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Fifth Circuit Holds That Electricity Agreements Are Shielded From Avoidance Powers Under Bankruptcy Safe Harbor

In its recent decision in *Lightfoot v. MXEnergy Electric, Inc. (In re MBS Mgmt. Serv., Inc.)*, No. 11-30553, 2012 U.S. App. LEXIS 15995 (5th Cir. Aug. 2, 2012), the United States Court of Appeals for the Fifth Circuit ruled that a requirements contract for electricity supply that did not specify quantities or delivery dates is a "forward contract" within the meaning of Section 101(25)(A) of the Bankruptcy Code. Therefore, such contracts are within the ambit of Bankruptcy Code Section 546(e)'s "safe harbor," which exempts nondebtor parties to forward contracts from preference liability for contract payments received from the debtor before the commencement of its bankruptcy.

Section 546 and other provisions of the Bankruptcy Code provide "safe harbors" for specified commodities and financial contracts and related payments and transactions. The bankruptcy safe harbors limit the application and effect of the automatic stay and avoidance actions to recover fraudulent transfers and preferential payments, thereby insulating nondebtor counterparties to specified contracts from preference and fraudulent transfer liability, and permitting them to close and settle transactions and exercise other rights under specified contracts following the commencement of a bankruptcy case without violating the automatic stay. *See, e.g.*, 11 U.S.C. §§ 362(b)(6) & (7) (limitations on automatic stay of certain contract rights) and 546(e), (f), (g) & (j) (limitations on avoidance powers of trustee). In particular, Section 546(e) of the Bankruptcy Code exempts from the operation of various bankruptcy avoidance statutes "a transfer that is a … settlement payment … made by or to [a] … forward contract merchant . …" 11 U.S.C.§ 546(e).

In *MBS Mgmt.*, the Fifth Circuit ruled that a contract between an electricity supplier and a real estate management company, which became a Chapter 11 debtor, was a "forward contract" as defined by Section 101 of the Bankruptcy Code: "a contract (other than a commodity contract[]) for the purchase, sale, or transfer of a commodity …with a maturity date more than two days after the contract is entered into . …" 11 U.S.C. § 101(25)(A). The Fifth Circuit applied this "statutory language alone" to conclude that the contract was a "forward contract" — even though it did not specify quantity or delivery dates — and therefore the contract fell within the Section 546(e) safe harbor. Accordingly, the Fifth Circuit held that Section 546(e) insulated pre-bankruptcy payments made by the debtor to the electricity supplier from avoidance as preferential payments under Section 547(b) of the Bankruptcy Code.

The *MBS Mgmt.* decision stands in contrast to the Fourth Circuit's decision in *In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009), which held analogous "forward agreements" must specify price, quantity and "time element" terms to fall within a Section 546 safe harbor. *MBS Mgmt.* appears to extend, in the Fifth Circuit at least, Section 546 safe harbor protections to energy and other commodity supply requirements contracts that do not specify fixed quantities or delivery dates.

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Background

The debtor, MBS Management Services, Inc., was a residential real estate management company that had agreed to purchase electricity from an energy supplier (the Supplier) for certain properties pursuant to 24-month contracts that specified a fixed rate per kilowatt-hour, based on actual metered usage. The post-confirmation trustee for the unsecured creditors' trust later initiated an adversary proceeding against the Supplier to avoid and recover from the Supplier, as preferential transfers under Section 547(b) of the Bankruptcy Code, debtor payments made prepetition to the Supplier on account of the debtor's affiliates' past-due electric bills. The Supplier responded that the prepetition payments it received were exempt from Section 547(b) avoidance because the underlying contract was a "forward contract" that qualified for the Section 546(e) safe harbor protection against such avoidance actions. Following a bench trial, the bankruptcy court held that the underlying agreement was a "forward contract," the transfers in question were "settlement payments" under the Section 546(e) safe harbor and, therefore, the post-confirmation trustee could not avoid and recover the pre-petition payments to the Supplier as preferential transfers. The district court affirmed, and the trustee appealed to the Fifth Circuit.

The Fifth Circuit Decision

The Fifth Circuit affirmed that the bankruptcy court properly determined that the parties' electricity supply agreement was a forward contract exempt from preference recovery under Section 546(e). *Slip Op*. at 14-15. The Fifth Circuit explicitly rejected the trustee's argument that the supply contract could not be a "forward contract" within the meaning of the Bankruptcy Code because it did not specify the quantity of electricity to be purchased or precise delivery dates. *Slip Op.* at 10-11. The Fifth Circuit concluded that the agreement was "well within the class covered" by Bankruptcy Code Section 101(25)'s definition of "forward contract" and the Section 546(e) safe harbor. *Slip Op.* at 10.

The Fifth Circuit reasoned that "close statutory analysis" of Bankruptcy Code terms addressing forward contracts was required, as was undertaken in its prior decision in *In re Olympic Natural Gas,* 294 F.3d 737 (5th Cir. 2002)*,* and said "we rely on the statutory language alone" to conclude that "specific quantity and delivery date" terms are not requirements of the definition of a "forward contract" under Section 101(25) of the Bankruptcy Code or the safe harbor exemption from preference recovery under Section 546(e). *Slip Op.* at 6-7.

The *MBS Mgmt.* court distinguished the Fourth Circuit's decision in *National Gas Distributors*, which observed 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." *Slip Op.* at 8 *(quoting National Gas Distributors,* 556 F.3d at 255 *(emphasis in original))*. The *MBS Mgmt.* court acknowledged that the Fourth Circuit's *National Gas Distributors* opinion "lists 'fixed' 'quantity and time elements' as characteristics of forward agreements." *Slip Op*. at 8. However, the Fifth Circuit said that the Fourth Circuit's opinion had "little bearing" because it was "open-ended" and focused on "forward agreements," the Section 546(g) safe harbor (against fraudulent transfer liability) and the Section 101(53B) definition of "swap agreement" — instead of the Section 546(e) safe harbor (against preference liability) and Section 101(25) definition of "forward contract." *Slip Op*. at 8.

Although the Fifth Circuit recognized "concerns expressed in various cases that payment debtors make on 'ordinary supply contracts' should not be protected from preference litigation," it concluded "these concerns are immaterial when laid against the statutory text." *Slip Op.* at 9. The Fifth Circuit adopted the Bankruptcy Court's finding (based on expert testimony) that "forward contracts for electricity do not typically limit the quantity sold or purchased," and its reasoning that "because forward contracts are

individually negotiated and not exchange-traded, the Bankruptcy Code reasonably forewent encumbering the definition [of 'forward contract'] with technical requirements." *Slip Op.* at 11.

Accordingly, the Fifth Circuit affirmed the bankruptcy court ruling that the Supplier's electricity requirements contract with the debtor was a "forward contract" within the meaning of Section 101(25)(A) of the Bankruptcy Code, and therefore Section 546(e) insulated payments made to the Supplier under the contract from preference liability under Section 547 of the Bankruptcy Code.

Implications

MBS Mgmt. arguably creates a split of authority between the Fifth and Fourth Circuits on the issue of whether requirements contracts (or other commodity supply contracts) without fixed quantity or delivery terms are "forward contracts" for purposes of Section 546 and other safe harbor provisions of the Bankruptcy Code. The *MBS Mgmt.* ruling may be of special importance to investors in energy tax credit driven transactions and agreements that require ongoing supply of electricity or other commodities to a site host or other long-term purchasers. Following *MBS Mgmt.*, investors, energy suppliers and other parties in such transactions may confront less bankruptcy-related risk and uncertainties to the extent their agreements are "forward contracts" within the meaning of Section 101(25) of the Bankruptcy Code. Also, the applicability of bankruptcy safe harbors to energy requirements contracts and similar commodity supply agreements may make it easier for financially distressed companies with energy and commodity supply needs to obtain more flexible and favorable terms from energy and commodity suppliers, even when financial distress is perceived by suppliers who might otherwise avoid entering into contracts with financially distressed companies.

While courts outside the Fifth Circuit are not bound by the *MBS Mgmt.* decision and may or may not follow its reasoning, *MBS Mgmt.* affords the prospect of bankruptcy safe harbor protections to requirements and other commodity supply contracts that do not have fixed quantity and delivery terms.