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Delaware Bankruptcy Law Update

Bankruptcy Court holds that private label credit card program is not a contract to make a loan or to extend a financial accommodation and thus may be assumed and assigned over the credit card issuer's objection.

In a recent hearing to consider the sale of the Boscov's department store chain, the United States Bankruptcy Court for the District of Delaware held that Boscov's private label credit card program agreement was not a "contract to make a loan or extend a financial accommodation" and therefore could be assumed and assigned in the sale. *In re Boscov's, Inc.*, Case No. 08-11637 (KG) (Bankr. D. Del. November 21, 2008). The opinion is noteworthy because although two courts of appeal have already held that credit card *processing* agreements are not "contracts to make a loan or to extend a financial accommodation," the agreement here was more than just a processing agreement and contemplated the actual extension of hundreds of millions of dollars of credit to Boscov's customers every year.

The agreement at issue was a private label credit card program between HSBC Bank Nevada, N.A. ("HSBC") and Boscov's. Under the agreement, HSBC extended credit to Boscov's customers for purchases at Boscov's stores only. Interested Boscov's customers could fill out an application and, upon approval by HSCB, would be issued a private label credit card. In return for the business, HSBC paid Boscov's a 4% royalty fee for each sale made to customers who used the private label card. Both the Debtors and HSBC conceded that the agreement was one of Boscov's most lucrative and important contracts, generating tens of millions of dollars per year in royalties for Boscov's.

Boscov's sought to assume the private label credit card agreement and assign it to the purchaser of its assets. HSBC objected. It claimed that assumption of the agreement was prohibited under section 365(c)(2) of the Bankruptcy Code, which prohibits the assumption and assignment of an executory contract if "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, *to or for the benefit of a debtor*."

HSBC conceded that under the agreement, it was not extending credit *to* Boscov's. But HSBC did contend that it was extending credit *for the benefit of* Boscov's, because Boscov's customers would use the credit to purchase goods at Boscov's which would then entitle Boscov's to a royalty fee. HSBC argued that the language of section 365(c)(2) was plain: it required (1) an extension of credit (2) for the benefit of a debtor. Where a statute's language is plain, all that is left for a court to do is to enforce the statute according to its plain meaning. According to HSBC, it was (1) extending credit (2) for Boscov's benefit, thus implicating section 365(c)(2).

The Bankruptcy Court disagreed with HSBC. According to the Bankruptcy Court, the language "for the benefit of the debtor" is not plain because it is unclear what "benefit" means. The Bankruptcy Code does not define "benefit." Does it mean *any* benefit, no matter how small? Or must there be a significant material benefit? Under HSBC's interpretation of section

365(c)(2), even a small benefit would be sufficient to render an agreement involving an extension of credit non-assumable.

Taken to its logical conclusion, HSBC's position would completely nullify the "for the benefit of the debtor" language. *Every* contract provides a bargained-for benefit to both parties. Thus, under HSBC's position, every contract involving an extension of credit to a third party would fall within the ambit of section 365(c)(2), because all that section requires is (1) an extension of credit (2) for the benefit of a debtor. In other words, the Court would not even have to do a "for the benefit of the debtor" analysis because every contract that a debtor is party to is, in some way, "for the benefit" of the debtor. This couldn't have been what Congress meant when it enacted the section, because giving section 365(c)(2) such a broad scope could prohibit a debtor from assuming *any* contract involving *any* extension of credit, even if the extension of credit is incidental to the contract's purpose.

Because the language of section 365(c)(2) was ambiguous and could potentially lead to absurd results, the Bankruptcy Court turned to the section's legislative history. Although the history was scarce, the Bankruptcy Court was persuaded by the purpose of section 365(c)(2), namely to prevent bankruptcy courts from compelling lenders to extend financing under pre-petition agreements to debtors either as the primary borrower or as a guarantor. Clearly that was not the case here, as HSBC was not extending *any* financing to Boscov's and was not relying in any way on Boscov's creditworthiness. It was only extending credit to third parties who applied for a credit card and whose applications it approved.

The Bankruptcy Court noted that its conclusion was consistent with case law on the subject. In almost every circumstance where a financial accommodation has been found to exist, the debtor has been directly or secondarily liable for the debt incurred. Here Boscov's was never liable for any debt -- only the individual consumers were. Again, this accorded with the purpose behind section 365(c)(2) of prohibiting forced loans or guaranties to or on behalf of a company in bankruptcy.

On November 24, 2008, the United States District Court for the District of Delaware granted HSBC's expedited appeal of the Bankruptcy Court's opinion. The District Court heard oral argument on November 25, 2008 and affirmed the Bankruptcy Court, essentially adopting the Bankruptcy Court's reasoning. It also denied certification to the Third Circuit and denied a stay pending appeal to the Third Circuit, thereby letting the sale proceed.

The Bankruptcy Court's decision provides guidance on the scope of section 365(c)(2), a topic that has not been the subject of any prior reported opinions out of the Delaware Bankruptcy Court. Given that HSBC's interpretation of section 365(c)(2) could cause the restrictions of that section to apply to a broad range of contracts, the Bankruptcy Court's narrow holding provides some comfort and guidance to debtors in possession seeking to assume and assign their executory contracts as part of a sale or chapter 11 plan. In particular this is a very important decision for retail debtors with credit card agreements, providing such debtors with a more level playing field when negotiating with their credit card banks. Often for retailers, as was the case in Boscov's, private label credit card agreements are valuable assets for the estate, which can now be utilized to provide enhanced value and recovery for the estate.

The Court's opinion also reflects one other resonating theme: a single objector will have to work very hard to topple a sale that is supported by other major constituencies in the case, especially given the difficulty of consummating a sale in the current economic environment. Indeed, the Bankruptcy Court noted that the sale was too important to too many constituencies to "permit [HSBC's] dubious argument to interfere with its consummation." A single party's desire to extricate itself from, or renegotiate, what it believes to be a bad contract is not good reason to hold up (and destroy) a sale that was months in the making, and the Court here took special note of that fact.