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The Assumption of Credit Card Merchant Agreements in Bankruptcy: Another Important Right of Debtors Filing for Chapter 11

Introduction

The United States Court of Appeals for the Seventh Circuit recently held that a merchant in bankruptcy may, under section 365 of the Bankruptcy Code, assume a "merchant agreement," the agreement between the merchant and the merchant bank by which the merchant is paid for credit card sales. The Court of Appeals concluded that the merchant agreement was not an unassumable financial accommodation contract even if the other party to the agreement, the merchant bank, was guaranteeing the merchant's obligation to its customers to provide the goods and services that they purchased through the credit card transactions. *In re United Airlines*, 368 F.3d 720 (7th Cir. 2004). This decision resolves (at least in the Seventh Circuit) a hotly disputed issue that arises in many Chapter 11 cases.

Each year, businesses throughout the world process billions of credit card transactions. A typical credit card transaction involves four parties: the customer (or cardholder), the bank that issued the card to the customer (the issuing bank), the merchant whose goods or services the customer is purchasing with the credit card, and a merchant bank (the bank that is in contractual privity with the merchant). When the customer pays for the merchant's goods or services with a credit card, the merchant submits the credit card receipt or sales slip to the merchant bank. According to the terms of the merchant agreement, the merchant bank remits payment to the merchant of the sales charge, net of its fee. The merchant bank then remits the sales charge, through the relevant card association (e.g., Visa, MasterCard), to the cardholder's issuing bank, which reimburses the merchant bank for the full amount. Finally, the issuing bank bills the cardholder for the sales charge on the customer's monthly account statement.

Under certain circumstances, cardholders are authorized under federal consumer credit law to "charge back" a charge on their credit card account. In this circumstance, the issuing bank credits the cardholder and, through the relevant association, charges back to the merchant bank, which must reimburse the issuing bank. The merchant bank typically has a contractual right under the merchant agreement to obtain reimbursement from the merchant. But what happens if the merchant becomes insolvent? The merchant bank takes the credit risk that its merchant will file for bankruptcy and not pay its debts in full, just as the issuing bank takes the credit risk that its cardholder will file for bankruptcy or otherwise not pay his or her credit card debt.

Assumption of Merchant Agreements: The *United Airlines* Case

One of the most significant powers granted a debtor in bankruptcy is the right, if it chooses, to assume its executory contracts and unexpired leases.

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But there are some agreements that are not assumable, including contracts "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." 11 U.S.C. § 365(c)(2).

Read broadly, the amorphous term "financial accommodation" could cause the exception to swallow the rule. As the Seventh Circuit recognized in *United Airlines*, virtually all contracts that do not call for simultaneous performance by both sides entail, to some degree, the extension of some credit or financial accommodation by one side to the other. The courts have, therefore, generally read Section 365(c)(2) narrowly so as to preserve the debtor's broad powers to assume beneficial executory contracts.

Following that tradition, the *United Airlines* court held that a merchant agreement, under which National City Bank and National Processor processed credit card transactions for United Airlines, was not a contract to extend a loan or financial accommodation.

After United filed for bankruptcy, National had perhaps an understandable concern: that United might cease flying, in which case thousands of consumers might demand refunds of their credit card charges for flights they had booked on United that would never occur. National argued that since its merchant agreement with United was a contract to make a loan or to extend a financial accommodation to United, it could not be assumed by United in bankruptcy.

The Seventh Circuit disagreed. It readily rejected National's first argument—that the credit card system allowed United to borrow money from National by selling tickets (and collecting payment immediately) for flights in the future:

> The answer is that neither National Processing nor National City Bank lends United . . . one penny. Any loan is made by the issuing bank, not the merchant bank; the loan is to the issuing bank's customer (United's passenger), not to United. National Processing does not deposit anything into United's account at National City Bank until after the issuing bank has made the loan to its customer and placed the funds in the interbank system on the customer's behalf. . . . National Processing functions as a conduit, not a lender, in this transaction. *In re United Airlines*, 368 F.3d 720, 723 (7th Cir. 2004).

The Court of Appeals took more seriously National's other argument—that it was, in effect, guaranteeing United's contingent obligation to refund any charges for tickets for flights in the future that might never occur if United ceased operation, and that National was thereby extending a financial accommodation to United through the chargeback process. The Seventh Circuit acknowledged that a guarantee was a financial accommodation within the meaning of Section 365(c)(2). And it accepted *arguendo* that, to the extent chargebacks exceeded new credit card sales, one might conclude that National was guaranteeing United's contingent liability. But the Court of Appeals held that this contingent guarantee was a "small" part of the overall transaction and that Section 365(c)(2) barred the assumption only of a contract that "as a whole" could be deemed one to extend a financial accommodation. In so concluding, the Seventh Circuit recognized that a contrary reading of Section 365(c)(2) could render the general rule that a debtor may assume its executory contracts a nullity:

> The statute asks whether the contract as a whole is a 'financial accommodation,' not whether one clause could be so characterized. To see the difference, think of a contract that everyone recognizes may be assumed: a lease of operating assets, such as United's aircraft. . . . Take a lease calling for payment in mid-month. It would be possible to call the arrangement a 15-day loan from the lessor to the lessee. . . . [A]lmost every lease and other executory contract has some provision that could be characterized as a short-term loan to one side or the other. . . . Accepting National Processing's argument that assumption is impossible whenever any non-trivial clause of a contract entails a loan or a guaranty would go far toward defeating debtors' entitlement to assume executory contracts. Doubtless this is why no one . . . has argued that debtors cannot assume leases and sales contracts. Well, if a lease may be assumed despite an implicit loan, a credit-card-processing agreement may be assumed despite an implicit guaranty. *Id.* at 724.

Finally, the Seventh Circuit rejected National's argument that United should not be able to assume the merchant agreement without providing additional security. United was not in default under the contract. Noting that the Bankruptcy Code requires a debtor to provide adequate assurance of future performance as a precondition to assumption only "if" the debtor is in default, the Seventh Circuit characterized National's argument as seeking to "amend the statute," something that only Congress could do. *Id.* at 726. The Court of Appeals showed little sympathy for National, noting that when it entered into the contract, it could have negotiated for a larger reserve, shorter term or a higher processing fee. "United has kept its part of the bargain and is entitled to insist that National Processing do the same." *Id.*

Conclusion

United Airlines is the second appellate court decision holding that merchant agreements may be assumed by a debtor in bankruptcy. See *In re Thomas B. Hamilton Co.*, 969 F.2d 1013 (11th Cir. 1992). The decision reinforces the broad powers granted a debtor in bankruptcy to assume its executory contracts and the limited exception to those powers provided by Section 365(c)(2). In addition, it underscores the need for any party entering into an agreement that could impose a material risk if the other party becomes insolvent, to negotiate in advance for adequate security or sufficient compensation to offset that risk.

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