

**THE BANKRUPTCY CODE'S
"SAFE HARBOR"
FOR FORWARD CONTRACTS**

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I. INTRODUCTION.

In much the same way that secured creditors are a “favorite” of bankruptcy law, forward contracts and forward contract merchants also receive “favored” treatment under the Bankruptcy Code. This is because a legislative policy decision was made to protect the financial stability of contract counterparties who participate in the complex web of interrelationships that make up the forward contract trade in particular industries, such as energy. Various black-letter rules of bankruptcy which present serious obstacles to the typical commercial creditor are inapplicable in the context of forward contract transactions.

II. THE AUTOMATIC STAY.

The filing of a bankruptcy petition under any of the bankruptcy Chapters 7, 11, or 13 automatically gives rise to an injunction that precludes most creditor collection activity that would have been perfectly lawful before bankruptcy. Likewise, contract provisions that trigger a default upon the filing of bankruptcy are generally not enforceable because the Code seeks to reserve to the Trustee the decision of whether to assume or reject contracts that are in midstream on the bankruptcy filing date.

§ 362. Automatic stay.

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of**

the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate;
- (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title. . . .

§ 365. Executory contracts and unexpired leases.

- (e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
 - (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
 - (B) the commencement of a case under this title; or
 - (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

However, under a forward contract which calls for the potential liquidation of obligations upon the filing of a bankruptcy petition, it is “business as usual” without regard to the automatic stay or the prohibition against bankruptcy defaults.

§ 556. Contractual right to liquidate a commodities contract or forward contract.

The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract, as defined in section 761 of this title, or forward contract because of a condition of the kind specified in section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, 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. As used in this section, the term “contractual right” includes a right set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

III. SETOFFS.

Post-bankruptcy setoffs (*i.e.* netouts) are forbidden under most commercial contracts unless a motion is made to the Bankruptcy Court and approval is given. Indeed, pre-bankruptcy setoffs during the last ninety days before bankruptcy are usually subject to the creditor's being required to disgorge any resulting improvement in position.

§ 362. Automatic stay.

- (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
 - (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor. . . .

§ 553. Setoff.

- (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—
 - (1) the claim of such creditor against the debtor is disallowed;
 - (2) such claim was transferred, by an entity other than the debtor, to such creditor—
 - (A) after the commencement of the case; or
 - (B) (i) after 90 days before the date of the filing of the petition; and
 - (ii) while the debtor was insolvent; or
 - (3) the debt owed to the debtor by such creditor was incurred by such creditor—
 - (A) after 90 days before the date of the filing of the petition;
 - (B) while the debtor was insolvent; and
 - (C) for the purpose of obtaining a right of setoff against the debtor.
- (b) (1) Except with respect to a setoff of a kind described in sections 362(b)(6), 362(b)(7), 362(b)(14), 365(h), 546(h), or 365(i)(2), of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—

- (A) 90 days before the date of the filing of the petition; and
 - (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
- (2) In this subsection, “insufficiency” means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.
- (c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

However, setoffs under a forward contract are perfectly fine, without Bankruptcy Court involvement and without any prospect of disgorgement of eve-of-bankruptcy improvements in position.

§ 362. Automatic stay.

- (b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—
 - (6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761 of this title, forward contracts, or securities contracts, as defined in section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 of 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts.

IV. PREFERENCES.

The debtor’s payments to creditors in the last ninety days before bankruptcy are generally subject to being set aside and recovered from the affected creditors, in spite of the legitimacy of the pre-existing obligations being paid.

§ 547. Preferences

- (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

However, payments by or to a forward contract merchant under a forward contract are immune from preference recovery, even if they would otherwise meet the test for a preference.

§ 546. Limitations on avoiding powers.

- (e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

V. Since forward contracts are “golden,” and seem to be exempt from so many of the usual strictures of bankruptcy, what is a “forward contract” and what is a “forward contract merchant?”

§ 101. Definitions.

- (25) “forward contract” means 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, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon;

- (26) “forward contract merchant” means a person whose business consists in whole or in part of entering into forward contracts as or with merchants in 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;

VI. DISCUSSION.

While the “favored” status of forward contracts under the Bankruptcy Code, as evident in the “safe harbor” provisions set forth above, must be understood to be applied to good advantage for the benefit of creditors, the determination of what constitutes a forward contract is still an imprecise art rather than an exacting science. The statutory provisions and the caselaw which has developed under them to date leave a great deal of uncertainty (and room for creativity!) putting creditors at risk who assume too much about the legal status of their agreements.

One of the most encouraging of the recently reported decisions originated in Bankruptcy Court here in Houston and was affirmed on appeal to the federal Fifth Circuit, namely, *In re Olympic Natural Gas Company*, 258 B.R. 161, 164-65 (Bankr. S.D. Tex. 2001), *aff’d* 294 F. 3d 737 (5th Cir. 2002). See attached Memorandum prepared by this presenter for the *Bethlehem v. Superior* case.

However, not all Bankruptcy Courts have been embracing forward contracts and forward contract merchants with open arms. In *Aurora Natural Gas, LLC, v. Texas Eastern Transmission Corporation, et al.*, 316 B.R. 481 (Bank. N.D. Tex. 2004), Aurora’s Chapter 7 Trustee brought an adversary proceeding to avoid a pre-petition payment to Duke Energy Field Services. Duke moved for summary judgment under Section 546(e) of the Bankruptcy Code set forth above. The Bankruptcy Court denied Duke’s motion because it held that a genuine issue of material fact existed to be tried in a fullblown evidentiary proceeding concerning whether Duke acted as a forward contract merchant or instead as a debt collector when it engaged in activities to collect amounts owed

to it by Aurora. The Bankruptcy Court suggested that if Duke was acting as a debt collector, and not a forward contract merchant, then Duke may not be entitled to “safe harbor” protection.

This decision comes shortly after the holding in *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co.*, 310 B.R. 548 (Bank. N.D. Tex. 2004), where the Bankruptcy Court rejected Kern Oil & Refining Company's suggestion that it was entitled to be treated as a forward contract merchant simply because it entered into a forward contract in connection with its business.

These two recent cases interpret the term “forward contract merchant” in a way that appears to be more limiting than what the statutory definition alone provides.

Moral: It ain't a forward contract until the Bankruptcy Judge says it's a forward contract.

Since this material has been edited and abbreviated for educational purposes, it should not be relied upon as definitive or as legal advice. Consult a Creditors' Rights Specialist with expertise and experience in these matters any time you are confronted with a forward contract problem or issue in your business or credit world.

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 - (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
 - (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
 - (4) any act to create, perfect, or enforce any lien against property of the estate;
 - (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
 - (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.

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(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

- (A) the insolvency or financial condition of the debtor at any time before the closing of the case;**
- (B) the commencement of a case under this title; or**
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- (1) the claim of such creditor against the debtor is disallowed;
 - (2) such claim was transferred, by an entity other than the debtor, to such creditor—
 - (A) after the commencement of the case; or
 - (B) (i) after 90 days before the date of the filing of the petition; and
(ii) while the debtor was insolvent; or
 - (3) the debt owed to the debtor by such creditor was incurred by such creditor—
 - (A) after 90 days before the date of the filing of the petition;
 - (B) while the debtor was insolvent; and
 - (C) for the purpose of obtaining a right of setoff against the debtor.
- (b) (1) Except with respect to a setoff of a kind described in sections 362(b)(6), 362(b)(7), 362(b)(14), 365(h), 546(h), or 365(i)(2), of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
- (A) 90 days before the date of the filing of the petition; and
 - (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
- (2) In this subsection, “insufficiency” means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.
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(6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761 of this title, forward contracts, or securities contracts, as defined in section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 of 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts.

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 - (5) that enables such creditor to receive more than such creditor would receive if—**
 - (A) the case were a case under chapter 7 of this title;**
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