

# When a Contract Counterparty Files for Bankruptcy

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# Bankruptcy Is Part of the Human Condition

If a man owe a debt and Adad [the Babylonian storm god] inundate his field and carry away the produce, or, through lack of water, grain have not grown in the field, in that year he shall not make any return of grain to the creditor, he shall alter his contract-tablet and he shall not pay the interest for that year.



Hammurabi's Code, Section 48

# Introduction

- Nobody here will have direct experience with bankruptcy (we hope)
- But sometimes you will deal with other less fortunate souls
- What do you need to think about?
- What must you do?



# Our Scenario

- Solvent Corp. has a contract with Bankrupt Co.
- Solvent and Bankrupt license intellectual property to each other
- Solvent sells widgets to Bankrupt
- Solvent extends 30-day terms, secured by a small letter of credit (not enough to cover the whole balance)
- Solvent gets notice Bankrupt just filed – what does Solvent do?

# Notice of Appearance?

- Ordinarily, you will only receive notice of the bankruptcy and certain extraordinary events
- In big cases, you may be one entry among hundreds or thousands
- Lawyers won't get notice without filing notice of appearance in the case
- Although it will cost a little more to have lawyers watch the docket, often it is worthwhile for important relationships
- Lot's of information available through bankruptcy dockets, whether or not your lawyer appears in the case



# The Automatic Stay

- Bankruptcy generally imposes automatic stay on creditor action
- Covers attempts to collect pre-bankruptcy debts, all property of estate
- Substantial penalties for willful violations
- So don't fire off demands without talking to counsel
- Inquiries generally okay
- Exceptions for certain swap contracts, forward agreements, and exercise of "police power"

# Your Widgets – Must You Keep Shipping?

- Surprisingly little authority describes whether you must keep shipping, and on what terms
- Could depend on terms of your contract
  - Committed supply contract means you probably should keep shipping
  - No commitment to ship gives you more wiggle room
- May be fair to ask for some kind of assurance of payment, such as COD
- No post-bankruptcy financing without court approval



# Goods in Process and Shipments

- Partly depends on terms of the contract
- Title issues may be resolved unexpectedly under the UCC
  - Generally, you don't own anything delivered to retailer, no matter what the contract says
- Think about carrier liability issues
  - Basic rule is that carrier is always paid
  - Pay attention to your bill of lading
  - Other payment arrangements don't matter unless they are part of contract with the carrier



# Protect Your Claim!

- Bankruptcy law incorporates the concept of “reclamation” of goods
- Must deliver notice to preserve reclamation rights
- Consider PACA liens, state law liens giving special rights or protections (like warehouseman and landlord liens)
- Dig out your letter of credit and make sure you have the documents you need

# But Don't Offset New Invoices to Pay the Old

- Resist temptation to short pay any amounts owed to Bankrupt
- Setoff requires mutual obligations
- Setoff generally requires relief from automatic stay
- May implement “temporary administrative hold” to give you time to go to court (particularly useful to banks with deposit accounts)
- Recoupment does not require stay relief, but talk to a lawyer before leaping to conclusions

# File Your Proof of Claim

- Simple form, but dramatic consequences, like consent to jurisdiction
- Sometimes you don't need to file a claim; e.g., if your claim is listed as undisputed on bankruptcy schedules
- Should include supporting documentation
- Include even contingent, unliquidated claims, such as indemnities
- Secured, unsecured, priority (and don't forget setoff rights)

# You May Need a Separate Document for 503(b)(9) Claims

- Applies only to goods received by Bankrupt within 20 days before filing
- Often subject to different procedures for preserving claim
- Administrative expenses generally get paid, while others don't

# Draw On Your Letter of Credit

- Letters of credit are obligations from third parties (usually banks)
- Not ordinarily subject to automatic stay
- Other forms of security, such as surety bonds or cash deposits, may be subject to automatic stay
- That is why letters of credit are the gold standard



# Assumption or Rejection of Contract

- Bankrupt's chance to breach contract without damaging consequences
- Requires court approval – subject to Bankrupt's business judgment
- Rejection just means breach
- Assumption means agreeing to comply with the contract
- Assumption may also involve assignment to a third party

# Rejection

- Breach resulting in ordinary claim for damages
- Claim treated like most other claims – badly
- Not termination – does not require invocation of termination provisions
- Claim calculated under applicable state or other substantive law
  - Note cap on real property lease rejection damages
- Specific performance theoretically possible, but tough to obtain

# Intellectual Property Licenses After Rejection

- Solvent's license of intellectual property from Bankrupt is probably protected
- 11 U.S.C. § 365(n) gives explicit protection to patents and copyrights
- Some courts extend those protections to trademarks
- Gives Solvent the option to keep using the IP, subject to payment of royalties
- Obviously there is no right for Bankrupt to keep using IP licensed from Solvent after rejection



# Assumption

- Procedure allowing Bankrupt to wipe away prior defaults
- Must cure existing defaults and provide adequate assurance of future performance
- Most non-curable defaults (e.g., bankruptcy) are deemed cured
- May assume and assign, subject to certain restrictions on assignability

# Intellectual Property Licenses After Assumption

- In the Ninth Circuit, “hypothetical” test may prevent assumption even without assignment
- In other jurisdictions, assumption may be permitted, but not assignment
- Depends on the kind of intellectual property involved



# Bankruptcy Sales and Plans of Reorganization

- Other strange things may happen in sale orders, plans of reorganization
- Debtors may try to slip in third party injunctions, termination provisions
- Will generally determine how much goes to creditors, which contracts will be assumed and assigned (or rejected)

# Discharge and Closing the Case

- Individual debtors get a discharge order, which is like a permanent injunction
- Corporate debtors may get similar injunction through plan of reorganization
- Closing of case has no particular significance—may be reopened to administer estate property



# Questions?



# Biographies



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