required to make payments currently under the contract. In this regard, most courts recognize the obligation of the debtor to make payments, but in the end the remedy may be that the non-debtor party is relegated to deferring payment to be treated as an administrative claim, at least for a short period of time.⁴ The non-debtor party not only may not be entitled to current payments but if the case becomes administratively insolvent, it may not be paid at all or only a small portion of the post-petition accrual. Moreover, as one court has pointed out, "That one might be paid in full if a plan is confirmed, as required by § 1129(a)(9), hardly recognizes the detriment to its cash flow in the interim." *In re Beker Industries Corp.*, 64 B.R. 890, 899 (Bankr. S.D.N.Y. 1986).

⁴ As discussed below, many courts consider the failure to make current payments to be just one factor in determining whether the court should set a deadline for the debtor to assume or reject the contract.

Adding insult to injury, the non-debtor party is not necessarily entitled to be paid the contract rate. This is because administrative claims are only entitled to payment “to the extent that the consideration supporting the claimant’s right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business.” *In re Mammoth Mart, Inc.*, 536 F.2d 950, 954 (1st Cir. 1976). As the Supreme Court stated in *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 497 (1984):

If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services ... which, depending on the circumstances of a particular contract, may be what is specified in the contract.

Id. at 531, 104 S. Ct. at 1199, 79 L. Ed. 2d at 497 (citations omitted).

To understand the potential unfairness faced by the non-debtor party to a supply agreement, consider the situation faced by Hazleton Fuel Management Company in *In re Continental Energy Associates Limited Partnership, supra*. Hazleton supplied the debtor with natural gas under a long term contract that was in pre-petition arrears in the amount of \$15 million. Daily accruals for natural gas purchases by the debtor amounted to \$100,000 per day. As with most commodities, the price of natural gas fluctuates according to market conditions. During the term of a supply agreement the contract price may be above or below the market price. The seller is comforted to a certain extent that if the market price increases above the contract price there is a reasonable chance that in the long run it will also fall below the contract price, thus balancing off any losses. In *Continental Energy*, the debtor agreed to pay to Hazleton the contract price and even to pay it in advance of delivery, but it reserved the right to seek to recover from Hazleton any amounts it paid that were in excess of the current market price. While the court recognized that “Hazleton or its predecessor embarked on a costly and

time-consuming effort to guarantee the supply of natural gas to the Debtor over a lengthy period of time,” it agreed with the debtor, based on the very principles enunciated in *Bildisco* and *Mammoth Mart*. 178 B.R. at 408. In order to counterbalance the harm to Hazleton, the court required the debtor to make a decision within 30 days as to whether to assume or reject. But, even then, at approximately \$3 million a month in sales, even a small reduction in the purchase price could have resulted in substantial losses to Hazleton.

The problem is not confined to sellers. In *In re Enron Corp.*, *supra*, for example, a purchaser of electricity from the debtor was required to continue to buy at above market contract prices pending the assumption or rejection of a power supply agreement. When market prices for electricity rose above the contract price the debtor rejected the agreement.

While the courts do recognize the burden on the non-debtor party they consistently have held that the balance of the equities favor binding the non-debtor party to the contract pending assumption or rejection. *In re Pacific Gas and Electric Company*, *supra*; *In re Enron Corp.*, *supra*; *In re Beker Industries Corp.*, 64 B.R. 890 (Bankr. S.D.N.Y. 1986). In the end, they have concluded that the non-debtor’s right to seek an early decision on assumption or rejection (discussed below) is sufficient protection against the risks and burdens imposed on the non-debtor party.

What Supply Agreements Are Covered?

Before one can determine whether a non-debtor party to a supply agreement must perform, one must first conclude (1) that there is an enforceable contract and (2) that the contract is executory.

In most cases, the question of whether a contract is executory is rather straight forward. According to the Supreme Court, executory contracts are those where “performance is due to

some extent on both sides.” *National Labor Relations Board v. Bildisco & Bildisco*, *supra* at 522 n.6, 104 S. Ct. at 1194 n.6, 79 L. Ed. 2d at 493 n.6 (1984). In a typical supply agreement, the agreement will be considered executory as long as (1) the contract has not been terminated pre-petition⁵ and (2) the seller has an obligation to deliver goods and the buyer has not yet paid for them.

Contracts that are illegal, such as those in restraint of trade, or are not supported by consideration are illegal would not be subject to enforcement by the debtor. Indeed, as to the latter point, it is not uncommon for a seller and a buyer to enter into “agreements” that are nothing other than expressions of intent, rather than actual commitments to purchase. *See, e.g., Cabot Corporation v. AVX Corporation*, 448 Mass. 629; 863 N.E.2d 503 (2007).

The law divides supply agreements into three types – definite quantity contracts, requirements contracts and indefinite quantity contracts. Definite quantity contracts are those where the buyer has obligated itself to buy a specific amount of product for a specific amount of money. Requirements contracts are those where the amount purchased is measured by the output of the seller or the requirements of the buyer. Indefinite quantity supply agreements leave open the maximum amount to be purchased, but may or may not contain a minimum purchase requirement. Because definite purchase contracts and requirements contracts require a definite commitment from both sides they are by definition supported by valid consideration. Where the indefinite supply agreement contains a minimum purchase requirement, it too is supported by consideration. Many indefinite supply agreements, however, do not contain a commitment for the purchaser to buy any specific quantity. Consider, for example, the contract that sets the price

⁵ If the seller anticipates a bankruptcy filing it may want to immediately terminate the agreement before the case is filed. By doing so, the seller (subject to possible claims of preference or fraudulent transfer) would avoid the negative effects of section 365. However, it would in the process lose the ability to try to convince the debtor to assume the contract and, with the attendant obligation of the debtor to cure pre-petition defaults, the ability to collect the full amount owed pre-petition.

for raw material for the upcoming year. Without a commitment by the buyer to purchase a minimum quantity it is not supported by consideration and is deemed by the courts to be illusory and unenforceable. See *Willard, Sutherland & Company v. United States*, 262 U.S. 489; 43 S. Ct. 592; 67 L. Ed. 1086 (1923); *Anchor Glass Container Corporation*, 297 B.R. 887 (Bankr. M.D. Fla. 2003).

Seeking Early Assumption or Rejection of the Contract

Assuming a valid contract that has not been terminated pre-petition and as to which performance is still required on both sides, the remedy for the non-debtor party is to seek an order requiring the debtor to assume or reject the supply agreement prior to the confirmation of the plan. In this regard, section 365(d)(2) of the Bankruptcy Code provides:

(2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

While the Bankruptcy Code provides that a party to the contract may seek an order shortening the time to make the decision as to whether to assume or reject, it gives absolutely no guidance as to what standards to apply, leaving it to the courts to decide. The courts have consistently held that the existence of pre-petition defaults, in themselves, does not constitute grounds to shorten the time period. *E.g., In re Pacific Gas and Electric Company, supra; In re Beker Industries Corp., supra.* Moreover, those courts that have directly addressed the issue⁶ have held

⁶ There is language in a number of decisions that might be read as stating that payments must be made currently. For example, in *National Labor Relations Board v. Bildisco & Bildisco, supra*, the Supreme Court stated that “[i]f the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services.” 465 U.S. at 531, 104 S. Ct. at 1199, 79 L. Ed. 2d at 499. Similar statements are found in other

that the failure to make post-petition payments is not a *per se* reason to require immediate assumption or rejection. *In re Beker Industries Corp., supra.* As the court stated in *Beker Industries*:

WCFL observes that several cases, in denying § 365(d) motions, have stressed a debtor's keeping current with post-petition obligations and reasoned that the resultant absence of harm to an obligee to an executory contract belies a need to require a debtor to assume or reject prior to confirmation. ... The converse of this proposition, however, is not necessarily true. Congress made no such provision. In amending § 365(d) in 1984, Congress added § 365(d)(3). That section requires a debtor-in-possession to "timely perform" all of the post-petition obligations of the debtor only under leases of non-residential real property. The failure to make such payments is an element to be considered in determining whether cause exists pursuant to § 365(d)(4) to extend the 60-day period for assumption or rejection. Not even in this area where Congress has acted has it provided for mandatory assumption or rejection on the ground that a debtor failed to keep current.

64 B.R. at 898.

The uncertainty facing the non-debtor party was best expressed by the First Circuit in *Public Service of New Hampshire*:

Parties who wish to know where they stand may, pursuant to 11 U.S.C. § 365(d)(2), seek to compel an early election ... But there is no assurance that the judge will acquiesce. The interests of the creditors collectively and the bankrupt estate as a whole will not yield easily to the convenience or advantage of one creditor out of many.

Id. at 14-15.

In the end, courts balance the equities. A good list of the factors bearing upon a court's decision was aptly stated in *In re Enron Corp., supra*:

cases. *E.g., In re Resource Technology Corporation*, 254 B.R. 215 (Bankr. N.D. Ill. 2000); *In re Continental Energy Associates Limited Partnership, supra.* However, while all of these cases state that the debtor is obligated to pay, they do not specify when the payment becomes due. Moreover, none address the consequences of not making payment.

In fixing the time for a debtor to assume or reject a contract, the standard applied by the court is whether a debtor has been afforded a reasonable time within which to make its determination on assumption or rejection of the contract. ... The decision as to whether a reasonable time has been afforded is within the court's discretion as considered under the facts of the particular case. ... The factors considered by a court in reaching its conclusion include (1) the damage the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (2) the importance of the contract to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan; and (4) whether exclusivity has terminated. ... In addition, a court must consider the complexity of the case, including the number of contracts to be evaluated, and the need for a court to determine the validity of the contract.

330 B.R. at 393. *See also, In re Beker Industries Corp., supra* at 896 (In deciding whether to require the debtor to make a decision on assumption or rejection prior to confirmation the court will take into account "the nature of the interests at stake, the balance of hurt to the litigants, the good to be achieved, the safeguards afforded those litigants, and whether the action to be taken is so in derogation of Congress' scheme that the court may be said to be arbitrary.")

Each case clearly will have to be determined on its own facts, with each such determination subject to the sound discretion of the court. *In re Resource Technology Corporation*, 254 B.R. 215 (Bankr. N.D. Ill. 2000); *In re Beker Industries Corp., supra*. The non-debtor party to the supply agreement will want to emphasize the harm that it is suffering or will suffer by the debtor's delay in making a decision to assume or reject. Where the non-debtor is the supplier, this may include the failure of the debtor to make current payments, additional obligations that the supplier will be forced to undertake during this limbo period or lost opportunities that it might face due to its inability to divert resources away from that needed to satisfy its obligations to the debtor, should it elect to assume the contract. For the non-debtor purchaser, this could include the ability of the non-debtor currently to obtain an alternate source

of supply in a market where alternatives are scarce, the need to assure a commitment from the debtor in order for the non-debtor purchaser to fulfill its obligations to its own customers and an expected rise in the price of the goods that are the subject of the supply agreement. Against all of this, the non-debtor party will be up against the tendency of the court to give the debtor a reasonable time to assume or reject the contract, the aversion to creating an administrative claim through assumption that later turns out to be an unwise decision, and the priority with which the court could reasonably expect the debtor to address the issue in what could be only one of hundreds of issues that the debtor may have to deal with in its case.

The burdens of being a non-debtor party to an executory supply agreement are quite tangible and often can have severe negative consequences to the non-debtor party, whether it be a supplier or a purchaser. While the non-debtor party clearly has an uphill battle in convincing the court to require assumption or rejection early in the case, in an appropriate case the court will exercise its discretion to grant such relief. The challenge for the non-debtor party is to garner a sufficient amount of facts to convince the court that of that it suffers real harm by the requiring its performance during the limbo period prior to assumption, that such harm outweighs any harm to requiring the debtor to make that decision prior to confirmation of the plan and that the time period for making the decision should be made as short as possible.