ANDREWS LITIGATION REPORTER

THOMSON WEST

Bankruptcy

COMMENTARY

REPRINTED FROM VOLUME 2, ISSUE 5 / JULY 1, 2005

The Chapter 11 Debtor and Section 556 of the Bankruptcy Code: Are Your Supply Contracts Safe?

By Brad B. Erens, Esq., and Scott J. Friedman, Esq.*

A company that files for protection under Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. § 101 et. seq., obtains many important new powers to restructure its business. One of the most powerful tools it obtains is the ability to reject executory contracts and leases.[1] When a company files for bankruptcy protection, it essentially obtains an option under its executory contracts and leases that did not previously exist. For most contracts other than non-residential leases of real property, the debtor can decide whether or not to reject a contract through the end of the Chapter 11.[2]

During this option period, the non-debtor to the contract must continue to perform according to its terms, but the debtor is free, with court approval, to reject the contract if it so chooses. *United States v. Dewey Freight System, Inc.,* 31 F.3d 620, 624 (8th Cir. 1994) ("After a debtor commences a Chapter 11 proceeding, but before executory contracts are assumed or rejected under § 365(a), those contracts remain in existence, *enforceable by the debtor but not against the debtor*") (italics in original).[3]

Should a debtor reject an executory contract or lease, the rejection is treated as a breach of the contract. The non-debtor's "breach" claim is deemed to arise prior to the bankruptcy proceeding even though the rejection of the agreement occurred during the bankruptcy. 11 U.S.C. § 365(g)(1). As a result, the rejection claim is typically a general unsecured claim against the debtor that may receive only a fraction of its face amount.

Bankruptcy also has the ability, however, to impair, rather than improve, a debtor's contract rights. For example, under Section 365(c)(1) of the Bankruptcy Code, a debtor in bankruptcy may be unable to maintain an executory contract if, under applicable law, the non-debtor party to the contract is not required to accept performance from, or render performance to, a party other than the debtor. While Section 365(c) traditionally has been limited to so-called "personal service" contracts, recently courts have been expanding that section's application to other contracts, such as intellectual property agreements. See, e.g., *In re Sunterra Corp.,* 361 F.3d 267 (4th Cir. 2004) (debtor cannot assume copyright license); *In re Catapult Entertainment, Inc.,* 165 F.3d. 747 (9th Cir. 1999) (debtor cannot assume patent license).

Forward Contracts in Chapter 11

While the risk of losing a contract under Section 365(c) of the Bankruptcy Code is well known to bankruptcy professionals, a potential similar risk to Chapter 11 debtors under Section 556 of the Bankruptcy Code is far less recognized. Section 556 essentially provides that "commodity brokers" and "forward contract merchants" who are party to "commodity contracts" or "forward contracts" may "liquidate" those agreements upon the commencement of a bankruptcy filing by the debtor, as long as the agreements so provide. Section 556 states, in relevant part, that:

> the contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract, as defined in Section 761, or forward contract because of a condition of the kind specified in Section 365(e)(1) of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title.

This section is an exception to the general rule in bankruptcy that a non-debtor party to a contract must continue to perform under the contract even after a bankruptcy filing.

While terms such as "commodity contract" and "forward contract" sound technical and applicable only to financial players in the commodities or futures trade, the definitions of these terms may be far broader. For instance, Section 101(25) of the Bankruptcy Code defines a "forward contract" to be:

a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in Section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into.

In turn, the definition of a "commodity" for purposes of the Bankruptcy Code is the definition of that term in the Commodities Exchange Act, 7 U.S.C. § 1 *et seq.*, which defines "commodity" to include certain specified agricultural commodities and "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(4). As a result, a forward contract, which is subject to liquidation as a result of a bankruptcy, potentially could include any contract for the delivery of a good, if that good (or similar good) is the subject of dealing in the forward contract trade, and if the contract contemplates the delivery of the good and payment therefor more than two days after execution of the contract.

The Risks to Supply Contracts

Under this reading, many ordinary supply contracts today — and more in the future as commodity markets develop — arguably could be forward contracts. For instance, assume that a Chapter 11 debtor is a manufacturing company which has a simple supply contract to purchase copper from ABC Company at a specified price. Further assume that copper is a good, which is the "subject of dealing in the forward contract trade." With these assumptions, an argument potentially could be made that the copper contract is a forward contract for purposes of the Bankruptcy Code. If so, the result could be that ABC Company can liquidate the contract upon the debtor's bankruptcy under Section 556 if the contract itself gives ABC the right to do so. What exactly liquidating a supply contract might mean is something that would be subject to interpretation by a bankruptcy court. However, if the copper supply contract is on price terms favorable to the debtor, ABC Company would have a significant economic incentive to seek termination of the agreement and would argue that liquidating the agreement means essentially terminating the agreement.[4]

The notion that such a supply agreement might be subject to termination under Section 556 undoubtedly would be quite a surprise to most bankruptcy observers. Indeed, Section 556 is generally considered a provision that is designed only to protect firms in the commodities and securities industry. Consistent with this view, the legislative history of Section 556 of the Bankruptcy Code indicates that the provision was enacted to protect the commodities market against a "ripple effect" caused by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.[5] In other words, if a firm in the commodities or securities markets could not liquidate its position upon the bankruptcy of another firm in the industry, that inflexibility could itself cause the insolvency of the first firm, with the risk that financial distress and panic could spread throughout the entire industry.

The view that Section 556 exists solely to protect commodity firms is further supported by some of the legislative history to amendments to the definition of "forward contract," "forward contract merchant," and "commodity" in the Bankruptcy Code passed by Congress in 1990, which sought to clarify and, to some extent, expand such definitions. In particular, the House Report to the 1990 legislation describes forward contracts as follows:

> The primary purpose of a forward contract is to hedge against possible fluctuations in the price of a commodity. This purpose is financial and risk-shifting in nature, as opposed to the primary purpose of an ordinary commodity contract, which is to arrange for the purchase and sale of the commodity. If the price of a commodity – such as crude oil or soybeans – rises or falls on some future date, the buyer or seller can minimize the risk involved through the use of forward contracts to offset the fluctuations in price from the date of the agreement to the actual date of transfer or delivery.
>
> Section 201 of the bill amends Section 101 of the Bankruptcy Code to clarify the definition of "commodity" as it relates to forward contracts and forward contract merchants . . . This amendment is intended to clarify that these exemptions from the Bankruptcy Code apply to genuine forward contracts regarding a commodity not currently listed in the Commodity Exchange Act, but that the exemptions do not apply to ordinary supply-of-goods contracts, which are not essentially financial in character.

The Olympic Natural Gas Co. Case

Notwithstanding this legislative history, the one court of appeals decision that has considered the definition of a "forward contract" reached a result potentially consistent with a position that forward contracts may include ordinary supply agreements. See *In re Olympic Natural Gas Co.,* 294 F.3d 737 (5th Cir. 2002). In *Olympic Natural Gas,* Morgan Stanley entered into numerous transactions with the debtor pursuant to a Natural Gas Sales and Purchase Contract. Each month the parties would enter into a series of transactions (each party would sometimes act as buyer, sometimes as seller) for the sale of natural gas after agreeing upon price, quantity, timing, and point of delivery. The contract provided for a single net payment in settlement of each month's trading. After Olympic filed for bankruptcy, the trustee sought to avoid certain payments to Morgan Stanley as preferences or fraudulent conveyances. Morgan Stanley argued that the payments were protected "settlement payments" made under forward contracts and thus could not be avoided.[6] As a result, the court had to determine whether the contract at issue was a forward contract.

The trustee argued that the contract was not a forward contract, but rather an ordinary commodity contract. Under the trustee's view, the Bankruptcy Code "divides the 'world of commerce of commodities' into three parts: (i) futures, or on-exchange financial instruments; (2) forwards, or off-exchange financial instruments; and (3) ordinary commodity contracts (*i.e.* contracts for the commercial supply of goods with a future delivery date)." Id. at 740. The first two parts comprise "financial" forward contracts, which fall into the definition of "forward contract" under the Bankruptcy Code. The latter part comprises "ordinary purchase and sale" forward contracts, which fall outside of that definition. The trustee noted that the contract at issue contemplated actual delivery of natural gas in order to support its position that the contract was not a financial forward contract and, therefore, should not be deemed a forward contract under the Bankruptcy Code.

Morgan Stanley argued instead that Section 556 of the Bankruptcy Code, consistent with established practice in the commodity industry, divides the world into only "off-exchange forward contracts" (i.e. forward contracts under the Bankruptcy Code) and "on-exchange futures" (which would be commodity contracts under the Bankruptcy Code), and that no third category of "ordinary commodity contracts" exists. Id. at 740. The 5th Circuit agreed with Morgan Stanley. According to 5th Circuit, forward contracts are "contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade." Id. at 741 (quoting Collier on Bankruptcy ¶556.02[2]). The court stated that: "[i]n sum, we see no reason to adopt the interpretation the Trustee advocates, and distinguish between 'financial' forward contracts, and 'ordinary purchase and sale' forward contracts, when the statutory language makes no such distinction." Id. at 742. Further, in refuting the trustee's position that the Morgan Stanley agreement should not be deemed a forward contract because the agreement contemplated actual delivery, the court stated that "courts in other circuits have repeatedly stated that one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery." Id. at 741. As a result, the court found the Morgan Stanley agreement to be a forward contract.

Thus, in the 5th Circuit, an agreement may not be exempted from the definition of a "forward contract" simply because the contract provides for the actual supply of goods. In other words, in the 5th Circuit, "ordinary" commodity contracts may still be "forward contracts" under the Bankruptcy Code, although it should be noted that the agreement at issue in *Olympic Natural Gas* was not an ordinary supply agreement between a manufacturer and a commercial end-user.

Notwithstanding *Olympic Natural Gas*, in cases of true ordinary supply contracts, bankruptcy courts may be inclined to narrow the impact of Section 556 by finding that the non-debtor party to the contract is not a "forward contract merchant." Section 101(26) of the Bankruptcy Code defines "forward contract merchant" as a "person whose business consists in whole or in part of entering into forwards contracts as or with merchants in a commodity . . . or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade."

The Mirant Case

In fact, in the recent decision of *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.),* 310 B.R. 548 (Bankr. N.D. Tex. 2004), a bankruptcy court in the 5th Circuit found that there were triable issues of fact as to whether a non-debtor party to the contract at issue was a forward contact merchant (although the court did find the contract at issue was a forward contract). In interpreting the definition of "forward contract merchant" in Section 101(26) of the Bankruptcy Code, the court focused on two key words — "merchant" and "business." The court seemed to indicate that a "merchant" is someone not acting as an end-user or a producer. The Bankruptcy Court also stated the term "business" to mean something in which one engages to produce a profit. Thus, the court concluded that a "forward contract merchant is a person that, in order to profit, engages in the forward contract trade as or with merchants." Id. at 568. The non-debtor party had asserted, based on the language of Section 101(26), that a forward contract merchant was any person that, in connection with its business, entered into forward contracts. Id. The court rejected this interpretation since, arguably, it would mean that almost every supply contract could be forward contract terminable upon a bankruptcy filing. Id.

Thus, we return to the question of whether a copper supply agreement between a debtor and ABC Company is a "forward contract" that can be liquidated or terminated by ABC upon the debtor's bankruptcy filing. As long as ABC is a forward contract merchant, at least in the 5th Circuit (which covers bankruptcy courts in Texas, Louisiana and Mississippi), the answer is possibly, although the extent to which this risk exists must await further interpretation by the courts. As a result, any company potentially contemplating filing for Chapter 11 which has favorable long-term raw material contracts should conduct a thorough legal review of those agreements to determine whether they might be deemed forward contracts under the Bankruptcy Code. Termination of those contracts after a bankruptcy likely could have material negative consequences for the debtor's reorganization.

Notes

[1] The term "executory contract" is not defined in the Bankruptcy Code and the proper definition of the term has been the subject of much dispute. However, a contract is typically considered "executory" between two parties where material performance remains due by each such party.

[2] Section 365(d)(2) of the Bankruptcy Code provides that in a Chapter 11 case the debtor may assume or reject an executory contract or unexpired lease at any time before confirmation of a plan, although a contract party, for cause, may be able to have the Bankruptcy Court require the debtor to make an earlier decision.

[3] Pending rejection, if the debtor does not perform under the contract the non-debtor may be able to cease performance or seek a court order to compel either performance under, or rejection of, the contract.

[4] It should be noted that recent legislation that will become effective in October, 2005 and apply to cases filed after that time has amended Section 556 to give a forward contract merchant the right to cause the "liquidation, termination, or acceleration" of a forward contract. As a result, once such legislation becomes effective, ABC Company would not have to argue that "liquidation" means "termination" of the forward contract. Instead, Section 556 as applicable to such future cases will expressly allow termination of the forward contract if the provisions of Section 556 are satisfied.

[5] H.R. Rep. 97-420 at 1-2 ("The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security from spreading to other firms and possible threatening the collapse of the affected market. The Bankruptcy Code now expressly provides certain protections to the commodities market to protect against such a "ripple effect." The thrust of several of the amendments contained in H.R. 4935 is to clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market.")

[6] Section 546(e) of the Bankruptcy Code insulates from avoidance recovery "settlement payments," as defined in the Code, made to parties such as forward contract merchants.

** Brad B. Erens is a partner in the Business Restructuring & Reorganization practice at Jones Day in Chicago. Scott J. Friedman is an associate in the Business Restructuring and Reorganization practice at Jones Day in New York. The views expressed in this article are those of the authors solely and not Jones Day. In addition, Jones Day was counsel to Kern Oil in the Mirant case cited in this article.*