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A Bankruptcy Court Can't Force You to Provide Service to a Third Party – Or Can It?

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One of the fundamental principles of commercial law is the freedom to contract with a particular party, or to refuse do so. "As a general rule, businesses are free to choose the parties with whom they will deal, as well as the prices, terms and conditions of that dealing." See Pac. Bell Tel. Co. v. Linkline Commc'ns, Inc., 555 U.S. 438 (2009). However, the Bankruptcy Code may permit a court to alter this fundamental principle in certain circumstances. A bankruptcy court did just that in *In re Mathson Industries, Inc*., 423 B.R. 643 (E.D. Mich. 2010).

In that case, Negri Rossi (Seller) sold a number of injection molding machines valued in excess of $3 million for which it was not paid prior to debtor's bankruptcy. The Seller also failed to perfect its security interest in the machines, making it an unsecured creditor. The machines were the most valuable asset in the bankruptcy estate. The case was converted to a Chapter 7 liquidation and the trustee (Trustee) held an auction to sell the machines. During the course of the auction, the Seller advised the bidders that it would not service the machines post-sale. Because of the proprietary nature of the machines, apparently no third party could do so. Draexlmaier (Bidder), who indicated a desire to make a bid to purchase the machines for $2 million, said it was unable to make a bid on that basis. The Seller sent a letter to the Trustee indicating that without its willingness to service the machines, they would likely have to be sold for scrap value. In the alternative, the Seller said it would make an offer to buy them for $100,000 and waive its unsecured claim against the estate, which it estimated was worth $900,000.

The Bidder said it would proceed with its bid if the Trustee was able to compel the Seller to service the machines by agreement or court order. The Trustee then filed an adversary proceeding seeking an order requiring the Seller to service the machines for the successful bidder, claiming that the Seller's refusal to do so was a violation of the automatic stay imposed by section 362(a)(6) of the Bankruptcy Code. This section precludes a creditor from taking "any act[tion] to collect…or recover a claim against the debtor that arose before commencement of the case…". The Trustee argued that the Seller's actions were an attempt to recover its claim by buying the machines at a discounted price and then reselling them at full value, thereby depriving the estate of the machines' value. The bankruptcy court granted the Trustee's motion for summary judgment and the Seller

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appealed to the district court (Court).

The Court said that the Sixth Circuit Court of Appeals in *Pertuso v. Ford Motor Credit Co*., 233 F.3d 417 (6th Cir. 2000) fashioned a useful two-part test to determine whether conduct violated section 362(a)(6). Conduct violates the automatic stay if it "(1) could reasonably be expected to have a significant impact upon the debtor's determination as to whether to repay and (2) is contrary to what a reasonable person would consider to be fair under the circumstances." *Pertuso* at 423 (citations omitted). In applying this test, the Court found that the Seller's actions of dissuading other bidders from buying the machines by refusing to service them, and to attempt to acquire them for a fraction of what another credible bidder was willing to pay, was a clear attempt to recover its prepetition debt. In testimony before the bankruptcy court, the Seller admitted that it was motivated by the fact that it had not been paid for the machines and felt that it could ultimately receive payment by refusing essential services to any other bidders.

Regarding the fairness element of the test, the Seller argued that its conduct, which would be considered lawful outside of bankruptcy, could not be considered unlawful in a bankruptcy proceeding. The Court disagreed, saying the stay imposed by section 362(a)(6) makes irrelevant what would be lawful outside of bankruptcy. Under circumstances of this case, the Seller's conduct attempted to deprive the estate of the value of the machines at the expense of the other creditors. Intervention of the Court is required to ensure that all creditors are treated equally.

The Court also rejected the Seller's argument that while the Bankruptcy Code prohibits a creditor from taking certain action to collect its prepetition debt, the Code does not authorize a court to require a creditor to take action. In support of its position, the Court cited *Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co*. (*In re Sportfame of Ohio, Inc*.), 40 B.R. 47 (Bankr. N. D. Ohio 1984), where a creditor who refused to continue to do business with a debtor until its prepetition debt was paid was forced to sell irreplaceable product to the debtor for cash. However, the Court rejected the *Sportfame* court's ruling that while Wilson could have refused to sell product for any reason without explanation and not have violated the automatic stay, its expressed intention to collect its prepetition debt is what made Wilson's conduct unlawful. Here, the Court found that the Seller's conduct had the effect of coercing payment of its prepetition debt, and whether or not this was the expressed intent was not controlling.

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This case is troubling. Often, a creditor's position may give it significant leverage in a bankruptcy case, and use of that leverage in a sale context should not be found to be a violation of the automatic stay. Perhaps the Seller doomed its position by expressing its intention so blatantly and violating the "pig" theory by bidding a significantly lower amount than the $2 million offered by the Bidder. One wonders whether, if the Seller had not made any bid and simply said it was unwilling to service the machines, the result would have been different. At that point, the Trustee's logical alternative would have been to come to the Seller to strike a deal. While the desired result would have been achieved, the Trustee would have approached the Seller and likely would not have attempted to force the Seller to service the machines in the hands of another purchaser because that would risk deriving any value for the machines.

What if the Seller's policy, like the policy of other companies, was not to service machines where a loss had been incurred and it was indifferent to whether it acquired the machines or not? This clearly seems like a decision regarding when and with whom to contract and not an attempt to violate the stay. Yet under the broad ruling of the Court, if the effect of the Seller's conduct would have been the same—to deprive the estate of significant value—an injunction nonetheless would seem to be appropriate whether or not the Seller was attempting to recover its prepetition claim. This seems to be stretching the debtor's protections under section 362(a)(6) too far and likely was not what Congress intended.

Please contact your Reinhart attorney or any attorney in Reinhart's Business Reorganization Practice if you have any questions concerning Bankruptcy Code section 362(a)(6) and how it may affect your business.

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