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INSIDE

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IN FUTURE ISSUES

Seventh Circuit vacates Animal Welfare Act order based on an invalid rule

The USDA, like other federal agencies, prescribes binding substantive "rules" in internal agency handbooks instead of promulgating the rules as legislative rules under the procedures mandated by the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1994). As Professor Robert A. Anthony has noted, "[n]onlegislative provisions in [USDA] manuals are legion, and they are enforced." Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like—Should Federal Agencies Use Them To Bind the Public?*, 41 Duke L.J. 1311, 1336 (1992). Not only is this practice unlawful under the APA, it is poor public policy for it defeats the salutary purposes underlying the "notice and comment" rulemaking procedures mandated by the APA. Yet, as a recent Seventh Circuit decision illustrates, the USDA persists in its attempts to sanction the public it regulates for violations of rules that are themselves illegal. In an entertaining but to-the-point opinion written by Judge Posner in his unique style, the Seventh Circuit has reminded the USDA that its binding rules must be promulgated in accordance with the requirements of the APA to be enforceable. *Hoctor v. United States Dep't of Agric.*, 82 F.3d 165 (7th Cir. 1996).

At issue in *Hoctor* was an order directed against an exotic animal dealer, Patrick Hoctor, citing him for not having an eight-foot-high perimeter fence around his "Big Cat" compound. Mr. Hoctor raised a variety of animals, including lions, tigers, cougars, and other "Big Cats," within a compound bordered by a six-foot-high fence. Construction of an eight-foot-high fence would cost him "many thousands of dollars," a sum Mr. Hector could not afford. 82 F.3d at 168.

Under the Animal Welfare Act, the USDA is authorized to promulgate regulations governing the housing and other matters relating to the care and treatment of warm-blooded animals. 7 U.S.C. §§ 2151, 2413(a) (1994). Under this authority and in accordance with the APA's notice and comment rulemaking provisions, the USDA promulgated a "structural strength" regulation requiring that animal housing "must be constructed of such material and of such strength as appropriate for the animals involved." 9 C.F.R. § 3.125(a) (1996).

Notwithstanding the "structural strength" regulation's generality, an internal USDA memorandum instructed USDA inspectors that all "dangerous animals," including lions, tigers, and leopards, must be confined inside a perimeter fence at least eight feet high. This "rule," however, was never promulgated under the APA. Before the Seventh Circuit, the USDA argued it did not have to promulgate the eight-foot high fence rule under the APA's notice and comment provisions because the rule was an "interpretative rule," not a "legislative rule." Unlike legislative rules, interpretative rule are exempted from the APA's notice and comment requirements. 5

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Equine for slaughter transportation bill passed despite controversy

As part of the Federal Agriculture Improvement and Reform Act of 1996, Congress passed provisions that propose to regulate the transportation of horses intended for slaughter. Federal Agriculture Improvement and Reform Act of 1996, Pub. L. No. 104-127, 110 Stat. 888 (1996). The law is the culmination of an effort by horse industry groups and animal welfare organizations to regulate the transportation of horses to slaughter facilities. However, many who worked toward the passage of the provision are disappointed in the final product because of extensive revisions made during the legislative process.

Earlier versions of the bill included mandatory language requiring the Secretary of Agriculture to promulgate regulations concerning equine transportation within

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U.S.C. § 553(b)(A). Thus, the issue before the court was whether the rule was an interpretative rule; that is, whether the internal memorandum's requirement of an eight-foot-high fence was merely an interpretation of the "structural strength" regulation, 9 C.F.R. § 3.125(a), a validly promulgated legislative rule.

Acknowledging that the distinction between interpretative rules and legislative rules is often difficult to draw, the court viewed its task as requiring it "to give effect to a distinction that the Administrative Procedure Act makes...." 53 F.3d at 170. It approached this task by first reasoning that an interpretative rule interpreting a legislative rule is only such "if it can be derived from the regulation by a process reasonably described as an interpretation." *Id.* (citation omitted). From that premise, the court posed the question: "Supposing that the regulation imposes a general duty of secure containment, the question is, then, Can a requirement that the duty be implemented by erecting an eight-foot-high perimeter fence be thought an interpretation of that general duty?" *Id.*

The court answered that question by noting that "'[i]nterpretation' in the narrow sense is the ascertainment of meaning. It is obvious that eight feet is not part of the meaning of secure containment." *Id.* Nonetheless, the court observed that "interpretation" has a broader meaning, as illustrated by judicial interpretations of the United States Constitution—"To skeptics the Miranda rule is as remote from the text of the Fifth Amendment as the eight-foot rule is from the text of 9 C.F.R. § 3.125(a)." *Id.* From this premise, the court turned to the purpose of the APA's distinction between interpretative rules and legislative rules. That "purpose is to separate the cases in which notice and comment rulemaking is required from the cases in which it is not required." *Id.*

After opining that the selection of eight feet for the height of perimeter fencing was essentially the kind of arbitrary decision that the legislative process must necessarily make because eight feet is an inherently arbitrary height; that is, not materially different from seven or nine feet, the court stated:

> The common sense of requiring notice and comment rulemaking for legislative rules is well illustrated by the facts of this case. There is no process of cloistered, appellate-court type reasoning by which the Department of Agriculture could have excogitated the eight-foot rule from the structural-strength regulation. The rule is arbitrary in the sense that it could well be different without significant impairment of any regulatory purpose. But this does not make the rule a matter of indifference to the people subject to it. There are thousands of animal dealers, and some unknown fraction of these face the prospect of having to tear down their existing fences and build new, higher ones at great cost. The concerns of these dealers are legitimate and since, as we are stressing, the rule could well be otherwise, the agency was obliged to listen to them before settling on a final rule and to provide some justification for that rule, though not so tight or logical a justification as a court would be expected to offer for a new judge-made rule. Notice and comment is the procedure by which the persons affected by legislative rules are enabled to communicate their concerns in a comprehensive and systematic fashion to the legislating agency. The Department's lawyer speculated that if the notice and comment route had been followed in this case the Department would have received thousands of comments. The greater the public interest in a rule, the greater reason to allow the public to participate in its formation.

Id. at 171.

Recognizing that its reasoning concerning the inherent arbitrariness of height requirement could be construed to mean that an interpretive rule can never have a numerical component, the court expressly disclaimed such an intention by stating that:

> [e]specially in scientific and other technical areas, where quantitative criteria are common, a rule that translates a general norm into a number may be justifiable as an interpretation.... Even in a nontechnical area the use of a number as a rule of thumb to guide the application of a general norm will often be legitimately interpretive. Had the Department of Agriculture said in the internal memorandum that it could not imagine a case in which a perimeter fence for dangerous animals that was lower than eight feet would provide secure containment, and would therefore presume, subject to rebuttal, that a lower fence was insecure, it would have been on stronger ground. For it would have been tying the rule to the animating standard, that of secure containment, rather than making it stand free of the standard, self-contained, unbending, arbitrary. To switch metaphors, the "flatter" a rule is, the harder it is to conceive of it as merely spelling out what is in some sense latent in a statute or regulation, and the eight-foot rule in its present form is as flat as they come.

Id. With that disclaimer, the court ruled that it was for the courts, not the agency, "to say whether [a rule] is the kind of rule that is valid only if promulgated after notice and comment." *Id.* Here, the court held that the eight-foot-high fence rule was such a rule.

Aside from the lively style that often characterizes Judge Posner's opinions, the *Hector* opinion is noteworthy for its thoroughness in reasoning through the APA's distinctive treatment of legislative and interpretative rules. Because that distinction is likely to remain a recurring issue for those who must deal with the USDA's fondness for relying on internal agency directives in lieu of published regulations, the *Hector* opinion is well worth a careful review.

—Christopher R. Kelley, Of Counsel, Lindquist & Vennum P.L.L.P., Minneapolis, MN

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12. USDA; Fluid milk promotion order; proposed rule; comments due 10/7/96. 61 Fed. Reg. 47093.

13. USDA; APHIS; International sanitary and phytosanitary standard setting activities; notice and solicitation of comments. 61 Fed. Reg. 49432.

14. Farm Credit Administration; Loans in areas having special flood hazards; final rule; effective date 10/1/96. 61 Fed. Reg. 45684.

15. APHIS; Official brucellosis tests; proposed rule; comments due 11/12/96. 61 Fed. Reg. 48430.

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one year of enactment. Also included were detailed minimum requirements for the humane handling, care, and treatment of equine for slaughter, and for equipment necessary to ensure safe and humane transportation of equine for slaughter. Minimum requirements included:

- equine could not be transported for more than 24 hours without being unloaded and allowed to rest at least eight consecutive hours with access to adequate food and water;
- adequate headroom must be provided in transportation vehicles with a minimum of at least six feet, six inches of headroom; however, only six feet of headroom would be required when transporting six equines of 16 hands or less.

Vehicles used in transporting equines to slaughter were also regulated. The interior of the vehicle could have no protrusions, sharp edges, or harmful objects, and was required to have ramps and floors adequately covered with a nonskid nonmetallic surface.

The earlier versions of the bill also required stallion segregation, and horses were to be loaded in vehicles by size. All horses were required to have inspection certificates that stated that the animals had been inspected and were fit to travel, and that described each equine. Restrictions also contained in the bill prohibited transportation to slaughter of any equine found to be:

- suffering from a broken or dislocated limb;
- unable to bear weight on all four limbs;
- blind in both eyes;
- obviously suffering from severe illness, injury, lameness, or physical debilitation that would make the equine unable to withstand the stress of transportation.

Foals and mares in foal that exhibited signs of impending parturition were also prohibited from being transported for slaughter.

Slaughter facilities were required to refuse acceptance of equine that were not:

- inspected upon arrival by an employee of the slaughter facility or an employee of USDA;
- accompanied by a certificate of inspection from an accredited veterinarian, issued not more than seven days before the delivery, stating that the veterinarian inspected the equine on a specified date.

S. 744, 104th Cong., 2d Sess. § 813, 142 Cong. Rec. S744-02, S825 (1996).

Recordkeeping requirements were also included for those engaged in the business of transporting equine for slaughter. *Id.* § 814, 142 Cong. Rec. at S825. Criminal penalties were established for interference with the enforcement of the bill's provisions. *Id.* § 818, 142 Cong. Rec. at S825. Knowing violations of the provisions also would have resulted in criminal penalties, with civil penalties for all other violations. *Id.* § 820, 142 Cong. Rec. at S825-S826.

In contrast to this language, Title IX, Subtitle A of the 1996 Farm Bill states that "[b]ecause of the unique and special needs of equine being transported to slaughter, Congress finds that it is appropriate for the Secretary of Agriculture to issue guidelines for the regulation of the commercial transportation of equine for slaughter by persons regularly engaged in that activity within the United States." *Id.* § 901. All mandatory language was removed from the final version.

The Secretary's guidelines should address the issues of food, water, and rest provided to the animals in transit and the segregation of stallions from other equine during transit. In addition, the Secretary can require records and reports, conduct investigations and inspections, and establish and enforce civil penalties. *Id.* § 903.

The provisions are specifically limited to equine that are being transported for slaughter, and do not regulate the routine or regular transportation to slaughter or elsewhere of livestock other than equine or poultry. *Id.* section 904.

Despite the drastic differences between the earlier and final versions, some equine and animal welfare organizations maintain their support of the bill. The Humane Society of the United States, which aided in drafting the original legislation, chose to support the new bill because they were concerned that the bill would die if they declined support and that the chances of passing any other bill in the near future were minimal. Betsy Sikora Süno, *Results of the Transportation Bill*, Horse Illustrated, Sept. 1996, at 28. These groups are now calling for strict regulations to be adopted by the Secretary of Agriculture under the act to replace the language stricken from the original bill. *Id.* at 29.

Other equine organizations have not been as supportive of the final version. A number of groups have called for their membership to demand Congress to change the bill. Many humane groups have refused to support the bill because it did not go far enough. Claiming that the act was "senseless, harmful legislation," the Redwings Horse Sanctuary president argues, "Obviously, lots of people today know about horse slaughter, they realize it's an atrocity and they want it stopped. Rubber mats are no longer the issue—legislative wording that sounds good on paper but in reality contributes to horse suffering must never again go on the books." Bonnie Stoehn, *President's Message, Redwings Horse Sanctuary News*, Spring 1996, at 2. Groups opposing the bill include animal rights and welfare groups along with several equine welfare groups. [Opposing groups include: Friends of Animals, Humane Farming Association, PETA, Last Chance for Animals, California State Horsemen's Association, Hoofed Animal Humane Society, California State Humane Association, Animal Protection Institute, United Animal Nations, California Equine Council, Redwings Horse Sanctuary, Equus Rescue & Sanctuary, Project Equus, Animal Rights Mobilization, and Horse Welfare Committee. Cathleen Doyle, Project Equus, Animal Rights Mobilization, and Horse Welfare Committee. Cathleen Doyle, *Your Phone Calls Are Needed Now*, Redwings Horse Sanctuary News, Spring 1996, at 5.]

Despite the controversy, the "Regulation of Commercial Transportation of Equine for Slaughter" is now a part of the 1996 Farm Bill. The groups interested in its impact have now turned to the USDA rulemaking process for changes in equine slaughter transportation practices.

—Teena G. Gunter, Staff Attorney, NCALRI, Fayetteville, AR

Federal Register *in brief*

The following is a selection of matters that were published in the Federal Register from August 14 to September 20, 1996.

1. CCC; NRCS; Wetlands Reserve Program; responsibility transferred from NRCS to CCC; final rule; effective date 8/14/96. 61 Fed. Reg. 42137.

2. CCC; Farmland Protection Program. 61 Fed. Reg. 43226.

3. FCIC; Catastrophic risk protection endorsement; final rule; effective date 8/20/96. 61 Fed. Reg. 42979.

4. FCIC; General administrative regulations; Federal Crop Insurance Reform Act of 1994; regulations for implementation; final rule; effective date 8/20/96. 61 Fed. Reg. 42970.

5. Farm Service Agency; Future recovery of losses paid on liquidated guaranteed loans; final rule; effective date 9/20/96. 61 Fed. Reg. 43147.

6. Farm Service Agency; CCC; 1986-1990 Conservation Reserve Program; 1991-2002 Conservation Reserve Program; interim rule; effective date 8/27/96. 61 Fed. Reg. 43943.

7. Farm Service Agency; Handling payments from the FSA to delinquent FSA Farm Credit program borrowers; proposed rule. 61 Fed. Reg. 45907.

8. IRS; Estate and gift taxes; disclaimer of interests and powers; notice of proposed rule; comments due 11/9/96. 61 Fed. Reg. 43197.

9. IRS; Generation-skipping transfer tax; correction; effective date 12/27/95. 61 Fed. Reg. 43656.

10. USDA; Alternative Agricultural Research and Commercialization Corporation; request for proposals. 61 Fed. Reg. 44035.

11. USDA; Highly erodible land and wetland conservation; interim final rule with request for comments; effective date 9/6/96; comments due 11/5/96. 61 Fed. Reg. 47019.

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Hedge to arrive contracts in Chapter 12 bankruptcy

By Susan A. Schneider

As the Wall Street Journal reported, "Feuds are erupting between grain elevators and farmers all across the Midwest. Enough threats are flying that ministers are using their Sunday sermons to preach peace."[1] The cause of the feuds: the now infamous "hedge-to-arrive" (HTA) contracts. One of the potential "threats" that farmers under such contracts are exploring is Chapter 12 bankruptcy. This article discusses the issues raised by a farmer with an HTA contract filing for relief in bankruptcy under Chapter 12.

For purposes of this discussion, it is presumed that the HTA contract at issue is essentially a forward contract between a farmer and a grain elevator in which the farmer has agreed to deliver a set quantity of a commodity at a price to be determined by reference to the futures market for that commodity.[2] It is further presumed that the farmer is either unable or unwilling to deliver the commodity,[3] largely because of high prices for that commodity. For this reason, the farmer eventually expects to be presented with an action either for specific performance or for breach of contract damages.

This discussion addresses how the filing of a Chapter 12 bankruptcy would affect the rights of the parties to the HTA contract and raises the likely objections of the elevator, acting as a diligent creditor.

Eligibility for Chapter 12 relief

The first question to be addressed is whether the farmer is eligible for Chapter 12 relief. Because Chapter 12 presents the debtor with a number of rights not available in other chapters, a creditor's likely first attack is to challenge the debtor's eligibility.

Only a "family farmer with regular annual income" is eligible for Chapter 12 relief.[4] The term "family farmer" is defined in section 101(17) of the Bankruptcy Code, with specific requirements for individuals[5] and similar, but distinct, requirements for partnerships and corporations.[6]

There is no insolvency requirement for filing a Chapter 12 bankruptcy. This may be important in bankruptcy cases filed specifically because of an HTA contract, because these farmers may have operations that are otherwise financially secure. As will be discussed, plan confirmation requirements act as the most important check on filings that could be considered unnecessary or abusive.[7]

In addition to a direct challenge to the debtor's eligibility for Chapter 12 relief, however, a creditor may bring a motion to dismiss the bankruptcy alleging a "bad faith filing."[8] There is some authority for a bankruptcy court's "inherent power" to dismiss a case for bad faith filing, even though a specific statutory basis is not found.[9]. 5 B.R. 539 (Bankr. C.D. Cal. 1980).[10]

Most rulings on the issue of dismissal, however, turn on specific statutory grounds.[11] The grounds for dismissing a Chapter 12 case include unreasonable delay, gross mismanagement, failure to pay fees, failure to file a timely plan, denial of confirmation, material default with respect to a term of the plan, continuing loss to the estate, the "absence of a reasonable likelihood of rehabilitation," and fraud.[12] The "good faith" requirement in Chapter 12 is set forth not as an eligibility requirement, but as a plan confirmation requirement; i.e., the debtor's plan must be "proposed in good faith."[13]

Exeeutory contracts in bankruptcy

Assuming that the debtor survives any Chapter 12 eligibility challenges, the next issue is the treatment of the HTA contract in bankruptcy. Section 365 of the Bankruptcy Code governs the treatment of "executory contracts."[14] This section provides that, with certain exceptions, "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[15]

In Chapter 11 and 12 bankruptcies, the debtor acts as the debtor-in-possession and assumes many of the rights of the trustee, including the right to assume or reject an executory contract.[16] In Chapters 11, 12, or 13, the assumption of an executory contract may be accomplished before plan confirmation.[17] More commonly, however, assumption or rejection is incorporated into the plan.[18]

Definition of an exeeutory contract

Because the Bankruptcy Code does not define the term "executory contract," the courts have had to grapple with its meaning. The consequences are dramatic. As one author described it, the determination of whether a contract is executory "can make the difference between the non-debtor being fully protected and receiving 100% of his contractual expectations versus the non-debtor receiving the usual small dividend on a breach of contract claim."[19]

The Countryman definition

The most frequently cited definition is that contained in a law review article by Professor Vern Countryman.[20] Professor Countryman defined an executory contract as:

> a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[21]

The concept of material performance remaining due on both sides of the contract is key to this definition. In large part, the Eighth Circuit has adopted this definition.[22] However, what type of performance and how much performance must remain due is often difficult to assess.

The functional approach

A number of courts have criticized the Countryman definition and have focused on a more pragmatic, result-oriented approach. For example, the Sixth Circuit Court of Appeals modified the Countryman definition of executory contract in the Chapter 13 case of *Chattanooga Memorial Park v. Still (In re* Jolly).[23] Referring to the Countryman definition, the court stated:

> Such definitions are helpful, but do not resolve this problem. The key, it seems, to deciphering the meaning of the executory contract rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act.... Thus, executory contracts involve obligations that continue into the future.[24]

At issue in *Jolly* was a contract for the purchase of cemetery plots. Prior to the bankruptcy, the debtor had defaulted under his obligation; and pursuant to a liquidated damages clause in the contract, the seller had obtained a judgment against him. The debtor sought to reject the contract in bankruptcy as an executory contract, thereby recomputing the damages that he would owe. Based upon the definition of executory contract stated above, the court held that the contract was not executory. The contract had already been breached, and "the precise

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goal of the rejection provisions has already been accomplished." The court noted that the damages claim obtained prepetition would be included in the debtors plan and eventually be discharged along with other obligations.[25] Despite the court's dissatisfaction with the Countryman definition, the contract in *Jolly* would have also failed to be executory under the Countryman test. However, the modified definition of executory contract was reaffirmed by the Sixth Circuit court in *Sloan v. Hicks (In re* Becknell).[26]

In the case of *In re General Development Corporation*,[27] the Eleventh Circuit recently adopted the Sixth Circuit's approach to defining executory contracts. This decision referred to the Sixth Circuit definition as the "functional approach" and noted that it expands the definition to include contracts that might not be considered executory under the Countryman definition. The court stated that:

> [t]he express language of § 365 reflects that Congress did not adopt a specific definition of an "executory contract" which would require mutual obligations, in spite of its clear opportunity to do so. Legislative history for that section evidences that Congress considered mutual obligation to be indicative of an executory contract in some, but not all, cases.... Even though there may be material obligations outstanding on the part of only one of the parties to the contract, it may nevertheless be deemed executory under the functional approach if its assumptional rejection would ultimately benefit the estate and its creditors.[28]

Regardless of the definition followed by a particular court, it has been observed that "there is little consistency in the application of any definition. The controlling case law in the particular jurisdiction must be examined closely when any question arises as to whether a contract is executory."[29]

HTA contracts as executory contracts

Under either the Countryman definition or the functional approach adopted by the Sixth Circuit, it appears that a standard, unperformed HTA contract would be an executory contract. A review of the case law did not reveal any published case addressing this specific issue,[30] so this conclusion is based on an application of the definitional language and by analogy to other contracts.

Under the Countryman definition, the HTA contract remains executory as long as material performance remains due on each side. The material performance that is required of the farmer is delivery; payment is the material performance due of the elevator.

Under the functional approach, the HTA contract is also executory in that the obligations "continue into the future."[31] As long as the farmer is still under a duty to perform, and his or her breach of that duty has not been reduced to judgment, rejection could accomplish the estate's purposes.

In contrast, an HTA contract would not be considered executory if the farmer had already delivered the commodity and was awaiting payment. A contract is not executory simply because a party is obligated to make payments of money to the other party.[32] The court in one case explained this distinction as follows:

> It is evident that an executory contract is one under which some further performance is due. Any further refinement of the definition is, of course, mere gloss on the statutory term. Among other things, it is well recognized that where all elements of performance have been accomplished, leaving only an obligation for the payment of money, the contract is not executory within the meaning of the statute. Such a contract then entails a mere debt, and such debt was claimable both under the former Bankruptcy Act and under the present Bankruptcy Code.... It is sometimes said that to qualify as an executory contract there must be some further performance to be rendered by each party so that such remaining obligations are bilateral in nature. The essence of that concept is that there be a bilateral involvement.[33]

Similarly, in a case involving a bankrupt grain elevator, the Seventh Circuit Court of Appeals held that the "to arrive" contracts at issue were not executory.[34] In this case, it was the elevator that argued that the contracts were executory, and the elevator sought to assume them. The court held that the contracts were not executory because prior to the bankruptcy, the elevator had surrendered its requisite state license to deal in grain. This surrender constituted an anticipatory repudiation of the contracts, relieving the other party to the contract of any obligation to perform. The court stated that:

> implicit in every grain contract entered into by C & S Grain was an assurance that it was licensed to deal and store grain. But by surrendering its licenses to the Department [Illinois Department of Agriculture], C & S Grain declared itself unable to perform and effectively repudiated its contractual obligations. Upon one party's anticipatory repudiation, the other party is entitled to rescind the contract for all purposes of performance [citations omitted]. Unless the non-repudiating party wishes to hold the repudiator responsible for contract damages, the non-repudiating party need not make efforts to keep the contract in force [citations omitted]. Put another way, in the face of clear evidence of an intent to repudiate, the non-repudiating party is no longer under an obligation to perform. Because one party is not obligated to perform, the contract is no longer executory as defined in bankruptcy.[35]

Rejection of executory contracts

The trustee or the debtor in possession is typically given broad discretion in determining whether to reject an executory contract. Although section 365(a) requires court approval, the courts generally apply the "business judgment" test and will allow the debtor to reject the contract as long as the decision is made in good faith as a reasonable exercise of his or her business judgment.[36] If the rejection meets this broad requirement, the court will affirm the rejection regardless of its impact on the non-debtor party to the contract.[37]

In the HTA context, there is usually much at stake for both the farmer and the elevator. A farmer who files a Chapter 12 bankruptcy for the sole purpose of avoiding HTA contractual obligations should anticipate an aggressive challenge to actions proposed in the bankruptcy.

Therefore, despite the broad authority for executory contract rejection, any possible grounds for objection should be considered. Two such grounds are apparent in the case law. These objections are that 1) the rejection is made in bad faith; and/or 2) that the rejection is not in the best interests of the unsecured creditors.

Bad faith

There are several cases in which a creditor challenged the overall good faith of a bankruptcy filing when its sole purpose was to reject an executory contract. For example, in the case of *In re Waldron*,[38] the Eleventh Circuit ordered that the debtors' Chapter 13 case be dismissed for bad faith. The debtors had filed the case "for the sole purpose of rejecting [the] option agreement" to which they were bound. The court described the debtors as "financially secure and without any debts" and stated that they had "set out to use the bankruptcy process in attempting to reject a contract which they felt might not be as profitable as it could be."[39] The court further stated that a finding of bad faith "need not be based upon a finding of actual fraud, requiring proof of malice, scienter or an intent to defraud. We simply require that the bankruptcy courts preserve the integrity of the bankruptcy

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process by refusing to condone its abuse." The court remanded the case for dismissal.[40]

Similarly, in the case of *In re Southern California Sound Systems, Inc.*[41] the court denied the debtor's motion to reject an executory contract and granted the motion of the other party to the contract to dismiss the case. The case involved an exclusive license to sell a product developed by the debtor. The court stated that:

> [a]lthough the proper standard in determining whether this Court should authorize rejection of an executory contract is the "business judgment" standard, implicit in the debtor's exercise of this rejection power is good faith and a valid reorganization purpose. Where the Court finds these threshold requirements lacking, the Court need not further test rejection by application of the business judgment standard.[42]

The court found that the sole purpose of the bankruptcy filing was to reject the contract and to avoid the state law remedy of specific performance. The court held that this was not an allowable purpose under the circumstances and ordered the dismissal of the case.[43]

While these decisions must be considered, under the terms of an HTA contract, if the farmer does not perform, he or she will be subject to a breach of contract action that is likely to produce an award of damages. Absent fraud or misdealing, this debt would be treated as an unsecured claim in a subsequent bankruptcy. Thus, rejection only accomplishes what would likely be the ultimate result had the bankruptcy been delayed. In the bad faith filing cases, the debtors usually either sought to reject the contract in order to retain or resell unique property that otherwise could be subject to a specific performance action, or to avoid a liquidated damages clause. Thus, the bad faith filing issue is likely to arise only when:

1) The HTA contract at issue contains an enforceable liquidated damages clause that the farmer wishes to avoid;

2) There are concerns regarding fraud allegations; or,

3) The farmer has grain on hand that he or she wishes to sell to another at a more lucrative price.

As a defense in these situations, there are cases that authorize the filing of a bankruptcy by a financially troubled debtor in order to reject an executory contract under circumstances where rejection was essential to the success of the business.[44]

The business judgment test

There are a few cases that have applied a modified version of the business judgment test to balance the equities of the parties. The Bankruptcy Appellate Panel for the Ninth Circuit took this approach in the case of *In re Chi-Feng*.[45] This court articulated the business judgment test in the following manner:

> The primary issue is whether rejection would benefit the general unsecured creditors. This may involve a balancing of interests. In *Matter of Minges*, 602 F.2d at 43, the Second Circuit noted the need for a flexible test, stating that, "the trustee and ultimately the court, must exercise their discretion fairly in the interest of all who have had the misfortune of dealing with the debtor." This statement illustrates that it is proper for the court to refuse to authorize rejection of a lease or executory contract where the party whose contract is to be rejected would be damaged disproportionately to any benefit to be derived by the general creditors of the estate as for example where most of the "benefit" of rejection of the contract would be captured by a third party at the expense of the unsecured creditors.[46]

Applying this reasoning, objections to rejection may be brought if the non-debtor party to the contract is the only or the major unsecured creditor.[47]

As with the bad faith objections, however, it seems unlikely that the business judgment objections would prove successful with regard to the rejection of an HTA contract. Unless the grain were still on hand, an order of specific performance would not generally be possible, and contract rejection that occurred outside of bankruptcy would produce the same or a similar result.

Effect of rejection

If an executory contract is rejected, the rejection is deemed to have occurred immediately before the filing of the bankruptcy.[48] The rejection of a contract under section 365(a) gives rise to a breach of contract claim for damages. These damages would generally be treated as an unsecured claim in the bankruptcy.

Measure of damages

The appropriate measure of damages upon the debtor's rejection of an executory contract is usually determined by state and not federal law, provided only that the relevant state law is not inconsistent with federal bankruptcy policy.[49] Applying this general rule, most courts look to state law to determine whether a liquidation clause in a contract is enforceable. In contrast, however, some courts have held that liquidated damages clauses should not be enforced when the rejection occurred under section 365(a).[50]

Chapter 12 confirmation standards

In addition to the general good faith requirements referenced earlier, Chapter 12 contains specific plan confirmation requirements that control whether a debtor's proposed plan can be confirmed.[5] Two specific requirements apply to unsecured creditors, and these requirements would apply to the breach of contract damages claim held by the non-debtor party to an HTA contract.[52]

The first requirement, the liquidation test, is that the plan provide that the unsecured creditors be paid at least as much as they would receive if the debtor liquidated the farming operation in a Chapter 7 bankruptcy.[53] This generally means the value of the unsecured assets, less the exempt property. This test may be problematic for a debtor who is financially sound, but for the anticipated HTA contract damages.

The second requirement is that the plan provide that the unsecured creditors receive whatever income the debtor has each year after making the plan payments and paying normal expenses.[54] This is the disposable income requirement. Although Chapter 12 requires that the plan provide for payment of "projected disposable income," courts have interpreted this to mean "actual disposable income."[55] Under this interpretation, at the end of the plan term, the debtor can be required to provide a complete accounting and to pay any amount of income that exceeds expenses to the unsecured credi tors before discharge can be granted.

Conclusion

In many cases, Chapter 12 can be an effective tool for dealing with an unfavorable HTA contract. The HTA contract is likely to be found to be an executory contract that can be rejected by the debtor in possession. The non-debtor party to the HTA contract would be entitled to a unsecured claim for damages, payable along with other unsecured claims from the debtor's disposable income during the term of the plan. Problems with this strategy may be anticipated if the debtors have the means to perform under the contract, but are seeking a more financially favorable outcome. Similarly, if the HTA contract damages are the only unsecured debt that the debtors will have, objections to the rejection of the contract may be raised. Perhaps most significant, however, the liquidation test for plan confirmation may make the Chapter 12 alternative undesirable for many debtors.

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[1] Scott Kilman, *As Grain Prices Soar, Towns Divide Over Hedging Tactic*, Wall St. J., July 2, 1996.

[2] *See*, Roger A. McEowen, *In Depth: Marketing Agricultural Commodities Through the Use of Hedge-to-Arrive Contracts May Violate CFTC Rules*, Agric. L. Update, May 1996, at 4; Christopher R. Kelley, *In Depth: CFTC Issues "Hedge to*

Arrive" Contract Policy and Guidance Statements, Agric. L. Update, June 1996, at 4.

[3] If the farmer has the grain, but has it stored with the contract holder, the issue of setoff may arise. *See* 11 U.S.C. § 362(b)(6).

[4] 11 U.S.C. §109(f).

[5] For individuals, § 101(17)(A) provides that a "family farmer" is—

(an)individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed $1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed.

[6] For corporations and partnerships, § 101(17)(B) provides that a "family farmer" is—

(a) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and (i) more than 80 percent of the value of its assets consists of assets related to the farming operation; (ii) its aggregate debts do not exceed $1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and (iii) if such corporation issues stock, such stock is not publicly traded.

11 U.S.C. § 101(17)(B).

[7] *See* 11 U.S.C. §§ 1222, 1225.

[8] *See, e.g., In re Miller*, 122 B.R. 360 (Bankr. N.D. Iowa 1990) (filing of Chapter 12 to renegotiate previously confirmed Chapter 11 found to be in bad faith).

[9] *See, e.g., In re Fast Foods Properties, Ltd.*, 5 B.R. 539 (Bankr. C.D. Cal. 1980)(Chapter 11 case filed solely for the purpose of frustrating the enforcement of a power of sale provision in a deed of trust was dismissed for bad faith).

[10] *In re Cross Timbers Ranch, Inc.*, 151 B.R. 923 (Bankr. W.D. Mo. 1993) (in response to a creditor's motion to dismiss alleging both bad faith and ineligibility, the court dismissed on eligibility grounds and did not address bad faith).

[11] 11 U.S.C. § 1208.

[12] 11 U.S.C. § 1225(a)(3).

[13] 11 U.S.C. § 365.

[14] *Id.*

[15] 11 U.S.C. § § 1107, 1203. *See, e.g., In re Lane*, 96 B.R. 164 (Bankr. C.D. Ill. 1988). As to Chapter 13 bankruptcy, although § 1303 (listing the powers of the debtor) does not reference § 365 powers, § 1322(b)(7) authorizes the debtor to utilize these powers under the reorganization plan. 11 U.S.C. §§ 1303, 1322(b)(7). This includes the assumption and rejection powers under § 365.

[16] 11 U.S.C. § 365(d)(2).

[17] 11 U.S.C. §§ 1123(b)(2), 1222(b)(6), 1322(b)(7). In Chapter 7 bankruptcies, the assumption of an executory contract must occur within sixty days of the bankruptcy filing or the contract is deemed rejected. 11 U.S.C. § 365(d)(1).

[18] Arnold M. Quittner, *Executory Contracts and Leases*, Commercial Law and Practice Course Handbook, (Practicing Law Institute, Apr.-May 1996).

[19] Lawrence P. King, 2 Collier On Bankruptcy, at ¶ 365.02. *See also In re Walat Farms*, 69 B.R. 529, 531 (Bankr. N.D. Mich. 1987).

[20] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, Minn. L. Rev. 439, 460 (1973)).

[21] *See, e.g. In re Knutsen*, 563 F.2d 916 (8th Cir. 1977).

[22] 574 F.2d 349 (6th Cir.), cert. den. 439 U.S. 929, 99 S.Ct. 316 (1978).

[23] *Id.* at 351.

[24] *Id.*

[25] 761 F.2d 319 (6th Cir. 1985).

[26] *Sipes v. Atlantic Gulf Communities Corporation, In re General Development Corporation*, 84 F.3d 1364 (11th Cir. 1996).

[27] *Id.* at 1374 (citing *In re Arrow Air, Inc.*, 60 B.R. 117, 121-22 (Bankr. S.D. Fla.1986).

[28] Randy Rogers & Lawrence P. King, Collier Farm Bankruptcy Guide, ¶ 2.10 (1994).

[29] The case of *Matter of C & S Grain Company, Inc.*, 47 F.3d 233 (7th Cir. 1995) involves contracts identified only as "to arrive" contracts. The court's decision is based on facts specific to that case and not applicable to this analysis.

[30] *Jolly*, 574 F.2d at 351.

[31] *See, e.g, Smith Jones*, 26 B. R. at 292; H. Rep. No. 95-595, 95th Cong., 2d Sess. 347, reprinted in 1978 U.S. Code Cong. & Ad. News 5963, 6303-04; *In re Preston*, 53 B.R. 589 (Bankr. M.D. Tenn. 1985).

[32] *Smith Jones*, 26 B. R. at 292.

[33] *Matter of C & S Grain Company, Inc.*, 47 F.3d 233 (7th Cir. 1995).

[34] *Id.* at 237.

[35] *See, e.g., Lewis v. Anderson*, 615 F.2d 778, 782 (9th Cir. 1979); *Polin v. Conductron Corp.*, 552 F.2d 797, 809 (8th Cir. 1977).

[36] Randy Rogers & Lawrence P. King, Collier Farm Bankruptcy Guide, ¶ 2.10 (1994).

[37] *Shell Oil Co. v. Waldron (In re Waldron)*, 785 F.2d 936 (11th Cir.) cert. den., 478 U.S. 1028, 106 S.Ct. 3343 (1986).

[38] *Id.* at 938.

[39] *Id.* at 941.

[40] 69 B.R. 893 (Bankr. S.D. Cal. 1987).

[41] *Id.* at 900.

[42] *Id.*

[43] *See, e.g., In re Bofill*, 25 B.R. 550 (Bankr. S.D.N.Y. 1982); *In re Marina Enterprises*, 14 B.R. 327 (Bankr. S.D. Fla.1981). *See also, In re James Taylor*, 91 B.R. 302, *aff'd* 103 B.R. 511 and 913 F.2d 102 (3d Cir. 1990) (recording contract found to be executory and rejection allowed).

[44] *Robertson v. Pierce (In re Chi-Feng)*, 23 B.R. 798 (B.A.P. 9th Cir. 1982).

[45] *Id.*, 23 B.R. at 801.

[46] *In accord, In re Midwest Polychem, Ltd.*, 61 B.R. 559 (Bankr. N.D. Ill. 1986).

[47] 11 U.S.C. § 365(g).

[48] *See, e.g., In re Rega Properties, Ltd.*, 1990, 894 F.2d 1136 (9th Cir.), cert. den. 111 S.Ct. 251, 498 U.S. 898 (1990).

[49] *See, e.g., In re TransAmerican Natural Gas Corp.*, 79 B.R. 663 (Bank. S.D. Tex. 1987).

[50] 11 U.S.C. 1225.

[51] 11 U.S.C. §§ 1225(a)(4), 1225(b).

[52] 11 U.S.C. § 1225(a)(4).

[53] 11 U.S.C. § 1225(a)(4).

[54] *See, e.g., Rowley v. Yarnall*, 22 F.3d 190 (8th Cir. 1994).

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