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The Assumption Or Rejection of Executory Contracts in Bankruptcy – Are Commodity Contracts Within A Safe Harbor?

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Overview

In 2005, the Congress substantially overhauled the Bankruptcy Code[1] (Code) with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).[2] While the BAPCPA's primary emphasis focused on consumer bankruptcies, the BAPCPA also has important implications for business bankruptcies.[3] One key issue involves the impact the BAPCPA may have on certain "safe harbor" transactions, including forward contracts. A creditor under a forward contract, like a secured creditor, receives favored treatment under the Code. That's an important point for any party to a forward contract, and has implications for Midwest corn farmers who entered into contracts for future delivery of corn to VeraSun, a significant ethanol producer that filed bankruptcy in late 2008.

Executory Contracts

When a business files bankruptcy, other parties may have an existing business relationship with the bankrupt debtor under what is known as a pre-petition "executory contract." The Code provides that, subject to court approval (and other specific limitations), the bankruptcy trustee may assume or reject executory contracts.[4] Unfortunately, the Code doesn't define "executory contract," so the courts have determined the definitional parameters of executory contracts on a case-by-case basis. In *N.L.R.B. v. Bildisco & Bildisco*,[5] for example, the U.S. Supreme Court defined an executory contract as a contract where "performance is due to some extent on both sides."[6] Perhaps the most common example of an executory contract is a lease – whether involving real estate and/or equipment. Under a lease, the landlord must provide future possession of the leased property, and the tenant must make future payments.[7]

But, it is also possible that a contract could be so materially performed that it is no longer properly classified as executory. For example, contracts where one party has no post-petition obligation or no obligation other than the payment of money are not executory.[8] In that situation, the contract would either be treated in bankruptcy as an unsecured claim or as a "disguised" security interest that would then be subject to the normal rules for perfection under Revised Article 9 of the Uniform Commercial Code.

> **Note:** Whether a contract is executory or not is generally determined at the time the bankruptcy petition is filed,[9] although there is some uncertainty on that point.[10]

What Happens To Executory Contracts in Bankruptcy?

Debtor's rights in an executory contract. The filing of a bankruptcy petition creates a bankruptcy estate that is similar to a trust. A trustee is appointed to administer the estate and has a fiduciary duty to the creditors of the debtor. Under the Code, the estate contains "all legal or equitable interests of the debtor in property as of the commencement of the case."[11] Thus, the debtor's rights in an executory contract constitute property of the bankruptcy estate that are subject to the administrative powers of the trustee to use, lease or sell in accordance with 11 U.S.C. §363.

> **Note:** The Code invalidates any contract clause that terminates or modifies the contract based on the debtor's financial condition or insolvency, and pre-empts similar state laws that have the potential to deprive the bankruptcy estate of the benefits of the unexpired contract.[12]

The "automatic stay" also protects the debtor's rights under an executory contract. The automatic stay arises by operation of law when the bankruptcy petition is filed.[13] The automatic stay applies to all individuals and entities and prohibits the commencement or continuation of an action against the debtor to enforce a pre-petition claim, and any act to obtain possession of, or to exercise control over property of the estate.[14] The automatic stay also prevents the termination or interference with the debtor's executory contract rights without the permission of the bankruptcy court (which has the power to grant relief from the automatic stay).[15] So, as long as an executory contract remains unassumed and unrejected (as discussed below), the contract remains in effect and all non-debtor parties must honor the contract and perform in accordance with the contract's terms.[16] That's a key point for a party to an executory contract with a bankrupt business.

Assumption or rejection of executory contracts. The bankruptcy trustee may either affirm and accept (assume) or terminate and surrender (reject) an executory contract or unexpired lease.[17] The bankruptcy court must approve assumption of an executory contract,[18] while rejection is automatic if the contract is not assumed within a certain amount of time.[19] In addition, the *entire* contract must be assumed or rejected – it is not possible to assume part of the contract and reject part.

> **Note:** When must the debtor decide to either assume or reject executor contracts? The trustee has a reasonable time to determine how to handle executory contracts, with the determination of what is reasonable subject to the bankruptcy court's discretion. But, a creditor may petition the bankruptcy court to compel the debtor to decide how it is going to treat an executory contract in a shorter timeframe.[20]

The rejection of an executory contract is treated as a pre-petition breach of the contract.[21] The bankruptcy trustee's rejection of an executory contract results in any breach of contract damages that might be available under state law to be treated as an unsecured claim. But, if the trustee assumes an executory contract, the contract becomes an administrative liability of the bankruptcy estate. In that event, the court can award the creditor an administrative expense claim.[22] Administrative expenses of the bankruptcy estate include the "actual, necessary cost and expenses" of preserving and administering the estate. Those expenses include professional fees, taxes and other liabilities that accrue during the bankruptcy. So, the assumption of an executory contract can be beneficial for the creditor.[23]

> **Note:** Unless the court fixes a time for payment of administrative expenses, they are paid upon plan confirmation.[24]

Exception for forward contracts. A forward contract that contains a provision that terminates contractual obligations upon the filing of bankruptcy is exempt from the effect of the automatic stay.[25] In addition, while post-bankruptcy set-offs are barred under most commercial transactions without court approval,[26] set-offs under a forward contract are allowed.[27] Similarly, while a debtor's payments to creditors in the 90-day period before bankruptcy filing are generally subject to being set aside and recovered from the affected creditors,[28] payments made under a forward contract are exempt.[29]

BAPCPA Safe Harbor Transactions – The Impact on Forward Contracts

As noted above, it is clear that forward contracts enjoy favored status under the Code. But, what is a "forward contract"? While the BAPCPA provisions made technical amendments to the statutory language of the existing safe harbors, there remains lack of clarity concerning the definition of "forward contract" and how that definition is to be applied in various contractual settings. In addition, the BAPCPA expands the category of contracts that qualify for special protection under the Code. For instance, the BAPCPA adds 11 U.S.C. §561 which specifically preserves the contractual right to terminate, liquidate, accelerate or offset under a "master netting agreement" and across all types of safe harbor contracts. A "master netting agreement" is defined as "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts…," including swap agreements, *forward contracts* and commodity contracts (emphasis added). The BAPCPA preserves the contractual right of a master netting agreement participant to terminate, liquidate, accelerate or set-off among safe harbor transactions and states that these rights "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order court or administrative agency in any proceeding under this title." The BAPCPA also amends the definition of forward contract to include any option to enter into a forward contract, a master agreement that provides for a forward contract, and any security or arrangement or other credit enhancement related to a forward contract.

Note: Before the BAPCPA amendments, the Code did not specify whether damages should be calculated from the date the bankruptcy petition or the date of contract termination or rejection. That lack of clarity led to litigation on the issue.[30] The BAPCPA specifies that damages are to be calculated at the earlier of termination or rejection of a safe harbor transaction.[31]

Do Commodity Supply Contracts Involve a Safe Harbor Transaction? – *In re National Gas Distributors, LLC*.[32]

Facts of the case. A recent court opinion has dealt with the issue of whether a physical supply contract may qualify as a forward contract or "swap agreement" under the Code's safe harbor protections. The case involved Natural Gas Distributors, LLC, a small natural gas supplier that filed bankruptcy in January 2006. The court-appointed trustee filed fraudulent conveyance complaints against numerous customers, claiming that National Gas sold gas at prices less than market price, either as part of a fraudulent scheme or in a constructively fraudulent manner.[33] The defendants in the fraudulent conveyance actions were several end users of gas, including Smithfield Packing Co. The contract at issue involved a base contract for sale and purchase of natural gas – National Gas was to sell natural gas to Smithfield at a future date at the price specified in the contract irrespective of market price fluctuations. The parties acknowledged that the contract constituted a "forward contract" under the Code. But, while the bankruptcy trustee agreed that the contract was a forward contract involving a commodity, the trustee argued that it differed from a "forward agreement" as that term is used in the definition of a "swap agreement." Thus, because the contract was not a forward agreement or any other type of contract explicitly listed in the definition of swap agreement, the trustee claimed that the contract was not a swap agreement and could be assumed or rejected.[34] Smithfield, on the other hand, claimed that the underlying contract was a "swap agreement" (in other words, Smithfield claimed that the contracts were "commodity forward contracts") and that the parties to the contract were "swap" participants.[35] Thus, Smithfield filed a motion to dismiss the complaint, based on the Code's safe-harbor provision pertaining to swaps.

The Bankruptcy Court's opinion. Dealing with Smithfield's motion, the Bankruptcy Court examined the definitions of "swap agreement" and "swap participant." Even though the trustee and Smithfield agreed that the contract was a forward contract, the court disagreed and suggested that the contract was a simple "commodity contract" which the Code differentiates.[36] While the bankruptcy court reasoned that the forward contract issue was not dispositive and made no determination of whether the contract was a forward contract, the court held that the contract was not entitled to the protections offered to swap agreements based on Congressional intent – the Congress had only intended such protections to apply to financial market transactions, and exempting the contract at issue in this case (which was a contract for the delivery and supply of a physical commodity), the court reasoned, would not serve the Congressional purpose of protecting financial markets. In reaching its conclusion, the court disagreed with the Fifth Circuit's holding in *Olympic Natural Gas*,[37] where that court held that a gas supply contract was a forward contract under the Code's definition that qualified for safe harbor protection.[38] The bankruptcy court distinguished *Olympic Natural Gas* on the basis that the seller in that case acted as both the buyer and the seller under the contract, which made the contract something other than a simple supply contract. So, the bankruptcy court denied Smithfield's motion to dismiss.

The Court of Appeals opinion. On appeal, the United State Court of Appeals for the Fourth Circuit reversed.[39] The court noted that the BAPCPA amendments broadly define "swap agreement" and that while "commodity forward agreements" are included as one of the transactions under the definition of a "swap agreement," (and, hence, within a safe harbor) they are undefined. But, while the bankruptcy court assumed that a swap agreement must be traded on exchanges or in financial markets, the appellate court disagreed. The appellate court noted that the Code refers to both "forward contract" and "forward agreement," and that "forward contract" is a subset of "forward agreement." Thus, by that reasoning, a forward contract must also be a forward agreement, thereby making the definition of "forward contract" critical to a determination of whether the bankruptcy court too narrowly defined "forward agreement." So, if a forward contract does not need to be traded on an exchange or in a financial market, neither does a forward agreement. On that issue, the court noted that the Code defines "forward contract" as "a contract (other than a commodity contract)."[40] "Commodity contract" is defined so as to include contracts "on, or subject to the rules of, a contract market or board of trade."[41] Thus, the court reasoned, by excluding "commodity contracts" from the definition of "forward contracts," the Congress intended that "forward contracts" need not be traded on any exchange or in any financial market. In addition, while the bankruptcy court concluded that simple supply contracts that contemplate physical delivery cannot qualify as commodity forward agreements, the appellate court noted that the contracts at issue in the case also contained hedging elements.[42] Thus, the Congress did not preclude physical delivery in connection with a "commodity forward agreement" as defined in 11 U.S.C. §101(53B)(A).

So, while the appellate court reversed the bankruptcy court, the appellate court did *not* hold that the contracts at issue were entitled to safe harbor protection. Instead, the appellate court remanded the case to the bankruptcy court and instructed the bankruptcy court to "allow the customers to attempt to demonstrate factually and legally that their natural gas supply contracts were swap agreements" based on the classification included in 11 U.S.C. §101(53B). But, the court did provide some guidance for the bankruptcy court by pointing to certain non-exclusive elements that the statutory language appears to require – (1) the subject of a commodity forward agreement must be a commodity where the expected costs of performance are attributable to the expected costs of the underlying commodity, determined at the time of contracting; (2) the contract must require payment for the commodity at a price that is fixed at the time of contracting for delivery more than two days after the date the contract is entered into; (3) the quantity and time elements of the contract must be fixed at the time of contracting; and (4) swap agreements also include forward contracts which are not necessarily assignable.

In re Cascade Grain Products.[43] A recent bankruptcy case out of Oregon[44] addressed forward contracts for grain suppliers to an ethanol plant. Within 90 days of the bankruptcy petition date, the ethanol plant made payments to the grain suppliers in the amount of $19,885,728.12. The bankruptcy trustee sought to recover the payments.[45] The suppliers argued the amounts eceived were settlement payments made to them as forward contract merchants. The trustee did not dispute that the payments were settlement payments, the suppliers were forward contract merchants or that some of the contracts were actually forward contracts. The trustee, however, argued that four of the contracts were not forward contracts because they had a maturity date less than two days after that particular contract was entered into,[46] which meant they were mere ordinary commodity contracts not within the safe harbor provision.[47]

The four contracts each had a shipment occurring within a timeframe encompassing the date of the contract's formation. The trustee argued the contracts matured on the date when the suppliers' performance could start, which was the date the contract was entered into and less than the required two days after the contract was entered into. The suppliers argued that the maturity date, instead, is the last day the suppliers could perform, which would be more than two days after the contract was entered into.

The Bankruptcy Code does not define "maturity date." Courts have reached different conclusions about the definition of the term. In Texas, for example, the court has held maturity the "due date for commencement of performance". The court also found that the legislative history of the safe harbor provision did not intend to restrict the number of times a forward contract can mature.[48] A court in Wisconsin, however, used the common sense usage of the term which is the date when delivery has occurred and payment is due.[49] The court looked at when delivery was actually made to determine whether the contracts fell within the safe harbor.

In the Oregon case, the court looked to the purpose behind the safe harbor rule in crafting a definition, which is to protect financial markets from the destabilizing effects of bankruptcy proceedings for parties engaged in commodity and financial contracts because with the significant changes in markets the non-bankrupt party could face losses unless transactions are resolved quickly.[50] The purpose of a forward contract is to hedge against price shifts in a commodity—a financial purpose, which is different than a pure commodity contract, which is for the sale of a commodity.[51] Because of the financial background of the contract, the court relied on the financial industry for a definition of maturity date.

From this, the court defined maturity date as "the future date at which the commodity must be bought or sold." The benefit or detriment will be realized on that date when ownership and risk of loss passes to the buyer. The court determined the time the risk passed to the buyer was when delivery is actually made on the contract.

The court then reviewed the specific delivery dates of the shipments and found that none were delivered within two days of the contract. Because no contract had a maturity date less than two days after the contract was entered into all four contracts were future contracts and the bankruptcy trustee could not recover the payments.

Implications of the Recent Cases

There have only been a handful of cases that have examined the issue of forward contracts in the context of bankruptcy.. In the Midwest the big issue at the present time involves the rights of corn farmers that have entered into corn supply contracts with ethanol plants. The ethanol industry continues to experience financial difficulties and the bankruptcy filing of VeraSun, the nation's number two producer impacted many farmers that entered into corn supply contracts with the company.

The Fourth Circuit's focus on non-exclusive elements that are not found in the Code (such as the requirement that price, quantity and time of delivery be "fixed" at the time of contracting) makes application of the court's opinion difficult. Three different bankruptcy courts came to different definitions regarding the "maturity date" of forward contracts.[52] Contracts that are used to hedge various types of risk may have price, quantity and delivery provisions that may or may not be within the "forward contract" safe harbor, but that outcome will be dependent on a court's interpretation. Further, if the court looks to each individual circumstance to determine when the maturity date for each contract was reached without a standard definition, the outcome for individual suppliers may also be uncertain.

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[1] 11 U.S.C. §§101-1532.

[2] S. 256, Pub. L. No. 109-31, signed into law on April 20, 2005.

[3] BAPCPA also contains significant changes to Chapter 12 (farmer) bankruptcy, including a provision that converts governmental claims from priority status to non-priority, general unsecured creditor status. For a complete discussion of this issue, see http://www.calt.iastate.edu/briefs/CALT LegalBrief-Bankruptcy.pdf.

[4] 11 U.S.C. §362.

[5] 465 U.S. 513 (1984). See also, In re Frontier Properties, Inc., 979 F.2d 1358 (9th Cir. 1992)(same).

[6] One court has described the area of law involving executor y contracts in bankruptcy as a "thicket…where…lurks a hopelessly convoluted and contradictory jurisprudence." In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992)(quoting Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991)).

[7] Other examples of executory contracts could include insurance policies, an escrow with respect to a land sale, a license agreement or a joint venture. But, a contract could be so fully performed that it is no longer executory.

[8] *See, e.g.*, In re Munple, Ltd., 868 F.2d 1129 (9th Cir. 1989)(real estate brokerage commission not executory even though payment of fee was conditioned upon closing of sale); In re Spectrum Information Technologies, Inc., 193 B.R. 400 (Bankr. E.D.N.Y. 1996)(contract not executory where only performance remaining is payment of money).

[9] *See, e.g.,* In re Columbia Gas System, Inc., 50 F.3d 233, (3d Cir. 1995); In re Kong, 162 B.R. 86 (Bankr. E.D.N.Y. 1993)

[10] *See, e.g.*, In re Nemko, Inc. 163 B.R. 927 (Bankr. E.D. N.Y. 1994)(determination of whether contract is executor is made by looking at the contract at the time the issue is before the court); In re Wang Laboratories, Inc., 154 B.R. 389 (Bankr. D. Mass. 1993) (same).

[11] 11 U.S.C. §541. While bankruptcy law is a matter of federal law, bankruptcy courts often look to state law to define the "legal and equitable interests" of the estate.

[12] 11 U.S.C. §§365(c), (e)(1).

[13] 11 U.S.C. §362(a).

[14] For a more complete discussion of the impact of the automatic stay, see McEowen, Roger A., *et al.*, *Principles of Agricultural Law*, §5.05[1], Rel. 24, Jan. 2009.

[15] The grounds for relief from the automatic stay are contained in I.R.C. §362(d). Included among the grounds are "cause" and lack of "adequate protection" for the creditor's interest under the contract. In addition, courts often examine the contract to determine if the benefits of the executor contract have value to the estate or are necessary to the debtor's reorganization.

[16] Also, a contract provision that triggers default upon bankruptcy filing is generally not enforceable.

[17] 11 U.S.C. §365(a).

[18] An executory contract may not be assumed unless the bankruptcy trustee first cures the defaults or provides "adequate assurance" that any defaults will be cured. 11 U.S.C. §365(b).

[19] In a Chapter 11, 12 or 13 bankruptcy, an executory contract must be assumed or rejected before confirmation of the debtor's reorganization plan unless the court sets a different date.

[20] 11 U.S.C. §365(d)(2).

[21] 11 U.S.C. §365(g).

[22] 11 U.S.C. §503(b).

[23] Administrative expenses are entitled to priority payment ahead of unsecured creditors under 11 U.S.C. §726(a). While the creditor would most likely prefer contract performance, achieving priority claim status certainly puts the creditor in a better position than the creditor would be in if the contract were rejected.

[24] There is a possibility that an administrative claim may not be recoverable if the debtor fails to put together a confirmable reorganization plan, or if the estate is administratively insolvent or cannot close and pay its administrative claims for a long period of time.
[25] 11 U.S.C. §556.
[26] 11 U.S.C. §553.
[27] 11 U.S.C. §362(b)(6).
[28] 11 U.S.C. §547.
[29] 11 U.S.C. §546(e).
[30] *See, e.g.,* In re Enron Corp., 330 B.R. 387 (Bankr. S.D.N.Y. 2005); In re Mirant Corp., 303 B.R. 319 (Bankr. N.D. Ill. 2003)(court also held that governmental units are not "persons" under the Code, and cannot be forward contract merchants entitled to safe harbor protection).
[31] 11 U.S.C. §562.
[32] No. 07-2105, 2009 U.S. App. LEXIS 2830 (4th Cir. Feb. 11, 2009).
[33] Specifically, the trustee alleged that the contracts were entered into while the debtor was insolvent and, as a result, were constructively fraudulent conveyances under 11 U.S.C. §548a(a)(1)(B). Alternatively, the trustee claimed that the debtor's former management intentionally used the contracts to "hinder, delay, or defraud" creditors, thus engaging in an actually fraudulent conveyance under 11 U.S.C. §548a(a)(1)(A). At stake was a $4 million difference between the market prices when the customers took delivery and the prices the customers paid under the contracts.
[34] The trustee filed a constructive fraudulent transfer action in an attempt to recover the difference between the market price at the time of delivery and the price paid under the contract.
[35] Interestingly, Smithfield did not claim the same defense that is available to forward contract merchants with respect to forward contracts.
[36] Ultimately, the court reasoned that the forward contract issue was not dispositive and chose not to reach any conclusion on whether the contract constituted a forward contract.
[37] 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff'd,* 294 F.3d 737 (5th Cir. 2002).
[38] But see Aurora Natural Gas, LLC v. Texas Eastern Transmission Corporation, *et al.*, 316 B.R. 481 (Bankr. N.D. Tex. 2004)(genuine issue of material fact existed concerning whether creditor acted as a forward contract merchant or as a debt collector when it engaged in activities to collect amounts owed by debtor); Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. 310 B.R. 548 (Bankr. N.D. Tex. 2004)(court rejected defendant's suggestion that it was entitled to be treated as a forward contract merchant simply by entering into a forward contract in connection with its business).
[39] In re National Gas Distributors, LLC, No. 07-2105, 2009 U.S. App. LEXIS 2830 (4th Cir. Feb. 11, 2009)
[40] 11 U.S.C. §101(25)(A).
[41] 11. U.S.C. §761(4).
[42] The contracts were part of a series of contracts in which the customers hedged their risk of future fluctuations in the price of natural gas, and were also part of a larger risk management program involving the regular use of forward contracts and other derivatives.
[43] In re Cascade Grain Products, L.L.C., No. 0930508elp7, 2011 WL 5147548 (Bankr. D. Ore. Ooct. 28, 2011).
[44] Id.
[45] 11 U,S.C. §547(b).
[46] Forward contracts require that the contract be for the purchase, sale, or transfer of a commodity with a maturity date more than two days after the contract is entered into. 11 U.S.C. §101(25)(A).
[47] 11 U.S.C. §546(e).
[48] In re Mirant Corp., 310 B.R. 548, 565 n. 26 (Bankr. N.D.Tex. 2004).
[49] In re Renew Energy LLC, 2011 WL 3793157 (Bankr. W.D. Wis. Aug. 24, 2011).
[50] In re Cascade Grain Products, L.L.C., No. 0930508elp7, 2011 WL 5147548 (Bankr. D.Ore. Oct. 28, 2011) (citing In re Natural Gas Distributors, 556 F.3d 247, 252-53 (4th Cir. 2009)).
[51] H.R.Rep No. 101-484, at 3 (1990).
[52] In re Cascade Grain Products, L.L.C., No. 0930508elp7, 2011 WL 5147548 (Bankr. D.Ore. Oct. 28, 2011); In re Renew Energy LLC, 2011 WL 3793157 (Bankr. W.D. Wis. Aug. 24, 2011); In re Mirant Corp., 310 B.R. 548, 565 n. 26 (Bankr. N.D.Tex. 2004).