

Supply Contract Trumps Preference

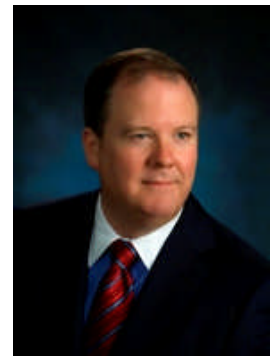
A **lmond Products, Inc.** A Supply contract may be an absolute defense to a preference claim. A supply contract is an “executory contract”, a bankruptcy term meaning a contract where both parties to the contract owe material performance obligations. In furtherance of the Chapter 11 policy of restructurings, the Bankruptcy Code provides that a debtor may, in its discretion, assume or reject an executory contract.

If the debtor elects to reject an executory contract, the resulting damage claim, including the unpaid pre-petition invoices, are deemed to be a general unsecured claim. Experience indicates that such claims often have little value, so rejecting a contract is a cheap and easy for the debtor.

If the debtor assumes a contract it must “cure” defaults, including paying pre-petition obligations owed. In a “true” Chapter 11 reorganization (as opposed to a “liquidating 11” involving a Section 363 sale), it is unlikely that a debtor will assume a contract until close to plan confirmation. This is because the Bankruptcy Code provides that the non-debtor party must continue performing post-petition unless and until the debtor decides to assume or reject the contract. In addition, once a contract is assumed, any amounts owed under the contract, including damages arising from a subsequent breach of contract, are administrative claims. Thus, if the Chapter 11 case fails, an assumed executory contract increases the amount of administrative claims that must be paid. Debtors often wait to see if the Chapter 11 succeeds before it commits to assumption.

In recent times, however, many Chapter 11 cases are filed as liquidating Chapter 11’s with the purpose of selling the assets as a going concern to a strategic or financial buyer who intends to continue the debtor’s business operation. If the debtor’s business depends on a particular supply contract, the buyer in a Section 363 sale will likely condition its purchase on obtaining an assignment of the contract. Assumption is a condition of assignment in the Bankruptcy Code.

Almond Products, Inc. involved a Chapter 11 case where the “main event” was a Section 363 sale of all of the assets. Apparently the buyer of the assets wanted the supply contract at issue. The vendor was owed \$518,786, but agreed to accept 70% as its cure payment. The contract was then assumed and assigned to the buyer. Once the Section 363 sale was completed, the case was converted to Chapter 7. As is often the case, the Chapter 7 trustee filed preference complaints against numerous pre-petition suppliers including one against the vendor whose supply contract was assumed, seeking to recover \$1.4 million. The vendor asserted that the payments did not meet all of the elements of a preference that a trustee must prove.



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To establish a preference claim, the trustee has the burden of proving certain elements: (1) a payment within the 90 day period, (2) that is on account of an antecedent debt (an existing debt, such as that arising from delivery of goods or services), (3) that was made to or for the benefit of the creditor, (4) made while the debtor was insolvent, and (5) that enabled the creditor to receive more than it would in a liquidation. The last requirement is why payments on secured claims are usually not preferential ... because a lender with collateral will usually receive payment in a liquidation.

However, the last requirement is also not met in the case of an assumed executory contract, since any missed payments would have been part of the cure amount. The Bankruptcy Court agreed with Almond Products that the assumption of its supply a contract shielded Almond Products from any preference liability. The trustee has appealed the Bankruptcy Court’s decision, so stay tuned for further developments. However, we believe the Bankruptcy Court’s ruling will be upheld.