



MEMORANDUM

Executory Contracts in Bankruptcy An Overview from a Buyer's Perspective

Introduction

This memorandum addresses bankruptcy considerations under circumstances in which you are the buyer of products under a long-term supply agreement or requirements contract where the seller/supplier is obligated to manufacture and deliver conforming goods and you are obligated to accept and pay for conforming goods.

The Automatic Stay

The Bankruptcy Code provides an automatic stay that is effective on the filing of a petition under the Bankruptcy Code.¹ The stay, among other things, suspends (prohibits) a wide range of actions that would affect or interfere with the property of the debtor.²

The automatic stay is one of the fundamental protections afforded the debtor under the bankruptcy laws. It gives the debtor a “breathing spell” during which the debtor (in Chapter 11) has time to attempt a reorganization plan. The automatic stay is intended to protect and preserve the debtor’s property during this process. It is very broad in scope and, with very narrow exceptions, applies to almost every kind of formal or informal action taken against the debtor or the property of the debtor. The stay prohibits the continuation or commencement of litigation, the enforcement of judgments, acts to obtain possession or control over property of the debtor, and acts to create, perfect or enforce liens.

Acts taken in violation of the stay are void or voidable. Willful violations of the stay are punishable as contempt of court.

Executory Contracts

Executory contracts are a form of property of the debtor. The stay protects the debtor’s interest in executory contracts against termination or other interference that would have the effect of dispossessing the debtor of its rights under the contract. The rationale for this protection is that the debtor’s efforts to reorganize and maximize the value available

¹ 11 U.S.C. §362

² 11 U.S.C. §362(a)(3)

to pay creditors would be impaired if the debtor's customers could terminate existing contracts.

The Bankruptcy Code does not define executory contract, but the term is generally considered to mean a contract under which (i) the debtor and non-debtor each have unperformed obligations and (ii) the debtor, if it ceases further performance, would have no right to the other party's continued performance.³

Based on this definition, an executory contract would include an unexpired long-term supply agreement or a requirements contract between the debtor and a customer.

Contractual Termination Provisions – Post-petition

The Bankruptcy Provision. Executory contracts often include provisions that permit the buyer to terminate the contract in the event of the supplier's insolvency, the commencement of a bankruptcy case, the appointment of a receiver under state law, or an assignment for the benefit of creditors. Such provisions are **not** enforceable after the supplier has filed a bankruptcy petition.

The Termination for Convenience Provision. A post petition termination for convenience is probably stayed and good practice would require a motion for a court order lifting the stay and authorizing such termination. However, absent a showing that the buyer will be prejudiced if it is prevented from terminating the contract and moving on to another supplier, it is unlikely that the buyer will prevail.

Contractual Termination Provisions – Pre-petition

Pre-petition termination of a supplier's contract due to acts of insolvency (other than bankruptcy) should be upheld if the termination is carried out in compliance with the terms of the contract and is final and cannot be cured at the time the bankruptcy petition is filed. Pre-petition termination of the contract for convenience should be upheld as long as the supplier has no remaining rights under the contract except the right to receive payment for its termination claim.

Terminated Contracts

If the contract is properly terminated under applicable nonbankruptcy law before the commencement of bankruptcy, the contract no longer exists and, therefore, no longer constitutes property for the bankrupt estate. As with any contract termination, care should be taken to comply with the terms of the contract governing termination as well as applicable provisions of the Uniform Commercial Code (and other applicable law) to avoid an argument by the debtor that the contract has not been validly terminated or that the termination can be reversed under nonbankruptcy law.

³ H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347 (1977)

Defaults

If a default occurs before the commencement of bankruptcy, but the contract has not been terminated at the time the petition is filed, the contract, even though in default, becomes part of the bankruptcy estate and the stay applies. Thereafter, the buyer would need to obtain a court order approving termination of the contract. Prompt action is necessary to request the court to lift the stay and the buyer must demonstrate prejudice. For example, if the default negatively affects the buyer's ability to satisfy obligations to its customers, e.g., late deliveries or nonconforming goods, the court may authorize termination. However, the trustee⁴ will be given the opportunity to prove that it can cure the default. The trustee must also provide adequate assurance of future performance.⁵ As a condition to keeping the contract, the bankruptcy estate may also be required to compensate the buyer for actual pecuniary loss resulting from the default.⁶

Assumption or Rejection

The Bankruptcy Code gives the trustee the right to assume or reject executory contracts subject to the court's approval.⁷

If there has been a default in the contract then the trustee may not assume the contract unless, at the time of assumption, the trustee (i) cures, or provides adequate assurance that the trustee will promptly cure, the default,⁸ (ii) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor for actual pecuniary loss resulting from such default, and (iii) provides adequate assurance of future performance. Because the court's approval is required for the assumption of the contract, the nondebtor party will have the opportunity to challenge the trustee's election.

Assumption of the contract results in an administrative expense status for all obligations under the contract, regardless of whether the expense arose before or after filing the petition.

If the trustee elects to reject the executory contract, the rejection of the contract constitutes a breach of the contract immediately before the date of filing the petition.⁹ The language of Section 365(g) has serious consequences. First, the rejection constitutes a breach of the contract and not a termination. This means that the contract is still effective, but in breach by the debtor. Second, by placing the time of the breach pre-petition, any claim for pre-petition damages will not have priority as an administrative expense and is probably an unsecured claim. However, claims for damages caused by a breach after filing, but prior to rejection, may be treated as an administrative expense.

⁴ The term "trustee" includes a debtor-in-possession in a Chapter 11 case

⁵ 11 U.S.C. §365

⁶ U.S.C. §365(b)(1)(B)

⁷ 11 U.S.C. §365(a)

⁸ There are exceptions to the obligation to cure that are beyond the scope of this memorandum

⁹ 11 U.S.C. §365(g)

Performance after Filing but before Assumption

After the petition is filed, but before the trustee assumes or rejects the contract, both the nondebtor party and the trustee must timely perform all obligations of the debtor under the contract.¹⁰

Time for Assumption or Rejection

In most cases involving the bankruptcy of a business entity, the trustee may assume or reject an executory contract at any time prior to the confirmation of the plan. However, the court, on the request of any party to the contract, may order the trustee to determine within a specified period whether to assume or reject the contract.¹¹

Assignment of Executory Contracts

The trustee may assign an executory contract to a third party on the conditions that the trustee first assumes the contract in accordance with §365(a) and the assignee provides adequate assurance of future performance. Requiring assumption of the contract before assignment means that the trustee must cure all defaults and provide compensation for pecuniary loss caused by the defaults.¹² The proposed assignee must provide adequate assurance that it can perform all of the material terms of the contract.

Provisions in the executory contract that prohibit, restrict, or impose conditions on assignment are unenforceable.¹³ However, the contract cannot be assumed or assigned by the trustee if the contract is not assignable under nonbankruptcy law.¹⁴

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Practice Suggestions

► Know your supplier

To the extent possible/practical, qualify a supplier before entering into a long-term supply relationship. Consider obtaining credit reports. Confirm that the supplier has adequate resources to fulfill the contract. Beware of small, undercapitalized companies. Private companies often refuse requests for financial information, but request references, including bank references, and make inquiries.

► Protect your assets

If the supplier will use tooling and/or equipment that belongs to you or your customer, protect your interest in such assets by having the supplier sign a **bailment**

¹⁰ 11 U.S.C. §365(d)(3)

¹¹ 11 U.S.C. §365(d)(2)

¹² 11 U.S.C. §365(f)(2)

¹³ 11 U.S.C. §365(f)(3)

¹⁴ 11 U.S.C. §365(e)

agreement clearly establishing your rights to the assets and the supplier's obligations, **mark** the equipment to show ownership, and file **UCC Financing Statements** in the appropriate jurisdiction.

► **Monitor your suppliers**

A supplier that is financially stable at the beginning of a long-term relationship can run into trouble. Be alert to signs of financial difficulty. If the supplier is a publicly traded company, information concerning its financial situation is publicly available. For private companies, credit-reporting services are available and credit reports should periodically be updated. Generally, watch for signs of financial difficulty, such as, requests for accelerated payment, negative media reports, industry rumors, and the like.

► **Act promptly to correct defaults**

If the supplier defaults under any of its material obligations under the contract, you must give prompt notice of the default and give the supplier an opportunity to cure. Carefully document all communications with the supplier. Confirm in writing all telephone and other oral communications. Preserve e-mail and other electronic communications.

► **Demand assurances of future performance**

Even in the absence of a default, you can demand adequate assurance of future performance if you have commercially reasonable grounds for doubting your supplier's future ability to perform its obligations. If the supplier does not provide within a reasonable time (not exceeding 30 days) assurance of due performance that is adequate under the circumstances, the contract is deemed to be repudiated by the supplier.¹⁵

► **Identify back-up suppliers**

Identify alternative sources, particularly for critical components and services.

► **After the supplier files for bankruptcy**

§ As discussed above, after the supplier has filed for bankruptcy, you will not be able to terminate the contract without the bankruptcy court's approval. If there is an existing, material default or if there are commercially reasonable grounds for doubting future performance, you may be able to move the work, but only after a hearing and a favorable court order.

§ Keep in touch with the supplier. Identify the person who is making the business decisions and discuss the situation. If the contract is important to the future success of the bankrupt estate, your concerns will likely be addressed. If the contract is

¹⁵ Uniform Commercial Code § 2-609

not so important, for example, because it is a loss or near loss contract, the trustee may be willing to reject the contract early in the proceeding and let you move the business.

\$ Monitor the bankruptcy proceeding. A small percentage of Chapter 11 reorganization cases result in the survival of the debtor. More frequently, the plan of reorganization turns into a liquidation in which the company's assets are sold to one or more bidders. You may then have a new supplier if your contract is assumed and assigned in the sale process. By identifying as soon as possible the potential buyers, you can assess the acceptability of these companies as a supplier and raise objections if there are legitimate concerns.

► **Keep your attorneys informed**

Throughout the relationship with a supplier, your attorneys can offer helpful guidance and assistance.