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Feature

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# Dueling Bankruptcies Prove that Rejection Beats Assumption

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Given the complex web of contracts in the oil and gas sector, counsel should take note of a recent decision granting a debtor's motion to reject a mineral supply contract over the objection of a counterparty that was pursuing assumption of the same contract as a debtor in a different court. Notably, in *In re Noranda Aluminum Inc*., the court applied the business-judgment test to the debtor's request for rejection under § 365 of the Bankruptcy Code without considering the effect of rejection on the other debtor or applying heightened scrutiny.[2] In other words, the fact that the counterparty was seeking assumption of the same contract in its own case had no bearing on whether rejection was best for the debtor's estate — the key inquiry under the business-judgment test.

The decision highlights the difficulty of strategic planning based on assumption of a favorable critical-supply contract when an adverse counterparty has the potential to reject the same contract in its own bankruptcy case. A party relying on assumption must recognize up front that a properly supported request for rejection will be given deference. This reality underscores the need for an alternative source of supply or, failing that and if possible, an agreed-upon contract modification. To put it another way, pressing assumption in the face of another debtor's motion to reject may not be the best use of limited resources.

## Background and Procedural Posture

The basic dispute in *Noranda Aluminum* centered on the parties' simultaneous efforts to assume and reject the same mineral supply contract, with each party claiming that there would otherwise be disastrous consequences to their businesses. The dispute was complicated by traversing two bankruptcy cases, one in Missouri and the other in Texas, as well as judicially assisted mediation in one of the cases.[3]

The first of the two cases to be filed was that of Sherwin Alumina Co. LLC, which purchased bauxite from Noranda, pursuant to the supply contract, and used it to make alumina.[4] Sherwin believed that continued access to Noranda's bauxite was critical to maintaining its value in light of a pre-negotiated program to sell substantially all of its assets through a chapter 11 case filed in the U.S. Bankruptcy Court for the Southern District of Texas.[5] Revealingly, Sherwin advised the Texas bankruptcy court that "[a]bsent [a] continued supply of bauxite, Sherwin is not viable and value cannot be maximized."[6]

Accordingly, Sherwin included an emergency motion to assume the supply contract in its first-day motions.[7] In response, Noranda filed a preliminary objection, after which the court entered an order (1) setting a briefing schedule for the motion to assume, (2) authorizing Sherwin to pay up to $1.942 million to Noranda on account of pre-petition amounts due under the supply contract, and (3) preserving the parties' rights until the motion to assume was resolved.[8] The order provided that, pending resolution of the motion to assume, "*Noranda shall not seek to terminate or purport to terminate the [sup-*

1 With thanks to Hon. **Louis H. Kornreich** (ret.) for his comments. Judge Kornreich is Of Counsel at Bernstein Shur in Portland, Maine.

2 *In re Noranda Aluminum Inc*., Case No. 16-10083-399, 2016 WL 1417923 (Bankr. E.D. Mo. April 7, 2016).

3 While the *Noranda Aluminum* court's decision did not mention that mediation occurred in the contract counterparty's case, other court filings make it clear that the court was aware of mediation before it issued its decision. *See, e.g., In re Noranda Aluminum*, Case No. 16-10083-399, Debtor's Objection to Sherwin Alumina Co. LLC's Second Emergency Motion for Coordination Among the U.S. Bankruptcy Courts for the Southern District of Texas and the Eastern District of Missouri, D.E. 558 (Bankr. E.D. Mo. March 29, 2016).

4 *In re Sherwin Alumina Co. LLC*, Case No. 16-20012, Voluntary Petition, D.E. 1 (Bankr. S.D. Tex. Jan. 11, 2016).

5 *In re Sherwin Alumina Co. LLC*, Case No. 16-20012, Emergency Motion of Sherwin Alumina Co., et al., LLC for Entry of an Order Authorizing the Debtors (I) to Assume the Noranda Agreement and (II) to Satisfy Obligations under the Noranda Agreement and Enforce the Automatic Stay, ¶ 1, D.E. 21 (Bankr. S.D. Tex. Jan. 11, 2016).

6 *Id.* at ¶ 2.

7 *See, generally, id.*

*ply contract] except as otherwise ordered by the Court*, and during such period, the Debtors and Noranda shall continue to perform their respective duties and retain their respective rights under the [supply contract]" with all rights reserved in the meantime.[9]

Nevertheless, shortly thereafter, Noranda filed its own chapter 11 petition in the U.S. Bankruptcy Court for the Eastern District of Missouri.[10] Noranda's first-day motions included a motion to reject the supply contract; it did not consider the supply contract economically viable and contended that it lost money on each ton of bauxite sold to Sherwin.[11] At the same time, Noranda also filed a motion for relief from the automatic stay in Sherwin's case to allow it to impose modified pricing terms under the supply contract.[12]

Noranda's filings triggered a flurry of objections and additional motions by Sherwin in both cases.[13] In Sherwin's objection to the motion to reject, it contended (1) that a form of heightened scrutiny under a "balancing of the equities test" was appropriate because the dispute involved two debtors seeking inconsistent relief, or, alternatively, (2) that the effect of rejection on Sherwin had to be considered under the business-judgment test. Unsurprisingly, Noranda disagreed.

## The *Noranda Aluminum* Court's Decision

Following an evidentiary hearing, the Missouri court determined that Noranda's decision to reject the supply contract was entitled to deference under the business-judgment test without consideration of the effect on Sherwin, and that Noranda met its burden under that test.[14] The court began its analysis by setting forth prevailing law under § 365, which required deference to a debtor-in-possession's (DIP) business judgment to assume or reject contracts.[15]

Under the business-judgment test, a court will generally approve a motion to assume or reject an executory contract as long as "the transaction is in the best interest of the estate."[16] In other words, "the court should normally grant approval [a]s long as [the proposed action] appears to enhance [the] debtor's estate."[17] There is no second-guessing a trustee or DIP. Rather, a bankruptcy court is limited to acting as an "overseer of the wisdom" of the DIP's decision and "should not interfere with [its] business judgment except on a finding of bad faith or gross abuse of their business discretion."[18]

Against this backdrop, the bankruptcy court turned to three cases that Sherwin offered in support of its argument for heightened scrutiny.[19] Sherwin's main case was *In re Midwest Polychem*,[20] which involved "a debtor seeking to reject a contract containing a restrictive covenant so that it could expand its business and compete with the contract counterparty (who was also a debtor in bankruptcy)."[21] While *Midwest Polychem* said that a "balancing of the equities is especially necessary" when two debtors seek opposing relief under § 365, the bankruptcy court reviewed the case and did not think that test controlled the outcome.[22] The court stated:

> The *Midwest Polychem* court did not need to choose between the business judgment test or the balancing of the equities test because the result was the same under both tests after considering the equities. Ultimately, it denied the debtor's motion to reject, stating that allowing the debtor to reject the contract "makes no business or equitable sense."[23]

**_Noranda Aluminum_ is a product of its unique factual circumstances and does not signal a change in the law.... As this case demonstrates, all roads may lead right back to the negotiating table.**

To the extent that the case held otherwise, the court "respectfully disagree[d]."[24] The court dismissed two of Sherwin's other cases because, like *Midwest Polychem*, they were decades old and nonbinding and, in its view, applied the business-judgment test rather than heightened scrutiny.[25]

The court next turned to Sherwin's argument that "even under the business-judgment test, [the court] must consider damages to the counterparty relative to the benefit to the debtor's estate."[26] Sherwin gained little traction here: "Again, the cases cited by Sherwin are not binding authority and are not current. In addition, it would contradict binding authority to read into the business-judgment test a consideration of the interest of counterparties before allowing rejection of contracts."[27] (Sherwin's remaining arguments with respect to the legal standard were handily dismissed.[28])

With the decks cleared for application of the business-judgment test, the court determined that Noranda had met its burden despite Sherwin's efforts to prove otherwise. "Overall, the evidence shows that rejection of the [supply contract] is necessary if [Noranda] is to effectuate a restructuring. There is no evidence of bad faith or abuse of business

8 *In re Sherwin Alumina Co. LLC*, Case No. 16-20012, Preliminary Objection of Noranda Bauxite Ltd. to Emergency Motion of Sherwin Alumina Co. LLC, *et al.*, for Entry of an Order Authorizing the Debtors (I) to Assume the Noranda Agreement and (II) to Satisfy Obligations under the Noranda Agreement and Enforce the Automatic Stay, D.E. 54 (Bankr. S.D. Tex. Jan. 11, 2016); *In re Sherwin Alumina Co. LLC*, Case No. 16-200212, Agreed Order Authorizing the Debtors to Satisfy Obligations under the Noranda Agreement and Enforcing the Automatic Stay, D.E. 109 (Bankr. S.D. Tex. Jan. 15, 2016).

9 *In re Sherwin Alumina Co. LLC*, Case No. 16-200212, Agreed Order Authorizing the Debtors to Satisfy Obligations under the Noranda Agreement and Enforcing the Automatic Stay, D.E. 109 (Bankr. S.D. Tex. Jan. 15, 2016) (emphasis added).

10 *In re Noranda Aluminum Inc.*, Case No. 16-10083, Voluntary Petition, D.E. 1 (Bankr. E.D. Mo. Feb. 8, 2016).

11 *In re Noranda Aluminum Inc.*, Case No. 16-10083, Debtors' Motion for an Order Pursuant to §§ 105(a) and 365 of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing the Rejection of Certain Executory Contracts *Nunc Pro Tunc* to the Petition Date, D.E. 52 (Bankr. E.D. Mo. Feb. 8. 2016).

12 *In re Sherwin Alumina Co. LLC*, Case No. 16-200212, Noranda Bauxite Ltd.'s Expedited Motion for Relief from the Automatic Stay Pursuant to 11 U.S.C. §§ 105(a) and 362(d), D.E. 234 (Bankr. S.D. Tex. Feb. 8, 2016).

13 Sherwin filed two emergency motions in each case requesting that the bankruptcy courts coordinate with respect to assumption or rejection of the supply contract, as well as other motions requesting various forms of relief. The motions for coordination were not granted.

14 For reasons that are unclear, a hearing was held on the motion to reject before the motion to assume was resolved.

15 *In re Noranda Aluminum Inc.*, Case No. 16-10082-399, 2016 WL 1417923, at *1 (Bankr. E.D. Mo. April 7, 2016).

16 *Id.* at *2 (internal quotations omitted).

17 *Id.* (edits in original; quotation omitted).

18 *Id.* (quotation omitted).

19 *Id.* at *2-*3.

20 61 B.R. 559 (Bankr. N.D. Ill. 1986).

21 *Noranda Aluminum Inc.* at *2.

22 *Id.* (quoting *Midwest Polychem*).

23 *Id.* (quoting *Midwest Polychem*).

24 *Id.*

25 *Id.* at *3.

26 *Id.*

27 *Id.*

28 *Id.* at *3-*4. For example, while § 365 provides special treatment to certain types of executory contracts and case law authorizes heightened scrutiny when regulatory, federal statutory or the public interests are involved, none of these circumstances were applicable here. *Id.*

discretion."[29] Rather, "[t]he evidence clearly reflected that [Noranda] loses money on every ton of bauxite it ships ... making the cost of performance substantially more than the benefits it confers."[30] Simply put, "the inquiry under the business judgment test concerns the benefit to the estate of rejecting the burdensome contract; it does not consider the interests of the counterparty to the contract being rejected."[31]

## Analysis

While disputes with dueling debtors seeking conflicting relief are rare, given the spate of recent bankruptcies in the energy sector, the court's decision is a timely reminder that a debtor is entitled to no greater deference as a contract counterparty than a nondebtor. To put a finer point on it, had the Texas bankruptcy court granted Sherwin's motion to assume before the ruling by the Missouri bankruptcy court, the outcome likely would have been the same because assumption of an executory contract restores the status quo between the parties and does not necessarily determine the parties' rights more broadly.[32] In other words, once assumed, it is as if the bankruptcy did not happen as to that specific contract. This is a far cry from the position advanced by Sherwin: essentially, that one debtor's assumption of a contract can vitiate the counterparty's right to reject as part of its own reorganization.[33]

Stepping back from the law to consider tactics and strategy, Noranda's apparent game plan emphasizes the strength of using litigation (*i.e.*, the motion to reject) to gain leverage toward a negotiated resolution. As the bankruptcy court keenly observed in a footnote:

> Sherwin must either discontinue its business, renegotiate a different contract with [Noranda] on terms less attractive to it or alter its refinery to accommodate bauxite from a different seller (which has a different chemical composition). *[Noranda] is sophisticated and understands the leverage derived by rejection of the [supply] [c]ontract*.[34]

This proved prescient. About a month after the court granted the motion to reject, the parties entered into a stipulation pursuant to which they agreed to modified business terms for the delivery of bauxite to Sherwin for a 90-day period, during which they planned to negotiate in good faith for a longer-term arrangement.[35] They also agreed to withdraw with prejudice most (although not all) of their pending motion papers, as well as Sherwin's notice of appeal with respect to the court's order granting the motion to reject.[36] The stipulation was entered as an order in each case.[37]

## Conclusion

*Noranda Aluminum* is a product of its unique factual circumstances and does not signal a change in the law. Even so, there are two important takeaways: First, a bankruptcy strategy dependent on the assumption of a favorable contract might be misplaced if it ignores the prospect of dueling cases and a counterparty's ability to reject. Second, if there is a credible evidentiary challenge to be made under the business-judgment test, make it to preserve leverage for negotiation, but do not count on it for a successful outcome. As this case demonstrates, all roads may lead right back to the negotiating table. abi

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29 *Id.* at *4.
30 *Id.*
31 *Id.* at *7.
32 For example, in another recent decision involving § 365, a court permitted rejection under the business-judgment test without considering the parties' rights under the contract more broadly. *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 73 (Bankr. S.D.N.Y. 2016).
33 The basic idea is that one cannot contract away bankruptcy rights, as has recently been noted by two courts that denied motions to dismiss petitions as unauthorized for their failure to comply with governance provisions that placed control over the decision to file for bankruptcy in the hands of certain parties. *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016); *In re Intervention Energy Holdings LLC*, Case No. 16-11247, 2016 WL 3185576, at *1 (Bankr. D. Del. June 3, 2016).
34 *In re Noranda Aluminum Inc.*, Case No. 16-10082-399, 2016 WL 1417923, at *4 n.1 (parenthetical in original; bracketed text and emphasis added).
35 *In re Noranda Aluminum Inc.*, Case No. 16-10083-399, Agreed Stipulation and Order Between Sherwin Alumina Co. LLC and Noranda Bauxite Ltd., D.E. 749 (Bankr. E.D. Mo. May, 13, 2016); *In re Sherwin Alumina Co. LLC*, Case No. 16-20012, Agreed Stipulation and Order Between Sherwin Alumina Co. LLC and Noranda Bauxite Ltd., D.E. 584 (Bankr. S.D. Tex. May 9, 2016).
36 *Id.*
37 *Id.*