Dealing With Financially Distressed Contract Parties: Should I Terminate My Contract Before They File for Bankruptcy?

There are advantages and disadvantages to having a contract in effect when bankruptcy is filed. Where a default exists prebankruptcy that would justify a notice of default, unilateral termination, or both, the non-debtor party has options and can evaluate and implement an optimal course of action. Once bankruptcy is filed, those options become more limited, as the automatic stay will prevent the non-debtor from unilaterally terminating the contract, and actions, such as court-approved assumption and/or assignment, may occur without the non-debtor's consent.

Key Issues

Among the advantages to having a contract in effect when bankruptcy is filed are:

- The debtor must cure (*i.e.*, pay) all monetary defaults before it can assume a contract;
- If the contract is assumed, there will be no preference (*i.e.*, clawback) exposure for amounts paid within 90-days before bankruptcy (a contract that has been terminated prebankruptcy cannot be assumed); and
- There is potential for an ongoing business relationship with the debtor (or a purchaser) if the debtor's business continues to operate or is being sold.

The disadvantages to having a contract in effect when bankruptcy is filed include:

- The automatic stay prevents a non-debtor from unilaterally terminating the contract;
- The non-debtor must continue to perform under the contract until it is rejected;
- Contractual provisions allowing unilateral termination or alteration of terms based on the bankruptcy or the debtor's financial condition will be unenforceable;
- Contractual limitations on assignment may be unenforceable;
- The non-debtor can't be certain whether the debtor will ultimately assume or reject the contract, or when that might occur, but may still incur costs in preparing to perform (think of the manufacturer that may have ordered supplies well in advance to produce goods under a supply agreement); and
- The bankruptcy case must be carefully monitored to ensure that rights are preserved.

Takeaway

In deciding whether to terminate a contract prebankruptcy, one must assess (1) one's own need for the benefits conferred by the contract; (2) the likelihood that the debtor or a purchaser will want or need to assume the contract to continue to operate the debtor's business, and what leverage that may create; (3) the outstanding obligations that would need to be paid as cure if the contract is assumed; (4) the potential preference exposure for any recent payments received; and perhaps most importantly, (5) the soundness of the contractual basis for termination. Given the speed with which rumors of financial distress may be followed by an actual bankruptcy, contract parties should act diligently to determine their best path forward while they still have options.