

**SUPPLY CONTRACTS:
RIGHTS OF THE NONDEFAULTING SELLER OR BUYER**

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I. IDENTIFICATION AND ANALYSIS OF CONTRACT WITH TROUBLED SUPPLIER

A. Article 2 of the Uniform Commercial Code (“UCC”) Governs All Transactions Involving the Domestic Sale of Goods

1. Identification and Analysis of Typical Contract Documents. One of the first tasks of counsel to a vendor or customer of a troubled supplier is to collect and analyze all documents evidencing the contract or contracts for the purchase and sale of the subject goods. These documents include requests for quotations, purchase orders, invoices, and any amendments of those pieces of paper. Sometimes, correspondence exchanged between the parties will have the effect of modifying the contract terms. These documents are almost always prepared on the basis of preprinted forms that contained detailed terms and conditions printed on the reverse side of the form or on a separate sheet. Sometimes, certain basic terms in the parties’ documents conflict in which case the conflict must be resolved with reference to section 2-207 of the UCC or other applicable law. After these documents have been collected and reviewed, legal counsel to the vendor or customer of the troubled supplier should interview the persons employed by the client that were primarily responsible for maintaining the business relationship with the troubled supplier. Counsel conducting these interviews should address any ambiguities, conflicts or omissions in the contract documents and obtain factual background concerning the parties’ business relationship.

2. General Rules of Contract Formation and Construction

a. Article 2 Of The Uniform Commercial Code. Article 2 of the UCC establishes uniform provisions governing the sale of goods. Article 2 also covers contract formation, contract terms, contract enforcement, and warranties. It is important to note that Article 2 is not the same in each state. When adopting the UCC, certain states altered the UCC’s model version of Article 2 by removing or adding certain provisions. Therefore, any analysis should begin with applicable state statutory and case law to ensure accuracy. Since the focus herein is not on a particular state, Article 2 of the generic UCC will be analyzed.

b. The Sale Of Auto Parts. At its most basic level, Article 2 applies to the sale of goods. UCC § 2-102. Goods are defined as “all things that are movable at the time of identification to a contract for sale” including future goods and specially manufactured goods. UCC § 2-103(1)(k); *Propulsion Technologies, Inc. v. Attwood Corporation*, 369 F.3d 896, 900 (5th Cir. 2004) (the UCC definition of goods is broad); *True North Composites, LLC v. Trinity Industries, Inc.*, 65 Fed.Appx. 266, 271 (Fed. Cir. 2003) (unpublished decision); *Waterfront Properties, Inc. v. Xerox Connect, Inc.*, 2006 WL 266581 at *4 (W.D. N.C. Jan. 31, 2006); *Bell v. United Auto Group*, 2006 WL 231572 at *2 (D. N.J. Jan. 30, 2006). Article 2 further provides that “[g]oods must be both existing and identified before any interest in them may pass.” UCC § 2-105(1). Goods that are neither existing nor identifiable are considered “future goods” and any

“purported present sale of future goods or of any interest therein operates as a contract to sell.”
Id.

In the current auto supplier world of just-in-time delivery and reduced or no stockpiles most, if not all, contracts with auto suppliers will be contracts for the sale of future specially manufactured goods. *See, e.g., Propulsion Technologies, Inc. v. Atwood Corp.*, 369 F.3d 896, 901 n.21 (5th Cir. 2004). (“The U.C.C. specifically addresses the circumstance of goods ‘to be specially manufactured for the buyer and ... not suitable for sale to others in the ordinary course of the seller’s business’”) (citations omitted). Therefore, specially manufactured goods purchased from auto suppliers for future delivery fall within the purview of Article 2. Accordingly, interest in specially manufactured goods will not pass to the buyer until the goods are identifiable. This time frame is important for a purchaser to know when its rights attach to the goods. Such goods may be sold in bulk, lots or commercial units. UCC § 2-105(3)-(5).

c. Know Your Contract Rights. When negotiating with an auto supplier, it is important to know your contract rights to ensure that you are obtaining the benefit of your bargain and retaining the protections afforded under Article 2. *Standard Bent Glass Corp. v. Glassrobots Oy*, 333 F.3d 440, 444 (3d Cir. 2003) (the UCC recognizes “the bad fact that many . . . sales contracts are not fully bargained, not carefully drafted, and not understandingly signed by both parties”)(citations omitted). The following points will assist purchasers in dealing with auto suppliers.

- Purchasers should add terms and conditions at the time of contract formation that may be useful if the contract is challenged or breached at a later date - such as a reasonable liquidated damages provision and arbitration clause. *In re Exemplar Manufacturing Co.*, 2005 WL 2605612 (Bankr. E.D. Mich. Oct. 14, 2005) (liquidated damages provisions must be reasonable to be enforceable); *Standard Bent Glass Corp.*, 333 F.3d at 447-48 (3d Cir. 2003) (arbitration clause part of the agreement).
- Purchasers should inspect documents received from an auto supplier and be able to identify whether or not the auto supplier added additional terms/deleted terms that may change the original offer or exclude certain warranties.
- Troubled auto suppliers may alter form contracts by adding or deleting terms. Therefore, purchasers should never rely on common practice or previous contracts because the terms may not be the same. All contracts should be carefully reviewed to ensure that the terms of the same as previously agreed upon.

These changes or exclusions are not welcome surprises at a later date when the relationship between the parties is not very cordial. Documents are regularly exchanged between parties contracting for the sale of goods; however, these documents rarely contain all of the terms and conditions the parties think are applicable to the transaction. Further, documents such as purchase agreements, purchase orders, letters, and other correspondence may be exchanged between the parties and affect the terms and conditions of the initial offer or previous contract. Since supply agreements, purchase agreements, and purchase orders in the auto industry regularly cover extended periods of time (sometimes for the entire life of a part), it is important to carefully review subsequent purchase orders and other correspondence to ensure that the auto

supplier is not attempting to change the original agreement. It is much easier to control the terms of the deal during formation rather than attempting to “clarify” the deal terms later through litigation.

d. Contract Formation. At its most basic level, a contract is an agreement. UCC § 2-204(1). The analysis, however, is not that simple. There first must be an offer, usually in the form of a supply agreement, purchase agreement, or purchase order, that invites a reasonable acceptance by the auto supplier. UCC § 2-206; *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393, 427-428 (2nd Cir. 2004) (acceptance may be by “word, act, or conduct which *evinces the intentions of the parties to contract*”) (emphasis in original). For example, a purchase order requesting the “prompt or current shipment” of parts from an auto supplier is an offer that invites acceptance by the auto supplier. *Id.* The auto supplier can either promise to ship the parts or promptly ship the parts. In most instances, the auto supplier will promise to ship by a date certain. If acceptance is not made in a reasonable time, the offeror may treat the offer as having lapsed. In the age of electronic communication, it is important to note that an offer and/or an acceptance may be by electronic means. UCC § 2-204.

(i) Important Definitions. Certain definitions are important when entering into any contract for the sale of goods:

- “**Contract’ for sale** includes both a present sale of goods and a contract to sell goods at a future time.” UCC § 2-106(1).
- “**Contract for sale’** includes both a present sale of goods and a contract to sell goods at a future time.” *Id.*
- “A ‘**sale**’ consists in the passing of title from the seller to the buyer for a price[.]” *Id.*
- “A ‘**present sale**’ means a sale which is accomplished by the making of the contract.” *Id.*
- “Goods or conduct including any part of a performance are ‘**conforming**’ or conform to the contract when they are in accordance with the obligations under the contract.” UCC § 2-106(2).
- “**Termination**’ occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach. On ‘termination’ all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.” UCC § 2-106(3).
- “**Cancellation**’ occurs when either party puts an end to the contract for breach by the other and its effect is the same as that of ‘termination’ except that the canceling party also retains any remedy for breach of the whole contract or any unperformed balance.” UCC § 2-106(4).

(ii) Nonconforming Goods. If the auto supplier does not have or cannot produce goods that conform to the offer, an auto supplier may ship nonconforming goods. UCC § 2-206. The shipment of nonconforming goods is not an acceptance by the auto supplier if the auto supplier “seasonably notifies the buyer that the shipment is offered only as an accommodation to the buyer.” *Id.* The buyer does not have to accept the nonconforming goods; however, the buyer’s remedies may be limited. *A.O. Smith Corporation v. ELBI S.P.A.*, 123 Fed. Appx. 617, 619 (5th Cir. 2005) (“Under the [UCC], breach of contract damages are available for failure to perform, but not for delivery of nonconforming goods . . . [There is] a definitive distinction between failure to conform and failure to deliver. Thus, breach of contract damages are not available when a buyer accepts non-conforming goods. In that instance, breach of warranty is the remedy.”)(citations omitted).

On the other hand a buyer may accept nonconforming goods with an expectation that the nonconforming goods will be “reasonably covered” by the manufacturer. *Atchole v. Silver Spring Imports, Inc.*, 379 F.Supp 2d 797, 803 (D. Md. 2005) (“whether a ‘general right to cure, applicable where a buyer accepts without knowledge of a nonconformity and thus without expectation that it will be cured, is also to be inferred, has been the subject of considerable dispute and the decisions are in conflict’”); *Monarch Nutritional Laboratories, Inc. v. Maximum Human Performance, Inc.*, 205 WL 1683734 at *9 n.13 (D. Utah July 18, 2005) (“The UCC expressly allows a seller to limit a buyer’s remedy to ‘return of the goods and replacement of nonconforming goods or parts.’”).

A buyer should be aware that it can refuse nonconforming goods, which may happen more often than not when the auto supplier is facing troubled times and trying to raise capital by jettisoning its inventory.

(iii) Additional Terms Added to the Contract. A written acceptance can add additional terms that are different from the original offer. UCC § 2-207. The additional terms may not materially alter the contract, unless expressly consented to by the parties. *Gage Products Co. v. Henkel Corporation*, 393 F.3d 629, 641 (6th Cir. 2004) (additional terms found in writings exchanged between the parties and materially alter the original agreement will not be included in the final agreement unless expressly agreed to by the receiving party); *Dallas Aerospace, Inc. v. CIS Air Corporation*, 352 F.3d 775, 781 (2nd Cir. 2003) (material alterations in computing writings are invalid unless expressly consented to). In other words, an acceptance does not have to be the mirror image of the offer. For example, an auto supplier may respond to a purchase order by sending the buyer a writing that changes the original shipment terms, warranties, and/or credit terms.

- Purchasers must be alert to changes and their potential impact, especially with the long-term nature of many contracts with auto suppliers and the numerous documents being exchanged. *Standard Bent Glass Corp.*, 333 F.3d 440, 445 (3d Cir. 2003) (“Under UCC section 2-207(1), the offerer’s expression of acceptance or transmission of a written confirmation generally results in the formation of a contract. This is true unless the offeree makes that expression or confirmation ‘expressly conditional’ on the offerer’s assent to the proposed additional or different terms.”).

- Purchasers must also be alert as to their conduct because conduct can alter the agreements. *Gage Products Co.*, 393 F.3d at 641-42 (notwithstanding a writing to the contrary, conduct between the parties can establish a contract).

The affect of competing contract terms is addressed in UCC § 2-207, which provides:

Subject to Section 2-202, if

- (i) conduct by both parties recognizes the existence of a contract although their records do not otherwise establish a contract,
- (ii) a contract is formed by an offer and acceptance, or
- (iii) a contract formed in any manner is confirmed by a record that contains terms additional to or different from those in the contract being confirmed, the terms of the contract are:
 - (a) terms that appear in the records of both parties;
 - (b) terms, whether in a record or not, to which both parties agree; and
 - (c) terms supplied or incorporated under any provision of this Act.

e. The Statute of Frauds. All contracts for the sale of goods in the amount of \$500 or more must be in writing, contain all material terms and be signed by the party upon which enforcement is sought. UCC § 2-201; *cf. GMAC Business Credit, L.L.C. v. Ford Motor Company et al.*, 100 Fed.Appx. 404, 410 n.1 (6th Cir. 2004) (unpublished) (“the statute of frauds does not apply where the goods have been received and accepted”) (citation omitted); *Cohen Development Company v. JMJ Properties, Inc.*, 317 F.3d 729, 737 (7th Cir. 2003) (statute of frauds does not apply to a contract fully performed by one of the parties); *Camle v. Mattel, Inc.*, 394 F.3d 1355, 1361 (Fed. Cir. 2005). The underlying purpose of the Statute of Frauds is to protect parties to the contract from legal actions based upon alleged terms that were not originally part of the contract. In other words, the Statute of Frauds protects parties from fraudulent actions and baseless claims.

(i) Required Terms. The writing may omit or incorrectly state the terms of the contract, except for the quantity term. UCC § 2-201. The quantity term, however, may be satisfied by a requirements contract. For example, in *Acemco, Inc. v. Olympic Steel Lafayette, Inc.*, Case No. 256638 (Mich. Ct. App. October 27, 2005) the Michigan Court of Appeals held that a supply contract was not enforceable under Article 2 “[b]ecause there is no discernable quantity included in the four corners of the [contract], and because Amemco offered no admissible testimony providing both an admission of a contract for the sale of goods and an admitted quantity, the trial court erred when it denied Olympic’s motion for summary disposition” arguing that a contract was not enforceable. Additionally, the contract was not a requirements contract under UCC § 2-306 and, therefore, the quantity terms could not be satisfied. *See Acemco, Inc. v. Olympic Steel Lafayette, Inc.*, Case No. 256638 (Mich. Ct. App. October 27, 2005); *see Propulsion Technologies, Inc.*, 369 F.3d at 904 (“the formality of written

quantity terms is satisfied by a written specification that buyer will buy exclusively from seller or will buy its 'requirements' from seller"). A contract governed by the Statute of Frauds is not enforceable in an amount of goods greater than listed in the writing.

On the other hand, contracts made between merchants are allowed to deviate from the strict requirements of the Statute of Frauds by confirming an oral agreement by a writing, unless the recipient of the confirming memorandum objects.

(ii) Certain Terms May Remain Open. The general contract formation requirements are forgiving because (i) the exact time of contract formation can be undetermined and (ii) certain nonmaterial contract terms may be left open. UCC § 2-204(2)-(3) ("Even if one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."); *Conner, M. D. v. Lavaca Hospital District*, 267 F.3d 426, 433 (5th Cir. 2001) ("The parties can have some of the contract terms open for future negotiations. Nonetheless, those terms left open cannot be essential or material elements of the contract because having such terms open renders the contract unenforceable under the statute of frauds.").

(iii) Specially Manufactured Goods. The Statute of Frauds is also relaxed with respect to specially manufactured goods. *See GMAC Business Credit, L.L.C. v. Ford Motor Company et al.*, 100 Fed.Appx. 404, 410 n.1 (6th Cir. 2004) ("the statute of frauds does not apply to contracts for specially manufactured goods") (citation omitted); *Arsape S.A. v. JDS Uniphase Corp.*, 2005 WL 2989296 at *5 (D. N.D. Nov. 3, 2005). As previously noted most, if not all, contracts with suppliers will involve specially manufactured goods. Contracts for specially manufactured goods that do not comport with the written requirements of the statute of frauds are enforceable against the buyer if the goods can not be used by others in the ordinary course of the suppliers' business and the supplier begins production or causes production to begin.

(iv) Requirements Contracts. Article 2 of the UCC also addresses output, requirement and exclusive dealing contracts. UCC § 2-306. Contracts with auto suppliers for the amount of goods required to satisfy output requirements are limited to good faith and reasonableness. In other words, a requirements contract for 100 pieces a month can not be unilaterally changed to 1,000 pieces a month. Contracts with respect to the manufacturing of special goods require the supplier to use its best efforts to produce the goods and a concomitant requirement by the buyer to sell the goods. *See Metal One America, Inc. v. Center Manufacturing, Inc.*, Case No. 1:04-CV-431 (W.D. Mich. 2005) (seller's plant shut-down to soften financial losses and termination of requirements contract was in bad faith and considered a breach of the requirements contract) (citing *General Motors Corp. v. Paramount Metal Products Co.*, 90 F.Supp.2d 861 (E.D. Mich. 2000); *Plastech Engineered products v. Grand Haven Plastics, Inc.*, 2005 WL 736519 (Mich. Ct. App. March 31, 2005)).

f. Contract Modification. An additional protection provided by Article 2 is the Parol Evidence Rule. UCC § 2-202. Under the Parol Evidence Rule, written contracts intended by the parties to be their entire and final agreement cannot be changed by prior written agreements or oral agreements made during contract formation - otherwise known as a merger clause. Therefore, contracts with auto suppliers should provide that the contract is

intended to be the entire agreement between the parties and may only be modified by a writing signed by both parties. One exception is that prior written agreements “may be supplemented by evidence of: (a) course of performance, course of dealing, or usage of trade (section 1-303); and (b) consistent additional terms unless the court finds the record to have been intended also as a complete and exclusive statement of the terms of the agreement.” UCC § 2-202.

The Parol Evidence Rule does not prohibit contract modification. Parties to a contract may enter into a subsequent agreement to modify a previous contract, without consideration, subject to certain limitations. *See GMAC Business Credit, L.L.C. v. Ford Motor Co.*, 100 Fed. Appx. 404, 410 (6th Cir. 2004) (“[E]ven if the agreement by its terms required that any modification be in writing, an agreement that modifications to a contract must be made in writing does not preclude the parties from orally modifying the contract, unless the modification falls within the statute of frauds.”). UCC § 2-209 identifies these limitations and provides:

- (1) An agreement modifying a contract within this Article needs no consideration to be binding.
- (2) An agreement in a signed record which excludes modification or rescission except by a signed record may not be otherwise modified or rescinded, but except as between merchants such a requirement in a form supplied by the merchant must be separately signed by the other party.
- (3) The requirements of Section 2-201 [(Statute of Frauds)] must be satisfied if the contract as modified is within its provisions.
- (4) Although an attempt at modification or rescission does not satisfy the requirements of subsection (2) or (3), it may operate as a waiver.
- (5) A party that has made a waiver affecting an executory portion of a contract may retract the waiver by reasonable notification received by the other party that strict performance will be required of any term waived, unless the retraction would be unjust in view of a material change of position in reliance on the waiver.

g. Warranties. Article 2 of the UCC also provides protections to persons contracting with auto suppliers in the form of warranties. *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 872, 106 S. Ct. 2295, 2302-2303 (1986) (“The maintenance of product value and quality is precisely the purpose of express and implied warranties. Therefore, a claim of a nonworking product can be brought as a breach-of-warranty action, or, if the customer prefers, it can reject the product or revoke its acceptance and sue for breach of contract.”) The warranties in Article 2 are as follows:

- § 2-312 - *Warranty of Title and Against Infringement; Buyer’s Obligation Against Infringement*. This warranty provides that the goods purchased from a supplier are conveyed with good title and protect the purchaser from future litigation challenging title. This warranty also provides that the goods purchased are not subject to an unknown security interest, lien or other encumbrance. On the other hand, in the case of specially manufactured goods with specifications provided by a purchaser, the purchaser must protect the supplier from claims arising from the design characteristics of the specially manufactured goods. This warranty may be disclaimed.
- § 2-313 - *Express Warranties by Affirmation, Promise, Description, Sample; Remedial Promise*. Promises made by suppliers with respect to the goods are enforceable. For example, a supplier warrants that a good will conform to a previous description, model or sample. The creation of this warranty is fluid and the terms “warrant” or “guarantee” are not required - an affirmation is sufficient.
- § 2-313A - *Obligation to Remote Purchaser Created by Record Packaged With Accompanying Goods* and § 2-313B - *Obligation to Remote Purchaser Created by Communication to the Public*. Suppliers are required to honor promises (i) made in writings included in packaging and/or (ii) communicated to the public with respect to new goods that are sold or leased not only to the original purchaser or lessee but to a third-party that purchases or leases the new good from the original purchaser or lessee. The words “warrant” or “guarantee” are not necessary - an affirmation is sufficient. The supplier may; however, limit the remedies in the case of breach.
- § 2-314 - *Implied Warranty: Merchantability; Usage of Trade*. Merchants warrant that the goods that they normally sell are merchantable and can be used for their intended purpose, are appropriately packaged, and conform to representations made on the label. This warranty may be excluded or modified.
- § 2-315 - *Implied Warranty: Fitness for a Particular Purpose*. The auto supplier warrants that the goods are fit to be used in the manner relied upon by the purchaser.
- § 2-316 - *Exclusion or Modification of Warranties*. As previously noted, certain warranties may be waived. *See Parsley v. Monaco Coach Corp.*, 327 F.Supp.2d 797 (W.D. Mich. 2004) (disclaimers of express and implied warranties in contract were conspicuous and effective under Michigan law). For example, a

modification of the implied warranty of merchantability in any contract, but a consumer contract, “must mention merchantability and in case of a record must be conspicuous.” *Cole v. U.S. Capital, Inc.*, 389 F3d 719, 730 (7th Cir. 2004)(“A contract’s warranty disclaimer satisfies the conspicuous requirement when it is printed in all capital letters, when it appears in a larger type than the terms around it, or when it is in a larger and boldface type. Likewise, a disclaimer in boldface type, printed in all capitals on the face of the warranty above the buyer’s signature meets the definition of conspicuousness. A disclaimer is not conspicuous, however, when it is printed in small print on the back of the document, when it is the same size and typeface as the terms around it, or when it is not in boldface or capital lettering.”) (quoting *Stevenson v. TRW Inc.*, 987 F.2d 288, 295 (5th Cir. 1993)). Additionally, the warranty of fitness for a particular purpose may be excluded by language stating that “There are no warranties that extend beyond the description on the face hereof.” All implied warranties may also be excluded by language such as “as is”, “with all faults” or other language that indicates that the warranty is excluded.

- § 2-317 - *Cumulation and Conflict of Warranties Express or Implied*. Warranties should be interpreted to be consistent with each other. When the parties’ intention is not clear “(a) [e]xact or technical specifications displace an inconsistent sample or model or general language of description[;] (b) [a] sample from an existing bulk displaces inconsistent general language of description[;] (c) [e]xpress warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose.”

B. United Nations Convention on Contracts for the International Sale of Goods

There may be instances in which a contract for the sale and purchase of goods across national borders between different-tiered suppliers or between a supplier and an OEM is not governed by Article 2 of the Uniform Commercial Code but by the United Nations Convention on Contracts for the International Sale of Goods (“CISG”). The CISG was adopted in 1980 at a diplomatic convention in Vienna, Austria and represented 50 years of efforts by international legal experts to adopt uniform rules for the international sale of goods. For the history of these efforts, see Peter Winship, *The Scope of the Vienna Convention on International Sales Contracts*, published in Galston & Smit, ed., *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender Company (1984). To date, the CISG has been ratified by 66 nations including the United States, Canada, Mexico, France, South Korea and The Peoples’ Republic of China. The text of the CISG is reprinted at 15 U.S.C.A. Appendix (West 2005).

If applicable to a contract for the sale of commercial goods, the CISG will provide “gap filler” rules that govern contract formation and establish the rights and obligations of the buyer and seller. The 101 Articles of the CISG are divided into four parts. Part I sets forth the general provisions on the CISG’s sphere of application and rules of interpretation. Part II codifies the rules on formation of international sales contracts. The five chapters of Part III define the rights, obligations and remedies of the buyer and seller. Part IV defines the relation of the CISG to

other international agreements, describes the reservations that nations are permitted to make to the convention, and provides rules for implementing the CISG.

The CISG applies only to international commercial sales of goods, *viz.*, sales between merchants of goods. Specifically excluded are sales of consumer items, auction or execution sales, and sales of ships, vessels or aircraft. CISG, Article 2. In order to be “international” in character, the sale must involve “parties whose places of business are in different states.” CISG, Article 1(1). The United States, when ratifying the CISG, stipulated that, absent express agreement by the parties to an international sales contract, the CISG would not apply to contracts between a U.S. party and a party whose place of business is in a nation that has not adopted the CISG. The provisions of the CISG do not apply to contracts for the delivery of services only. When a contract includes both goods and services, the CISG will apply when the sale of goods constitutes the “preponderant part” of the seller’s obligations. CISG, Article 3(2).

A primary benefit of the CISG to American exporters of goods is that it modulates disagreements concerning choice of law provisions in contracts for the international sale of goods. The contracting parties can elect to have the CISG provide the rules concerning the formation, performance and breach of contracts that can be easily discerned by reference to the CISG’s provisions and to court decisions interpreting them. An annotated version of the CISG and texts of court decisions from subscribing countries interpreting the CISG can be found on the following website maintained by Pace University: <http://joe.law.pace.edu>.

Finally, the CISG’s rules closely parallel the provisions of UCC Article 2 and American courts will often refer for guidance to case law decided under a provision of Article 2 when its language closely tracks a corresponding provision in a CISG Article. *See, e.g., Delchi Carrier S.p.A. v. Roforex Corp.*, 71 F.3d 1024, 1028 (2d Cir. 1995); *Raw Materials Inc. v. Manfred Forberich GmbH & Co., KG*, 2004 WL 1535839 (N.D. Ill. 2004). Nevertheless, there are important differences between the CISG and Article 2 of the UCC, which must be kept in mind when an American buyer or seller of commercial goods negotiates an international sales transaction. These primary differences are as follows:

1. *Price Specification.* Under the CISG, a contract for the sale of goods will not exist unless a price term or a provision for determining price is provided in the agreement. CISG Article 14(1). Section 2-305 of the UCC, in contrast, permits the formation of an enforceable sales contract when there is no specified price.

2. *Offer Revocability.* Article 16(2)(b) of the CISG provides that a written or oral offer will become irrevocable when the offeree reasonably relies on it. Under section 2-305, an offer to be irrevocable must be stated in writing.

3. *Terms of Acceptance.* Under CISG Article 18(2), an acceptance of an offer occurs at the instant the acceptance reaches the offeror in a timely manner. In the majority of jurisdictions that have adopted UCC Article 2, acceptance occurs when it is mailed or transmitted by the offeree to the offeror.

4. *Battle of the Forms.* The CISG adopts the “mirror image” rule of offer and acceptance. If the acceptance materially alters the terms of the offer, the offer is deemed rejected

and the acceptance becomes a counteroffer. CISG Article 19. Section 2-207 rejects this “mirror image” rule, permitting a contract to result from the “battle of the forms.”

5. *Statute of Frauds.* The CISG does not require that, in order to be enforceable, a contract must be reduced to writing. In contrast, UCC Section 2-201 requires most commercial contracts to be evidenced by a writing “sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought.” UCC § 2-201(1).

Finally, when international sales contracts involve the rights of third parties, an American buyer or seller of goods must be aware that the CISG does not contain any provisions concerning third party beneficiaries. If the CISG applies to a contract, third party rights are determined by applicable local law. *See, e.g., Caterpillar, Inc. v. Usinor Industeel*, 305 F.Supp.2d 659 (N.D. Ill. 2005).

C. Special Tooling Issues

The term, “tooling,” as used in the auto industry encompasses a broad range of tangible personal property that is used to make metal or plastic parts for incorporation into a motor vehicle. Other descriptions of this special type of property are dies, molds, jigs and patterns. Existing tooling is sometimes delivered by the OEM to a supplier already fabricated, such as when an OEM switches suppliers (referred to as “resourcing”), or is specially ordered by the OEM to be manufactured by the supplier who will then use the tooling to produce parts for the OEM. In other instances, a higher-tiered supplier may contract with a lower-tiered supplier to fabricate the required tooling on the basis of provided specifications and drawings. If tooling is withdrawn from the automotive production process, assembly lines are subject to shutdown, which will reverberate throughout the manufacturing process. “For the want of a nail, the shoe was lost. . . .”

1. Customer-Supplied or Ordered Tooling. In order to enable suppliers to produce automotive parts, OEMs will often deliver finished tooling to those suppliers under the terms of a bailment agreement. In this agreement, the supplier-bailee is required to recognize that it holds no title to the tooling, which remains in the OEM-bailor. The only interest held by the supplier in this property is one of possession and use as directed by the OEM. The bailment agreement will normally provide that it is terminable upon default or the OEM at will and that, upon termination, the supplier must surrender possession of the bailed property to the OEM. The bailment agreement may also require the bailee to waive any rights that it has under any tooling lien statute or common law artisan’s lien. For example, General Motors’ Contract Terms and Conditions, at Paragraph 19, states as follows:

All supplies, materials, tools, jigs, dies, gauges, fixtures, molds, patterns, equipment and other items furnished by Buyer (i.e., General Motors) to perform this contract, or for which seller has been reimbursed by Buyer, shall be and remain the property of Buyer and held by Seller on a bailment basis (“Buyer’s Property”). Seller shall bear the risk of loss and damage to Buyer’s Property. Buyer’s Property shall at all times be properly housed and maintained by Seller, at its expense, and shall not be used by Seller for any purpose other than the

performance of this contract; shall be deemed to be personalty; shall be conspicuously marked by Seller as the property of Buyer; shall not be commingled with the property of Seller or with that of a third person; and shall not be moved from Seller's premises without Buyer's prior written approval. Buyer shall have the right to enter Seller's premises at all reasonable times to inspect such property and Seller's records with respect thereto. Upon the request of Buyer, Buyer's Property shall be immediately released to Buyer or delivered to Buyer by Seller, either (i) F.O.B. transport equipment at Seller's plant, properly packed and marked in accordance with the requirements of the carrier selected by Buyer to transport such property, or (ii) to any location designated by Buyer in which event Buyer shall pay to Seller the reasonable costs of delivering such property to such location. When permitted by law, Seller waives any lien or other rights that Seller might otherwise have on any of Buyer's Property for work performed on such property or otherwise.

General Motors Corporation's Motion for Contingent Relief from Automatic Stay to Obtain Possession of Tooling dated September 2, 2005 at pages 6-7 filed in *In re Collins & Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich.).

In other circumstances, the OEM may contract with the supplier for the fabrication of tooling based on specifications and drawings supplied by the OEM. After its fabrication, the tooling may be retained by the supplier for production of parts separately contracted for by the OEM. This often occurs when there is a change in the design of an automobile. The contract documents providing for the creation of this tooling will normally provide that, upon payment in full of the tooling's purchase price, title to that property will pass to the OEM and that the tooling will be held by the supplier as a bailee to manufacture parts. These documents will also require that the tooling be stamped with the OEM's part number or other identifying marks. A sample tooling purchase order submitted by DaimlerChrysler to Collins & Aikman Auto Trim, Inc. contains the following language:

Tools purchased under this Order as an end item when completed and paid for by DaimlerChrysler, become DaimlerChrysler's property and are subject to all the provisions of Clause 10 of the General Terms and Conditions of this Order. In addition, each tool is to be clearly stamped or stenciled with a tool number and DaimlerChrysler's part number of the part which the tool is intended to produce Equipment to produce the above part, having been completed and paid for by DaimlerChrysler is DaimlerChrysler's property and is to be maintained in accordance with Clause 10 of the General Terms and Conditions.

DaimlerChrysler Corporation's Motion for Contingent Relief from Automatic Stay to Obtain Possession of Tooling, dated September 12, 2005 filed in *In re Collins & Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich.)

2. Tooling Manufactured by Supplier for Another Supplier. In order to produce a part for a motor vehicle, a supplier may contract with a lower-tiered supplier for the manufacture of tooling. For an example of such a scenario, see *American National Bank and Trust Co. v. Matrix IV, Inc. (In re S.M. Acquisition Co.)*, 296 B.R. 452 (Bankr. N.D. Ill. 2003),

remanded 2004 WL 1151575 (N.D. Ill. April 29, 2004), *on remand* 319 B.R. 553 (Bankr. N.D. Ill. 2005). In the contract documents providing for the manufacture of tooling, the fabricating supplier may obtain a purchase-money security interest in the equipment so produced and perfect that interest by filing a Uniform Commercial Code financing statement with the proper filing office at the time that the purchaser obtains possession of the tooling or within 20 days thereafter. UCC § 9-324(a). The fabricator may also hold a common law artisan's lien in the tooling while it is in his possession. *See, e.g., In re Alston*, 322 B.R. 265 (Bankr. D. N.J. 2005) (New Jersey law); *In re Lott*, 196 B.R. 768 (Bankr. W.D. Mich. 1996) (Michigan law); *cf., Enterprise Products Operating, L.P. v. Enron Gas Liquids Inc. (In re Enron Corp.)*, 306 B.R. 33 (S.D.N.Y. 2004), *aff'd*, 119 Fed.Appx. 344 (2d Cir. 2005) (natural gas fractionator not entitled to artisan's liens under Texas law). Finally, the manufacturer of the tooling may be granted a lien under state special tooling statutes. For examples of these statutes, *see* 770 ILCS 105/1-6 (Illinois); 66 Tenn. Code Ann. § 1-5 (Tennessee); and IC 32-33-16-1 through 32-33-16-9 (Indiana); Mich. Comp. Laws §§ 570.541 *et seq.* and 445.611, *et seq.* (Michigan). These state statutes generally permit the tooling manufacturer to repossess and sell the tooling in order to recover amounts due by the defaulting supplier-purchaser. *See, e.g., In re Outboard Marine Corp.*, 304 B.R. 844 (Bankr. N.D. Ill. 2004) (interpreting Indiana statute); *Gateplex Molded Products, Inc. v. Collins & Aikman Plastics, Inc.*, 681 N.W.2d 1 (Mich. Ct. App. 2004) (interpreting Michigan statute).

II. REMEDIES AVAILABLE TO NONDEFAULTING PARTY

A. Request for Adequate Assurance Under UCC § 2-609

Often, certain factors will lead a seller to believe that a buyer is experiencing financial difficulties which may result in the buyer's inability to provide payment for goods, or otherwise render it unable to perform its obligations under an agreement. Perhaps the relationship in the auto industry most susceptible to such concerns is that between the supplier and customer, where the supplier believes the customer is in financial crisis and it is industry knowledge that the customer is considering a major restructuring or even filing for bankruptcy. In such a situation, the supplier is likely to experience subjective, although not necessarily objective and reasonable, insecurity with respect to the customer's ability to perform under the existing purchase orders and requirements contracts that it has with the customer.

The UCC authorizes a party, upon reasonable grounds for insecurity, to demand adequate assurances of due performance and until it receives such performance, . . . if commercially reasonable, to suspend any performance for which he has not already received the agreed return. UCC § 2-609(1). However, the UCC does not require a party to request assurances as a condition precedent to recovery. *Hessler v. Crystal Lake Chrysler-Plymouth, Inc.*, 788 N.E.2d 405, 415 (Ill. Ct. App. 2003). The purpose of a demand under section 2-609 is to permit a party likely to be injured by the other party's nonperformance to take steps to protect itself without worrying that its own nonperformance will later be construed as a repudiation. *See U.S. v. Great Plains Gasification Associates*, 819 F.2d 831, 835 (8th Cir. 1987).

Whether a supplier has reasonable grounds for insecurity is generally a question of fact. *Puget Sound Energy*, 271 B.R. at 640; *but see BAI Banking Corp. v. UPG, Inc.*, 985 F.2d 685, 703-04 (2d Cir. 1993) (deciding as matter of law no reasonable ground for insecurity existed).

Because the reasonableness of a supplier's insecurity is determined by commercial standards, an objective factual basis must exist for the supplier's insecurity, as opposed to a purely subjective fear that the customer will not perform. *Top of Iowa Coop. v. Sime Farms, Inc.*, 608 N.W.2d 454, 466 (Iowa 2000). The UCC provides a broad definition of the circumstances that could cause a supplier's insecurity, including the solvency of a customer. UCC § 2-609 cmt. 4. However, the supplier's dissatisfaction with the customer's financial standing cannot be false or arbitrary. *Enron Power Marketing, Inc. v. Nevada Power Co.*, 2004 WL 2290486 at *3 (S.D.N.Y. Oct. 12, 2004).

Along those lines, a supplier will not have a reasonable ground for insecurity based solely on the fact that its customer filed for bankruptcy. See *In re Beeche Systems Corp.*, 164 B.R. 12, 16-17 (N.D.N.Y. 1994). However, reasonable security may arise solely from the customer falling behind on its account with supplier. *Hornell Brewing Co., Inc. v. Spry*, 174 Misc.2d 451, 455 (N.Y. Sup. Ct. 1997). So long as the customer continues to satisfy its contractual obligations and does not indicate that it does not intend to honor future obligations, the supplier has no reasonable grounds for insecurity. *Id.*; but see *Clem Perrin Marine Towing, Inc. v. Panama Canal Co.*, 730 F.2d 186, 191 (5th Cir. 1984) (reasonable grounds for insecurity exists where another entity was making payments on behalf of customer).

The UCC requires a clear demand so that all parties are aware that, absent assurances, the demanding party will withhold performance. *Puget Sound Energy, Inc. v. Pacific Gas and Elec. Co.*, 271 B.R. 626, 642 (N.D. Cal. 2002) (citations omitted); see *Johnson v. Land O'Lakes*, 181 FRD 388, 394 (N.D. Iowa 1998) (demand must be in writing); *Beeche Systems*, 164 B.R. at 12 (letter stating concern about ability to perform that does not track language of 2-609(1) is not request for assurance of performance); but see *AMF, Inc. v. McDonald's Corp.*, 536 F.2d 1167, 1170-71 (7th Cir. 1976) (rejecting formalistic approach and holding oral or written demand acceptable, so long as clear understanding). Any demand for adequate assurance typically needs to be answered within thirty (30) days, unless the express terms of the agreement reduce or extend such period. *Enron Power Marketing*, 2004 WL 2290486 at *3.

Where a customer fails to timely respond to a supplier's demand, the supplier should take immediate action to terminate the agreement or the supplier will risk waiving the right to terminate. *Puget Sound Energy*, 271 B.R. at 643 (citing *National Fuel Gas Distrib. v. TGX Corp.*, 1992 WL 170819 (W.D.N.Y. July 10, 1992)); but see UCC § 2-610 cmt. 4 (aggrieved party may proceed with remedies, including termination, unless it has taken some positive action which in good faith requires notification to the other party before remedy is pursued). As an alternative, a supplier who wishes to continue performance after expiration of the thirty (30) day period may do so without waiving any of its rights to seek remedies by expressly and explicitly reserving its rights. *Nat'l Fuel Gas Distrib.*, 1992 WL 170819 at *11 (W.D.N.Y. July 10, 1992).

Whether a customer will be deemed to have offered adequate assurance is determined by factual conditions, including an exercise of good faith and observance of commercial standards. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985). An absolute definition of adequate assurance does not exist, though. In some cases, the assurance offered by the customer may be less than a supplier demands and still be considered adequate. *By-Lo Oil Co., Inc. v. Partech, Inc.*, 11 Fed. Appx. 538, 545 (6th Cir. 2001). Prior to demanding adequate assurance, the supplier should assess whether the requested assurances are reasonable. If the

assurances demanded are more than adequate and the customer refuses to accede to the excessive demands, a court may find that the demanding supplier is in breach or has itself repudiated. *Hope's Architectural Prod., Inc. v. Lundy's Construction, Inc.*, 781 F.Supp. 711, 716 (D. Kan. 1991); *see also* UCC 2-609 cmt. 4 (promise by seller that defect will not be repeated normally sufficient). As such, a supplier's request for adequate assurance must be reasonable under the circumstances and not be tantamount to overreaching.

B. Anticipatory Repudiation Under UCC § 2-610

The UCC provides that when a party “repudiates the contract with respect to performance not yet due, the loss of which will substantially impair the value of contract, the aggrieved party may . . . resort to any remedy for breach . . . even though he has notified the repudiating party that he would await the latter's performance and has urged retraction. . .” UCC § 2-610.

As discussed above, in a typical relationship between supplier and customer, certain factors, including statements or actions, may lead the supplier to believe that the customer will be unable to continue to perform its obligations pursuant to applicable agreements. In such a situation, a supplier may be tempted to infer that such statements or actions constitute a repudiation of the applicable agreement by the customer. However, a supplier must cautiously proceed with respect to anticipatory repudiation, which is deemed to have occurred where the statements or actions are unequivocal, definite and final or where an action reasonably indicates a rejection of the customer's continuing obligations. *See* UCC § 2-610 cmt. 1; *Cabot v. Lucent Technologies, Inc.*, 836 N.E.2d 349 (Mass. Ct. App. 2005) (citations omitted).

If a supplier regards an apparent repudiation as an anticipatory repudiation, terminates its own performance and sues for breach, the supplier is placed in jeopardy of being found to have itself breached if the court determines that the apparent repudiation was not sufficiently clear and unequivocal to constitute an anticipatory repudiation justifying nonperformance. *Norcon Power Partners, LP v. Niagra Mohawk Power Corp.*, 705 N.E.2d 656, 668 (N.Y. 1998) (citation omitted). Conversely, if a supplier continues to perform after an apparent repudiation that, unbeknownst to the supplier, is actually an anticipatory repudiation, the supplier may be denied recovery for post-repudiation expenditures because of its failure to avoid those expenses as part of an effort to mitigate damages after the repudiation. *Id.* (citation omitted). Thus, where the supplier is unclear as to whether an anticipatory repudiation has occurred, it is advisable for the supplier to utilize section 2-609 of the UCC by demanding adequate assurance of future performance.

On its face, section 2-610 of the UCC appears to allow suit for breach upon a demand by the other party for more than the contract requires. *See* UCC § 2-610; *see also* *Norcon Power Partners*, 705 N.E.2d at 659 (under common law, suit allowed where party commits voluntary affirmative act rendering obligor unable or apparently unable to perform). The UCC cautions though, that a demand for more than what the contract requires in the way of counter-performance is not a repudiation. Rather, only when such demand amounts to an intention not to perform except on conditions which go beyond the contract does the demand constitute a repudiation. *See* *Government of Rep. of China v. Compass Comm.*, 473 F.Supp. 1306 (D. Colo. 1979) (seller's unequivocal refusal to perform by word or conduct constitutes anticipatory repudiation). Similarly, a request for modification of a contract does not amount to a

repudiation. *Truman L. Flatt & Sons Co., Inc. v. Schupf*, 649 N.E.2d 987, 990 (Ill. Ct. App. 1995).

In order to qualify as an anticipatory repudiation, the performance repudiated must substantially impair the value of the contract to the other party. UCC § 2-610; *see Cary Oil Co. v. MG Ref. & Mktg., Inc.*, 90 F.Supp.2d 401, 411 (S.D.N.Y. 2000). While such a requirement is seemingly easily satisfied in cases of non-payment under non-requirements contracts, it becomes somewhat more complicated under requirements contracts. Where a supplier and customer enter into requirements contracts over several years, and the contract contains a minimum overall requirement, the customer may not be considered to have repudiated due to its failure to order its yearly requirements. *See id.* at 410-11. Instead, because the overall requirements would be satisfied, the reduction in orders for the contract's final year would not amount to a substantial impairment of the contract's value. *See id.*

Generally, the material breach of one contract does not justify an aggrieved party in refusing to perform another separate and distinct contract. *National Farmers Organization v. Bartlett and Company, Grain*, 560 F.2d 1350, 1357 (8th Cir. 1977); *Barz v. Geneva Elevator Co.*, 12 F.Supp.2d 943, 961 (N.D. Iowa 1998). Therefore, the aggrieved supplier should refrain from attempting to exercise its rights under section 2-610 with respect to agreements that the customer has not breached. Instead, it is advisable for the supplier to rely on the provisions of section 2-609 and demand adequate assurance of performance based, in part, on the customer's inability to perform the repudiated contract.

With respect to a supplier's actions for anticipatory repudiation, section 2-610(b) provides that an aggrieved party may "resort to any remedy for breach" of the contract "even though he has notified the repudiating party that he would await the latter's performance." UCC § 2-610(b). Therefore, despite a supplier's representations to the contrary, the supplier could exercise its rights under sections 2-701 *et seq.* of the UCC.

C. Sellers' Remedies Under UCC Article 2

1. In General. Part 7 of Article 2 of the Uniform Commercial Code creates remedies for breach of contract for the benefit of nondefaulting sellers and buyers of goods on credit terms. In the automotive industry, sellers entitled to assert these remedies include vendors to higher tiered suppliers or to an OEM customer. These remedies are summarized in section 2-703 of the UCC and are discussed below.

2. Termination of Credit Terms. In the circumstance where a seller determines that its buyer that is purchasing goods on credit terms, is "insolvent" may refuse to ship goods on credit terms to the buyer. UCC § 2-702(1). The term, "insolvent," is defined in UCC § 1-201(23) as a person "who either has ceased to pay his debts in the ordinary course of his business or cannot pay his debts, as they come due or is insolvent within the meaning of the federal bankruptcy law." *See, e.g., Monsanto Co. v. Walter E. Heller & Co. Inc.*, 114 Ill. App. 3d 1078, 449 N.E.2d 993 (1983). In these circumstances, a seller may insist upon cash payment for further shipments of goods on a cash in advance or cash on delivery basis. *Id.* *See also Maddux Supply Co. v. A-C Electric Co.*, 321 S.C. 182, 467 S.E.2d 448 (1996).

3. Reclamation. Reclamation is a remedy provided to unpaid sellers of goods under section 2-702 of the UCC. It allows sellers of goods on credit to an “insolvent” buyer to reclaim those goods from the seller’s possession. To exercise this right of reclamation, the seller must carefully follow the procedures set forth in §2-702(2) of the Uniform Commercial Code. Specifically, the seller must make demand within ten (10) days after the goods are received by the buyer.¹ Although the UCC does not require the demand to be made in writing, the prudent seller is well advised to make such a demand and to transmit it on an expedited basis by overnight courier, email and facsimile to the buyer. This demand should contain a list of the specific goods shipped by invoice number and description. The seller should retain records concerning proof of delivery, the invoices for the reclaimed goods, and the actual written notice of reclamation for judicial enforcement of the demand. *See generally, In re Builders Capital and Services, Inc.*, 317 B.R. 603 (Bankr. W.D.N.Y. 2004).

A seller’s reclamation rights are subject to the rights of a buyer in the ordinary course or other good faith purchaser. Consequently, reclamation of the goods may not be possible if a creditor of the buyer holds a security interest in inventory that attaches to the goods sold on credit. Such a creditor is deemed to qualify as a good faith purchaser under the overwhelming weight of reported case law. *See, e.g., In re Nitram, Inc.*, 323 B.R. 792 (Bankr. M.D. Fla. 2005); *In re McLouth Steel Corp.*, 22 B.R. 722 (Bankr. E.D. Mich. 1982).

If the reclamation demand is proper and the goods are not subject to the lien of a senior lender and have not been consumed or sold, the seller has the right to a return of the subject goods. Under the UCC, the seller may use “self-help” to obtain possession of the goods, but may not breach the peace to do so. Thus, if the buyer refuses to turn over the goods, the seller may be required to file a replevin action in state or federal court to obtain possession.

4. Stoppage of Goods in Transit. If the seller has placed goods sold on credit terms with a carrier or other bailee for delivery to the buyer and, prior to their effective delivery, the seller learns of the buyer’s insolvency, the seller may exercise its right to stop delivery of those goods in transit under §2-705 of the UCC. *See, e.g., In re Trico Steel Co., L.L.C.*, 282 B.R. 318 (Bankr. D. Del. 2002); *In re National Sugar Refinery Co.*, 27 B.R. 565 (S.D.N.Y. 1983). The seller may also stop delivery of a “carload, truckload, planeload or larger shipments of expenses or freight” where the buyer repudiates the contract, fails to make a payment due before delivery or “if for any other reason the seller has a right to withhold or reclaim the goods.” UCC § 2-705(1). To exercise this remedy, the seller must notify the bailee by reasonable diligence to prevent delivery of the goods. UCC § 2-705(3)(a). After the bailee receives notice of stoppage in transit, the bailee must hold the goods and deliver them according to the instructions given by the seller. UCC § 2-705(3)(b). The seller is nevertheless responsible to the bailee for the payment of any costs or damages arising from stopping delivery. *Id.*

5. Identification and Salvage of Goods. Upon the breach by the troubled supplier of its contract obligations to buy parts or systems from a vendor in the midst of the

¹ If during the three months prior to delivery the buyer has made a misrepresentation of solvency in writing, the ten day limitation described above does not apply UCC §2-702(2). *See, e.g., In re Bel Air Carpets, Inc.*, 452 F.2d 1210 (9th Cir. 1971).

vendor's manufacture of those goods, the disappointed seller may proceed to identify² all conforming goods in its possession upon learning of the breach. UCC § 2-704(1)(a). The seller may also treat the finished and unfinished goods as the subject for resale to third parties. UCC § 2-704(1)(b). With respect to unfinished goods, the seller may "in the exercise of reasonable commercial judgment for the purpose of avoiding loss and of effective realization" either (i) complete manufacture of the goods and identify all of them to the contract; (ii) halt manufacture and resell the unfinished goods for scrap value; or (iii) act in "any other reasonable manner." UCC § 2-704(2). *See, e.g., Bead Chain Mfg. Co. v. Saxton Products, Inc.*, 183 Conn. 266, 439 A.2d 314 (1981); *Young v. Frank's Nursery & Crafts, Inc.*, 58 Ohio St.3d 242, 569 N.E.2d 1034 (1991).

When a seller has work in process and raw materials that it is fabricating for the troubled supplier at the time that the seller learns of the supplier's breach of contract, Professors White and Summers recommend that the seller should proceed as follows:

"In summary, the general standard, though not the exclusive one, is to compare two quantities: 'What are my damages if I stop now?' against 'What are my damages if I complete and resell?' If the former is greater than the latter, completion is commercially reasonable. Recall that the burden is on the buyer to show absence of commercial reasonableness and that the test is to be applied at the time of repudiation, not by hindsight at the time of trial."

1 James J. White and Robert S. Summers, *Uniform Commercial Code* § 7-15 at pp. 408-09 (4th ed. 1995).

6. Resale of Goods. Section 2-703 of the UCC permits a seller of goods to a defaulting troubled supplier to resell the goods subject to the contract by public or private sale. Such a sale must be conducted by the seller in good faith and in a commercially reasonable manner to permit the seller to recover from the defaulting buyer, as damages, the difference between (i) the resale price for the goods; and (ii) the contract price plus any incidental damages to which the seller is entitled³ but minus any expenses saved by the seller caused by the breach. UCC § 2-706(1). If the seller determines to resell the goods by "private sale," the seller must transmit to the buyer "reasonable notification" of the seller's intent to resell the goods and identify the resale contract to the breached contract. UCC §§ 2-706(2), (3). The statutory requirements of a public sale, *viz.*, an auction, are more detailed:

² "Identification" of manufactured goods subject to a contract for their sale occurs, in the absence of the parties' agreement to the contrary, (i) when the contract is made if it is for the sale of goods "already existing and identified"; or (ii) if the contract provides for the sale of future goods, when those goods are "shipped, marked or otherwise designated by the seller as goods to which the contract refers." UCC § 2-501(1). Official Comment 4 to this section states that "there is no requirement . . . that the goods be in deliverable state or that all of the seller's duties with respect to the processing of the goods be completed in order that identification occur."

³ UCC § 2-710 defines a seller's incidental damages as including "any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation care and custody of goods after the buyer's breach, in connection with the return or resale of the goods or otherwise resulting from the breach." Incidental damages, however, do not include consequential damages which a seller may not recover from a defaulting buyer under Article 2. *See, e.g., Firwood Mfg. Co. v. General Tire, Inc.*, 96 F.3d 163 (6th Cir. 1996); *Sonfast Corp. v. York International Corp.*, 875 F.Supp. 1088 (M.D. Pa. 1994).

- (a) the seller must identify the auction contract to the breached contract;
- (b) the seller may resell only identified goods except where there is a recognized market for the subject goods;
- (c) the seller must conduct the public sale at the “usual place” for such a sale (if one exists);
- (d) give the buyer reasonable notice of the time and place of the public auction unless the goods are perishable or threaten to decline speedily in value; and
- (e) display the goods at the public sale or provide for their reasonable inspection by bidders where the goods are located.

UCC §§ 2-706(2), (4).

At a public sale, the seller is permitted to purchase the goods. UCC § 2-706(4)(d). A good faith purchaser at a private or public sale under this Code section will take free and clear of the defaulting purchaser’s rights even though the seller fails to comply with all of the provisions of this section. UCC § 2-706(5).

In the even that the seller fails to comply with the provisions of UCC § 2-706 in conducting a public or private sale of the subject goods, the seller’s damages will be measured in accordance with the standards set forth in UCC § 2-708, discussed below. *See, e.g., Sprague v. Sumitomo Forestry Co.*, 104 Wash.2d 751, 709 P.2d 1200 (1985).

7. Damages for Nonacceptance of Goods or Repudiation of Contract.

Section 2-708 of the UCC provides two separate measures for contract damages when a buyer of goods refuses to accept goods subject to the contract or repudiates that contract. The first measure, set forth in UCC § 2-708(1) and commonly referred to as the “contract-market differential,” permits the seller to recover the difference between (i) the market price determined at the time and place for tender of the goods; and (ii) the unpaid contract price plus incidental damages but minus expenses saved as a result of the buyer’s breach. UCC § 2-723 sets forth standards for proving at trial the market price at the time and place for tender. *See generally Klockner, Inc. v. Federal Wire Mill Corp.*, 663 F.2d 1370 (7th Cir. 1981).

In the event that a court determines that contract-market differential damages are inadequate to place the seller “in as good a position as [the buyer’s] performance would have done,” then the seller’s measure of damages will be “the profit (including reasonable overhead) which the seller would have made” had the buyer fully performed its obligations under the breached contract plus any recoverable incidental damages and plus any costs reasonably incurred by the seller but less any payments or proceeds of resale. UCC § 2-708(2). *See, e.g.*, the extensive discussion of this “lost profits” measure of damages in 1 James J. White and Robert S. Summers, *Uniform Commercial Code*, §§ 7-8 to 7-14 (4th ed. 1995).

8. Action for the Price. In three limited circumstances, the vendor of goods to a defaulting troubled supplier may sue for and recover the unpaid contract price for those goods plus any incidental damages. UCC § 2-709. These circumstances are as follows:

- (a) where the defaulting buyer has “accepted”⁴ the goods;
- (b) where the risk of loss has passed to the buyer and the goods were lost or damaged within a reasonable time after risk of loss has passed to the buyer; or
- (c) when the goods have been identified to the contract, have not been shipped to the buyer and the seller is unable to resell them.

UCC § 2-709(1). *See generally Weil v. Murray*, 151 F.Supp.2d 250 (S.D.N.Y. 2001); *Emanuel Law Outlines, Inc. v. Multi-State Legal Studies, Inc.*, 899 F.Supp 1081 (S.D.N.Y. 1999); *The Colone’s Inc. v. Cincinnati Milacron Marketing Co.*, 910 F.Supp 323 (E.D. Mich. 1996), *aff’d*, 149 F.3d 1182 (6th Cir. 1998).

If the seller commences an action to recover the contract price from the defaulting buyer, the seller must retain any goods identified to the contract still in the seller’s control. UCC § 2-709(2). However, if the seller is thereafter able to resell these goods, the resale may be made at any time before the seller collects its money judgment from the buyer. *Id.* Upon such a resale, the buyer is entitled to receive a credit against the judgment for the net resale proceeds. *Id.* If the buyer satisfies the judgment, the seller must deliver to the buyer any such goods remaining in its possession. *Id.*

Finally, in the event that a seller fails to qualify for recovery of lost profits on account of a buyer’s wrongful rejection or revoked acceptance of goods, the seller will nonetheless be entitled to recover damages computed according to the “contract-market differential” rules of section 2-708 of the Code. UCC § 2-708(3). The same result occurs when the buyer fails to make a payment due under the contract or repudiates the contract under section 2-610 of the Code. *Id.*

9. Cancellation of the Contract. The final remedy specified in UCC § 2-703 for a vendor of goods to a troubled supplier upon the supplier’s breach is cancellation of the contract. UCC § 2-703(f). The term, “cancellation,” is defined in UCC § 2-106(4) as occurring when either party to a contract for the sale of goods “puts an end to the contract for breach by the other.” Cancellation is tantamount to “termination”⁵ of a contract except that the canceling party “retains any remedy for breach of the whole contract or any unperformed balance.” *Id.* As discussed in Section VI(B)(1)(a), a party to an executory contract with a Chapter 11 debtor will

⁴ Section 2-606 defines what constitutes acceptance of goods in the context of a contract for their sale.

⁵ “Termination” of a contract for the sale of goods occurs “when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach.” UCC § 2-106(3) (emphasis supplied). Upon termination, all executory obligations of the parties will be discharged but “any right based on prior breach or performance” will survive. *Id.*

be prohibited by the automatic stay provisions of the Bankruptcy Code from canceling the contract.

D. Buyer's Remedies Under Article 2

1. In General. Buyers of automotive parts and systems are either higher-tiered suppliers that purchase goods from lower-tiered suppliers or OEMs, such as Ford Motor Company, that purchase goods from Tier One suppliers. In the event that a troubled supplier/seller fails to deliver the goods or repudiates the contract under UCC § 2-610 or where the buyer rightfully rejects goods⁶ or justifiably revokes acceptance of goods, then the buyer may cancel the contract, recover the portion of the contract price previously paid to the seller, and take one of the following two actions:

- affect “cover” under UCC § 2-712 concerning all goods even those that have not been “identified to the contract;” or
- recover damages for nondelivery as calculated pursuant to UCC § 2-713.

UCC § 2-711(1). In addition, when the seller fails to deliver the contract goods or repudiates the contract under UCC § 2-610, the buyer may resort to one of the two alternative remedies:

- where the goods have been “identified,” the buyer may recover them as provided in UCC § 2-502; or
- in a “proper case,” the buyer may obtain specific performance requiring delivery of the goods or replevy those goods. UCC §§ 2-711(2), 2-716.

2. Buyer's Security Interest in Goods. Where the buyer rightfully rejects or revokes acceptance of nonconforming goods previously delivered by a troubled supplier/seller, the buyer will hold a security interest in those goods still in the buyer's possession or control. UCC § 2-711(3). This lien secures (i) any payments made by the seller on their price; and (ii) any expenses reasonably incurred by the buyer “in their inspection, receipt, transportation, care and custody.” *Id.* The buyer may resell these in the manner described in UCC § 2-706, which permits an aggrieved seller to resell goods. *Id. See, e.g., Furlong v. Alpha Chi Omega Sorority*, 73 Ohio Misc.2d 26, 657 N.E.2d 866 (1993).

3. Cost of Cover. Once the seller's breach, the buyer may obtain substitute goods from another source. This remedy is provided in UCC §2-712 and is known as “cover.” The buyer must purchase substitute goods in “good faith and without unreasonable delay”. *Id.* The buyer may then recover from the seller as damages the difference between the cost of cover and the contract price together with any incidental or consequential damages but less expenses saved in consequence of the seller's breach. If the buyer does not “cover”, it will not be barred from exercising other remedies. UCC § 2-712(3). Where a buyer could have covered and its

⁶ As a general rule, a buyer of goods may reject them only when they do not conform to the contract. UCC § 2-601. Rejection must be made within a “reasonable time” after they are tendered to the buyer. UCC § 2-602(1). Absent reasonable rejection, any later rejection will be ineffective. *Id.* The rights and obligations of the buyer and seller of goods upon a rightful rejection are set forth in UCC §§ 2-602(b), 2-603, 2-604 and 2-605.

failure creates higher damages that could have been avoided, the buyer may be denied recovery of the avoidable consequential damages. UCC § 2-715(2)(a).

Thus, if the troubled supplier fails to deliver goods, the customer may find an alternative source and purchase the goods from that source. The customer may recover from the supplier the difference in cost of the goods, if the price is higher, as well as other incidental costs such as increased transportation. The customer is entitled to be placed in the identical economic position that performance by the supplier would have placed it. See *Bigelow-Sanford, Inc. v. Gunny Corp.*, 649 F.2d 1060 (5th Cir. 1981). To comply with the requirements of UCC § 2-712, the customer must purchase cover goods that are commercially used as reasonable substitutes for the original goods under the circumstances. I *James J. White and Robert S. Summers, Uniform Commercial Code* §6-3 (4th Ed. 1995); *Valley Di Case Corp. v. A.C.W. Inc.*, 25 Mich. App. 321, 181 N.W.2d 303 (1970) (no “cover” occurred where buyer purchased entirely different type of goods).

4. Actions for Specific Performance. If the troubled supplier fails to deliver goods as required by the contract, the customer may elect to cover by obtaining substitute goods from an alternative source. This may be the easiest way for the customer to maintain production levels and to avoid additional costs and legal expenses. There may be circumstances, however, where the goods are available only from the breaching seller and without those goods, the customer’s assembly line would be shut down. In these circumstances, the buyer may have no option except to sue the defaulting seller for specific performance under UCC § 2-716(1) and to request in such an action a preliminary injunction mandating the seller to continue performance under the contract. Specific performance is allowed where the goods are “unique” or where “other proper circumstances” require this outcome. *Id.* The order for specific performance may include such terms and conditions as to payment of the price, damages and other relief the court concludes is appropriate. UCC § 2-716(2).

What are “unique goods”? Official Comment 2 to § 2-716 suggests that the decision will be based upon the totality of the circumstances. This comment further notes that output and requirements contracts involving a particular or peculiarly available source or market present the typical commercial specific performance situation. Nevertheless, uniqueness is not the only test for specific performance and an inability of the buyer to effect cover “is strong evidence of ‘other proper circumstances.’” *Id.* For example, one court held that in circumstances where a buyer borrowed \$96,000 to pay for a machine, the machine failed to function and the buyer was unable to borrow sufficient funds to purchase a replacement machine, the buyer was entitled to specific performance. *Stephan’s Machine & Tool, Inc. v. H & H Machinery Consultants, Inc.*, 65 Ohio App.2d 197, 417 N.E. 2d 579 (1979). See also *Magellan Intern. Corp. v. Salzgitter Handel GmbH*, 76 F.Supp.2d 919 (N.D. Ill. 1999); *International Casings Group, Inc. v. Premium Standard Farms, Inc.*, 358 F.Supp.2d 863 (W.D. Mo. 2005).

5. Special Property Interests in Goods. The buyer who has paid to an insolvent seller part of the purchase price may hold what is identified by the UCC as a “special property” interest in the subject goods even though the goods have not been delivered. UCC § 2-502. This potential remedy may be of particular interest to a buyer who has a substantial need for these goods and will not be satisfied with merely obtaining a money judgment against the insolvent seller. If the seller of the goods becomes insolvent within ten (10) days after receipt of

the first installment of the payment for the goods, the buyer will obtain a special property interest in the goods under UCC § 2-502. If these goods are identified to the contract and are conforming, the buyer may recover these goods from the seller. UCC §§ 2-502(2), 2-711(2)(a). This interest, however, may be unenforceable in a subsequent bankruptcy case of the seller. See *In re G. Paoletti, Inc.*, 205 B.R. 251 (Bankr. N.D. Cal. 1997) (UCC § 2-502 special property rights are trumped by section 365 of the Bankruptcy Code; buyer holds only an unsecured claim against seller).

6. Breaches of Installment Contracts. An “installment contract” is a contract which requires or authorizes the delivery of goods in separate lots to be separately accepted, even though the contract states that “each delivery is a separate contract” or its equivalent. UCC § 2-612(1). Frequently, buyers will enter into installment contracts to obtain a standard price over a multi-month or multi-year period. The buyer may reject any installment of nonconforming goods if the non-conformity substantially impairs the value of that installment and cannot be cured. UCC § 2-612(2). See generally *TransWorld Metals, Inc. v. Southwire Co.*, 769 F.2d 902 (2d Cir. 1985). If the nonconforming installment can be effectively cured, and the seller gives adequate assurance of such cure, the buyer must accept the nonconforming installment. *Id.*; *Midwest Mobile Diagnostic Imaging, L.L.C. v. Dynamics Corp. of America*, 965 F.Supp 1003 (W.D. Mich. 1997), *aff’d*, 165 F.3d 27 (6th Cir. 1998). If the non-conformity or default of one installment substantially impairs the value of the entire contract, however, the whole contract is in breach. UCC § 2-612(3). Nevertheless, a buyer who accepts a non-conforming installment and does not notify the seller of cancellation within a reasonable time may not bring an action for breach and will be deemed to have reinstated the entire contract. UCC § 2-612(3). See, e.g., *Mextel, Inc. v. Air-Shields, Inc.*, 56 U.C.C.Rep.Serv.2d 6 (E.D. Pa. 2005).

7. Remedies for Breach When Buyer Accepts Goods. A buyer that accepts goods sold by the buyer and thereafter gives the buyer notice of their nonconformity within a reasonable time⁷ (e.g., where the nonconformity is caused by the failure of a manufactured part or system to meet contract specifications), the disappointed customer may recover from the seller as damages “the loss resulting in the ordinary course of events from the seller’s breach as determined in any manner which is reasonable.” UCC § 2-714(1). When a breach of warranty is involved, the customer’s measure of damages is the difference at the time and place of acceptance between (i) the value of the accepted goods, and (ii) their value absent the breach of warranty unless “special circumstances show proximate damages of a different amount.” UCC § 2-714(2). See, e.g., *IMI Norgren, Inc. v. D&D Tooling & Manufacturing, Inc.*, 247 F.Supp.2d 966 (N.D. Ill. 2002); *Golden v. Gorno Bros., Inc.*, 247 F.Supp.2d 913 (E.D. Mich. 2003); *H.A.S. of Fort Smith, LLC v. J.V. Mfg., Inc.*, 54 U.C.C.Rep.Serv.2d 1007 (Ark. Ct. App. 2004). Incidental and consequential damages may also be recovered by the buyer “in a proper case.” UCC § 2-714(3). See, e.g., *Cambridge Planting Co. v. Napco, Inc.*, 85 F.3d 752 (1st Cir. 1996).

8. Buyer’s Right of Recoupment. Section 2-717 of the UCC specifically recognizes a disappointed buyer’s right to deduct “all or any part of the damages,” including incidental and consequential damages, resulting from the seller’s breach of contract from any

⁷ UCC § 2-607(3)(a).

remaining sums due by the buyer under that contract. *See, e.g., Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc.*, 7 F.Supp.2d 954 (N.D. Ohio 1998); *Berdex International, Inc. v. Milfico Prepared Foods, Inc.*, 258 Ill.App.3d 738, 630 N.E.2d 998 (1994).

9. Buyer's Incidental and Consequential Damages. As previously noted, Article 2 of the UCC permits a customer to recover in certain instances incidental and consequential damages from a seller of goods that breaches the sales contract. Incidental damages include the following categories: (i) expenses reasonably incurred in the inspection, receipt, transportation and care and custody of goods properly rejected; (ii) commercially reasonable charges; (iii) expenses or commissions incurred in effecting cover; and (iv) other reasonable expenses related to the delay or other breach. UCC § 2-715(1). *See, e.g., Jetpac Group, Ltd. v. Bostek, Inc.*, 942 F.Supp. 716 (D. Mass. 1996).

Consequential damages suffered by a customer may be massive in the event that the seller's breach of contract to deliver goods results in a line shutdown. *See, e.g., In re Autostyle Plastics, Inc.*, 216 B.R. 784, 788 (Bankr. W.D. Mich. 1997). Section 2-715(2) of the UCC defines consequential damages as including the following:

- (a) any loss resulting from "general or particular requirements and needs" that the seller had reason to know of at the time of contracting. In order to be recoverable, however, these losses could not reasonably have been prevented "by cover or otherwise;" and
- (b) any injury to person or property proximately resulting from a breach of warranty.

See, e.g., Stone Transport, Inc. v. Volvo Trucks North America, Inc., 129 Fed.Appx. 205 (6th Cir. 2005); *Porous Media Corp. v. Midland Brake, Inc.*, 220 F.3d 954 (8th Cir. 2000).

10. Liquidated Damages Provisions. The troubled supplier and its customer may agree in the contract to liquidate breach of contract damages that may be claimed by either party but only at a reasonable amount as determined with reference to the following factors: (i) the anticipated or actual harm caused by the breach; (ii) the difficulties of proof of loss; and (iii) the inconvenience or unfeasibility of otherwise obtaining an adequate remedy. UCC § 2-719(1). A contractual term that fixes "unreasonably large liquidated damages" will not be enforced as a penalty. *Id. See, e.g., In re Exemplar Manufacturing, Inc.*, 2005 WL 2065612 (Bankr. E.D. Mich. Oct. 14, 2005).

11. Limitation and Exclusion of Buyer's Right to Recover Consequential Damages. Section 2-719(3) permits the parties in their contract for the sale of goods to agree to a provision limiting or excluding the right of a buyer to recover consequential damages from a breaching seller and this provision will be enforced by a court unless it is deemed "unconscionable." Limitation of consequential damages where the losses are "commercial" losses are not deemed prima facie unconscionable, unlike a limitation of damages for personal injuries. UCC § 2-719(3). *See, e.g., Starr v. Dow Agrosciences LLC*, 339 F.Supp.2d 1097 (D. Or. 2004); *M.A. Mortenson Co., Inc. v. Timberline Software Corp.*, 140 Wash.2d 568, 998 P.2d

305 (2000). However, where the contract for sale of goods limits the buyer's remedies for the seller's breach or provides an exclusive remedy for that breach and where any such remedy is determined by a court to "fail of its essential purpose" under UCC § 2-719(2), a clause limiting or excluding consequential damages in the same contract may also be avoided by the court when the limitation of remedy and limitation of damages clauses are regarded as integrated provisions. *See, e.g., Kelynack v. Yamaha Motor Co.*, 152 Mich.App. 105, 394 N.W.2d 17 (1986). *See also Razor v. Hyundai Motor America*, 349 Ill.App.3d 651, 813 N.E.2d 247 (2004).

12. Commercial Impracticability. Prior to the adoption of Article 2 of the Uniform Commercial Code, the common law of many states provided that a seller of goods would be excused from performing its obligations under a contract for the sale of goods if it was found to be "impossible" for the seller to perform. *Chemetron Corp. v. McLouth Steel Corp.*, 381 F.Supp. 245 (N.D. Ill. 1974), *aff'd*, 522 F.2d 469 (7th Cir. 1975). This common-law test has been liberalized in section 2-615 of the UCC and, even though the statutory language applies only to sellers, courts have applied this Code section to buyers in appropriate cases. *See, e.g., Mextel, Inc. v. Air-Shields, Inc.*, 56 U.C.C.Rep.Serv.2d 6 (E.D. Pa. 2005); *Lawrance v. Elmore Bean Warehouse, Inc.*, 108 Idaho 892, 702 P.2d 950 (Ct. App. 1985).

Section 2-615 of the UCC permits a seller (and a buyer) to be excused from a delay in delivery or non-delivery of goods, in whole or in part, subject to a sales contract in the following circumstances:

(a) performance of the seller or buyer's duties under the contract has been rendered "impracticable by the occurrence of a contingency;"

(b) the non-occurrence of this contingency was a basic assumption on which the contract was made or by good faith compliance with "any applicable foreign or domestic governmental regulation or order."

UCC § 2-615(a). *See also Leanin' Tree, Inc. v. Thiele Technologies, Inc.*, 43 Fed.Appx. 318 (10th Cir. 2002); *Harnscom Svenska, AB v. Harris Corp.*, 3 F.3d 576 (2d Cir. 1993); *Cooper Grain v. Texas Gulf Sulphur Co.*, 508 F.2d 283 (7th Cir. 1974). A seller so excused must notify its buyer "seasonably" of the anticipated delay or non-delivery of the goods subject to the contract. UCC § 2-615(c). Upon such notification, the buyer may proceed to terminate or modify the contract as set forth in UCC 2-616. *See, e.g., Cliffstar Corp. v. Riverbend Products, Inc.*, 750 F.Supp. 81 (W.D.N.Y. 1990).

A mere increase or decrease in market price, without more, has been held not to excuse performance of contractual duties under UCC § 2-615. *See, e.g., Chainworks, Inc. v. Webco Industries, Inc.*, Case No. 1:05-cv-135 (W.D. Mich. Feb. 24, 2006); *In re Brooks Shoe Mfg. Co., Inc.*, 21 B.R. 604 (Bankr. E.D. Pa. 1982); *Hancock Paper Co. v. Champion International Corp.*, 424 F.Supp. 285 (E.D. Pa. 1976), *aff'd*, 565 F.2d 151 (3d Cir. 1977). If, however, the increased cost "is due to some unforeseen contingency [other than a rise or a collapse of the market] which alters the essential nature of the performance," the seller might have grounds for excused performance under this section. Official Comment 4 to UCC § 2-615. This Official Comment indicates some circumstances that might permit a court to excuse performance:

“[A] severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section.”

Id.

Courts have excused performance under UCC § 2-615 when the contracting parties have agreed upon a specific source of supply and that supplier is unable to deliver the required goods to the seller for manufacture and delivery to the buyer. *See, e.g., Paul T. Freund Corp. v. Commonwealth Packaging Co.*, 2004 WL 2075427 (W.D.N.Y. 2004); *Almance County Board of Education v. Bobby Murray Chevrolet, Inc.*, 121 N.C.App. 222, 465 S.E.2d 306 (1996). *See also* Official Comment 5 to UCC § 2-615. Consequently, a troubled supplier may be excused from delivering parts or systems to its customers when its contracts with its customers specify a source for the goods to be fabricated by the troubled supplier and that source is unable to deliver due to its own financial difficulties or shutdown.

In the event that commercial impracticability affects only a portion of the seller’s capacity to perform under its contract with the customer, the seller will be required to allocate production and delivery among all of its customers “but may at its option include regular customers not then under contract as well as his own requirements for further manufacture.” UCC § 2-615(b). This allocation must be made in a manner that is “fair and reasonable.” *Id.* *See, e.g., Roth Steel Products v. Sharon Steel Corp.*, 705 F.2d 134 (6th Cir. 1993). *See also* Official Comment 11 to UCC 2-615. Notice of such proposed allocation must be given to the buyer seasonably. UCC § 2-615(c). Upon receipt of this notice, the buyer may elect to either terminate the contract or modify the contract in accordance with UCC § 2-616.

III. BANKRUPTCY OF TROUBLED SUPPLIER

A. Imposition of the Automatic Stay

1. Overview

a. Institution and Scope. Upon the filing of a bankruptcy petition (whether voluntary or involuntary), a broad stay, or injunction, is automatically imposed pursuant to section 362(a), which is applicable to all entities to prevent those entities from taking most actions with respect to the debtor or its property which would otherwise be permitted under nonbankruptcy law. The basic purpose of the automatic stay is to facilitate an orderly administration of the debtor’s property. *See In the Matter of Rimstat, Ltd.*, 98 F.3d 956, 961 (7th Cir. 1996) (stating that primary use of the automatic stay is to prevent the debtor’s estate from being picked to pieces by creditors); *In the Matter of Guy E. McGaughey*, 24 F.3d 904, 906 (7th Cir. 1994) (discussing role of automatic stay, generally); *GATX Aircraft Corp. v. M/V Courtney Leigh*, 768 F.2d 711, 71 (5th Cir. 1985) (stay’s purpose is to “protect the debtor’s assets, provide temporary relief from creditors, and further equity of distribution among the creditors by forestalling a race to the courthouse”).

Section 362(a) automatically enjoins:

- (i) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case, or to recover a claim against the debtor that arose before the commencement of the case;
- (ii) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case;
- (iii) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (iv) any act to create, perfect, or enforce any lien against property of the estate;
- (v) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case;
- (vi) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case;
- (vii) the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor and
- (viii) the commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.

Most courts have held, as a general rule, that acts by a creditor in violation of the automatic stay are generally “void” (making the result of the act a nullity) and not just “voidable” (void only if the debtor or trustee challenges it). See *Far Out Productions v. Oskar*, 247 F.2d 986, 994 (9th Cir. 2001). These courts support the idea that a debtor should not be required to obtain a formal declaration from the bankruptcy court that each particular action by any party in violation of the stay was a nullity. See, e.g., *In re Schwartz*, 954 F.2d 569 (9th Cir. 1992); see *In re Jones*, 63 F.3d 411, 412 (5th Cir. 1995) (actions in violation of the stay are voidable because the court has the power to annul the stay retroactively).

Some courts have held that the automatic stay precludes a creditor of the debtor from unilaterally terminating an agreement. See *In re Computer Communications, Inc.*, 824 F.2d 725, 728-29 (9th Cir. 1987); *Matter of Whitcomb & Keller Mortgage Co.*, 715 F.2d 375, 378 (7th Cir. 1983). As such, even where a party has a valid reason for terminating an agreement, it nevertheless must seek relief from the automatic stay prior to terminating. See *In re Computer Communications, Inc.*, 824 F.2d 725, 728 (9th Cir. 1987). In the event that a party terminates prior to court approval, section 362(d), in conjunction with section 105(a), provides a court with the authority to order a party to continue to perform under the contract. See *Matter of Whitcomb & Keller Mortgage Co.*, 715 F.2d 375, 378 (7th Cir. 1983).

The authority of a court to require continued performance pursuant to section 362(d) is especially important in the automotive context, which operates on just-in-time delivery. A

supplier who has a valid reason for temporarily suspending, or even terminating, a contract with a customer should first file a motion for relief from the automatic stay, or risk having the court enter an order requiring the supplier's continued performance and sanctioning the supplier for the disruption in the debtor's manufacturing lines. *See In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 14, 2005).

b. Exceptions to the Automatic Stay

(i) In General. Section 362(b) of the Bankruptcy Code provides several exceptions to the automatic stay. Among the present 28 exceptions (ten of which were created by BAPCPA) to the automatic stay provided in section 362(b) are: (i) the commencement or continuation of criminal actions or proceedings against the debtor, (ii) proceedings by a governmental unit to enforce its police or regulatory powers or to enforce a nonmonetary judgment based on these powers, (iii) any act to obtain possession of property by a lessor of the debtor under a nonresidential real property lease that terminated by its terms before the commencement or during the pendency of the bankruptcy case and (iv) effecting certain setoff rights with respect to commodity contracts, forward contracts, securities contracts, repurchase agreements or pursuant to master netting agreements used in the financial marketplace.

(ii) Perfection of Interests in Property. Perhaps the most important exception to the automatic stay for secured creditors is section 362(b)(3), which permits "any act to perfect an interest in property" to the extent that the trustee's avoiding powers under section 546(b) would be subject to such perfection. Section 546(b)(1)(A) provides that "the rights and powers of a trustee . . . are subject to any generally applicable law that . . . permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection." Therefore, the filing of notices with respect to liens which "relate back" to a time before the bankruptcy case was commenced, such as a mechanic's lien or a purchase money security interest, are not enjoined. Creditors are also permitted "to maintain or continue the perfection of" their liens against a debtor's property (such as by filing a U.C.C. continuation statement) pursuant to section 362(b)(3).

Section 362(b)(3) provides for the post-petition perfection (or continuation) of liens where that perfection has a retroactive effect under non-bankruptcy laws. Section 362(b)(3) refers to section 346(b), which allows perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection. *See* 11 U.S.C. § 546(b).

c. Relief From the Automatic Stay. If a secured creditor is not being "adequately protected" pursuant to sections 361 and 363(e) with respect to its lien, it might obtain relief from the automatic stay under section 362(d)(1), and proceed to foreclose on its lien interest in state court. In addition, section 362(d)(2) provides that the automatic stay may be terminated if (a) the debtor does not have any equity in the property, and (b) the property is not necessary to an effective reorganization.

d. Permitted Self Help. Not all situations where a creditor can effect a remedy against a debtor regarding a pre-petition debt after the case is filed and the stay is in

effect are prohibited. If such a situation presents itself, the creditor (after seeking advice from counsel) should not pass up the chance to take advantage of the remedy. One such remedy is called “recoupment” and it is akin to setoff.

Setoff is a right (usually common law rather than statutory) that gives one party a right who owes a debt to another party to cancel that debt to the extent of an obligation of the other party to him. For instance, if party A owes party B \$1,000 for goods he purchased from B, and B owes party A \$800 for repair services B provided to A, A can setoff his debt to B against what B owes him by sending B payment for only \$200 (that way, A makes sure he is not out the whole \$1,000 should B not pay or pays with a bad check). The more drastic consequence is when B files bankruptcy. In the example above, A is prohibited under the automatic stay from effecting the setoff and must first obtain relief from the stay before effecting the setoff. Nonetheless, A remains obligated to pay B the \$1,000, but B is prohibited from paying any pre-petition debt.

Recoupment is a similar self-enforcing mechanism which, unlike setoff, is not impacted by the stay. *In re Health Management Ltd. P’ship*, 336 B.R. 392 (Bankr. C.D. Ill. 2005). In recoupment both the obligation and debt must arise out of the same transaction. This distinction may not seem substantial, but it is critical in that effecting a recoupment is generally held to be outside the purview of the stay, whereas effecting a setoff is a violation of the stay and would subject that creditor to possible sanctions. It should be noted that while section 553 “preserves” a creditor’s right to setoff, the creditor must nevertheless first seek and obtain the lifting of the stay in order to effect the setoff.

A preventative measure of sorts which may be upheld in certain jurisdictions under appropriate circumstances is obtaining an agreement from a debtor prior to its bankruptcy filing that the debtor will waive application of the stay to the particular circumstances. Some bankruptcy courts will uphold or enforce these pre-petition agreements if the debtor was represented by counsel and the court can determine the waiver was knowing and voluntary, and if the debtor received sufficient consideration in exchange for the waiver and the creditor’s post-petition enforcement action will not be detrimental to other creditors. The main arguments for denying use of this remedy are that the bankruptcy debtor is a different entity than the pre-petition debtor entity and cannot be bound by a waiver of bankruptcy rights by a non-bankrupt entity. Furthermore, such agreements are disfavored because the debtor’s creditors had no opportunity to object to the prepetition waiver, whereas creditors are entitled to object to the creditor’s motion for stay relief filed after the bankruptcy case was filed.

2. Impact on Vendors. The imposition of the stay can have a devastating affect on the unsecured vendor who has initiated an action prior to the bankruptcy filing to attempt to recover its debt. Not only is the vendor out the expenses incurred in prosecuting the claim, but it can no longer pursue the claim. Consequently, it will be left to the vagaries of the debtor’s ability to reorganize and provide a distribution to unsecured creditors. Of course, the “flip side” is that most debtor’s on the verge of a bankruptcy filing are facing multiple collection actions and other suits. The debtor needs the respite or “breathing spell” afforded by the stay in order to concentrate on stabilizing its business. In fact, the initial, primary motivating factor for many debtors to file bankruptcy is to obtain the benefit of the automatic stay to stop threatened or actually filed collection actions or other suits.

The impact on secured creditors is not as drastic and may only pose a temporary interlude in their recovery efforts or a temporary interruption of their payment stream. In the event the secured party is undersecured and can establish that the collateral is not needed for the debtor's reorganization (or that it is unlikely that the debtor can reorganize), the bankruptcy court can lift the stay and allow the creditor to proceed against the collateral (*e.g.*, a replevin, repossession or foreclosure action) as if the bankruptcy had never been filed.

If the creditor is oversecured (and thus, there is equity in collateral) the secured creditor is entitled to adequate protection of its security interest. One typical form of adequate protection is the debtor's payment of interest on the secured debt so that the "equity cushion" enjoyed by the creditor is not eroded. However, where the secured creditor is substantially oversecured, the equity cushion alone can serve as the creditor's adequate protection.

3. Impact on Customers. A Chapter 11 debtor will generally be allowed to operate its business "as usual" during the case. *See* 11 U.S.C. § 1108. One area where the customer can be substantially affected by a Chapter 11 filing by its supplier concerns the customer's pre-petition agreements with the debtor. As noted elsewhere in this article, the debtor may reject an executory contract and no longer perform under that agreement if in the debtor's business judgment, the debtor believes it would be better off without it. A related strategy attempted by debtors is to attempt to renegotiate their existing agreements in order to achieve more favorable terms. Another area where a customer may be affected by a supplier's bankruptcy is where the customer has a claim against the debtor for a pre-petition event, *e.g.*, a purchase of defective goods. As with other general unsecured, pre-petition claims, the debtor will be entitled to alter its repayment obligation and deal with these claims later in its plan of reorganization.

B. First Day Motions and Orders

1. DIP Financing. In many situations, a debtor will need new financing in order to continue to operate its business and fund its reorganization efforts. The debtor's ability to continue to use cash collateral is likely to address, at least in part, the debtor's post-petition financing needs. However, in other situations, the debtor's ability to continue to use cash collateral will not provide sufficient capital to continue to operate on a post-petition basis. Typically, within the first few days after a Chapter 11 bankruptcy case is filed (and usually on the petition date), the debtor will file a motion seeking court approval for debtor in possession financing. If a debtor cannot otherwise obtain credit post-petition, the Bankruptcy Code permits the court to authorize the debtor to obtain credit on a secured basis, and in some circumstances, by providing a priming lien.

Section 364 of the Bankruptcy Code provides the authority by which a debtor may obtain such financing. 11 U.S.C. § 364. Section 364 allows the debtor to obtain unsecured credit in the ordinary course of its business as an administrative expense without the need for court approval. 11 U.S.C. § 364(a); *see In re Blessing Industries, Inc.*, 263 B.R. 268, 272 (Bankr. N.D. Iowa 2001) (discussing "vertical" and "horizontal" tests for extensions of credit under 364(a)). If unsecured credit sought is outside of the debtor's ordinary course of business, or if the lender demands a superpriority over all other administrative expenses incurred in the bankruptcy case, a debtor must first obtain court approval. 11 U.S.C. § 364(b) and (c). Where a debtor cannot

otherwise obtain credit, section 364 authorizes the debtor, with court approval, to incur credit on a secured basis, often by providing a priming lien to the post-petition lender. 11 U.S.C. § 364(d).

Often the debtor's prepetition lender will be willing to extend additional credit post-petition. The prepetition lender may be willing to extend such financing where the Chapter 11 process increases the chances for the lender to recover its prepetition claim. A debtor in possession loan may also be attractive to a prepetition lender in order to enhance its prepetition status and reinforce its rights under the loan documents and any related forbearance agreements, indirectly exert control over the Chapter 11 process, or obtain waivers of avoidance actions, lender liability claims, and releases. However, in other cases, the prepetition lender may not be willing to provide post-petition financing, and instead the debtor will seek to establish a relationship with a new third party lender who recognizes post-petition financing to the particular debtor as a desirable investment opportunity.

Where a debtor seeks post-petition financing under section 364(c), the debtor must first demonstrate that reasonable attempts to obtain unsecured credit under section 364(a) or (b) were unavailing. *In re Ames Dept. Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990). Such reasonable attempt does not contemplate seeking unsecured financing from all possible sources; rather, several courts have held it is enough that the debtor conducts a diligent search. *In re Snowshoe Co., Inc.*, 789 F.2d 1085, 1088 (4th Cir. 1986); *In re Reading Tube Indus.*, 72 B.R. 329, 332 (Bankr. E.D. Pa. 1987). Section 364(c) allows the debtor to exercise its business judgment and incur a superpriority debt to its post-petition lender where the debtor (i) demonstrates the unavailability of funds, (ii) is unable to secure financing on an unsecured or administrative priority basis and (iii) the proposed borrowing is in the best interests of the estate. *See In re Simasko Production Co.*, 47 B.R. 444, 448 (Bankr. D. Colo. 1985).

The list of lending incentives set forth in section 364(c) is not exhaustive, however. Courts routinely authorize inducements to lenders not specifically enumerated in the statute. *See Unsecured Creditors Committee v. First Nat'l Bank & Trust Co. of Escanaba*, 834 F.2d 599, 604 (6th Cir. 1987) (prohibition on challenge to lender's existing liens); *In re Defender Drug Stores*, 126 B.R. 76, 81 (Bankr. D. Ariz. 1991) (allowing enhancement fee to post-petition lender), *aff'd*, 145 B.R. 312, 316 (BAP 9th Cir. 1992) (recognizing that bankruptcy courts approve post-petition financing arrangements beyond those in section 364); *In re Antico Mfg. Co.*, 31 B.R. 103 (Bankr. E.D.N.Y. 1983) (allowing cross-collateralization). However, courts uniformly hold that a proposed financing arrangement should not be approved where it is apparent that the purpose of the financing is to benefit a creditor rather than the estate. *See, e.g., Ames Dept. Stores*, 115 B.R. at 38.

Post-petition lenders, of course, will obviously seek the maximum protections afforded by the Bankruptcy Code in exchange for their post-petition financing of the debtor's operations. Where the debtor is unable to obtain credit otherwise, including through the options available in any other subsection of section 364 and the senior lienholder to be supplanted is adequately protected, a court will permit post-petition financing liens to prime those held by the debtor's prepetition lenders or other prepetition lienholders. *Ames Department Stores*, 115 B.R. at 37; *In re Sky Valley, Inc.*, 100 B.R. 107, 113 (Bankr. N.D. Ga. 1988).

When a debtor seeks to prime the liens of the prepetition lender in order to secure post-petition financing, the debtor has the burden of proving whether adequate protection to the pre-existing lien-holder has been provided. 11 U.S.C. § 364(d); *see also* 11 U.S.C. § 361. The purpose of adequate protection “is to insure that the [prepetition lienholder] receives the value for which [it] bargained prebankruptcy.” *In re Swedeland Dev. Group, Inc.*, 16 F.3d, 552, 564 (3d Cir. 1994). The focus in examining the sufficiency of adequate protection is whether the prepetition secured creditor has been protected or shielded from diminution in the value of its collateral during the reorganization. *In re Mosello*, 195 B.R. 277, 289 (Bankr. S.D.N.Y. 1996). A proposed credit facility should provide the prepetition secured creditor with the same level of protection it would have if there had not been post-petition financing. *Swedeland Dev. Group*, 16 F.3d at 564; *see In re Plabell Rubber Products, Inc.*, 137 B.R. 897, 899 (Bankr. N.D. Ohio 1992) (secured creditor should not be “unjustifiably jeopardized”).

When determining whether adequate protection has been granted to a prepetition secured creditor, courts often place substantial weight on whether an equity cushion exists. *See, e.g., In re C.B.G. Ltd.*, 150 B.R. 570, 573 (Bankr. M.D. Pa. 1992) (equity cushion below 20% does not constitute adequate protection). One commentator has suggested the following factors should be considered when determining whether adequate protection exists based on the equity cushion alone: (i) does the accrual of interest erode the equity cushion; (ii) is the property depreciating or increasing in value; (iii) has the debtor shown an inability to obtain refinancing since the filing; (iv) has the debtor offered any other method of adequate protection; and (v) do current economic conditions suggest no realistic prospects for successful reorganization. Norton Bankr. L. & Prac. § 38:7 (2d ed. West Group 2001); compare *In re Aqua Assocs.*, 123 B.R. 192, 196 (Bankr. E.D. Pa. 1991) (court should consider all alternatives, not simply whether equity cushion exists); *see supra* at IV.C.2 and IV.F for additional discussion of adequate protection and, in particular, the adequacy of an equity cushion.

Generally, the post-petition financing sought in an automotive bankruptcy is no different than in any other industry. As with any other debtor, an automotive debtor will most likely seek to grant its post-petition lender a superpriority claim with priority over all administrative expenses, diminution claims, and all other claims, possibly subject to a carveout for professional fees. *See* 11 U.S.C. §§ 364(c)(1) and 507(b). In addition, as security for the post-petition financing, an automotive debtor is likely to attempt to grant the post-petition lender (a) a first lien on all unencumbered property, excluding a debtor’s claims and causes of action under Chapter 5 of the Bankruptcy Code, (b) a priming lien on all prepetition property of the debtor, subject to the liens of non-prepetition lenders and the adequate protection provided to the debtor’s prepetition secured lender, and (c) a subordinate lien on all property encumbered by the liens of the non-prepetition lenders. 11 U.S.C. § 364(c)(2), (3) and (d)(1); *see In re Collins & Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich. May 17, 2005); *In re Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. March 2, 2005); *but see In re Citation Corp.*, Case No. 04-08130 (Bankr. N.D. Ala. Oct. 19, 2004) (proceeds of avoidance actions encumbered by lien of post-petition lender prior to conversion to Chapter 7); *but see also In re Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 292-93 (7th Cir. 2003) (proceeds of avoidance actions may be encumbered by post-petition lender).

In one distinguishing automotive case, the debtors attempted to subordinate setoff rights of its suppliers to the liens of the post-petition lenders, the adequate protection liens of the

prepetition lenders and the carve-out for professionals, without providing adequate protection to the supplier setoff claimants. *See In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 8, 2005). As of the petition date, any setoff rights of suppliers (and presumably other parties) are senior to the claims of the prepetition secured lenders and other parties holding prepetition security interests. *See* UCC § 9-404(a)(2); *see also U.S. Aeroteam, Inc. v. Delphi Automotive Systems, LLC*, 327 B.R. 852, 871 (Bankr. S.D. Ohio 2005). The proposed treatment of suppliers' setoff rights caused several objections to the proposed post-petition financing to be filed due to the lack of adequate protection to the setoff claimants in exchange for subordination of their setoff rights. *See In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 20, 2005). After extensive negotiations between the setoff claimants, the debtors and the debtors' pre and post-petition lenders, the setoff claimants received adequate protection from the debtors in the form of replacement liens and the ability to opt-out of certain setoff resolution procedures proposed by the debtors. *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 28, 2005).

2. Cash Collateral. At the inception of a Chapter 11 case, a debtor needs access to a significant amount of cash in order to satisfy certain immediate obligations, including payroll, utility expenses, rent and other critical operating costs. Where a creditor has a lien on the debtor's cash and cash equivalents, the debtor cannot use such cash collateral without either the secured creditor's consent or a court order that ensures adequate protection of the secured creditor's interest. On the petition date or shortly thereafter, a debtor is likely to file a motion seeking the authority to continue to use cash collateral subject to the secured creditor's prepetition liens. Such relief is often requested as part of a motion for court approval of post-petition financing.

Section 363(c)(2) of the Bankruptcy Code permits a debtor to use, sell or lease cash collateral only with consent of the entity with the interest in cash collateral or where the court determines that the debtor has provided adequate protection of the secured creditor's interest in the cash collateral. 11 U.S.C. § 363(e).

Section 361 of the Bankruptcy Code defines adequate protection, which is a fairly flexible concept subject to the specific circumstances in each case. 11 U.S.C. § 361. A debtor need only provide a secured creditor with adequate protection against diminution in the value of the collateral securing the creditor's allowed secured claim. *United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365 (1988). Therefore, an undersecured creditor is entitled to adequate protection only where the collateral is declining in value. *In re Continental Airlines, Inc.*, 146 B.R. 536, 539 (Bankr. D. Del. 1992) (adequate protection should "shield that interest from loss due to any decrease in value of the property during the time the automatic stay remains in effect").

A debtor may provide its secured creditor with adequate protection in a number of ways. The debtor may seek to provide adequate protection by providing periodic cash payments to the secured creditor during the pendency of the case, often in an amount which is deemed commensurate to the depreciation of collateral during the case. *See, e.g., In re TennOhio Transportation Co.*, 247 B.R. 715, 721 (Bankr. S.D. Ohio 2000). A debtor may also grant to its secured creditor replacement liens on other property, including property acquired by the debtor

after the commencement of the case. *See, e.g., In re LTV Steel Co. Inc.*, 278 B.R. 278, 286, (Bankr. N.D. Ohio 2001).

A sufficient equity cushion may in and of itself constitute adequate protection. *See, e.g., In re Kids Creek Partners, LP*, 220 B.R. 963, 970 (Bankr. N.D. Ill. 1998). Courts generally hold that an equity cushion of less than 10% is insufficient to constitute adequate protection. *See, e.g., Ukrainian Sav. and Loan Ass'n v. The Trident Corp.*, 22 B.R. 491 (E.D. Pa. 1982) (10% is inadequate); *In re Jug End in the Berkshires, Inc.*, 46 B.R. 892 (Bankr. D. Mass 1985) (8.5% is insufficient).

On the other hand, an equity cushion of approximately 20% or more has been held to constitute adequate protection. *See, e.g., In re McKillips*, 81 B.R. 454, 458 (Bankr. N.D. Ill. 1989) (equity cushion of 20% or more almost always constitutes adequate protection) (collecting cases); *In re Dynaco Corp.*, 162 B.R. 389, 398 (Bankr. D.N.H. 1993) (17% adequate).

As part of negotiations with its secured creditor for the continued use of cash collateral, a debtor is likely to grant the secured creditor certain concessions other than adequate protection payments and replacement liens. Many of these concessions will be prejudicial to the rights of unsecured creditors. For example, often a cash collateral stipulation will waive the rights of the debtor to challenge the liens of the secured creditor, in addition to waiving any claims and rights to setoff or other defenses against the secured creditor. In certain instances, a debtor will even attempt to grant a lien to its secured creditor which encumbers actions arising under Chapter 5 of the Bankruptcy Code and any proceeds thereof. *See Citation Corp.*, 04-08130 (Bankr. N.D. Ala. Oct. 19, 2004).

In other instances, a secured creditor will condition use of cash collateral on cross-collateralization or a “roll up” of its debt. While a creditors’ committee will typically object to such provisions on behalf of the unsecured creditors, in small cases, especially those under the small business debtor provisions of the Bankruptcy Code where no creditors’ committee exists, unsecured creditors should consider filing objections to such provisions.

Bankruptcy cases relating to the auto industry are typically no different than other cases with respect to treatment of suppliers under a cash collateral order. In fact, because certain proposed post-petition lenders are involved in several cases, motions for use of cash collateral and the grant of security in exchange for such financing are often nearly identical. Compare *In re Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. March 2, 2005) with *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 28, 2005); *In re Collins & Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich. May 17, 2005); *In re Citation Corp.*, Case No. 04-8130 (Bankr. N.D. Ala. Oct. 19, 2004). However, because setoff rights and statutory liens of suppliers and customers are particularly prevalent in auto-related cases, suppliers and customers alike should be concerned that the debtor will seek to subordinate setoff rights and other prepetition liens as part of their cash collateral negotiations with its prepetition secured lender. *See In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 28, 2005).

3. Reclamation. Section 546(c) of the Bankruptcy Code recognizes state law reclamation rights in bankruptcy cases. Specifically, section 546(c) provides that a trade creditor satisfying the state law requirements for reclamation under section 2-702(2), as well as

the additional requirements of section 546(c) itself, has a valid reclamation claim. *See* 11 U.S.C. § 546(c)(1). As a threshold matter, however, the rights of a reclamation claimant in bankruptcy depend on the date that the debtor filed its bankruptcy petition. As discussed below, in bankruptcy cases filed prior to October 17, 2005, a reclamation claimant's rights are much more limited than the rights of a reclamation claimant in a bankruptcy case filed after October 17, 2005.

In bankruptcy cases filed prior to the enactment of BAPCPA, a creditor filing a reclamation demand under section 546 must comply not only with the requirements of section 2-702(2) of the UCC, but it must also comply with the requirements of section 546(c)(1), including sending a written reclamation demand within either ten (10) days of the debtor's receipt of the goods, or if the ten day period expires after the bankruptcy filing, within twenty (20) days of receipt of the goods. *Id.* If a trade creditor satisfies both the applicable state law and the Bankruptcy Code requirements for reclamation, the creditor will generally be entitled to the return of the goods. *Id.* As an alternative though, a bankruptcy court can order that instead of the debtor returning the goods sought to be reclaimed, the debtor could grant the creditor a substitute remedy consisting of either a replacement lien in other assets of the debtor to secure payment of the reclamation claim, or an administrative expense claim in the amount of the reclamation claim, with priority over the claims of all prepetition unsecured creditors. 11 U.S.C. § 546(c)(1)(A) and (B).

Due to section 2-702(3) of the UCC, reclamation claimants have recently been denied a substantial portion, if not all, of their reclamation claim, which has been deemed subject to the debtor's secured inventory lender where that lender is undersecured. *See, e.g., In re Bridge Information Systems, Inc.*, 288 B.R. 133, 138 (Bankr. E.D. Mo. 2001). Section 2-702(3) provides that a seller's right of reclamation is subject to the rights of a buyer in the ordinary course or other good faith purchaser. UCC § 2-702(3). Pursuant to the definition of "good-faith purchaser," a purchaser includes a creditor holding a security interest or a lien. UCC § 1-201(20), (32) and (33). As such, reclamation rights have value under state law only to the extent that the value of the reclamation goods exceeds the amount of the secured lender's floating lien claim. *See, e.g., In re Quality Stores, Inc.*, 289 B.R. 324, 333-35 (Bankr. W.D. Mich. 2003). Bankruptcy courts have recently held that a secured party's security interest in a debtor's inventory has priority over an unpaid seller's reclamation rights, thereby leading to minimal or no distribution to reclamation claimants. *See, e.g., In re Pittsburgh-Canfield Corp.*, 309 B.R. 277 (B.A.P. 6th Cir. 2004) (holding reclamation claimants subject to secured lender's floating inventory lien and rejecting remedy of marshalling); *but see, e.g., In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003) (payment of prepetition secured lender from proceeds of post-petition financing agreement and not from sale of reclamation goods preserved value of reclamation claims).

Section 546(c) was revised by BAPCPA, which applies in cases filed on or after October 17, 2005, to include much greater protections to reclamation claimants. A reclamation claimant under revised section 546(c) now has the ability to reclaim goods sold on credit for a forty-five (45) day period prior to the debtor's petition date so long as written notice is provided to the debtor (i) within forty-five (45) days after the goods are received or (ii) within twenty (20) days after the petition date if the forty-five (45) day period expires after the petition date. 11 U.S.C. § 546(c)(1).

BAPCPA also grants administrative expense claims to reclaiming creditors for goods delivered within twenty (20) days before the debtor's petition date, subject to the requirement that the goods were sold in the ordinary course of the debtor's business. 11 U.S.C. §§ 503(b)(9) and 546(c)(2). A reclamation claimant need not provide written notice of its administrative claim under BAPCPA. 11 U.S.C. § 546(c)(2); *see* 11 U.S.C. § 503(b)(9). Moreover, under BAPCPA a reclamation claimant asserting its rights for an administrative claim arguably no longer needs to prove that the goods were still in the possession of the debtor prior to the demand, or that the goods were not consumed prior to the demand. 11 U.S.C. § 546(c). The reclaiming seller must merely demonstrate that the goods were delivered within twenty (20) days prior to the petition date. *Id.* Finally, although the reclaiming seller need not provide written notice of its administrative claim, such claim does not arise automatically. 11 U.S.C. § 503(b)(9). Rather, the reclaiming seller must be proactive by filing an administrative claim and seeking payment immediately or be subject to the applicable bar dates. *Id.*

Suppliers who sell goods to customers in the automotive sector are likely to reap substantial benefits from both the expansion of time in BAPCPA as well as the right to an administrative claim for goods provided in the twenty (20) days prior to the debtor's petition date. Because the automotive sector operates on a just-in-time basis, the extended reclamation period may not be as significant impact in automotive bankruptcy cases as in the bankruptcy cases relating to other industries. Nonetheless, suppliers will undoubtedly benefit from the administrative claims they hold against the debtor's estate for good they furnish to the debtor during the twenty (20) days prior to the petition date.

Despite the additional protections to reclamation claimants, BAPCPA does not provide protections to reclamation claimants with respect to the floating inventory lien of a prepetition secured lender. Rather, reclamation claimants are still susceptible to having their claims subordinated to the secured lender in cases under BAPCPA.

Suppliers seeking to reclaim goods that they provided to their customer-debtor should make a reclamation demand to the customer-debtor upon learning that the customer-debtor has filed for bankruptcy. As noted above, the demand should be made in writing, and contain certain information, including express references to section 2-702 of the UCC and section 546(c) of the Bankruptcy Code. Moreover, the demand should state the amount for which the supplier has not been paid, as well as either a summary of the shipment dates and the amounts evidencing the debt or copies of the actual invoices. Finally, the demand should request that the goods be segregated and immediately returned to the seller.

4. Critical Vendor. At the outset of a Chapter 11 bankruptcy case, debtors often seek entry of an order authorizing the debtors to pay, in their sole discretion, the prepetition claims of certain critical vendors that are essential to the uninterrupted functioning of the debtors' business operations and authorizing and directing the debtors banks to pay any checks or other transfers relating to such claims. *See, e.g., In re Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 2, 2005).

Initially, debtors relied on section 105(a) of the Bankruptcy Code, which codifies a court's general and equitable powers, for such authority. Under section 105(a), a court "can permit pre-plan payment of a prepetition obligation when essential to the continued operation of

the debtor.” *In re NVR LP*, 147 B.R. 126, 127 (Bankr. E.D. Va. 1992). Courts also looked to the “doctrine of necessity” and the “necessity of payment” doctrine, which recognize the existence of the judicial power to authorize a debtor in a reorganization case to pay prepetition claims where such payment is essential to the continued operation of the debtor. *In re Columbia Gas System, Inc.*, 171 B.R. 189, 191-92 (Bankr. D. Del. 1994); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

The rationale is that payment of the claims of critical vendors is vital to a debtor’s reorganization efforts because (i) the goods and services provided by critical vendors are often the only source from which the debtor can procure such goods or services; (ii) failure to pay the critical vendor claims would, in the business judgment of the debtor, result in the critical vendor refusing to provide its goods and/or services to the debtor; (iii) the critical vendors provide goods and services to the debtor on advantageous terms; and/or (iv) the critical vendors themselves would be irreparably damaged by the debtor’s failure to pay their prepetition claims, resulting in the debtor being forced to obtain goods and services elsewhere that would either be at a higher price or not of the quantity required by the debtor.

Prior to the decision of the Seventh Circuit Court of Appeals in *Capital Factors, Inc. v. Kmart Corporation*, critical vendor motions were routinely granted under the auspices of the court’s equitable powers pursuant to section 105(a) and the doctrine of necessity or the necessity of payment doctrine. Compare 359 F.3d 866 (7th Cir. 2004) with *In re Just for Feet, Inc.*, 242 B.R. 821, 824-25 (D. Del. 1999). In *Kmart*, the Seventh Circuit held that the critical vendor order entered by the bankruptcy court lacked the requisite factual foundation, and, therefore, had to be reversed. Moreover, the Seventh Circuit expressly rejected the view that the doctrine of necessity and the necessity of payment doctrine survived the enactment of the current Bankruptcy Code. Similarly, the Seventh Circuit rejected the idea that the bankruptcy court’s general equitable powers under section 105(a) could support a critical vendor order. Finally, the court rejected the notion that the critical vendor payments could constitute an administrative expense for credit advancements under section 364, nor could critical vendor payments be granted administrative expense status under section 503. However, the Seventh Circuit did suggest that critical vendor orders might be permissible under section 363(b)(1).

The *Kmart* decision now requires, at least in the Seventh Circuit, a rigorous showing that (i) the creditor truly is critical, (ii) the value of the continued relationship is critical, that the value of the continued relationship exceeds the amount to be paid, and (iii) the creditor would not continue to deal with the debtor, even on a COD basis, if not paid. *Kmart*, 359 F.3d at 873; see also *In re CoServe, Inc.*, 273 B.R. 487, 491 (Bankr. N.D. Tex. 2002) (allowing critical vendor payments, but only after three requirements satisfied); *In re Clark Retail Enterprises, Inc.*, No. 02-40045 (Bankr. N.D. Ill. Dec. 24, 2002) (refusing to authorize critical vendor payments due to failure of debtor to satisfy *CoServe* requirements).

After *Kmart*, the authority of a bankruptcy court to authorize payments to critical vendors appeared to be in doubt, especially in the Seventh Circuit. However, prior to the Seventh Circuit’s decision in *Kmart*, the authority relied upon to pay critical vendors changed due in large part to the bankruptcy court itself. *In re UAL Corp.*, Case No. 02-48191 (Bankr. N.D. Ill. Dec. 11, 2002).

In *UAL*, the debtors filed two critical vendor motions, both of which cited the doctrine of necessity as the statutory authority for the requested relief. As with most critical vendor motions, the *UAL* motions requested the authority, but not the obligation, to pay the claims of certain unidentified creditors up to an amount of almost \$100 million. At the first day hearings, the bankruptcy court appeared to surprise the debtors by recharacterizing the debtor's motion as a motion to pay the claims of certain prepetition vendors in the ordinary course of business pursuant to sections 363 and 364 of the Bankruptcy Code. In an apparent effort to clear up possible confusion, the bankruptcy court explained that it was not certain that such payments even required court authorization. According to the bankruptcy court, the only constraint on such payments was the exercise of the debtors' reasonable business judgment. The court, at least under the circumstances of the *UAL* cases, was willing to view the payment of vendors' prepetition claims as ordinary, re-negotiations of the trade terms between the debtors and their vendors and suppliers. *Id.*; see *Kmart*, 359 F.3d at 872-73 (suggesting that section 363, under appropriate circumstances, might provide support for critical vendor payments). Thereafter, the debtors filed, and the court entered, orders relying exclusively on sections 363 and 364 of the Bankruptcy Code as authority to pay the prepetition claims of trade creditors in the ordinary course of the debtors' business. *In re UAL Corp.*, Case No. 02-48191 (Bankr. N.D. Ill. Dec. 11, 2002).

Since *Kmart* and *UAL*, debtors generally have at least included the purported authority of a court to grant critical vendor motions pursuant to section 363(b)(1) and/or 364 as a precaution, along with the court's equitable powers under section 105(a), the doctrine of necessity and the necessity of payment doctrine. See *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 17 (Bankr. M.D. Fla. 2005); *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 13, 2005); *In re Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 2, 2005); see also *In re Meridian Auto. Sys.-Composites Operations, Inc.*, Case No. 05-11168 (Bankr. D. Del. May 26, 2005); but see also *In re CEI Roofing, Inc.*, 315 B.R. 50, 59 (Bankr. N.D. Tex. 2004) (suggesting section 362(a)(6) arguably allows for possibility of payment of unsecured prepetition claims prior to confirmation).

In the context of automotive bankruptcy cases, a debtor is likely to assert that the failure to pay critical vendor claims will result in (i) the debtor's inability to obtain necessary materials for the production of their products, (ii) temporary shutdowns of the facilities of the debtor's customers, including OEMs; and (iii) severe negative effects on the debtor's OEM customers. See, e.g., *Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 2, 2005).

In order to determine the amount of claims to pay, an automotive debtor is likely to represent to the court that it evaluated the critical nature of a supplier by analyzing several criteria, including: (i) whether the vendor was a sole-source vendor; (ii) whether certain quality control requirements of the debtor's OEM customers prevent the debtor from looking to alternative sources for a vendor's products or services; (iii) whether the debtor receives advantageous pricing or other terms from a vendor such that replacing the vendor post-petition would result in significantly higher costs to the debtor; and (iv) whether a vendor meeting the aforementioned standards might additionally be forced to cease business operations (due to such vendor's own liquidity constraints) in the event its prepetition claim against the debtor is not paid within a short time after the petition date. See, e.g., *Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 2, 2005); see also *In re Delphi Corp.*, Case No. 05-44481 (Bankr.

S.D.N.Y. October 8, 2005) (setting forth seven factors to consider in determining whether a supplier is a critical vendor).

In the past, debtors have used their discretion to pay prepetition claims to critical vendors as leverage by conditioning payment on the vendor's continued post-petition supply of goods and services that are consistent with historical trade terms between the parties. In recent cases, the debtors have expanded the conditions to which a supplier must agree in order to be paid as a critical vendor. *See, e.g., Tower Automotive, Inc.*, Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 2, 2005); *see In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. October 13, 2005).

The *Delphi* bankruptcy cases are illustrative of the strict conditions imposed on a supplier. The *Delphi* critical vendor order requires the supplier to execute a critical vendor agreement, which includes certain terms such as: (i) the supplier's agreement to supply pursuant to MNS-2 terms (payment due on the second business day of the second month after receipt of the goods), general terms and conditions of the debtors, and even any more favorable trade terms in effect between the supplier and the debtors in the twelve months prior to the petition date; (ii) the supplier's waiver of its lien rights; and (iii) the supplier's waiver of its reclamation rights.

In *Delphi* the debtors also included as part of their critical vendor motion the condition that if after the debtors and supplier enter into a critical vendor agreement, the supplier refuses to provide goods or services to the debtors on customary trade terms, then the debtors may declare the trade agreement terminated. Upon termination, the critical vendor payments would be reapplied to satisfy post-petition claims of the critical vendor. Any amounts paid as critical vendor payments that exceed the post-petition claims would then need to be returned to the debtors.

The *Delphi* critical vendor motion is fairly creative, in that it penalizes suppliers who attempt to coerce the debtors into making prepetition payments. In the event that such supplier, deemed a "rogue" supplier by *Delphi*, threatens to withhold the supply of goods without first being paid its prepetition claims, the critical vendor order allows the debtors to pay the amount to the rogue supplier on a conditional basis. Upon payment to any rogue supplier, the debtors are permitted to file a notice of waiver and a proposed order to show cause requiring the rogue supplier to explain to the bankruptcy court why its coercive actions did not amount to a violation of the automatic stay. According to the critical vendor order, if the court agrees with the debtors and finds a violation of the automatic stay, then the bankruptcy court could order the rogue supplier to disgorge the critical vendor payments plus attorneys fees and interest.

Finally, the *Delphi* critical vendor order provides by ratifying certain prepetition payments made to "prefunded suppliers." Such payments were allegedly made to the prefunded suppliers because their supply was essential to the debtors continued operations. Because payments were made prepetition, the prefunded suppliers would seemingly have no incentive to execute a critical vendor agreement and be bound by terms most favorable to the debtors. Recognizing this fact, the debtors in *Delphi* agreed to waive any preference claims against the prefunded suppliers in exchange for their execution of the critical vendor agreement.

Because the automotive industry operates almost wholly within a just-in-time framework, automotive debtors must ensure that their supply chains are uninterrupted. Critical vendor

payments allow automotive debtors to maintain relations with their suppliers while also receiving some concessions from those same suppliers in that the debtors may impose their most favorable trade terms. As the number of automotive bankruptcies increase, the recent shield and sword characteristics of critical vendor motions are likely to result in additional conditions imposed on a suppliers in exchange for critical vendor payments.

5. Case Management. In larger bankruptcy cases, it is not uncommon for a debtor to file a motion seeking to establish case management procedures, including the establishment of omnibus hearing dates, notice, case management and administrative procedures, and case conferences. Bankruptcy courts routinely grant such motions by relying on section 102(1)(A) and 105(a), as well as Rules 9007 and 2002(a) of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”).

Case management orders will often modify or even override the local rules of the bankruptcy court in which the case is pending. In many instances, the failure of a party to follow the procedures set forth in the case management order may result in an untimely filed pleading. Where a case management order has been entered, parties in interest, including suppliers and customers of a debtor in the auto sector, should be careful to adhere to these procedures.

C. Cross-Border Insolvency Cases

In the recent past, there have been a number of cross-border auto supplier bankruptcy cases in which either (i) an insolvent debtor or debtors subject to pending bankruptcy cases in the United States have assets or creditors in more than one country; or (ii) related debtors have commenced bankruptcy cases in the United States and at least one other country. *See, e.g., In re Collins & Aikman Corporation*, Case No. 05-55927 (Bankr. E.D. Mich. 2005); *In re Venture Holdings Company, L.L.C.*, Case No. 03-48939 (Bankr. E.D. Mich. 2003); *In re Federal-Mogul Global, Inc.*, Case No. 01-10578 (Bankr. D. Del. 2001). The Bankruptcy Abuse Prevention and Consumer Protection Act, Public Law 109-8, enacted by Congress in 2005 and signed into law by President George W. Bush, adopted new Chapter 15 of the Federal Bankruptcy Code dealing with cross-border insolvency cases. Chapter 15 incorporates the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross Border Insolvency adopted on May 30, 1997. At present, a number of countries have also adopted the Model Law including Japan, Mexico and South Africa.

The statutory purpose of Chapter 15 are set forth in 11 U.S.C. § 1501(a), which seeks to provide “effective mechanisms for dealing with cases of cross-border insolvency” with the following objectives: (a) to facilitate cooperation between American courts, trustees, examiners, debtors and debtors in possession and their foreign counterparts; (b) to establish “greater legal certainty for trade or investment”; (c) to promote the “fair and efficient administration” of cross-border insolvencies so as to protect parties in interest, including the debtors and their creditors; (d) to protect and maximize the value of debtors’ assets; and (e) to facilitate “the rescue of financially troubled businesses, thereby protecting investment and preserving employment.” The provisions of Chapter 15 will apply in the following four circumstances:

(i) where a foreign court or foreign representative of a foreign debtor seeks assistance in the United States in connection with a foreign insolvency proceeding;

(ii) where a United States court or its officers (*e.g.*, a trustee, examiner or debtor in possession) seeks assistance in a foreign country in connection with an American bankruptcy case;

(iii) where a foreign insolvency proceeding and an American bankruptcy case with respect to the same debtor “are pending concurrently”; or

(iv) where foreign creditors or other parties in interest desire to commence an American bankruptcy case or proceeding or participate in such a case or proceeding.

11 U.S.C. § 1501(b).

Chapter 15 permits a foreign representative of a debtor to file with a United States Bankruptcy Court a “petition for recognition” of a foreign insolvency proceeding, thereby obtaining direct access to American bankruptcy courts to assist in the administration of assets located in the United States and to take other appropriate action here. 11 U.S.C. §§ 1504, 1507, 1509, and 1513. In the event that the United States court enters an order granting recognition of the foreign insolvency proceeding, certain circumstances will follow depending upon whether the foreign proceeding is deemed to be a “foreign main proceeding” or a “foreign nonmain proceeding.” 11 U.S.C. §§ 1519-1521.⁸

Chapter 15 also formally recognizes the general principle that foreign creditors will have “the same rights regarding the commencement of, and participation in,” an American bankruptcy case as domestic creditors have. 11 U.S.C. § 1513(a). This principle, however, is subject to the power of an American bankruptcy court to refuse to take an action “if the action would be manifestly contrary to the public policy of the United States.” 11 U.S.C. § 1506.

Finally, if a foreign proceeding and an American bankruptcy proceeding are pending with respect to related debtors, section 1526 of the Federal Bankruptcy Code permits an American trustee “or other person, including an examiner” to cooperate “to the maxim extent possible with a foreign court or a foreign representative” subject, however, to the supervision of the American court. 11 U.S.C. § 1526(a). These American trustees or other persons are entitled to communicate directly with a foreign court or foreign representative subject to the American’s court’s supervisory power. 11 U.S.C. § 1526(b). American courts are also authorized to cooperate with foreign courts and foreign representatives, which cooperation includes direct communication with the foreign court or foreign representative. 11 U.S.C. § 1525. The term, “cooperation,” as used in these Code sections specifically includes coordination of the concurrent insolvency proceedings and the approval or implementation of agreements concerning that coordination. 11 U.S.C. § 1527. The foregoing provisions codify the practice of the negotiation and approval of protocols between American and foreign courts when related debtors have commenced insolvency proceedings in the United States and other countries. *See*

⁸ The term, “foreign main proceeding,” is defined as “a foreign proceeding pending in the country where the debtor has the center of its main interests.” 11 U.S.C. § 1502(4). The term, “foreign nonmain proceeding,” means “a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment.” 11 U.S.C. § 1502(5). “Establishment” means “any place of operations where the debtor carries out a nontransitory economic activity.” 11 U.S.C. § 1502(2).

generally Evelyn H. Biery, *et al.*, *A Look at Transnational Insolvencies and Chapter 15 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 47 B.C.L.Rev. 23 (2005).

D. Executory Contracts Issues

1. What is an Executory Contract? Section 365 of the Bankruptcy Code allows the debtor, subject to approval of the court, to assume or reject executory contracts (and unexpired leases) that are part of the debtor's estate. 11 U.S.C. § 365. The Bankruptcy Code grants debtors the opportunity to reject executory contracts "in order to relieve the estate of burdensome obligations while at the same time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing may otherwise make them reluctant to do so." *In re Chateaugay Corp.*, 10 F.3d 944, 954-55 (2d Cir. 1993). 11 U.S.C. § 365.

Any analysis under section 365 of the Bankruptcy Code must begin with a determination as to whether a contract is in fact executory. Courts have adopted the definition first expounded by Professor Vern Countryman, which provides that:

A contract [is executory if it is one] under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

When application of the Countryman definition leaves a court in doubt, executory contracts may also be identified by reference to the goals of section 365, including: (i) taking advantage of contracts which will benefit the estate; (ii) relieving the estate of burdensome contracts, (iii) promoting a debtor's fresh start; (iv) permitting the allowance and determination of claims; and (v) preventing parties from remaining "in doubt concerning their states vis-à-vis the estate." *In re Cardinal Industries, Inc.*, 146 B.R. 720, 726 (Bankr. S.D. Ohio 1992) (citation omitted).

2. Types of Contracts Involved in Auto Supplier Cases. In the auto sector, contracts are commonly in the form of purchase orders, which tend to include various terms and conditions such as pricing, but often lack reference to specific quantity. Instead, a customer will often electronically issue a schedule of releases on a weekly or monthly basis that sets for the volume of production required. Based on the releases, a supplier will schedule production, manufacture and ship parts to the customer. Contracts may be for a definite duration without any extension clauses, while others are for a definite duration, subject to automatic renewal for an additional period unless notice of non-renewal is provided. In many instances, a customer will have the right to terminate the contract at will.

Aside from parts supply, customers will often request that a supplier manufacture, or arrange for the manufacture, of tools and dies. Payment for tools and dies is often made when the supplier submits an invoice requesting payment upon completion and or delivery of the tool or die. Where the customer issues a purchase order for tools and dies, the purchase order is

likely to provide that the customer owns the tools and dies and, therefore, such tools and dies are property of the customer, subject to removal from the supplier's premises upon short notice.

3. General Bankruptcy Code Provisions Governing Executory Contracts. As noted above, section 365 governs the assumption and rejection of executory contracts and unexpired leases. 11 U.S.C. § 365. The purpose is to permit the debtor to continue to use valuable estate property and to “renounce title to and abandon burdensome property.” *Orion Pictures Corp. v. Showtime Networks, Inc.*, 4 F.3d 1095, 1098 (2d Cir. 1993); see *Matter of JRT, Inc.*, 121 B.R. 5314, 320 (Bankr. W.D. Mich. 1990). In determining whether an executory contract is burdensome, courts overwhelmingly defer to the sound business judgment of the debtor. See, e.g., *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985). However, a court may override the debtor's business judgment where it “is so manifestly unreasonable that it could not be based on sound business judgment, but only bad faith, or whim or caprice.” *Id.* at 1047; see *In re Federal Mogul Global, Inc.*, 293 B.R. 124, 126 (D. Del. 2003) (decision should be approved unless bad faith or gross abuse of discretion).

a. “Limbo” period. The Bankruptcy Code is silent on the rights and obligations of the parties to an executory contract during the period between the filing of the petition and the time of assumption or rejection, often referred to as the “limbo” period. *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (citation omitted). However, it is widely accepted that an executory contract generally remains in effect pending assumption or rejection by a debtor. See, e.g., *Pub. Serv. Co. of N.H.*, 884 F.2d 11, 14 (1st Cir. 1989).

Most courts agree that before an executory contract is assumed or rejected, the contract continues to exist, enforceable by, but not against, the debtor. *In re Rhodes, Inc.*, 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005); *National Steel*, 316 B.R. at 305; *In re Boling Group, L.L.C.*, 2002 WL 31812671 *6 (Bankr. M.D.N.C. Dec. 13, 2002); *Matter of Travelot Co.*, 286 B.R. 462, 466 (Bankr. N.D. Ga. 2002); *Pittsburgh-Canfield*, 283 B.R. at 238. *But see In re Lucre, Inc.*, 339 B.R. 648 (Bankr. W.D. Mich. 2006). The non-debtor party to an executory contract must continue to perform prior to assumption or rejection, but the debtor is not bound by the provisions of the executory contract unless the contract is subsequently assumed. *In re El Paso Refinery, L.P.*, 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996); see *In re Pittsburgh-Canfield Corp.*, 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002) (non-debtor party “cannot unilaterally elect to cease performance on an executory contract prior to assumption or rejection.”).

When a debtor in the auto sector files for bankruptcy, it is likely that the debtor's suppliers will be obligated to continue to honor and perform under their agreements with the debtor, including requirements contracts. In order to compel performance, a debtor needs to demonstrate that it has continued to make timely post-petition payments to the supplier and that it would suffer irreparable injury as a result of any supplier's refusal to perform. See *In re Continental Energy Assocs. Ltd. P'ship*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) (setting forth requirements for issuance of injunction enforcing performance); see also *Matter of Whitcomb & Keller Mortgage Co., Inc.*, 715 F.2d 375, 378-80 (7th Cir. 1983) (injunction appropriate to compel performance where payments made by debtor and non-debtor suffers no harm or prejudice).

Under most circumstances, it is likely that a debtor's suppliers could be compelled to perform under their agreements with the debtor during the limbo period. In the event that a supplier is dissatisfied with the limbo period, the supplier's most appropriate attempt at relief would be to file a motion to compel assumption or rejection. *See, e.g., Pub. Serv. Co.*, 884 F.2d 11, 15-16 (1st Cir. 1989).

Where a supplier has a commercially valid reason to be concerned with a debtor's ability to continue to perform and is concerned that the debtor may file for bankruptcy, thus binding the supplier during the limbo period, the supplier can demand adequate assurance of performance from the debtor prior to the petition date. UCC 2-609; *see supra* at Section IV(A).

b. Contracts can be assumed, assumed and assigned, or rejected pursuant to a court order or as part of a Chapter 11 plan. Executory contracts may be assumed or rejected by a debtor upon approval by the court or as part of a Chapter 11 plan. 11 U.S.C. §§ 365(a) and 1123(b)(2). Moreover, the Bankruptcy Code authorizes a debtor, again, with court approval or as part of a Chapter 11 plan, to assume and assign an executory contract to a third party. 11 U.S.C. §§ 365(f) and 1123(b)(2). A debtor cannot assume or reject (i) a post-petition contract, (ii) a contract that has been properly terminated pursuant to applicable law prior to the petition date, or (iii) a contract expiring post-petition by its own terms. 11 U.S.C. § 365(c)(3); *In re National Steel Corp.*, 316 B.R. 287, 304 (Bankr. N.D. Ill. 2004); *In re Merry-Go-Round Enter., Inc.*, 208 B.R. 637, 643 (Bankr. M.D. Md. 1997); *In re Atlantic Computer Sys., Inc.*, 173 B.R. 844, 855 (S.D.N.Y. 1994).

A debtor can only assume or reject an executory contract in its entirety. In other words, the debtor may not pick and choose among contractual provisions, rejecting those it deems burdensome and accepting those it view as beneficial. The contract must be assumed *cum onere*, taking the bad with the good. *City of Covington v. Covington Landing Ltd. P'ship*, 71 F.3d 1221, 1226 (6th Cir. 1995); *Department of the Air Force v. Carolina Parachute Corp.*, 907 F.2d 1469, 1472 (4th Cir. 1990). This "all or nothing" requirement does not mean, however, that every document denominated a "contract" is in fact a single indivisible agreement. Where a single unitary contract includes several agreements, the above rule applies in that the debtor cannot assume some while rejecting others. However, if there are multiple, severable contracts, even though incorporated into a single document, the debtor may assume some, while rejecting others. The critical inquiry is whether a single, integrated agreement exists, which is primarily a question of the parties' intent, as determined from the agreement. *See Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741-42 (5th Cir. 1996). In the case of an auto supplier or customer, assumption or rejection *cum onere* will often arise due to the prevalence of master agreements governing several purchase orders.

The Bankruptcy Code provides three prerequisites for the assumption of an executory contract. 11 U.S.C. § 365(b). First, if the contract is in default at the time it is to be assumed (other than as a result of a breach of an insolvency or bankruptcy clause), the debtor must promptly cure all defaults, or at least provide "adequate assurance" that the defaults will be promptly cured. Second, the debtor must compensate or provide adequate assurance of prompt compensation for "actual pecuniary loss" to the non-debtor party resulting from such default. Third, the debtor must provide adequate assurance of future performance under the contract. The majority of courts hold that when a debtor seeks to assume an executory contract under section

365, the debtor must cure both the prepetition and post-petition defaults. *See, e.g., In re Emerald Forest Constr., Inc.*, 226 B.R. 659, 664 (Bankr. D. Mont. 1998); *In re Washington Capital Aviation & Leasing*, 156 B.R. 167, 173 (Bankr. E.D. Va. 1993).

Often, an executory contract will be of little value to the debtor in its efforts to reorganize, but may be of value to a third party assignee such that it will be beneficial for the debtor to assume the agreement and assign it to a third party in exchange for compensation. The prerequisites for assumption and assignment are essentially the same as the prerequisites for assumption with one exception. In the case of an assignment, in addition to fulfilling the first two requirements of assumption (*e.g.*, curing defaults and compensating for pecuniary loss), adequate assurance must be given of the future performance by the third party assignee. *See* 11 U.S.C. § 365(f)(2).

Section 365(g) of the Bankruptcy Code addresses the effect of a debtor's decision to reject an executory contract. In summary, rejection of the debtor's executory contract constitutes a breach of that contract, giving the aggrieved party a claim against the estate. 11 U.S.C. § 365(g). If the contract has not been previously assumed, then the claim is treated as if it arose immediately prior to the date of the petition, which has the effect of putting the aggrieved party on par with other unsecured creditors, who are entitled to share in the estate pro rata. 11 U.S.C. §§ 365(g)(1) and 502(g). If a debtor assumes an executory contract only to breach it later, the aggrieved party will be entitled to an administrative claim.

A decision to reject, similar to a decision to assume, is based on a debtor's business judgment. If the business judgment test is satisfied, courts generally consider the equities of rejection, including the effect on the non-debtor party, third parties and the economy. When the potential of severe harm to others from rejection of a contract exists, the debtor must demonstrate that the equities balance in favor of rejection, and that rejection of the contract would further the goal of permitting a successful rehabilitation of the debtor. *Matter of Mirant*, 378 F.3d 511, 525-26 (5th Cir. 2004). Courts have also examined the disproportionate damages to the other party to the contract in assessing whether rejection is appropriate. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984); *In re Monarch Tool & Mfg. Co.*, 114 B.R. 134, 137 (Bankr. S.D. Ohio 1990). Finally, as with assumption, a court must determine whether the debtor's decision to reject the executory contract has been undertaken in good faith. *In re Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985).

c. Ipsa facto clauses. Agreements often contain clauses which purport to terminate or modify the terms of that agreement upon the insolvency or financial condition of a party, including the commencement of a bankruptcy case or the appointment of a trustee or a receiver. Section 365(e)(1) renders such clauses ineffective in bankruptcy. 11 U.S.C. § 365(e)(1); *see In re Margulis*, 323 B.R. 130, 135 (Bankr. S.D.N.Y. 2005). If the termination or condition is triggered by an event other than one of the three set forth in section 365(e)(1), the clause will not be invalidated. *Id.* at 135-36; *see In re Nemko, Inc.*, 163 B.R. 927, 938 (Bankr. E.D.N.Y. 1994) (section 365(e)(1) does not apply to a contract breached prepetition); *In re LJP, Inc.*, 22 B.R. 556 (Bankr. S.D. Fla. 1982) (termination based on insolvency not undone because termination occurred prior to commencement of case).

d. Time periods for assumption and rejection. As a general rule, an executory contract may be assumed or rejected by the debtor at any time prior to confirmation of a plan. 11 U.S.C. § 365(d)(2). However, a party to an executory contract may seek to compel a debtor to determine whether to assume or reject the contract within a specified period of time. *Id.* In certain circumstances, the rights of a non-debtor party will outweigh the needs of the debtor for unlimited flexibility and breathing space. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 552 (1984). Thus, “the breathing space afforded to the debtor for the assumption or rejection of executory contracts is not without limits.” *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002). Rather, bankruptcy courts apply their discretion to determine the reasonable time for a debtor to decide whether to assume or reject by evaluating a list of non-exhaustive factors. *See, e.g., In re Adelphi Communications Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003).

4. Strategies for Customers with Executory Contracts. A debtor-supplier is likely to seek to reject certain executory contracts where (i) the contracts do not generate a profit for the debtor, (ii) pricing terms are below market, (iii) the timing of payments under the contracts is too slow, and (iv) requested price give-backs are too onerous. As discussed below, a customer whose contract is subject to rejection is likely to raise several policy issues against rejection.

A customer is most likely to desire to have its agreement with its debtor-supplier assumed because the debtor-supplier will be forced, as part of assumption, to cure any existing defaults, and to provide payment for pecuniary losses. In the auto sector, customers may have additional concerns in that the rejection of executory contracts would cause considerable economic harm to the customer, customers and suppliers to the customers, in addition to the customer’s employees, because the customer would be unable to readily locate alternative supply sources. *See In re Intermet Corp.*, Case No. 04-67597 (Bankr. E.D. Mich. Dec. 6, 2004).

Because the auto sector operates primarily on a just in time inventory delivery system, a decision by the debtor to reject executory contracts is likely to have a ripple effect throughout the industry. Therefore, attempts by a debtor to reject executory contracts with suppliers have been opposed to by the customers on the basis that rejection is sought by the debtor solely as a coercive tactic to obtain concessions from the customers. *Id.*

Customers facing rejection are likely to argue that a debtor is not necessarily seeking to reject based on sound business judgment, but rather as a threat in order to coerce the customer to capitulate to the debtor’s demands for uncompetitive price increases. *Id.* In an auto supply context, customers have previously requested, among other things, that, in the event the court approves rejection, such rejection not be deemed to occur until after the customer has a reasonable opportunity to transfer production to an alternate supplier. *Id.*

Customers are entitled to receive adequate assurance of future performance from the supplier-debtor or any assignee in some form or another if their contracts are assumed or assumed and assigned. *See* 11 U.S.C. § 365(b)(1)(C) and (f)(2). It is advisable for a customer to seek assumption where the debtor-supplier is the only source from which it can obtain the goods or services, and immediate resourcing is not an option, or, of course, where the terms of the agreement are extremely favorable to the customer. Finally, where a debtor has provided a

significant amount of payments within the ninety (90) days prior to the petition date, a customer should consider requesting that the debtor assume the agreement under which such payments were made so as to provide a defense to potential preference claims. *See, e.g., In re Kiwi Int'l Air Lines, Inc.*, 344 F.3d 311, 316 (3d. Cir. 2003).

Where a customer lacks confidence in the ability of the reorganized debtor or its proposed assignee to perform, the customer should consider seeking to compel rejection. As noted above, whether the customer can resource in such a fashion so as not to interrupt its business operations will also be a major consideration. Furthermore, where the terms of a specific agreement are unfavorable, the customer may decide to attempt to persuade the debtor to reject the agreement. However, any decision regarding rejection should be weighed against the two primary benefits offered through assumption, cure and waiver of preference liability with respect to the agreement assumed.

5. Strategies for Suppliers with Executory Contracts. If terms of a contract are unsatisfactory to the supplier, the supplier may wish to attempt to convince the debtor to reject its contract. Similarly, if the supplier's sales to the debtor are not substantial, rejection may be in the supplier's best interests. Finally, where a debtor's ability to reorganize is questioned or if the financial condition of the proposed assignee is weak, a supplier should consider attempting to persuade the debtor to reject the contract, or if the debtor seeks to assign the contract, oppose its assignment.

A supplier is more likely to desire to have its agreements with the debtor-customer assumed, though. It is most likely in the supplier's best interest for the debtor to seek assumption where the contract price and other terms (*e.g.*, payment terms) are satisfactory. If sales to the debtor have historically been substantial, the supplier may also desire assumption so as not to lose a formidable source of revenue. More importantly, a supplier may face a liquidity crisis due to its debtor-customer's indecision with respect to executory contracts. *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Jan. 27, 2006). A supplier's ability to obtain funding from its lender may be contingent on the supplier's ability to continue to supply the debtor-customer in the future.

A customer-debtor may attempt to use its ability to assume executory supply contracts as leverage to renegotiate certain terms. For instance, a customer-debtor may promise assumption, in its own discretion, of executory contracts where the supplier agrees to (i) extend the term, (ii) adhere to MNS-2 payment terms and conditions most favorable to the debtor, (iii) waiver of the supplier's right to seek further adequate protection of future performance. *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Nov. 18, 2005). In at least one recent case, the debtors demanded these concessions from their suppliers in exchange for assumption, but did not provide the suppliers with the entire cure amount. *Id.* Instead, a supplier whose agreement was assumed was entitled only to a 75% cure of defaults. More alarmingly, the bankruptcy court's order provided the debtors with the discretion to cure for less than 75%. Finally, the debtors attempted to entice suppliers by waiving their rights to pursue preference claims against the suppliers in exchange for the suppliers' execution of an assumption agreement. While a waiver of preference claims seemed very generous, what many suppliers failed to realize was that upon assumption, the supplier would have a complete defense to preference claims related to the contract assumed. Therefore, recent tactics have demonstrated that assumption is now being portrayed by debtors as

a luxury or privilege, despite the fact that debtors are deriving substantial benefits through assumption.