LITIGATION MINUTE: BANKRUPTCY ISSUES FOR VENDORS AND OTHER CONTRACTUAL COUNTERPARTIES

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U.S. Complex Commercial Litigation and Disputes Alert

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WHAT YOU NEED TO KNOW IN A MINUTE OR LESS

Companies should anticipate the possibility that they will find themselves in a situation where a vendor, customer, or other contract counterparty commences a bankruptcy case pursuant to Title 11 of the U.S. Code (the Bankruptcy Code). The ongoing COVID-19 pandemic has caused economic stress to a wide variety of business sectors, and it has underscored the risk that a contract counterparty may file for bankruptcy.

Bankruptcy effect on vendor and supply contracts

Vendor and customer contracts are subject to disruption or involuntary modification in bankruptcy. Contracts with ongoing duties of performance are treated as executory contracts under the Bankruptcy Code. A bankrupt debtor may elect to assume or reject executory vendor and customer contracts under 11 U.S.C. § 365. Executory contracts (with some limitations) may be assumed and assigned to a third party, notwithstanding contractual anti-assignment provisions. If a debtor elects to assume a contract, it must cure defaults and provide adequate assurance of ability to perform. If the debtor elects to reject the contract, the debtor is relieved from future obligations of performance and the nondebtor party is entitled to file a damages claim in the bankruptcy case. Vendor and supply contracts are commonly transferred in bankruptcy sale transactions on terms that fix or eliminate rights to claim arrearages or redress for other defaults. It is important to timely identify the effect of the bankruptcy filing on executory contracts like vendor and supply agreements in order to ensure that contract rights are not eliminated or modified to the detriment of a nondebtor party.

Setoff rights in bankruptcy

Clients are accustomed to offsetting or netting obligations with vendors and customers. These rights of offset will be impacted by a bankruptcy filing. The Bankruptcy Code generally preserves rights of setoff. However, rights of setoff will be limited to the netting of only prepetition mutual obligations or only postpetition mutual obligations, and the effectuation of setoffs for prepetition obligations will be stayed. Setoff rights must be carefully preserved. If payments are made, the rights of setoff associated with those payments will be lost. Clients should carefully assess their rights of setoff and recoupment in order to preserve and enforce these valuable rights in bankruptcy.

Automatic stay

The commencement of a bankruptcy case creates an “automatic stay” pursuant to 11 U.S.C. § 362. The automatic stay is an injunction that precludes any act to collect debts, obtain rights in property of the party in bankruptcy (the debtor), or continue litigation against the debtor. The automatic stay prevents parties from terminating a contract with a debtor or threatening to do so. Parties should not send an invoice to, or request payment from, a debtor for prepetition debts, and they should not effectuate a setoff of mutual prepetition debts owing by the parties. Parties who violate the bankruptcy automatic stay can be liable for actual damages, punitive damages, attorneys' fees, and costs. Companies should closely monitor bankruptcy notices they receive in the mail to make sure that they observe the automatic stay.

Preferential payments

In order to prevent a debtor from preferring one creditor over others as it approaches bankruptcy, the Bankruptcy Code allows a bankruptcy trustee or debtor to sue creditors to claw back or “avoid” transfers they received in the 90-day period before the bankruptcy was filed (preferential transfers). This means a party that provided goods or services to the debtor may need to return payments that it received during the preference period in exchange for a claim in the bankruptcy proceeding. There are several defenses to a preference action, the most common being that the payment was made in the “ordinary course” of business affairs between the debtor and creditor or according to terms common in the industry. In order to preserve this defense, the creditor must carefully monitor payments from account debtors that it suspects might be experiencing financial troubles and ensure that payments are made pursuant to invoice terms or consistent with the time frame in which payments had previously been made. The “ordinary course” defense can be compromised by actions that are not “ordinary,” such as switching payment terms from check to wire, shortening payment terms, or applying unusual pressure to elicit payment. The Consolidated Appropriations Act of 2021 has temporarily amended the Bankruptcy Code to except, from avoidance as preferential transfers, certain payments to landlords and suppliers of goods or services. The exception applies to payments made pursuant to an agreement or arrangement entered into on or after 13 March 2020 to defer or postpone payments owed, and it is subject to certain other limitations.

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