

# Clients & Friends Memo

## **Fifth Circuit Finds that an Electricity Requirements Contract Is a “Forward Contract” Exempt from Bankruptcy Code’s Avoidance Powers**

**October 11, 2012**

On August 2, 2012, the United States Court of Appeals for the Fifth Circuit held that a requirements contract for electricity is a forward contract for purposes of section 546(e) of the Bankruptcy Code and, therefore, settlement payments made under the contract are exempt from avoidance as preferences. [\*Claude Lightfoot v. MXEnergy Electric, Inc. \(MBS Management Services, Incorporated\)\*](#), 690 F.3d 352 (5th Cir. 2012). The Fifth Circuit’s ruling is a boon to electricity providers that receive payments from counterparties that are insolvent at the time of payment and file for bankruptcy protection shortly thereafter.

### **Background**

MBS Management Services, Incorporated provided management services for various residential properties in Texas and Louisiana. In December 2005, MBS entered into a two-year agreement to purchase the “full electric requirements” for certain properties from Vantage Power Services, LP at a fixed rate per kilowatt-hour. The agreement did not specify quantities or delivery dates. Vantage subsequently sold the agreement to MXEnergy Electric, Inc., and in August 2007, MBS paid MXEnergy \$156,345.93 to satisfy past-due electric bills owing under the agreement.

On November 5, 2007, MBS commenced a voluntary chapter 11 case in the United States Bankruptcy Court for the Eastern District of Louisiana. MBS’ confirmed chapter 11 plan transferred all of the estate’s potential avoidance actions to a litigation trust, which subsequently initiated an adversary proceeding to recover the \$156,345.93 as an avoidable preference pursuant to section 547(b) of the Bankruptcy Code.

The parties stipulated that all of the requirements of a preference action were satisfied – specifically, the payments had been made while MBS was insolvent and within 90 days of its bankruptcy filing, and the payments entitled MXEnergy to a greater recovery than it would have received in a chapter 7 liquidation. MXEnergy argued, however, that the agreement was a forward contract as defined by the Bankruptcy Code and, accordingly, the payments at issue were settlement payments exempt from avoidance pursuant to section 546(e) of the Bankruptcy Code.

Both the Bankruptcy and District Courts held that the agreement was a forward contract and the payments in question constituted settlement payments that were shielded from avoidance under section 546(e). The trustee for MBS' litigation trust subsequently appealed the District Court's determination that the agreement was a forward contract.

### **The Fifth Circuit's Decision**

The Bankruptcy Code defines a forward contract as follows:

[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 . . . with a maturity date more than two days after the date the contract is entered into . . .

11 U.S.C. § 101(25)(A). In turn, section 546(e) of the Code exempts "a transfer that is a . . . settlement payment as defined in section 101 or 741 of this title . . . made by or to [a] . . . forward contract merchant . . ." from the avoidance powers of the Bankruptcy Code. 11 U.S.C. § 546(e).

On appeal, the trustee argued that the agreement was not a "forward contract" because it did not state a specific quantity of electricity to be delivered, or specific delivery dates. In support of this argument, the trustee cited *In re National Gas Distributors, LLC*, 556 F.3d 247 (4<sup>th</sup> Cir. 2009), in which the Fourth Circuit lists "fixed" quantity and time elements as characteristics of "forward agreements." However, the Court found *National Gas* to be inapposite because it addressed the Bankruptcy Code's definition of "swap agreement" as opposed to the definition of "forward contract" and focused on the safe harbor from fraudulent transfer liability set forth in section 546(g) of the Bankruptcy Code rather than the section 546(e)'s safe harbor from preference liability.

The Court also relied on an earlier Fifth Circuit decision, *In re Olympic Natural Gas*, 294 F.3d 737 (5<sup>th</sup> Cir. 2002), which engaged in a close textual analysis of the Bankruptcy Code with respect to forward contracts, to conclude that the Bankruptcy Code imposed no requirement that a forward contract include set quantities and delivery dates. Furthermore, with respect to the absence of a prescribed quantity in the agreement, the Fifth Circuit observed that a requirements contract, like the agreement, is "sufficiently definite" to be enforceable under section 2-306 of the Uniform Commercial Code because a knowledgeable merchant can estimate the needs of a customer.

The trustee also pointed to the lack of specific delivery dates as evidence that the agreement did not have a maturity date. The Court quickly dispensed with this argument as “nonsense” because no delivery of electricity was scheduled to occur less than two days after execution of the agreement. Although the Court acknowledged that case law reflects some ambiguity regarding the exact meaning of “maturity date” as used in the Bankruptcy Code’s definition of a “forward contract,” the Court found no reported authority suggesting that a contract that does not *specify* a maturity date does not *have* one.

Perhaps in an attempt to get around the Court’s textual analysis, the trustee cited to authority expressing concerns that “ordinary supply contracts” should not be exempt from preference litigation, and argued that section 546(e) of the Bankruptcy Code was intended to cover only derivative contracts and other similar agreements made purely for financial hedging motives. The Court declined to engage in an extensive policy discussion, noting that the concerns were “immaterial when laid against the statutory text,” and referring to certain expert testimony given before the Bankruptcy Court which explained the nature and purpose of forward contracts and demonstrated that the agreement fell squarely within the Bankruptcy Code’s definition of “forward contract.”

### **Conclusion**

The Fifth Circuit’s plain text interpretation of the term “forward contract” heralds good news for creditors that transact with distressed counterparties to requirements contracts. The Court’s ruling clarifies the scope of creditors entitled to the protection of the Bankruptcy Code’s safe harbor provisions. This clarity should inspire confidence in the market, and may incentivize creditors to enter into requirements contracts with distressed counterparties that otherwise would have failed to satisfy commercial risk standards. The follow-on effect could mean that the distressed counterparties are in a better position to continue operations and prepare for, if not altogether avoid, bankruptcy proceedings.

The ruling, however, also raises significant policy concerns and could prove unduly troublesome for chapter 11 reorganizations. Non-debtor parties to forward contracts are not only exempt from preference avoidance, but also may avail themselves of other Bankruptcy Code safe harbor protections, including the ability to retain contractual rights to termination, closeout, and setoff and exemption from fraudulent transfer avoidance. These safe harbor protections, which were designed to protect the integrity of the securities markets, prevent the bankruptcy estate from retaining or recovering assets that otherwise would be available to satisfy claims against the estate. The Fifth Circuit acknowledged that the recovery of preferences is a “key tool for accomplishing an equitable distribution of the debtor’s limited assets.” However, the Court emphasized that it was constrained by the text of the Bankruptcy Code, stating that “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.” Although the Fifth Circuit’s plain reading of the applicable statutes is certainly defensible, expanding the scope of the safe harbor protections – and therefore limiting a debtor’s ability to pursue avoidance actions, such as preferences – will reduce the value of the debtor’s estate and potentially frustrate its efforts to reorganize.

Additionally, the Fifth Circuit’s decision left several pertinent issues unresolved. After the Bankruptcy Court rejected the trustee’s argument that the payments under the agreement were not “settlement payments” as contemplated by section 546(e) of the Bankruptcy Code, the trustee did not further pursue the issue on appeal to either the District or Circuit Courts. As a result, the Fifth Circuit did not address whether the payments in question constituted “settlement payments” for purposes of section 546(e).

In addition, although the Court made note of the issue, the facts of the case did not require the Court to address whether a residential consumer who has contracted with a local utility company for a favorable rate would be shielded by the Bankruptcy Code’s safe harbor provisions if the consumer sought bankruptcy protection. It is possible that different material terms in the relevant agreement, such as a variable price rate, or an agreement that called for a less predictable, highly fluctuating supply to the consumer, may lead a court to a different conclusion than the Fifth Circuit reached here.

It also bears noting that, despite the Fifth Circuit’s characterization of the Fourth Circuit decision, *In re National Gas Distributors, LLC*, at least one bankruptcy court in the Fourth Circuit has interpreted the *National Gas* decision as excluding a natural gas supply contract from safe harbor protection under the Bankruptcy Code. See *Hutson v. M.J. Soffe Co. (In re National Gas Distributors, LLC)*, 412 B.R. 758 (Bankr. E.D.N.C. 2009). Judge A. Thomas Small, the bankruptcy judge that issued this 2009 decision, reached this conclusion in dicta after his 2007 ruling on this issue was reversed and remanded for further legal and factual development by the Fourth Circuit. This disagreement may suggest that a split among the Fifth and Fourth Circuits is on the horizon.

The Patriot Coal bankruptcy cases, currently pending in the United States Bankruptcy Court for the Southern District of New York, may provide another forum for a different court to evaluate this decision or address these unresolved issues. For now, however, the Fifth Circuit’s decision should be viewed as source of comfort and clarity to creditors and commodity suppliers that deal with parties who may otherwise be viewed as an excessive credit risk.

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