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Requirement Contracts in Bankruptcy

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Comment

REQUIREMENT CONTRACTS IN BANKRUPTCY

INTRODUCTION

In this age of ever increasing needs for goods and services, requirement contracts have come to play an important role in allowing a company to tailor-make its contracts to fit not only present needs but also its future needs. The requirements buyer promises to order all or a certain percentage of his requirements from only the requirements seller in return for the seller's promise to fill all of the buyer's orders.[1]

Output contracts are very similar to requirement contracts except that fluctuations in the amount of goods involved under the former are contingent on the seller's output instead of the buyer's requirements because of the seller's promise to deliver his output, or a percentage of his output, only to the buyer. This distinction between requirement and output contracts has no significant bearing on the general rules applied to these two types of contracts when a breach is involved. Therefore, for the purpose of this article the term "requirements contract" will be considered to include output contracts.

Requirement contracts allow a company to increase and decrease its orders in relation to its needs, placing the company in an advantageous position to that held by companies with nonfluctuating supply contracts. However, this position is not always as advantageous as it would seem, especially when the needs of the requirement buyer are vastly increased, decreased or ceased altogether. When the latter occurs upon the bankruptcy of the buyer, whether voluntary or involuntary, the position of the parties is uncertain. Although there are several articles that have analyzed, in depth,

[1] "While older cases viewed such contracts as lacking in mutuality and consideration, because the buyer in a requirements contract might refrain from having requirements or the seller in an output contract might have no output, since the second or third decade of this century there has been a general rejection of the view. In substitution, most courts have found support for the return performance either in an implied promise to continue requirements at a level approximately equivalent to experience up to the time of contracting, or in an implied promise to remain or start in business and have good faith requirements. Probably the widest accepted position has been that a requirements or output contract involved the implied promise not to buy from suppliers or not to sell to other purchasers." R. DUESENBERG & L. KING, SALES & BULK SALES UNDER THE UNIFORM COMMERCIAL CODE § 4.05 (1966).

the rights and duties of the parties to an executory contract in general when one of the parties to the contract becomes bankrupt,[2] these analyses are not entirely applicable to requirement contracts. Requirement contracts, while considered to be a species of executory contracts, actually are a genus in themselves because of the unique rules that cover a breach of such contracts. While normally an executory contract is considered breached when one of the parties fails to perform within the time limit set for performance,[3] that is generally not true for both parties of a requirements contract. "A requirements buyer does not breach his contract when requirements for supplies diminish or when he ceases to have requirements by reason of his going out of business."[4] This article will deal exclusively with this uniqueness of requirement contracts and how it affects provable claims in bankruptcy when the requirements buyer is the bankrupt.

PROVABILITY OF CLAIMS BASED ON REQUIREMENT CONTRACT BREACHES

The general rule applied to an executory contract, of which one of the parties to the contract is a bankrupt, was stated by the United States Supreme Court in *Central Trust Company v. Chicago Auditorium Association:*[5] "Proceedings, whether voluntary or involuntary, resulting in an adjudication of bankruptcy, are the equivalent of an anticipatory breach of an executory agreement. . . ."[6]

Although this general rule would seem to encompass all executory contracts *in toto, In re United Cigar Stores Company of America*[7] has limited the rule's application in requirement contract cases to cover only those in which the bankrupt party is not acting in good faith.[8] *United Cigar* concerned a requirements buyer that ceased making purchases from its supplier upon filing a petition for voluntary bankruptcy. The court in its opinion recognized that: (1) requirement contracts are valid and binding; (2) the bankruptcy of one of the parties to an executory contract does not excuse his performance; and (3) a claim based on nonperformance

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2 Ballantine, *Anticipatory Breach and the Enforcement of Contractual Duties*, 22 MICH. L. REV. 329 (1924); Broude, *Executory Contracts and Bankruptcy: The Case for a Federal Common Law*, 17 KAN. L. REV. 1 (1968).

3 4 A. CORBIN, CORBIN ON CONTRACTS § 943 (1951).

4 Western Fuel & Oil Co. v. Kemp, 245 F.2d 633, 638 (8th Cir. 1957).

5 240 U.S. 581 (1916).

6 *Id.* at 592.

7 72 F.2d 673 (2d Cir. 1934).

8 *Id.* at 674.

is provable against the bankrupt.[9] However, it was held that under the circumstances of the case the contract was not breached because "though bankruptcy may not excuse a breach, it may have so changed the buyer's requirements that this contract was not broken."[10] The court imposed upon the buyer only the obligation to act in good faith.[11]

Thus, the exception to the general rule was established and it has been the polestar upon which later courts have relied.[12] Since the exception only applies to good faith action by the bankrupt, it would seem that the general rule that bankruptcy is an anticipatory breach would still apply in all those instances in which the bankrupt acts in bad faith. This, because of the broad meaning of "good faith" that courts have developed,[13] has not been substantiated by case law. However, because of the inherent unsoundness of the general rule, courts may be reluctant to apply it even where the bankrupt has acted in bad faith. This unsoundness is due basically to the conflict which arises between the powers of the bankruptcy trustee and normal anticipatory breach procedures as delineated by the Uniform Commercial Code.[14]

In addition to being unsound, the general rule would also be unnecessary in bad faith cases because of the basic rule of requirement contracts that a bad faith cessation of business is a present breach upon the cessation.[15] Since there would be a present breach whenever a bad faith cessation occurred before the bankruptcy petition was filed, the requirements seller would have a provable claim under section 63a(4) of the Bankruptcy Act[16] as a debt on an express contract.

In those cases where the cessation does not occur until after the petition is filed, the seller's claim would still seem to be provable.

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9 *Id.*
10 *Id.*
11 *Id.* at 675.
12 Western Fuel & Oil Co. v. Kemp, 245 F.2d 633 (8th Cir. 1957); Oregon Plywood Sales Corp. v. Sutherlin Plywood Corp., 246 F.2d 466 (9th Cir. 1957); HML Corp. v. General Goods Corp., 365 F.2d 77 (3d Cir. 1966).
13 *E.g.*, HML Corp. v. General Foods Corp., 365 F.2d 77, 81 (3d Cir. 1966). "[T]he seller assumes the risk of all good faith variations in the buyer's requirements even to the extent of a determination to liquidate or discontinue the business."
14 For an article that succinctly points up the weaknesses in the general rule, *see* Broude, *Executory Contracts and Bankruptcy: The Case for a Federal Common Law*, 17 KAN. L. REV. 1 (1968).
15 Western Fuel & Oil Co. v. Kemp, 245 F.2d 633, 638 (8th Cir. 1957).
16 Bankruptcy Act § 63a(4), 11 U.S.C. § 103a(4) (1964).

Under section 70b "[t]he trustee shall assume or reject an executory contract."[17]

> Unless the contract clearly provides that bankruptcy terminates the contract or gives the other party the option to terminate, the bankruptcy trustee cannot be prevented from exercising the privilege vested in him by 70b of choosing whether to assume or reject the contract.[18]

When the trustee acts under this power to reject an executory contract, the rejection constitutes a breach of such contract as of the date of the filing of the petition.[19] Thus, the implied requirement in section 63a that the breach must have occurred before or upon the filing of the petition[20] is satisfied, and claims resulting from the breach are provable as claims upon an express contract under 63a(4).[21]

Notwithstanding the express language of section 70b, the question may be raised whether section 70b should be applied at all to requirement contracts as the trustee may not have the power to accept this peculiar type of executory contract. The trustee's power to accept under section 70b is correlated to section 70a from which the trustee derives the title of the bankrupt as of the date of filing the bankruptcy petition in regard to property specified in section 70a.[22] Such property includes "property . . . which prior to the filing of the petition [the bankrupt] could by any means have transferred."[23] Therefore, the power of the trustee to accept a requirements contract is dependent upon whether the contract is transferable. This could be a barrier blocking acceptance of a requirements contract. There have been decisions in which the requirement contracts involved have been held non-transferable due to their personal nature.[24]

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[17] Bankruptcy Act § 70b, 11 U.S.C. § 110b (1964).

[18] 4A W. COLLIER, BANKRUPTCY, Para. 70.43 at 535 (14th ed. 1967).

[19] Bankruptcy Act § 63c, 11 U.S.C. § 103c (1964).

[20] "That part of the present bankruptcy act which describes what debts may be proved does not repeat at all points the words 'owing at the filing of the petition,' but it is impossible to consider it other than as though it did thus repeat them." *In re* Swift, 112 F. 315, 321 (1st Cir. 1901). There are now several exceptions to the above quote, one of which specifically relates to express contracts, *i.e.*, section 63a(8) allows the provability of contingent debts.

[21] Bankruptcy Act § 63a(4), 11 U.S.C. § 103a(4) (1964).

[22] Bankruptcy Act § 70a, 11 U.S.C. § 110a (1964).

[23] *Id.*

[24] *E.g.*, Crane Ice Cream Co. v. Terminal Freezing & Heating Co., 147 Md. 588, 128 A. 280 (1925).

If a requirements contract is considered non-transferable, apparently section 70b would not be applicable. Therefore, the seller's claim would be considered to have come into existence after the bankruptcy petition was filed, making it a non-provable claim. Feasibly, in a rare case, this problem might arise, but the interaction between the Uniform Commercial Code, the Bankruptcy Act and accepted contract principles would limit this possibility to insignificance. In the vast majority of cases where the requirements buyer is bankrupt, the trustee should be allowed to assume the bankrupt's requirement contracts if desired. As Professor MacLachlan states, "[t]he Bankruptcy Act provides that the court may authorize the business [of the bankrupt] to be conducted for limited periods by . . . [the] trustees, if necessary in the best interests of the estate."[25] Since the trustee is allowed to operate the bankrupt's business, he should, as a business necessity be allowed to assume those contracts essential to the proper operation, whether they be requirement contracts or otherwise.

This assumption, though it may cause minor hardships for the seller, could not be used to the disadvantage of the seller by the order of an unreasonable quantity of goods. The seller would still be protected from such orders by the trustee under the stipulation in section 2-306 of the Uniform Commercial Code that "no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded."[26]

Therefore, with the aid of sections 63a(4) and 70b, it is evident that a seller need not rely on the antiquated general rule that bankruptcy is an anticipatory breach of an executory contract to prove his claims arising from a bad faith breach by a requirements buyer. However, even with these two useful sections of the act, under present case law as developed in *United Cigar* and expanded upon by later cases,[27] the seller, in the majority of cessations of business involving bankruptcy, will still be left without a claim just as the seller in *United Cigar*.

The court in *United Cigar* felt that under a test of "good faith," the bankrupt did not have an obligation to continue to have requirements, but was only bound to buy from the seller to the extent "that he may have requirements when he is left free to deal with his business as he may deem best, provided his conduct is bona fide."[28]

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[25] J. MacLachlan, Bankruptcy § 85 at 76 (1956).
[26] Uniform Commercial Code § 2-306 [hereinafter cited as U.C.C.].
[27] Cases cited note 12 *supra*.
[28] *In re* United Cigar Stores, 72 F.2d 673, 675 (2d Cir. 1934).

Other courts have been reluctant to follow such a rule *in toto* and have implied a duty on the buyer to remain in business for the length of the contract.[29] However, the position taken by the court in *United Cigar* still predominates, but whether that position is completely sound is now at least questionable. In deciding if bankruptcy is considered a breach, the question is generally considered a matter of state law.[30] *United Cigar* was decided under New York law that has since been superseded, in New York and forty-eight other states, by the adoption of the Uniform Commercial Code.

THE "GOOD FAITH" REQUIREMENT IN BANKRUPTCY

At first glance it might seem that the Uniform Commercial Code does not significantly change the *United Cigar* rule. The basic requirement of "good faith" is still retained in section 2-306, but the draftsmen of the Code have attempted to define this previously undefined term. In section 1-201(19) the general definition of "good faith" is "honesty in fact in the conduct or transaction concerned."[31] This basic definition is qualified by section 2-103(b) which states that " '[g]ood faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[32] In addition to the "good faith" requirement there is the further limitation in section 2-306 that "no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.[33] Comment 2 to section 2-306 also provides an example of what would possibly be considered bad faith action, *i.e.*, a shutdown merely to curtail losses.[34] This clearly would be an evasion of the spirit of the contract. "Some judges recognize that to evade the spirit of a deal is to act in bad faith and thus is to commit a breach."[35] "Under the

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29 *E.g.*, Diamond Alkali Co. v. P. C. Tomson & Co., 35 F.2d 117, 119 (3d Cir. 1929). "Whenever a contract cannot be carried out in the way it was obviously expected that it would be carried out without one party or the other performing some act not expressly promised by him, a promise to do that act must be implied."

30 *In re* Robertson, 41 F. Supp. 665, 668 (W.D. Ark. 1941). *But see* Broude, *Executory Contracts and Bankruptcy: The Case for a Federal Common Law*, 17 KAN. L. REV. 1 (1968).

31 U.C.C. § 1-201(19).

32 U.C.C. § 2-103(1)(b).

33 U.C.C. § 2-306(1).

34 U.C.C. § 2-306, Comment 2.

35 Summers, *"Good Faith" In General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 234 (1968).

. . . Code, some courts are likely to say there is a general principle of law that the spirit of the deal is, within limits, just as much a part of that deal as its letter."[36]

Nevertheless, even with this effort to elucidate their "good faith" requirement, the draftsmen still failed to eliminate the uncertainty relating to requirement contracts in bankruptcy by failing to take a position at all as to the provability of requirement contract claims in bankruptcy.[37] Such a position in the face of *United Cigar* and other case law in the area is puzzling to say the least. True, in many of these cases it was held that there was no provable claim. However, that was simply because it was determined that the bankrupts had acted in good faith; consequently, there had not been a breach.[38] In none of these cases was it stated that there would not have been a breach if the bankrupts had acted in bad faith, nor that claims from breaches of requirement contracts were not provable in bankruptcy. There would now seem to be no obstacle in the path of a court to determine that such claims are provable, especially in the case of a voluntary bankruptcy. Courts may still be hesitant in implying a breach from the cessation of business due to a voluntary bankruptcy, but with the aid of Comment 2 of section 2-306, a voluntary bankruptcy instituted with the principle motive of curtailing losses would have all the characteristics of a bad faith cessation.

In the case of a cessation due to an involuntary bankruptcy of a requirements buyer, it would be more difficult to show that the bankruptcy was incident to the bankrupt's motive of curtailing losses. Obviously, if the bankrupt acted in collusion with any of his creditors to induce them to file a bankruptcy petition against him, the requisite bad faith would be clearly evident. However, that would seldom be a typical situation; instead of such open action the bankrupt would normally allow his affairs to fall into such a state of disrepair that an involuntary bankruptcy petition would be the only resort of his creditors. For a court to distinguish between the deliberate action of a company that wants to be thrown into bankruptcy and the action of a company that is doing everything within its power to stave off an involuntary petition could be a difficult, if not an impossible, task. Rather than taking this

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36 *Id.* at 235.

37 "This article takes no position as to whether a requirements contract is a provable claim in bankruptcy." U.C.C. § 2-306, Comment 2.

38 *In re* United Cigar Stores, 72 F.2d 673, 674-75 (2d Cir. 1934); Oregon Plywood Sales Corp. v. Sutherlin Plywood Corp., 246 F.2d 466, 471 (9th Cir. 1957); HML Corp v. General Foods Corp., 365 F.2d 77, 82-83 (3d Cir. 1966).

approach, a better solution would be for the court to attempt to distinguish between a voluntary and an involuntary bankruptcy. This could be accomplished by providing in the case of a voluntary bankruptcy that the burden of proof of good faith action would be on the bankrupt buyer instead of following the normal procedure of placing the burden of proving the breach on the non-breaching party. This distinction would be useful in placing the burden of proof, that the bankruptcy was in good faith, on the bankrupt, but only when it had chosen to cease business and would be in the better position to prove whether the cessation was made in good faith.

Such a policy would be in line with the definition of "good faith" in section 1-201(19), in conjunction with section 2-306(1) and the comments that follow, because it would seem likely that a requirements buyer is acting in as much bad faith by filing a voluntary petition as he would be in ceasing operations to curtail losses. However, in a case of cessation of business due to an involuntary proceeding, the fact that the alleged bankrupt has merely continued operating until he was forced to stop is strong evidence that he has not acted in bad faith.

Whatever procedure the courts may choose, when it is determined that a buyer has acted in bad faith by filing a voluntary petition or in allowing an involuntary petition to be filed against him, such a breach, as previously mentioned, would be a provable claim under section 63a(4) alone, or in conjunction with 70b.

CONCLUSION

The rules laid down in *United Cigar* are no longer the controlling principles for requirement contracts in bankruptcy. The Uniform Commercial Code in section 2-306 (1), in conjunction with the definition of "good faith" in section 2-103 (1) (b), has not made new law but has simply achieved the purpose of the Code, which is to clarify, modernize and simplify existing law.[39] By delineating a standard of "good faith," the Code has furnished the courts a criterion whereby it is now possible to evaluate a bankrupt's motives in filing a voluntary petition or in allowing creditors to throw it into bankruptcy. However, to provide a workable system, it may be necessary to place the burden of proof of "good faith" action on the bankrupt when a voluntary petition is involved.

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[39] U.C.C. § 1-102.

If the court should find that the bankrupt acted in bad faith, the requirements seller will have a provable claim in the bankruptcy proceedings. In this manner, then, the Code has provided for the provability of requirement contracts in bankruptcy and has taken a step forward in advancing one of the major purposes of the Bankruptcy Act: the distribution of the estate of the bankrupt to the creditors.[40]

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40 Burlingham v. Crouse, 228 U.S. 459, 473 (1913).