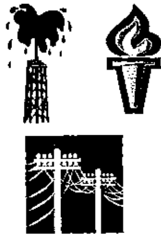
LATEST WORD ON THE BANKRUPTCY CODE'S "SAFE HARBOR" FOR FORWARD CONTRACTS



Houston Energy Credit Group

Wednesday, February 9, 2011

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LATEST WORD ON THE BANKRUPTCY CODE'S "SAFE HARBOR" FOR FORWARD CONTRACTS

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 hedge against market risks as they 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 non-energy commercial creditor are, at least theoretically, potentially 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, terminate, or accelerate a commodities contract or forward contract.

The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration 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. . . .

III. SETOFFS

Post-bankruptcy setoffs (*i.e.* netouts) are forbidden under most typical 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 section 362(b)(6), 362(b)(7), [and others], 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 exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts;

IV. PREFERENCES

The debtor's payments to pre-existing 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 subsections (c) and (i) 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 standard 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 (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, 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) The term "forward contract" means–

(A) a contract (other than a commodity contract as defined in section 761) 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 or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in this section), consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction or any other similar agreement;

(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);

(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);

(D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

(26) The term "forward contract merchant" means a Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) 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 known and understood in order to be applied to good advantage for the benefit of creditors attempting to manage market risk by a hedging strategy, the determination of what legally constitutes a forward contract is still an evolving and imprecise art rather than an exacting science. The statutory provisions, amended just six years ago, and the caselaw which has developed under them to date, leave a great deal of uncertainty (and room for

creativity!), imperiling energy creditors who assume too much about the legal status of their agreements. Often the affected creditor does not realize it has a problem until a preference case is filed as much as two years after a counterparty's bankruptcy was filed.

One of the most encouraging reported caselaw decisions for energy credit-grantors originated in Bankruptcy Court here in Houston just a decade ago 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). That case involved a standard NAESB form contract for the purchase and sale of natural gas which the Bankruptcy Court, District Court, and Fifth Circuit all readily construed to be a "forward contract" between "forward contract merchants." Importantly, "one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery." *Id.* at 741. So, as a result of *Olympic,* the Bankruptcy Code's "safe harbor" was understood to be available to not only financial derivative transactions, but also to physical delivery purchase-and-sale agreements with a sufficient (at least two-day) delay between contracting and performance. See attached copy of the Fifth Circuit opinion.

However, not all Bankruptcy Courts have consistently been embracing forward contracts and forward contract merchants with open arms during that decade. Complex analyses, such as that set forth by the federal Fourth Circuit in *In re National Gas Distributors, LLC,* 556 F.3d 247 (4th Cir. 2009), which distinguishes between "forward *agreements*" and "forward *contracts,*" have left energy counterparties and their attorneys feeling queasy about exactly where the "safe harbor" boundaries may start and stop. While the policy of protecting hedging strategies, aimed at managing risks associated with volatility of price and supply, is given approving deference, the *National Gas* opinion also observes: "[I]n addition to the price element, the quantity and time elements must be fixed at the time of contracting. *See, e.g., In re Olympic Natural Gas Co.*, 294 F.3d at 739 (the

forward contract at issue contained 'the price, quantity, timing, and delivery point for the natural gas'); *In re Borden,* 336 B.R. at 221 (the forward contracts at issue contemplated 'a specified quantity of natural gas ... at a fixed price')." So what can we say about a requirements contract, where the parties agree to future sales and deliveries, with pricing fixed or set based upon a method prescribed at the time of contracting, but with quantities to be determined in future periods based upon the buyer's fluctuating needs?

The latest word on the "safe harbor" for forward contracts has come to us from a New Orleans, Louisiana Bankruptcy Court in a preference case involving an electrical power supply agreement for a fixed price over a two-year term, *In re MBS Management Services, Inc.,* Adversary No. 09-1158, June 29, 2010 (a copy of which is attached). That Court correctly found that "forward contracts include contracts for the sale or purchase of a commodity [including electrical power] between an industry participant [*e.g.* non-producing, consuming buyer] and a forward contract merchant [including a non-producing energy trader]. They are not regulated or subject to the rules of a contract commodity exchange [*i.e.* they are private contracts, not exchange-traded] and provide a hedge against price fluctuations in a commodity market. They do not have to specify a set quantity for delivery, but are most often written to sell to the purchaser all it might need or demand [*i.e.* requirements] of the commodity during the term of the contract." *Id.* at 10. This well-reasoned opinion, written by a Judge who throughly understood the policies inherent in the Code's "safe harbor," is presently on appeal to the District Court in the Eastern District of Louisiana, and we are awaiting a hoped-for affirmance of the Bankruptcy Court decision. Keep your fingers crossed!

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

Further Moral: **It ain't a forward contract until the District Court (and perhaps the Fifth Circuit) affirm the Bankruptcy Judge.**

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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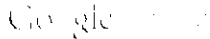

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In re Olympic Natural Gas Co., 294 F. 3d 737 - Court of Appeals, 5th Circuit 2002

294 F.3d 737 (2002)

In The Matter Of: OLYMPIC NATURAL GAS CO., Debtor. Randy W. Williams, Trustee, Appellant, v. Morgan Stanley Capital Group Inc., Appellee.

No. 01-20950.

United States Court of Appeals, Fifth Circuit.

June 28, 2002.

David James Askanase (argued), Ann dePender Zeigler, Hughes, Watters & Askanase, Houston, TX, for Appellant.

Jonathan I. Blackman (argued), Jonathan J. Gass, Cleary, Gottlieb, Steen & Hamilton, New York City, D. Michael Dalton, Martha McDugald, Jennifer Montgomery Gore, Andrews & Kurth Mayor, Day, Caldwell & Keeton, Houston, TX, for Appellee.

Before DAVIS, EMILIO M. GARZA and STEWART, Circuit Judges.

EMILIO M. GARZA, Circuit Judge:

Trustee Randy W. Williams (the "Trustee") appeals the district court's judgment affirming the bankruptcy court's grant of summary judgment in favor of Morgan Stanley Capital Group, Inc., ("Morgan Stanley"). On appeal, we must decide whether the Trustee is precluded from avoiding certain payments made by the debtor to Morgan Stanley pursuant to 11 U.S.C. § 546(e) of the Bankruptcy Code (the "Code"), which immunizes from avoidance settlement payments made by a forward contract merchant.

In 1995, Morgan Stanley entered into a Natural Gas Sales and Purchase Contract (the "Contract") with GM Hydrocarbons, Ltd., who later assigned its interest in the Contract to Olympic Natural Gas Co. and Olympic Gas Marketing, Inc. (collectively, "Olympic"). Pursuant to this Contract, each month the parties would enter into a series of individual transactions, in which each would act sometimes as buyer and sometimes as seller, after agreeing on the price, quantity, timing, and delivery point for the natural gas. Because the parties conducted numerous transactions each month, acting as both buyer and seller, the Contract provided for a single net payment to be made in settlement of each month's trading.

From January to May of 1997, a series of trades and payments occurred between Morgan Stanley and Olympic. At the end of each month's transactions, both parties paid the gross amount due to one another. Pursuant to the Contract's terms, Olympic transferred to Morgan Stanley cash in the amount of $817,919.60 and $1,000,000 on April 11 and April 15, 1997, in payment for the February transactions. Then, on April 29, 1997, Olympic transferred $10,850 to Morgan Stanley, representing the gross amount owing from the March transactions. Finally, on May 22, 1997, Olympic paid $48,000 to Morgan Stanley, in payment for the April transactions.

On June 6, 1997, an involuntary Chapter 7 petition was filed against Olympic Natural Gas Co., and on June 13, 1997, Olympic Gas Marketing, Inc., filed a voluntary Chapter 11 petition. The bankruptcy court subsequently consolidated both cases under Chapter 7 and appointed the Trustee. The Trustee filed a complaint against Morgan Stanley seeking avoidance of the $1.8 million in payments made by Olympic to Morgan Stanley for the February, March, and April natural gas transactions (collectively, the "Payments"). The Trustee alleged that the Payments were avoidable as preferential transfers under 11 U.S.C. § 547(b)[1] or fraudulent transfers under 11 U.S.C. § 548.[2] As a defense, Morgan Stanley argued that the Payments were "settlement payments" made by a "forward contract merchant" within the meaning of 11 U.S.C. § 546(e), and were therefore exempt from avoidance. The bankruptcy court agreed, and granted summary judgment in favor of Morgan Stanley. The district court subsequently affirmed the decision of the bankruptcy court, and the Trustee now appeals.

We review the district court's decision, as well as the underlying bankruptcy court determination, de novo. *In re Carney*, 258 F.3d 415, 418 (5th Cir.2001).

Section § 546(e) of the Code provides forward contract merchants with a complete defense to avoidance claims brought by a Trustee.[3] 11 U.S.C. § 546(e). In order to qualify for the exemption, a party must establish both that it is a "forward contract merchant," and that the

transfer sought to be avoided is a "settlement payment." *Id.* Thus, in order to determine whether the Trustee can avoid the Payments made to Morgan Stanley, we must analyze whether Morgan Stanley is a "forward contract merchant" and whether the contested Payments are "settlement payments" as provided in 11 U.S.C. § 546(e).

First, we must decide whether Morgan Stanley is a "forward contract merchant." In order to do so, we must determine whether it entered into a "forward contract" with the debtor. The term "forward contract" is defined in 11 U.S.C. § 101(25), which provides:

> "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.

11 U.S.C. § 101(25) (emphasis added). The parties have offered opposing interpretations of this definition, focusing on the inclusion of the parenthetical "other than a commodity contract" in the first line. The Trustee contends that the transactions at issue in this case were not "forward contracts," but rather ordinary commodity contracts, which are exempted from the definition of "forward contract" by the parenthetical. In essence, the Trustee claims that the Bankruptcy Code divides the "world of commerce in commodities" into three parts: (1) futures, or on-exchange financial instruments; (2) forwards, or off-exchange financial instruments; and (3) ordinary commodity contracts (*i.e.* contracts for the commercial supply of goods with a future delivery date). Morgan Stanley, on the other hand, argues that § 101(25)'s parenthetical simply reinforces the established practice of distinguishing off-exchange forward contracts from on-exchange futures, or "commodities" contracts, and that no third category of "ordinary commodity contracts" exists.

We agree with Morgan Stanley, and conclude that the transactions here fall within the scope of § 101(25)'s definition of forward contract. The commodities market is divided into only two categories: (1) on-exchange futures transactions; and (2) off-exchange forward contracts. *See* 5 COLLIER ON BANKRUPTCY ¶ 556.02[2], at 556-5 (Lawrence P. King ed., 15th ed. 2002) ("Thus, the terms 'commodity contract' and 'forward contract,' taken together, seamlessly cover the entirety of transactions in the commodity and forward contract markets, whether exchange-traded, regulated, over-the-counter or private."). The term "commodity contract" "encompasses purchases and sales of commodities for future delivery on, or subject to the rules of, a contract market or board of trade, and leverage transactions." *Id.* at 556-4. In contrast, "forward contracts" are "contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade." *Id.* at 556-5.

With this background in place, we believe § 101(25)'s parenthetical reinforces the commonly-understood distinction between on- and off-exchange transactions, by clarifying that not all contracts with a delayed-delivery component are included within the definition of "forward contract." By exempting "commodities contracts" from the definition of "forward contract" in § 101(25), the Code retains a distinct definition of "commodities contracts." *See* 11 U.S.C. § 761(4) (defining "commodity contract").[4] We decline to adopt an interpretation of "commodity contract" in § 101(25) that would conflict with a definition set forth in another portion of the Code. *See* United States Nat'l Bank of Oregon v. Indep. Ins. Agents of America, Inc., 508 U.S. 439, 460, 113 S.Ct. 2173, 124 L.Ed.2d 402 (1993) ("Presumptively, identical words used in different parts of the same act are intended to have the same meaning.") (internal quotations and citations omitted).

Furthermore, our interpretation is in accord with the traditional definition of "forward contract." Although the Trustee points to the fact that the transactions at issue here contemplated actual delivery as evidence that they are not true "forward contracts," courts in other circuits have repeatedly stated that one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery. *See, e.g.,* *Nagel v. ADM Investor Servs., Inc.*, 217 F.3d 436, 441 (7th Cir.2000) (when eventual delivery of commodity is reasonably assured, contract is a forward); *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573, 579 (9th Cir.1982) (forward contract is "predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future"); *Grain Land Coop v. Kar Kim Farms, Inc.*, 199 F.3d 983, 990 (8th Cir. 1999) ("[T]he contemplation of physical delivery of the subject commodity is the hallmark of an unregulated cash-forward contract.").

In sum, we see no reason to adopt the interpretation the Trustee advocates, and distinguish between "financial" forward contracts, and "ordinary purchase and sale" forward contracts, when the statutory language makes no such distinction.[5] Thus, we conclude that Morgan Stanley is a "forward contract merchant," and that the transactions between the parties were in fact "forward contracts."

We must next consider whether the Payments at issue were "settlement payments." Section 101(51A) provides: "'settlement payment' means, for purposes of the forward contract provisions of this title, a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, *or any other similar payment commonly used in the forward contract trade.*" 11 U.S.C. § 101(51A) (emphasis added).[6] We believe that the definition of "settlement payment" in § 101(51A) encompasses payments made in settlement of forward

contract transactions, such as the Payments at issue here. *See* 5 COLLIER ON BANKRUPTCY ¶ 546.06[2][b], at 546-48 (stating that "settlement payment" should be interpreted very broadly); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1240 (10th Cir.1991) (advocating broad interpretation of "settlement payment," and holding that consideration paid to shareholders for their stock in connection with a leveraged buyout would qualify as settlement payments under § 546(e)). We reject the Trustee's argument that in order to be exempt from avoidance, a "settlement payment" must be made on a financial derivative contract, and be cleared or settled through a centralized system. *See In re Resorts Int'l, Inc.*, 181 F.3d 505, 515-16 (3d Cir.1999) (holding payment for securities made in conjunction with leveraged buyout is settlement payment, regardless of whether clearing agency was involved). Thus, we hold that the Payments made pursuant to the Contract were "settlement payments" as defined in the Code.

Because we conclude that the Payments made by the debtor were settlements payments made to a forward contract merchant, we hold that pursuant to § 546(e), the Trustee cannot seek avoidance of these Payments. For the foregoing reasons, we AFFIRM the district court's order affirming the bankruptcy court's grant of summary judgment in favor of Morgan Stanley.

[1] 11 U.S.C. § 547(b)(4)(A) provides:

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

(4) made —

(A) on or within 90 days before the date of the filing of the petition.

11 U.S.C. § 547(b)(4)(A).

[2] The Trustee voluntarily dismissed its § 548 fraudulent transfer claims prior to this appeal.

[3] 11 U.S.C. § 546(e) provides:

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.

11 U.S.C. § 546(e) (emphasis added).

[4] 11 U.S.C. § 761(4) provides: "commodity contract" means —

(A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

(B) with respect to a foreign futures commission merchant, foreign future;

(C) with respect to a leverage transaction merchant, leverage transaction;

(D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization; or

(E) with respect to a commodity options dealer, commodity option.

[5] The Trustee argues that the immunization provision in § 546(e) was intended only to prevent disruptions in the securities markets, and therefore off-exchange sales transactions between private parties should not be exempt from avoidance, as they are not conducted on an exchange, and do not impact the financial derivatives market. The legislative history of § 546 (e) indicates that the provision was intended "to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries." H.R. REP. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583. More specifically, Congress sought to prevent the "ripple effect" created by "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry." *Id.* By including references to both the commodities and the securities markets, it seems clear that Congress meant to exclude from the stay and avoidance provisions both on-market, and the corresponding off-market, transactions.

[6] The Bankruptcy court concluded that the Payments were not "settlement payments" as defined in 11 U.S.C. § 741(8). Thus, we will analyze only whether the Payments fit within the definition of "settlement payments" included in 11 U.S.C. § 101(51A).

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

IN RE: CASE NO.

MBS MANAGEMENT SERVICES, INC. **07-12151**
SECTION A
DEBTOR CHAPTER 11

CLAUDE LIGHTFOOT, TRUSTEE FOR THE MBS UNSECURED CREDITORS' TRUST ADVERSARY NO.

09-1158

PLAINTIFF

VERSUS

MXENEGY ELECTRIC, INC.

DEFENDANT

MEMORANDUM OPINION

Trial in the above-captioned proceeding was held on May 27, 2010. At its conclusion, the Court took the matter under advisement.

I. Facts

On December 12, 2005, MBS Management Services, Inc ("MBS") and Vantage Power Services, LP ("Vantage") entered into a Commercial Agreement ("the Contract") that required Vantage to "supply the full requirements" of electricity to MBS, with MBS required to "receive and take its full electric requirements from Vantage."[1]

The Contract provided that the "Energy Charges will be calculated by multiplying the total monthly-consumed kilowatt hours multiplied by the Energy Price listed in the Price Exhibit."[2] The

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[1] Exh. MX1.

[2] *Id.*

Price Exhibit set a term of twenty-four (24) months for the Contract and listed the price as $.0119 per kWh.[3]

Although the Contract was signed by MBS, MX actually delivered electricity to forty-five (45) separate companies under the Contract. Each of these companies was a sister company to MBS and owned separate apartment complexes located throughout Texas. The companies were managed by MBS. None of the sister corporations signed the Contract.

MX's accounting records divided the charges incurred into forty-five (45) sub-accounts based on the delivery location for the electricity provided. Each month, invoices for electrical service were mailed to MBS' main office for each sub-account. Each invoice identified the property to which service was delivered.

On April 16, 2007, Vantage and MX entered into an Asset Purchase Agreement whereby Vantage transferred to MX all of its electrical service agreements, including the Contract.

On November 5, 2007, MBS filed a voluntary Petition For Relief under Chapter 11 of the Bankruptcy Code. Following confirmation of its plan, MBS transferred all rights to avoid preferential or fraudulent conveyances to a litigation trust for prosecution. Claude Lightfoot was named trustee ("Trustee"). Trustee instituted several fraudulent conveyance and preference actions against various parties including MX.

II. Law and Analysis

Trustee seeks to avoid and recover payments of $156,345.93 made by MBS to MX. Trustee alleges that the payments were preferential under 11 U.S.C. § 547. At trial, the parties stipulated that the payments were made within ninety (90) days of MBS' bankruptcy filing, while MBS was

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[3] *Id.*

insolvent, and entitled MX to receive more than it would have received in a chapter 7 liquidation. Because the parties have stipulated to all elements of a preference action, the resolution of this matter turns on MX's defenses to the complaint.

MX alleges that the payments cannot be recovered because it is a forward contract merchant, the Contract is a forward contract, and the payments in question were settlements under the Contract. In the alternative, MX alleges that the payments were received in the ordinary course of business or for new value.

A. Exception to Avoidance Under 11 U.S.C. § 546(e)

11 U.S.C. § 546(e) prohibits avoidance of settlement payments made to a forward contract merchant on a forward contract. 11 U.S.C. § 101(25) defines a forward contract as:

> [A] contract (other than a commodity contract, as defined in section 761) 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 ...

11 U.S.C. § 101(25) requires MX prove that the Contract:

1. Was a contract for the sale of a commodity;

2. With a delivery date more than two (2) days after execution;

3. By a forward contract merchant;

4. That is not otherwise subject to the rules of a contract board of trade.[4]

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[4] For the reasons set forth in this Court's earlier ruling (pl. 56), the contracts protected under 11 USC § 546(e) are contracts not traded or subject to the rules of a contract board of trade. *See*, 11 USC §§ 101(25) and 761(4).

All four elements under the statute have been satisfied. For the reasons assigned in this Court's prior Opinion on MX's Motion for Summary Judgment, the Contract involved the sale of electricity which is a commodity.[5] Neither party disputes that the Contract's initial delivery date was at least two (2) days following execution. According to the testimony of Jeffrey A. Mayer, President and Chief Executive Officer of MX, MX is in the business of buying and selling electrical power. It does not produce any of the power it markets. Therefore, the Court concludes that MX is a forward contract merchant. The record also establishes that the Contract was not subject to the rules or regulations of a contract board of trade, and MBS presented no evidence to refute this point.

Despite satisfaction of all statutory requirements, MBS argues:

1. That MX is not a party to the Contract; therefore, payments to it are not protected.
2. That Vantage never signed the Contract; therefore, the Contract is unenforceable, and the payments are not protected; and
3. The Contract is not a forward contract.

B. MX Is the Successor in Interest to Vantage

MBS argues that MX has not established that the Contract was assigned to it by Vantage. The testimony of Mr. Mayer established that MX purchased all of Vantage's contracts in April 2007, including this Contract. Following the assignment, MX delivered invoices for electrical power to MBS without complaint. The invoices in question were satisfied by MBS with checks made payable

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[5] Pl. 56; *See also, U. S. v. Reliant Energy Services, Inc.*, 420 F.Supp.2d 1043 (N.D.Cal. 2006). *See also, In re Nat'l Energy & Gas Transmission, Inc.*, 492 F.3d 297, 299 (4th Cir. 2007); *In re Erving Industries, Inc.*, 2010 WL 1416148 (Bankr.D.Mass. 2010); *In re Mirant Corp.*, 334 B.R. 800, 805 (Bankr.N.D.Tex. 2005); *In re Enron Corp.*, 274 B.R. 327, 334 (Bankr.S.D.N.Y. 2002); *In re Olympic Natural Gas*, 258 B.R. 161, 163 (Bankr.S.D.Tex. 2001); *In re Camelot Motors Corp.*, 86 B.R. 520, 523 (Bankr.W.D.Mich. 1988); *In re Charles Town Light & Power Co.*, 183 F. 160, 163 (D.C.W.Va. 1910).

to MX.[6] Nothing in the record supports MBS' position that MX is not the owner of the Contract.

C. The Contract is Enforceable Between the Parties

MBS next asserts that the Contract is unenforceable because Vantage never signed it. The Contract has a date of December 12, 2005. It is executed by MBS but unsigned by Vantage, now MX. Electricity was provided to MBS under the Contract for a minimum of twenty (20) months following its execution. Further, MX and Vantage invoiced MBS for the electricity supplied based on the price provided by the Contract. Vantage, and now MX, both performed under the Contract as required. MX has neither challenged the Contract nor its obligations under it. The Contract has been ratified by Vantage and MX's performance.[7] As the party who executed the Contract, MBS may not challenge MX's ratification in order to avoid its enforcement.[8]

D. The Contract Qualifies as a Forward Contract

Finally, MBS argues that the Contract is not a forward contract because it is not for a set quantity of power but instead requires MX to supply all power needed by MBS. In support of its position, MBS cites *In re Olympic Natural Gas Co.*[9] and *In re National Gas Distributors*.[10]

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[6] Exh. MX5.

[7] *Missouri Pacific R. Co. v. Lely Development Corp.*, 86 S.W.3d 787, 792 (Tex.App.-Austin 2002).

[8] *Id.*

[9] *Williams v. Morgan Stanley Capital Group Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737 (5th Cir. 2002).

[10] *Hutson v. E.I. du Pont de Nemours and Co., Inc. (In re National Gas Distributors, LLC)*, 556 F.3d 247 (4th Cir. 2009).

The Bankruptcy Code protects from avoidance payments made on a "forward contract."[11] Nothing in the Bankruptcy Code requires that a forward contract provide for the purchase of the commodity at a set price or quantity. Nevertheless, it is generally accepted that forward contracts must specify the terms of sale, particularly price. Trustee seeks to impose an additional requirement regarding the quantity sold. Trustee argues that a contract at a set price but no set quantity is an imperfect hedge of the risks associated with the sale of a commodity. Contracts with imperfect hedges of risk cannot be forward contracts in the Trustee's estimation.

At trial, the Court heard testimony from Mr. Mayer, an expert in commodity trading of electricity; including the formation, regulation, and trading of contracts for the purchase and sale among producers, users, marketers, middle-men, and brokers; and the standards and requirements of those contracts whether they be forward or future contracts traded on or off-exchange. Mr. Mayer was also accepted as an expert in energy risk management. Mr. Mayer possessed extensive experience with the New York Mercantile Exchange ("Mercantile Exchange"), a commodity trading house in New York City that trades electrical futures contracts among other commodities contracts. He served as counsel to the Mercantile Exchange and helped draft the uniform commodity contract used by the Mercantile Exchange for all futures trading in electricity. In addition, he helped draft one of the most common forms of forward contract agreements used in forward contract markets.

Mr. Mayer's testimony provided many missing details regarding the futures and forward contract markets. He explained that futures contracts are uniform to facilitate trading between members of an exchange. They provide for the delivery of a commodity at a set price, quantity, delivery date, and place of delivery. In a commodities exchange, all futures contracts are submitted

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[11] 11 U.S.C. § 546(e).

to a clearinghouse which assumes responsibility for the trade. The clearinghouse tallies the purchases and sales of individual members which are matched or offset within the member's account.

Because the clearinghouse assumes responsibility for delivery of the commodities involved, the members' accounts merely reflect the costs of purchase or sale in monetary terms. Those accounts compensate the clearinghouse for price fluctuations on the commodities acquired and delivered. For example, if A buys and sells the same quantity of corn on the same day, A's account will only reflect the difference in price between the two (2) trades as either a loss or profit. B's account, or more often B and C's accounts, reflect the other side of the contracts, balancing the loss or profit. But none of the members is required to actually deliver products or take delivery. Each is only responsible for the financial consequences of their trades.

In contrast, forward contracts are negotiated between industry participants and forward contract merchants. The industry participants are either producers or users of the commodity who sell or purchase the commodity in advance to hedge against price fluctuations. Forward contract merchants create or manage commodity markets by providing a place for industry participants to buy or sell a commodity in advance of its actual production.

There is no clearinghouse involvement with forward contracts. As a result, the forward contract merchant must deliver on the contracts to which it commits by supplying the commodity or taking delivery. While forward contracts provide an imperfect hedge against fluctuations in supply, the risks associated with an unexpected increase of demand for a commodity and the cost increases to purchase sufficient supply to fulfil the forward contract can be managed through security deposits, letters of credit, other financial instruments, or simply the creditworthiness of the

forward contract merchant. As a result, forward contracts for electricity do not typically limit the quantity sold or purchased. Instead, they are generally for the entire needs or demands of the purchaser.

The testimony of Mr. Mayer explained in sufficient detail why a forward contract differs from the uniformity of a futures contract. MBS offered no evidence to refute the opinions presented by Mr. Mayer, and the Court accepts his testimony as credible on the practices and procedures attendant with both markets.

Trustee argues that several courts, including the *Olympic* Court, have found that forward contracts must be for a specific quantity of goods.[12] However, in almost all cases, the contracts in question provided for a set quantity of goods at a set price. Therefore, the findings of the courts cited by MBS are *dicta* on the issue. Only in the case of *In re National Gas Distributors*,[13] did a North Carolina bankruptcy court hold that an all requirements contract was not a forward contract because the amount of product was not specified. The decision was based on the *dicta* contained in the previously indicated cases including a finding that "because the Wall Street Journal always quotes commodity contracts by price and quantity" both must be specified in order for a forward contract to exist. However, in so holding, the *National Gas* Court failed to note an important distinction between forward and futures contracts.

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[12] *Williams v. Morgan Stanley Capital Group Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737 (5th Cir. 2002); *In re Borden Chemicals and Plastics Operating L.P.*, 336 B.R.214 (Bankr.D.Del. 2006); *Hutson v. M.J. Soffe Co. (In re National Gas Distributors)*, 412 B.R.758 (Bankr.E.D.N.C. 2009); and *Hutson v. E.I. du Pont de Nemours and Co., Inc. (In re National Gas Distributors, LLC)*, 556 F.3d 247 (4th Cir. 2009).

[13] *Hutson v. M.J. Soffe Co. (In re National Gas Distributors)*, 412 B.R.758 (Bankr. E.D.N.C. 2009).

Futures contracts are traded on exchanges and regularly quoted in the financial papers by price, quantity, and delivery date. As previously noted, this creates an apples to apples market and facilitates trades between members of the exchange. The forward contract market is not so regulated nor uniform although forward contract merchants also create markets to buy and sell commodities. Because forward contracts are off-exchange trades, they may vary in their terms. The testimony of Mr. Mayer establishes that unlike futures contracts, forward contracts are not for specified quantities of the commodity. For the Court to require a forward contract to contain a condition that is not typically present would defeat the purpose of § 546(e) by narrowing its application. Nothing in the stature warrants such a limitation.

Trustee also argues that 11 U.S.C. § 546(e) was not designed to protect payments made under ordinary supply type contracts but only to protect derivative contracts or those made with pure financial hedging motives. He defines a "supply contract" as one between a consumer and broker or producer. Putting aside the issue of whether or not contracts solely between industry participants can qualify as forward contracts, Trustee argues that because the primary goal of MBS was to receive electricity, the Contract's purpose was not for financial risk management purposes.

Admittedly, even supply contracts have hedging or risk management attributes. By setting the price for electrical power, end users protect themselves against large fluctuations in price and stabilize their cost of power. As a result, Trustee must refine his position to admit that while the Contract contains hedging attributes, because those were not MBS' primary goal, it is not a forward contract. Trustee's position was squarely rejected by the United States Court of Appeal for the Fifth Circuit in *Olympic.*

In *Olympic,* the trustee argued a position identical to that of this Trustee. The Court found:

> [N]o reason ... to distinguish between "financial" forward contracts, and "ordinary purchase and sale" forward contracts, when the statutory language makes no such distinction.[14]

Based on the expert evidence submitted by MX, the Court finds that forward contracts include contracts for the sale or purchase of a commodity between an industry participant and forward contract merchant. They are not regulated or subject to the rules of a contract commodity exchange and provide a hedge against price fluctuations in a commodity market. They do not have to specify a set quantity for delivery, but are most often written to sell to the purchaser all it might need or demand of the commodity during the term of the contract.

Under the above definition, the Court concludes that the Contract was a forward contract and that the payments received by MX were settlement payments under the Contract. As a result, they are protected from avoidance by Trustee. Accordingly, the Court need not discuss MX's remaining defenses of ordinary course and new value.

MX's has requested a judgment against Trustee for attorneys' fees and costs incurred in connection with this matter.[15] "[A]bsent statute or enforceable contract, litigants pay their own

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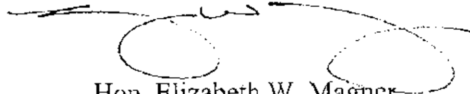
[14] *In re Olympic Natural Gas Co.*, 294 F.3d at 742. *See also, Hutson v. E.I. du Pont de Nemours and Co., Inc. (In re National Gas Distributors, LLC)*, 556 F.3d 247 (4th Cir. 2009) (supply contracts between industry participants are not *per se* excluded as forward contracts). This case is separate from *Hutson v. M.J. Soffe Co. (In re National Gas Distributors)*, 412 B.R.758 (Bankr.E.D.N.C. 2009), which involved different parties and contracts.

[15] Pl. 14.

attorneys' fees."[16] MX has not cited any statute or contract provision which supports an award of its fees and costs. As such, MX's request for attorneys' fees and costs is denied.

A separate Judgment will be rendered in accordance with this Memorandum Opinion.

New Orleans, Louisiana, June 29, 2010.



Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

[16] *Alyeska Pipeline Servcice Co. v. Wilderness Society*, 421 U.S. 240, 257, 95 S.Ct.1612, 1621 (1975) (citations omitted).

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

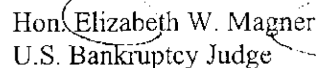
IN RE:	CASE NO.
MBS MANAGEMENT SERVICES, INC.	**07-12151** SECTION A CHAPTER 11
DEBTOR	
CLAUDE LIGHTFOOT, TRUSTEE FOR THE MBS UNSECURED CREDITORS' TRUST	ADVERSARY NO. **09-1158**
PLAINTIFF	
VERSUS	
MXENEGY ELECTRIC, INC.	
DEFENDANT	

JUDGMENT

For the reasons assigned in the Memorandum Opinion entered by the Court on this date,

IT IS ORDERED that the Court finds in favor of the defendant, MXEnergy Electric, Inc., and against the plaintiff, Claude Lightfoot, Trustee for the MBS Unsecured Creditors' Trust. Each party is to bear its own fees and costs.

New Orleans, Louisiana, June 29, 2010.



Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

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