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Fifth Circuit Expands Forward Contract Preference Defense
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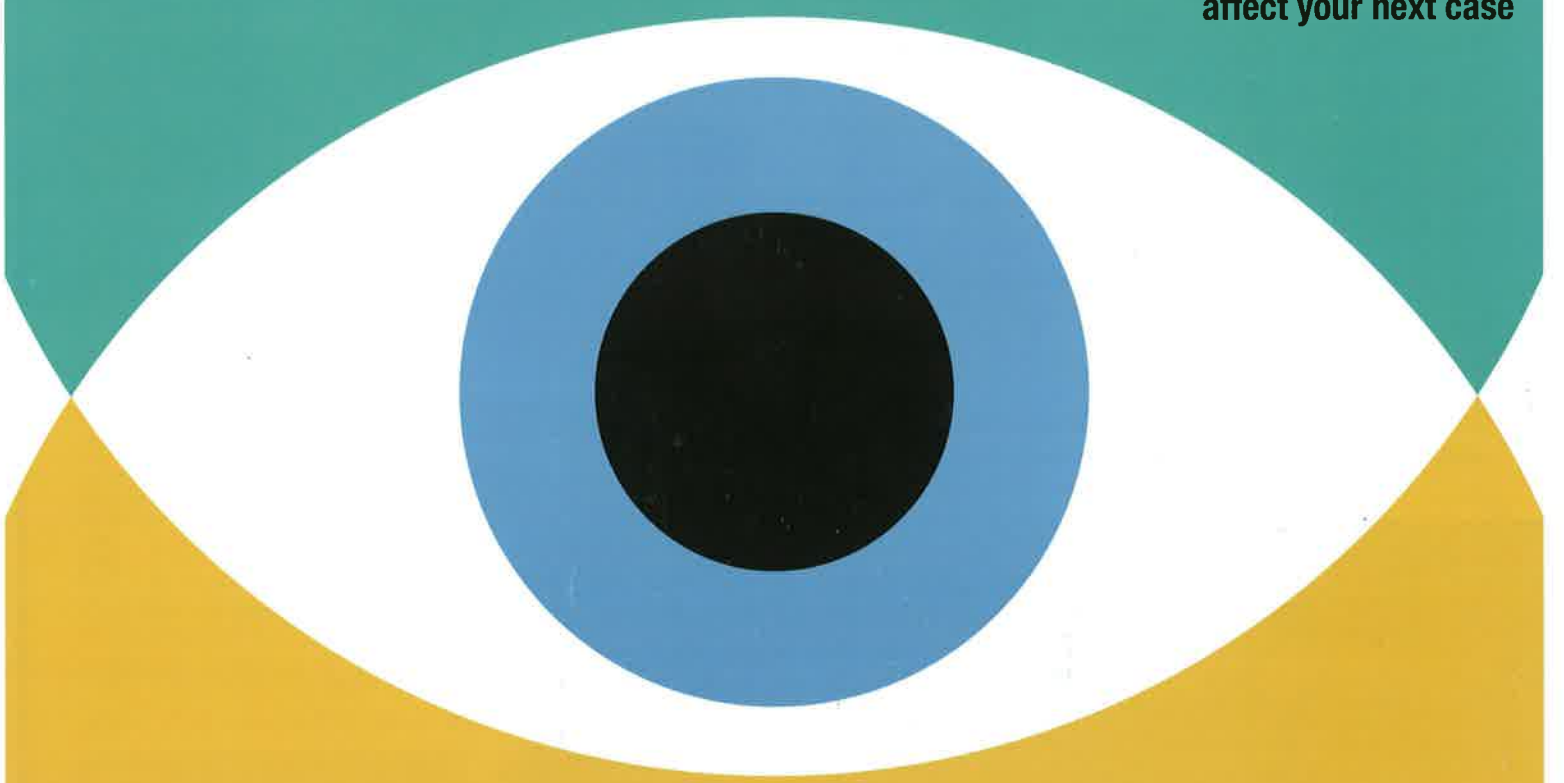

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Fifth Circuit Expands Forward Contract Preference Defense

Utilizing the Bankruptcy Code in cases involving defending preferences in bankruptcy

By D. Brent Wells, president of Wells & Cuellar, P.C.

If you are experienced defending preferences in bankruptcy, then you know the usual scenario.

Your commercial creditor client comes to you with a pre-suit letter or complaint demanding the disgorgement of amounts paid by the debtor during the last 90 days before bankruptcy. The client assures you that the amounts paid were justly owed and properly paid, as they understand state law expectations.

Surely, they say, this preference thing cannot be the law! Then you explain the elements and policy of Section 547 of the Bankruptcy Code and deliver the bad news that the justness and propriety of the payments when made is no defense.

Instead, the Bankruptcy Code provides a short-list of potential defenses, including the occasional challenge to the presumption of the debtor's insolvency under Sections 547(b)(3) and (f), a two-year statute of limitations under Section 546(a), and the often-invoked ordinary course of business and subsequent new value concepts, as well as a few others found in Section 547(c).

Other options

A somewhat arcane and less well-known defense is lurking in Section 546(e): "Notwithstanding section[]... 547..., the trustee may not avoid a transfer that is a... settlement payment... made by or to (or for the benefit of) a... forward contract merchant... or that is a transfer made by or to (or for the benefit of) a... forward contract merchant... in connection with a... forward contract...."

The definitions of "forward contract," "forward contract merchant" and "settlement payment" are found in three sub-sections of Section 101, which each defy linguistic precision by tautologically using the very phrase being defined in its own definition.

Thus, per Section 101(25), a "forward contract" is "a contract (other than [an exchange-traded] commodity contract...) for the purchase, sale or transfer of a commodity... 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... with a maturity date more than two days after the date the contract is entered into...."

Per Section 101(26), a "forward contract merchant" is "an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants...." And, per Section 101(51A), a "settlement payment" is, well, "a... settlement payment"! You can see why, when I have been approached by clients (particularly in the energy credit industries) over the past two decades, with the request that I opine whether their particular agreement or transaction is a protected "forward contract," my standard response has been the proverbial adage "it ain't a forward contract unless the bankruptcy judge says it is a forward contract."

But with a few notable exceptions, including the Fifth Circuit's teaching in *In re Olympic Natural Gas Co.*, 294 F.3d 737, 741 (5th Cir. 2002) ["one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery"], very few bankruptcy judges had so said, much less in reported decisions.

Unlike the bankruptcy universe, "forward contracts" are well-known and understood in the real commercial world, in numerous industries. When a product (including both goods and services) is sold pursuant to a contract entered into today that sets parameters for price and/or quantity that will be applicable for committed future deliveries, both the buyer and the seller are engaged in a forward projection second-guessing the marketplace in "spot" or "walk-up" pricing of such product.

If I commit to sell you a pencil next week for a quarter, then I am betting that the spot price of a pencil next week may be less than 25 cents, while you are betting that the market will be over 25 cents and your forward contract was a good hedge.

Natural gas traded between national and international counterparties, electrical power supplied to apartment complexes, fuel oil consumed by merchant fleet vessels, and generic hotel rooms sold to airlines in bulk for crew lodgings, are all the subject of a forward contract trade where supply over a future term is committed under price and/or quantity constraints agreed in the present.

"Unlike the bankruptcy universe, 'forward contracts' are well-known and understood in the real commercial world, in numerous industries."

The price may be fixed at the commencement of the contract, or determined based upon a formula or extrinsic reference. Quantities may be set upfront, or nominated on the basis of a periodic forecast. Your commercial clients can offer numerous examples from their own industries. Such hedging has been part of our economy and financial marketplace going back at least to medieval origins. *See, Interest rates and efficiency in medieval wool forward contracts*; Bell, Brooks, Dryburgh, Journal of Banking & Finance (2006).

A New Perspective

So it was potentially a major development in this area of the law last August when the Fifth Circuit applied a "plain meaning" analysis to conclude that an electrical power supply contract setting a fixed price for delivery of electricity during the two-year term was a forward contract immune from preference recovery under Section 546(e).

"The courts' task is not to fulfill a vague policy of furthering the recovery of last-minute transfers by debtors to certain creditors, but to apply the statutory provisions as Congress wrote them." [*In re MBS Mgmt. Services, Inc.*, 690 F.3d 352, 355 (5th Cir. 2012).] Not only did the Fifth Circuit eschew esoteric rumination as to legislative history about what may or may not have moved

Congress to create this "safe harbor," but it also boldly brought the Bankruptcy Code abstractions quoted above more into harmony with the real world of uniquely-negotiated, private, off-exchange, physical delivery forward contracts.

The expert testimony of an experienced electrical power industry participant, who also happened to be the CEO of the defendant-company, was relied upon to supply the factual framework for what was to be legally construed to be a forward contract. Importantly, as a matter of first impression, *requirements* contracts to supply the buyer's needs for the product were given imprimatur as Section 101(25) forward contracts.

MXEnergy and MBS

When MXenergy first brought our firm the complaint in November 2009, suing it for recovery of a $156,346 preference paid by the managing agent of the MBS apartment complex enterprise (whose consolidated Chapter 11 had been filed November 5, 2007, in Bankruptcy Judge Elizabeth Magner's Court in New Orleans), my first thought was to urge the subsequent new value and ordinary course of business defenses.

Indeed, MXenergy had been left holding the bag on the bankruptcy petition date with an unsecured proof of claim including more than $23,556 in unpaid subsequent new value.

Furthermore, at least $95,215 of the challenged payments for electricity service made during the last ninety days before bankruptcy could be argued to qualify as meeting the patterns of typicality established during the one-year pre-preference historical period of the relationship between MXenergy and MBS.

But it was the forward contract analysis that proved to be the complete defense, and you will see no discussion of the traditional defenses in either of the Bankruptcy Court's two reported decisions, the District Court affirmance, or the Fifth Circuit's ultimate pronouncements. In addition to the Fifth Circuit opinion, see *In re MBS Mgmt. Services, Inc.*, 430 B.R. 750 (Bankr. E.D. La. 2010), Judge Magner's interlocutory ruling on our Motion for Summary Judgment; *In re MBS Mgmt. Services, Inc.*, 432 B.R. 570, 572 (Bankr. E.D. La. 2010), Judge Magner's final determination; and *Lightfoot v. MXEnergy, Inc.*, 2011 WL 1899764 (E.D. La. May 19, 2011), the District Court's affirmance, which was reviewed by the Fifth Circuit.

Looking at the elements of Section 101(25), the two-page agreement between MBS and MXenergy was obviously an off-exchange private contract for the purchase and sale of electricity over an extended term. The requirements of the apartment complexes during each monthly billing period were delivered and billed based upon actual metered usage at the price set on the day the contract was signed. Any delivery followed by ensuing billing and payment obligations that accrued more than two days thereafter met the forward-looking two-day maturity requirement.

Since my client confirmed persuasively that such was the routine machinery of the forward contract trade in the electrical power industry, the agreement appeared to be a forward contract by all accounts. While electrical power service was not in the explicit list of "commodities" recognized under the Commodities Exchange Act, neither had natural gas been in that list when the Fifth Circuit approved as a forward contract the industry-standard natural gas sales and purchase contract under scrutiny in *Olympic*.

Also, creative lawyers can take some comfort and encouragement from the open-ended scope of Section 101(25)'s inclusion of "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." The touchstone is (or should be) whether there is, in fact, a forward contract trade dealing in the product in question.

How Congress Views Forward Contracts

The trustee in *MBS* did not choose to argue with us too vigorously about the status of electrical power as a commodity (whether or not it was a commodity, electricity was at least a "similar service" which was the subject of dealing in the

"So the next time your client brings you a preference case to defend, spend a moment considering whether the contract under which the challenged payments were made was a forward contract for the future delivery of your client's product under price and/or quantity constraints that were specified in advance."

forward contract trade).

But he did try valiantly to steer the three courts involved into the zone of legislative history, suggesting that our client's version of an isolated physical delivery supply contract could not possibly have sufficient financial character to provoke the congressional concerns about bankruptcy-induced displacement in the markets that financial derivatives, securities contracts, swap agreements, repurchase agreements, and the like, might have.

To that, it should be noted that if Congress meant to impose additional limitations, such as a financial nexus requirement, they could have done so in the wake of *Olympic*, both at the time of the 2005 Bankruptcy Abuse and Consumer Protection Act and also the 2006 Financial Netting Improvements Act.

Instead, Congress took both of those occasions to *broaden*, not limit, the scope of the "safe harbors" which include forward contracts within their purview. "Whether one agrees or disagrees with Congress's decision to exempt 'forward contracts' from preference recovery, this explanation places the type of futures contract arranged between the debtor and MX well within the class covered by §§ 101(25) and 546(e)." [*MBS, supra*, 690 F. 3d at 357.]

A more interesting debate surrounded the question of whether or not a definite quantity of the product needed to be specified in advance, as ours was a requirements contract within the meaning of UCC 2-306. The trustee argued that *Olympic, supra*, and a 2009 Fourth Circuit case both specified that exact quantities are required for forward contracts. The Fifth Circuit took umbrage and dispensed with that notion:

"*Olympic* says no such thing; exact price and delivery date were simply embodied in the contracts at issue in the case. Instead, *Olympic* rejected several arguments designed to narrow the scope of Section 101(25) contrary to the statutory text. See 294 F.3d at 741–42. Likewise, the Fourth Circuit case, *In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009), deflected attempts to restrict the definitions of 'forward agreements' and 'swap agreements' in 11 U.S.C. §§ 101(53B) and 546(g), respectively. To the extent *National Gas* construes these other statutory provisions, it is inapplicable here. The *National Gas* court in fact observes that, 'the Bankruptcy Code uses both 'forward *contract*' and 'forward *agreement*' but defines only 'forward *contract*,' and not 'forward *agreement*,' apparently making a distinction between the terms.' 556 F.3d at 255 (emphasis in original). Further, while *National Gas* lists 'fixed' 'quantity and time elements' as characteristics of forward *agreements*, and in so doing references forward *contracts* cases, the context of the court's discussion is intentionally open-ended, *see id.* at 259–60, and evocative rather than prescriptive. The [Fourth Circuit] court's discussion has little bearing on the issues before us [the Fifth Circuit], especially in light of the Code's definition of a 'forward contract.'" *MBS, supra*, 690 F. 3d at 356.

Moving Ahead with Forward Contract Cases

So the next time your client brings you a preference case to defend, spend a moment considering whether the contract under which the challenged payments were made was a forward contract for the future delivery of your client's product under price and/or quantity constraints that were specified in advance.

And requirements contracts are now more clearly within the zone of "safe harbor" protection! Ask your client whether the term "forward contract" is utilized in their industry's particular vernacular, and what it means in their world.

Ask your client whether there is an active forward contract trade in his or her product. If so, your client may be the next party-affiliated expert witness vindicated as ours was in MBS. But be forewarned that, in our experience, at this time not all bankruptcy judges are equally enamored of embracing this forward contract defense to take advantage of its apparent inclusiveness, particularly outside of the Fifth Circuit.

If you undertake to be courageous and explore the boundaries of the forward contract "safe harbor," perhaps my proverbial adage above should be quoted to your client, along with the encouraging words of MBS. ●

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Wells has spoken extensively on creditors' rights topics and routinely handles collection of debts and judgments, bank loan workouts and foreclosures, and energy credit issues. He particularly enjoys advocating for creditors who anticipate collection obstacles such as bankruptcy, complaints about a product or service, or disputes about the enforceability of a debt. Wells is also frequently called upon as a neutral mediator and arbitrator in the commercial and debtor-creditor arenas. He can be reached at bwells@wellscuellar.com or (713) 222-1281.