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Is Time of the Essence?

Section 556 Safe-Harbor Provision for Forward Contracts and Commodities Contracts

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Section 365 of the Bankruptcy Code authorizes debtors and bankruptcy trustees to assume or reject executory contracts and unexpired leases.[1] This flexible framework reflects the underlying bankruptcy policy that debtors should have the ability to abandon burdensome contracts and retain beneficial contracts. While § 365 is one of the most important tools available to debtors, a debtor's rights are not unfettered. Section 365 contains a number of provisions benefiting counterparties, including imposing time limits on the debtor's right to assume or reject,[2] and exempting particular types of contracts from assumption.[3] This balance of competing interests is woven into the Bankruptcy Code. However, in bankruptcy, not all contracts are created equal.

Safe Harbor Provisions for Commodities and Forward Contracts

The Bankruptcy Code contains "safe harbor" provisions applicable to securities contracts, commodities contracts, forward contracts, repurchase agreements and swap agreements.[4] These safe-harbor provisions provide counterparties with unique protections. In enacting the safe-harbor provisions, Congress recognized that without special protections, nondebtor counterparties would be vulnerable to loss or interference with their contractual rights, which would result in volatility to the commodities and financial markets.[5] The safe-harbor provisions are meant to counteract this risk.[6]

The safe-harbor provisions appear in several different Bankruptcy Code sections,[7] including multiple sections that allow certain counterparties[8] to liquidate, terminate or accelerate such contracts if a debtor files for bankruptcy, but only to the extent the contract contains an *ipso facto* clause. The recent increase in bankruptcy filings in the energy sector has resulted in further developments, including a split of authorities concerning application of the *ipso facto* safe-harbor provision.

Section 556: The Importance of an *Ipso Facto* Clause[9]

Section 556 of the Bankruptcy Code provides that "the contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract ... or [a] 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 order of a court in any proceeding under this title."[10]

1 *See* 11 U.S.C. § 365(a).
2 *See* 11 U.S.C. § 365(d).
3 *See* 11 U.S.C. § 365(c).
4 The Bankruptcy Code contains definitions for these various types of contracts. *See generally* 11 U.S.C. §§ 101 and 761.
5 For example, these types of contracts generally afford a nondefaulting party the right to "close out" or "liquidate" the contract upon the other party's default, which enables the nondefaulting party to terminate or cancel the contract, fix damages based on relevant market prices and accelerate other obligations. Without the flexibility to pursue these remedies, which would ordinarily be stayed post-petition, counterparties would bear the risk of adverse market price movements and be at the mercy of the debtor, which could, in turn, impact the markets.
6 *See* H.R. Rep. No. 97-420, at 1 (1982).
7 Other relevant provisions include (1) §§ 362(b)(6) and 362(o), which allow for the exercise of setoff and netting of mutual debts and claims under such contracts without relief from the automatic stay; and (2) §§ 546(e) and 548(d), which protect certain pre-petition payments under such contracts from preference and fraudulent-transfer avoidance. A discussion of these other safe-harbor provisions is beyond the scope of this article.
8 Notably, while broad, the special protections discussed herein are not applicable to all nondebtor counterparties. A careful review of the various Code sections should be undertaken to determine whether the safe harbors are applicable to any contract or agreement at issue. This limitation is further evidence of Congress's attempt to balance the rights of various parties to these contracts.
9 Similar safe-harbor provisions applicable to securities contracts (§ 555), repurchase agreements (§ 559) and swap agreements (§ 560) are also included in the Bankruptcy Code.
10 11 U.S.C. § 556.

Section 556 is clear that it does not prevent the exercise of such liquidation, termination and acceleration rights for all kinds of defaults. Instead, § 556 only extends to contracts that contain a provision allowing for termination based on the conditions specified in § 365(e)(1) of the Bankruptcy Code.[11] In other words, § 556 allows a party to terminate a commodity contract or forward contract due to a counterparty's bankruptcy filing only to the extent the contract contains a provision allowing for such termination (*i.e.*, an *ipso facto* clause) and not from failures to perform or pay. This provision stands in stark contrast to § 365(e)(1), which negates the effect of such *ipso facto* clauses.

Courts have debated whether the § 566 safe-harbor protection must be promptly exercised upon a counterparty's bankruptcy filing, or whether a party has breathing room to decide whether to terminate the contract. If a party terminates weeks or months post-petition, was the decision to terminate motivated by the bankruptcy or because the contract is no longer profitable for the party (*e.g.*, the nondebtor party has found themselves "out of the money" under the contract due to market conditions)? If profitability is the motive, is that a proper exercise of the counterparty's rights under § 556? These issues have led courts to consider whether a timeliness requirement applies to § 556.

Is Time of the Essence?

Courts are split as to whether the rights afforded by § 556 must be exercised immediately by the nondefaulting party upon receipt of notice of the bankruptcy filing, or whether the nondefaulting party is afforded leeway. In *In re S. California Edison Co.*, the U.S. District Court for the Southern District of Texas recently overruled the bankruptcy court on appeal, finding that a party to certain forward contracts did not waive its rights under § 556 by waiting 72 days after its counterparty's bankruptcy filing to exercise its termination rights under the contracts.

In this case, Berry Petroleum Co. LLC filed for chapter 11 protection on May 11, 2016.[12] Prior to the petition date, Berry entered into two electric supply and capacity agreements with Southern California Edison (SCE) in July 2012 and April 2014.[13] Pursuant to the agreements, Berry supplied SCE with electricity and capacity from its California cogeneration plants for a term of 84 months each.[14] The agreements provided that in the event of default, the nondefaulting party could terminate the agreements.[15] Importantly, an event of default included a bankruptcy filing.[16]

On July 22, 2016, SCE filed a motion to authorize termination of the agreements, 72 days after Berry filed for bankruptcy.[17] At the conclusion of the hearing on SCE's motion, the bankruptcy court found that SCE waived its right to terminate the agreements, explaining that "if you're going to rely ... solely on an *ipso facto* clause, it has to be done quick."[18] SCE appealed.[19]

The issue facing the *SCE* court on appeal was "whether a party waives application of an *ipso facto* clause by a delay of less than 90 days after notice of the counterparty's bankruptcy before asserting its desire to terminate, even in the absence of language in the statute regarding time limitations or evidence in the record regarding business circumstances."[20] On appeal, Berry emphasized the fact that it had continued to perform under the agreements despite filing for bankruptcy and that the "only reason SCE wanted to terminate the [agreements] was that SCE was out of the money."[21] In addition, Berry argued that § 556's legislative history supported the conclusion that the rights afforded thereunder must be promptly exercised.[22] However, the *SCE* court was not persuaded, noting that § 556 itself "does not include a time limitation on the right to terminate."[23]

The *SCE* court distinguished the case from oral findings of the U.S. Bankruptcy Court for the Southern District of New York in a 2009 hearing in *In re Lehman Brothers Holdings Inc*.[24] In *Lehman Brothers*, then-Judge **James M. Peck** (now co-chair of Morrison & Foerster LLP's Global Business Restructuring and Insolvency Group) held that a party's suspension of payments under an outstanding swap agreement with the debtor was not subject to the Bankruptcy Code's safe-harbor provisions but instead violated the automatic stay due to the counterparty's delay in exercising its termination rights.[25] Specifically, the *Lehman* court found that a nondebtor waived its rights when it waited a year before terminating a swap agreement with the debtor, explaining that "riding the market for the period of one year, while taking no action whatsoever, is simply unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code."[26]

The *SCE* court placed much emphasis on the fact that SCE continued to perform under the agreement post-petition.[27] In addition, the *SCE* court took note of the fact that SCE waited only 72 days post-petition to exercise its safe-harbor rights, unlike the movant in *Lehman Brothers*, who waited more than a year. The *SCE* court ultimately found that the bankruptcy court's interpretation "erected a court-imposed barrier to the plain language of § 556" and reversed, based on the bankruptcy court's "erroneous inclusion of an extra-statutory promptness requirement in § 556."[28]

At least one other court has reached a similar decision on the issue of waiver. In 2004, the U.S. Bankruptcy Court for the Northern District of Texas concluded that waiting seven weeks to terminate a swap agreement pursuant to an *ipso facto* clause did not result in a waiver of safe-harbor protections, even though the debtor argued that the party's reasons for termination were economic because it would be "cheaper

11 *See* 11 U.S.C. § 365(e)(1) (an "insolvency or financial condition of the debtor at any time before the closing of the case," the "commencement of a [bankruptcy case]" or "the appointment of or taking possession by a trustee ... or a custodian").
12 No. 6:16-CV-57, 2018 WL 949223, at *1 (S.D. Tex. Feb. 15, 2018).
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.*
18 Transcript of Evidentiary Hearing at 132:14-23, *In re Linn Energy LLC, et al.*, Case No. 16-60040 (Bankr. S.D. Tex. Aug. 16, 2016) [Docket No. 823].
19 *In re S. Calif. Edison Co.*, 2018 WL 949223, at *2.
20 *Id.* at *3.
21 *Id.* at *2.
22 *See* Brief of Appellee Berry Petroleum Co. LLC at 11, *S. Calif. Edison Co. v. Berry Petroleum Co. LLC*, Case No. 16-00057 (S.D. Tex. Jan. 20, 2017) [Docket No. 9] (citing H.R. Rep. No. 97-420, at 1-2 (1982) ("The prompt closing out of liquidation of such accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur.")).
23 *In re S. Calif. Edison Co.*, 2018 WL 949223, at *3.
24 *Id.* at *4.
25 *See* Evidentiary Hearing Transcript at 110:18-25, *In re Lehman Bros. Inc.*, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 17, 2009) [Docket No. 5261].
26 *Id.* at 22-25.
27 *In re S. Calif. Edison Co.*, 2018 WL 949223, at *4.
28 *Id.*

for [the party] to terminate than to continue the Swap agreement, as [the party] was 'out of the money.'"[29]

However, other courts have concluded that a counterparty's delay in exercising the right to terminate a contract under the Bankruptcy Code's safe-harbor provisions can result in a waiver of such rights. In *In re Enron Corp*., then-Judge **Arthur J. Gonzalez** (now a senior fellow with New York University School of Law) explained that for a swap participant to avail itself of the safe-harbor provisions of the Bankruptcy Code, "the swap participant must opt for the early termination of the swap agreement based upon one of the reasons enumerated in § 365(e)(1) of the Bankruptcy Code, and if based upon the bankruptcy filing, the election to terminate must be made *fairly contemporaneously* with the bankruptcy filing."[30] In 2016, the U.S. Bankruptcy Court for the Western District of Louisiana also ordered briefing on the issue of waiver of § 556 rights, acknowledging the line of reasoning that such rights must be invoked "close to the commencement of the filing of the case."[31]

Is the *Ipso Facto* Clause Just a Convenient Excuse?

The plain language of § 556 makes it clear that a counterparty to a commodities or forward contract could rely on a bankruptcy-default provision as a basis to enforce its remedies post-petition,[32] but the application of that principle is far from straightforward. The longer a counterparty waits to terminate (such as more than a year in *Lehman Brothers*), the more unwilling a court might be to permit the party to exercise the § 556 safe-harbor provision. This is particularly true where the evidence suggests that the decision to terminate was not based on the counterparty's bankruptcy filing, but was instead based on a determination that the contract was unprofitable.

As a result, upon receipt of notice of a bankruptcy filing, a counterparty to a forward or commodity contract should promptly and carefully analyze its position and determine whether termination is desirable. If the decision is made to terminate, such termination should not be delayed so as to ensure that the safe-harbor protection of § 556 remains.

Practitioners should recognize the impact of the safe-harbor provisions because failing to understand the safe harbors and act quickly can result in the evaporation of a contract's value. However, when properly utilized, the safe harbors allow counterparties to preserve value and mitigate risk. abi

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29 *See In re Mirant Corp*., 314 B.R. 347, 352 (Bankr. N.D. Tex. 2004).

30 *See In re Enron Corp*., No. 01 B 16034 (AJG), 2005 WL 3874285, at *4 (Bankr. S.D.N.Y. Oct. 5, 2005) (emphasis added).

31 Hearing Transcript at 10:4-22, *La. Pellets Inc*., Case No. 16-80162 (Bankr. W.D. La. May 11, 2016) [Docket No. 310].

32 *See In re La. Pellets Inc*., No. 16-80162, 2016 WL 4011318, at *4-5 (Bankr. W.D. La. July 22, 2016) (finding that "a right to terminate only falls within the safe harbor if that right is based on the conditions specifically stated in section 365(e)(1)" and not for termination based on other reasons, "such as termination based on contract performance"); *In re Calpine Corp*., 2009 WL 1578282 at *6-7 (Bankr. S.D.N.Y. May 7, 2009) (holding that "by its terms, Section 556 ... is limited to enforcing only those terms that trigger termination upon the occurrence of one of the three specified conditions listed in Section 365(e)(1)").