

A New Installment on the “*Kiwi* Defense” to a Preference Action

By

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When a creditor provides services to a debtor, one of the considerations given is whether such services should be done on a long-term contract basis. Although not always at the top of a credit manager’s considerations, the benefits are that if such executory contract is assumed by a debtor postpetition, the debtor must cure the creditor’s prepetition claim and the assumption should insulate the creditor from preference exposure. The Delaware bankruptcy court recently considered the broad issue in the recent case of *Guiliano v. Almond Investment Company (In re Carolina Fluid Handling Intermediate Holding Corp.)*. It further considered the underlying components of what is contract assumption and assignment.

But first, what is a “*Kiwi* defense” and how did it originate? The most applicable case law regarding pursuit of preference actions against counterparties to assumed executory contracts comes from the Third Circuit’s holding in *Kimmelman v. Port Authority of New York and New Jersey (In re Kiwi International Airlines)*. The court determined that if an executory contract was assumed pursuant to a court order, section 547 of the Bankruptcy Code cannot be satisfied. In the *Kiwi* case, creditors that were counter-parties to the assigned contracts received payments as cure under the debtors’ defaults under prepetition amounts owed. The court found that, in this situation, payments are not recoverable, since even if these defendants had not received these amounts pre-petition, they would have been compensated similarly when the Bankruptcy Court approved the cure amounts of their assigned agreements.

In a sale of assets, Section 11 U.S.C. § 365 of the Bankruptcy Code affords debtors the opportunity to reject or assume, and then assign executory contracts and unexpired leases to a purchaser. The purpose of this provision is to provide the trustee with a means to coerce vendors to continue trade relations with the debtor during the reorganization process. In order to protect the counterparties to these executory contracts, the Bankruptcy Code requires debtors to cure all outstanding defaults at the time of assumption, compensate the counterparty for actual loss from the default and provide adequate assurance of future payments. But does the Bankruptcy Code provide counterparties to assumed executory contracts any protection with respect to preferential liability? Are pre-petition payments made under an executory supply contract, which was both assumed and assigned by the debtor, liable to recovery under Section 11 U.S.C. § 547(b) of the Bankruptcy Code?

Prior to filing Chapter 11, Fluid Routing Solutions, Inc., one of the debtors, and Almond Investment Company entered into a supply agreement, in which Almond agreed to supply goods and services to the debtor. As of the petition date, the debtors had \$518,786 outstanding on this agreement. In the early stages of the bankruptcy, the debtors filed a “sale motion”, under which their purchaser, FRS Holding Corporation,

was to assume a list of trade payables; the supply agreement with Almond was not initially included.

Despite excluding Almond from the list of trade payables, the debtors attempted to enter into a critical vendor agreement with Almond to ensure a continued supply goods and services to the debtor throughout the reorganization. However, Almond declined this offer, and instead opted to amend their previous supply agreement to condition post-petition supplied goods and services on the debtor making a cure claim of \$367,385.57.

After the court approved the “sale motion”, the debtors were allowed to sell assets and pay off previous assumed cure amounts, including Almond’s claim. Several months later, the case was converted to a Chapter 7, and the trustee sued Almond for the recovery of \$1,445,659.77 in alleged preferential transfers under sections 547 and 550 of the Bankruptcy Code. In response, Almond filed its answer and affirmative defenses as well as a motion for summary judgment.

In determining whether or not to grant Almond’s motion for summary judgment, the Bankruptcy Court looked to the *Kiwi* decision. The Court had the burden of determining whether the contract between Almond and Fluid Routing Solutions was an executory contract, and furthermore, whether it was assumed or assigned by the debtors.

As defined by the Third Circuit, an executory contract is one under which the obligation of both the debtor and the counterparty to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach of contract. According to the supply agreement, Almond agreed to supply parts to the debtors at a specified constant rate for an extended period of time into the future. The supply agreement shows an on-going requirement for supply and purchase of parts, deeming it an executory contract.

Bankruptcy courts have held that a contract is not assumed and assigned unless it is specifically listed on the list of assumed executory contracts in the purchase agreement, filed with the sale order (*Litigation Trust v. Alpha Analytical Labs (In re IT Group, Inc.)*). The trustee challenged whether the Almond contract was assumed because it was not listed in the initial list of contracts to be assumed. However, the court found that the supply agreement was attached to the sale order and Almond was specifically included in the amendments to the asset purchase agreement. Furthermore, the sale order expressly references that the Almond “Cure Amount Agreement” is an “Assumed Contract” which the court declared binding and in full force and effect. For these reasons, the court found that the supply agreement with Almond was both assumed and assigned by the debtor.

Due to the Court’s findings that the supply agreement between Almond and the debtor was an executory contract, as well as assumed by the debtors and assigned to the purchaser, Almond’s motion for summary judgment was granted. The transfers were not avoidable under sections 547 and 550 of the Bankruptcy Code. Lesson learned for creditors – while your contract is not required to be on the list of assumed contracts in the

notice of motion, it must be on the list of assumed contracts in the purchase agreement and sale order.