US Column: A tutorial for vendors dealing with insolvent customers

David Conaway writes on Rite Aid v. McKesson: From $90 million vendor avoidance action to a vendor-sponsored plan of reorganization

DAVID H. CONAWAY
Attorney at Law, Shumaker, Loop & Kendrick, LLP

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On 5 May 2025, Rite Aid filed its second Chapter 11 proceeding less than 2 years after its first. Rite Aid is the 3rd largest pharmacy or "drug store" chain in the US, with over 2000 stores before its Chapter 11 filing. It's largest vendor, McKesson Corporation, is reported to be the largest distributor of pharmaceuticals in North America, responsible for one-third of all prescription medications delivered in the US.

In the first Rite Aid Chapter 11, the debtors attempted to compel McKesson, Rite Aid's largest pharmaceutical supplier, to continue to perform under a supply agreement by shipping goods unabated and extending pre-petition credit terms. McKesson refused to increase its $720 million pre-petition exposure during the Chapter 11 case, and the debtors responded with a Motion for a Temporary Restraining Order and Preliminary Injunction to compel McKesson to supply goods and extend pre-petition credit terms regardless of the increased risk to McKesson. The debtors did not acknowledge Bankruptcy Code section 365(e)(2), which supported McKesson's right to suspend performance and not increase its risk by requiring cash in advance payments.

Appropriately McKesson responded with the assertion that under section 365(e)(2) and other applicable law, it was entitled to terminate the supply agreement, suspend shipments of goods and require cash before delivery payment terms. Specifically, McKesson relied upon UCC sections 2-609 and 2-702 as other applicable law which allowed it to terminate or modify the contract with Rite Aid. McKesson argued:

> *"Any attempt by the Debtors to argue that the Bankruptcy Code's prohibition on enforcement of "ipso facto" clauses precludes McKesson from the protections of the California Commercial Code must fail. Section 365(e)(1) only prohibits termination or modification of an executory contract that is based solely on a contractual provision conditioned on insolvency, financial condition, or a bankruptcy filing."*

Within 30 days of Rite Aid's strong-arm litigation, the parties settled. Notably, key terms were:

1. 7-day payment terms on McKesson's invoices;
2. McKesson could suspend shipments and change payment terms if Rite Aid failed to pay; and
3. McKesson was granted super-priority administrative priority payment status for all post-petition shipments.

In other words, McKesson won.

But fast forward to 3 June 2025 when, upon Rite Aid's failure to pay post-petition invoices, McKesson asserted a $50 million administrative expense priority claim for goods delivered to Rite Aid post-petition.

In response, Rite Aid asserted that a $50 million payment by Rite Aid on 5 May 2025, the second Chapter 11 petition date, was in fact a post-petition payment that was a pre-payment for the $50 million of goods shipped post-petition. Thus, McKesson has been paid and has no administrative expense priority claim.

McKesson has countered that the $50 million payment on 5 May 2025 was a pre-petition payment made prior to the time of day of the filing of the petition, that paid invoices for goods delivered on 24 and 25 April 2025 in the ordinary course of business. As a result, the invoices for goods delivered after 5 May remain unpaid, giving McKesson an administrative expense priority claim for $50 million.

To up the ante, on 4 August 2025, Rite Aid filed a complaint alleging various avoidance claims against Rite Aid for approximately $90 million. Specifically, Rite Aid asserts that:

1. A $29 million payment by Rite Aid on 28 February 2025 was a preferential payment within 90 days of filing;
2. A $11 million payment by Rite Aid on 1 May 2025 was a preferential payment within 90 days of filing;
3. The $50 million payment on 5 May 2025 is either:
   a. A preference payment if found to have been paid pre-petition; or
   b. An authorized post-petition payment if found to be paid post-petition.
4. Pending resolution of preference claims, Rite Aid is permitted to withhold payment of post-petition claims and under 502(d) of the Bankruptcy Code.

The outcome of these disputes will turn on various legal issues, including:

1. Was McKesson entitled to change the terms of sale provided in the supply agreement under section 365 regarding "executory" contracts?

If a supplier is selling to a customer/debtor under a written sales or supply contract, Bankruptcy Code section 365(e)(1) prohibits the vendor from terminating or modifying the contract "solely based on a contract term regarding the insolvency or financial condition of the debtor or the commencement of a chapter 11".

However, Bankruptcy Code section 365(e)(2)(A)(i) further provides an exception to section 365(e)(1) if "applicable law" excuses a party from rendering performance. Both common law regarding contracts and the Uniform Commercial Code regarding the sale of goods are such "applicable law". UCC 2-609 (which codifies contract common law) allows a seller of goods to suspend performance when it has reasonable grounds for insecurity of the customer's ability to pay. UCC 2-702 allows a vendor to revert to cash in advance credit terms regardless of a contract term requiring credit terms if a customer is insolvent.

2. Were payments made by Rite Aid to McKesson in the ordinary course of business? Also, did McKesson provide "subsequent new value" (shipment of more goods) after payments by Rite Aid?

3. Was the payment made on the petition date a pre-petition payment or a post-petition payment?

When faced with a customer Chapter 11 filing, it is common for vendors to be confronted with high-risk issues on a "first day" basis.

1. Is a vendor with a formal supply contract required to continue shipping goods on pre-petition credit terms, regardless of risk?
   Debtors almost always take the position that section 365 of Bankruptcy Code requires a vendor to keep shipping, ignoring the inherent risk to the vendor due to the Chapter 11 filing. We always counter that vendors are relieved of that obligation if applicable non-bankruptcy law permits a change.
   In fact, Uniform Commercial Code Section 2-609 (suspension of performance) and 2-702 (insolvency) are such applicable non-bankruptcy law.
2. Defending preference claims can be a challenge; however, vendors have two very strong defences: subsequent new value and ordinary course of business. A vendor receives a dollar-for-dollar credit against preference exposure for goods shipped after a payment is made. For vendors, the subsequent new value defence can be a complete defence. The subsequent new value defence is objective, based solely on evidence of shipments and payments. Debtors have often asserted that if subsequent new value invoices are paid post-petition (whether by critical vendor payments, payments on 503(b)(9) claims for 20-day goods, or otherwise), then those paid invoices do not qualify for the subsequent new value defence. However, in *Auriga Polymers Inc. v. PMCM2*, LLC, 40 F.4th 1273 (11th Cir. 2022), the U.S. Court of Appeals, Eleventh Circuit handed down a landmark victory for our client Auriga Polymers, and all trade creditors, by holding that the subsequent new value analysis is fixed at the petition date and the post-petition payment of a 503(b)(9) claim does not deplete the subsequent new value defence. Since the Auriga ruling, there has been a material decline in preference claims generally as recoveries and contingency fees are reduced.
   The ordinary course of business defence shields payments that were paid similarly to how payments were made prior to the 90-day preference period. For example, if during the year prior to the 90-day preference period, payments to the vendor were mail slow, say 30-35 days on net 30-day terms, and the payments during the 90-day period were approximately the same, the alleged preference payments would be protected. The ordinary course of business defence is subjective, and depends on the interpretation of "ordinary".

Given the magnitude of the Rite Aid/McKesson avoidance actions, the parties will spend the legal fees to assert their respective positions. Unless settled, the Bankruptcy Court will be required to render judgments on these issues. Appeals are also likely.

On 4 September 2025, the Rite Aid debtors filed a proposed Chapter 11 Plan pursuant to which McKesson has agreed to support and sponsor a plan of reorganization pursuant to a Restructuring Support Agreement ("RSA"). The RSA provides that McKesson will acquire 100% ownership of the Reorganized Debtor in exchange for full satisfaction of McKesson's unpaid claims against Rite Aid, $15 million paid by McKesson, settlement of all litigation claims between Rite Aid and McKesson, and McKesson's agreement to purchase certain pharmaceutical inventory.

If the settlement is approved by the Bankruptcy Court, there will be no case law precedent on the avoidance claim issues presented by the litigation.

However, the proposed Plan demonstrates the flexibility and creativity of Chapter 11 to resolve both business and legal issues between vendors and Chapter 11 debtors. ■

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