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Brian King

st. john's UNIVERSITY
SCHOOL OF LAW

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Brian King, J.D. Candidate 2012

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INTRODUCTION

Derivative transactions and financial contracts are a critical component of the United States economy.[1] There are three main types of derivative contracts executed in our markets: futures, options and forward contracts. Each of these instruments derives value from an underlying security or resource with focus on a possible change in its future value. These instruments can be used as speculative investments, as hedges on securities already owned, or as a means of mitigating risk on volatility within a specific industry.[2] An essential attribute of trading in these derivatives is "the ability of the parties to value their transaction on a net basis with the counterparty and to close-out and replace the transaction in the event one party defaults."[3]

Prior to 1982, when one party to these types of transactions filed for relief under the Bankruptcy Code, the finality of the deal remained uncertain. This uncertainty led to a string of piece-meal amendments passed between 1982 and 1990, followed by a wholesale broadening of the bankruptcy safe harbor provisions in 2005 with the passing of the Bankruptcy Abuse

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[1] *E.g.* Eleanor Heard Gilbane, *Testing the Bankruptcy Safe Harbors in the Current Financial Crisis*, 18 AM. BANKR. INST. L. REV. 241 (Spring, 2010).
[2] *See generally,* http://www.sjsu.edu/faculty/watkins/deriv.htm (last visited on Mar. 10, 2012).
[3] *Id.* at 241.

Prevention and Consumer Protection Act ("BAPCPA").[4] "The Safe Harbor Provisions were designed 'to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code.'"[5] Congress wanted to avoid the potentially catastrophic domino effect that might be caused by unwinding settled financial transactions.[6] Essentially, Congress wanted the safe harbor provisions to "protect the financial markets from the destabilizing effects of bankruptcy proceedings for parties to specific commodity and financial contracts."[7]

While safe harbor provisions appear in many sections of the Code,[8] this memo will focus primarily on those afforded by section 546(e) as it relates to forward contracts.[9] In particular, the memo addresses bankruptcy court interpretations of the section with focus on the recently decided, *Lightfoot v. MXEnergy, Inc.*[10] Part I of this memo analyzes sections 546(e) and 101(25) of the Code and bankruptcy courts' scattered interpretation of 'forward contract' under 101(25) as it relates to 546(e). Part II addresses the trend toward expanding the scope of section 546's protection and the evolving definition of forward contract within our courts. Finally, Part III discusses the impact of *Lightfoot*[11] and the policy considerations and practical effects the holding may have for bankruptcy trustees going forward.

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[4] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, PUB. L. NO. 109-8, 119 Stat. 23 (2005); *see* H.R. Rep. No. 109-31, pt. 1, at 7.
[5] *Id.* at 243 (quoting H.R.Rep. No. 101–484 at 1).
[6] *See* H.R. Rep. No. 101-484 at 2.
[7] *In re National Gas Distributors, LLC*, 555 F.3d 247, 252 (4th Cir. 2009).
[8] *See generally* 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 546, 556, 559, & 560 (2006).
[9] 11 U.S.C. § 546(e) (2006).
[10] 2011 WL 1899764 (E.D. La. 2011).
[11] *Id.*

I. Background Analysis: the forward contract's historical interpretation

Forward contracts are not-so-artfully defined in section 101(25) of the Bankruptcy Code ("the Code") 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, 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.[12]

As a result of this rather vague definition, bankruptcy courts have had difficulty interpreting the meaning of forward contracts when used in other sections of the Code.[13]

Even when the language of the statute is parsed down to, "a contract for the purchase, sale or transfer of a commodity . . . with a maturity date more than two days after the date of contract," the exact meaning is not clear, as parties have argued over what "maturity date" and "commodity" should mean. The following, additional text in § 101 (25) above does not provide any additional guidance; it merely gives examples of what a forward contract might be.

The common trade usage meaning of forward contract is that it is a contract that locks in today the price of a good[14] to be delivered at some future date.[15] Forward contracts are used

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[12] 11 U.S.C. § 101(25) (2006).

[13] *Compare In re National Gas Distributors, LLC.*, 555 F.3d 247 (4th Cir. 2009) (holding forward contracts must set terms for quantity, price and time of delivery) *with Williams v. Morgan Stanley Capital Group, Inc. (In re Olympic Natural Gas Co.), 294 F.3d 737 (5th Cir. 2002) (stating nothing about required terms to be considered forward contract but breaking with past decisions in acknowledging forward contracts could be recognized as a negotiated agreement between two market participants).*

across a number of different industries. For example, they are often used by farmers seeking to "lock-in prices of grain for the upcoming fall harvest."[16] Additionally, transportation companies, such as an airline or trucking company, might purchase oil and gas forward contracts to ensure that the price of oil or gas will not exceed a certain threshold in coming months.[17] Finally, as will be seen in the case under review, forward contracts have been used by real-estate management companies to obtain set future prices for electricity and other utility expenses.[18]

The need for a clear definition of forward contracts arises often when a party asserts a defense under section 546(e) to limit the trustee's avoidance power as a preference under section 547 of the Code.[19] Section 546, captioned "Limitations on avoiding powers," provides an array of exceptions to the general ability of trustees and other estate representatives to recover money or property for the benefit of the creditor community generally. Section 546(e) specifically reads:

> 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, or that is a transfer 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

[14] Forward contracts are also used with financial instruments in addition to tangible goods.
[15] *Cf.* http://www.investopedia.com/terms/f/forwardcontract.asp#axzz1pWXpoMYp (last visited on Mar. 16, 2012).
[16] *Id.*
[17] *See* http://www.wisegeek.com/what-are-forward-contracts.htm (last visited Mar. 18, 2012).
[18] *Eg.* Lightfoot v. MXEnergy, Inc., 2011 WL 1899764 (E.D. La. May 19, 2011).
[19] 11 U.S.C. § 547 (2006).

made before the commencement of the case, except under section 548(a)(1)(A) of this title. (emphasis added).[20]

The pre-BAPCPA decisions were pretty much in harmony when it came to addressing 546(e) as it related to exchange-traded future contracts and financial derivatives. Congress, through the pre-BAPCPA amendments and BAPCPA itself "sought to clarify the definitions and increase consistency among the various insolvency laws so as to provide certainty and decrease the risk of systemic failure of our financial markets associated with activities in the derivatives market."[21]

While future contracts have clearly been deemed covered by 546(e), forward contracts have not automatically fallen under this protective umbrella. There are two main reasons for this. First, forward contracts are simply harder for courts to deal with. They lack uniformity in that they are structured, refined and settled as needed by the market participants creating them. Second, forward contracts do not have a central, regulated trading exchange. In contrast, future contracts are exchange-traded and *always* include specific terms for quantity, price, and time of delivery.[22] Future contracts *need* uniformity. The various markets could not facilitate trading in them without it. Futures contracts settle through clearing houses. These clearing brokers need specific terms outlined in order to settle the trades. Clearly defined terms allow the clearing house to simply shuffle the differences in prices around to the proper parties by comparing apples to apples. Accordingly, ease of interpretation and the ongoing concern about mitigation

[20] 11 U.S.C. § 546(e) (2006).
[21] *Gilbane* at 245.
[22] Investopedia definition *available at* http://www.investopedia.com/terms/f/futurescontract.asp#axzz1m0P2Quwg (last visited, Feb 10, 2012).

of systemic risk in the financial market place,[23] assure that bankruptcy courts give future contracts (and to a large degree option contracts) full protection under section 546(e).

Historically, this has not been the case regarding forward contracts. The rationale for non-inclusion of forward contracts was largely based on the perception that unwinding forward contracts did not have the same ripple effect across the market as unwinding settled future contracts transactions. This perception has begun to change.

II. Broadening the scope of §546(e)

With BAPCPA in 2005 and the Financial Netting Improvements Act of 2006,[24] Congress expanded and clarified the safe harbors from avoidance by a bankruptcy trustee for various kinds of payments and other transfers provided in Section 546 of the Code.[25] "Most significantly, to expressly encompass transfers made to or for the benefit of a forward contract merchant[26] . . . in connection with any securities, commodities or forward contracts that are not margin or settlement payments (which were already protected)."[27] The reform was prompted by Congress's fear and recognition of potentially inconsistent treatment due to the piecemeal enactment of the safe harbor provisions; and, by the massive groundswell of trading in derivative and structured products in the middle of the last decade.[28] Because of the importance of the

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[23] Mitigation of such risk is paramount in the marketplace today. *See* Dodd-Frank reform bill.
[24] Pub. L. No. 109-390 (Dec. 12, 2006).
[25] Patterson, Belknap, Webb & Tyler LLP., *The Financial Netting Improvements Act of 2006*, Client Alert (Winter 2006–07) *available at* http://www.pbwt.com/files/Publication/97417e91-fe83-4d0f-80d3-01495055adba (last visited March 18, 2012).
[26] *Id.* (including forward contract merchants among others such as: commodity brokers, stock brokers and securities clearing agencies).
[27] *Id.*
[28] Parantup Basu & William T. Gavin, *What Explains the Growth in Commodity Derivatives?*, FED. RES. BANK OF ST. LOUIS REV. (Jan//Feb. 2011) *available at* http://research.stlouisfed.org/publications/review/11/01/37-48Basu.pdf (last visited Feb 11,

capital, debt and derivative markets as the engine to our economy, Congress's focus was clearly more on exchange-traded financial contracts;[29] which left the judiciary to lead the way in broadening the interpretation of non-exchange-traded forward contracts.

Case law on the subject has expanded the safe harbor provisions for forward contract merchants under 546(e) greatly over the last half decade.[30] The clear trend across many circuits has been to be more inclusionary of contracts protected as forward under 546(e)'s safe harbor provisions.[31] These cases have served to broaden both who and what are protected. Congress and some bankruptcy courts share the opinion that settled financial transactions under contracts termed forward, swap or future are to be broadly construed under section 546 of the code.[32] The burgeoning view across the Circuits in support of broad construction[33] seems to be that unwinding forward contracts can have every bit the far reaching, damaging ripple effects across markets that the unwinding of futures contracts is deemed to have. The broad construction

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2012) (explaining the growth in futures and commodity trading on index fund contracts alone spiked from less than $20 billion in 2002 to over $250 billion in 2008).

[29] *See Id.* at 246.

[30] *See In re Natural Gas Distributors, LLC,* 556 F.3d 247 (4th Cir. 2009); Calpine Energy Services L.P. v. Reliant Electric Solutions, L.L.C. (*In re Calpine Corp.*), No. 05-60200, 2009 WL 1578282 (Bankr. S.D.N.Y. May 7, 2009); *In re Borden Chemicals and Plastics Operating Limited* Partnership, 336 B.R. 214 (D. Del. 2006) (hereinafter "*In re* Borden"); See *also In re American Home Mortgage,* 379 B.R. 503, 520 (Bankr. D. Del. 2008).

[31] *Id.*

[32] *Compare* Jonas v. Resolution Trust Corp. (In re Comark), 971 F.2d 322, 326 (9th Cir.1992) (joining the Third and Tenth Circuits in broadly defining the term settlement payment to include transfers that are normally regarded as part of the settlement process) and *Official Comm. of Unsecured Creditors of The IT Group, Inc. v. Acres of Diamonds, L.P., (In re The IT Group, Inc.),* 359 B.R. 97, 101 (Bankr.D.Del.2006) ("the term settlement payment is to be applied broadly to any transfer of stock or cash to pay for stock," and the fact that the stock was sold privately rather than on the public stock market is not a distinguishing factor) *with* In re Adler, Coleman Clearing Corp., 263 B.R. at 478 ("while the term 'settlement payment' as used in § 546(e) is to be read broadly, the term is not boundless, and thus it must read to include only a transaction involving the public securities market).

[33] Case law would support that this is the view across the 3rd, 4th, 5th and 10th Circuits presently.

rationale is sought to promote stability and to keep market players from feeling inhibited about participating in forward contract transactions.

Prior to the case at the focus of this memo,[34] decisions in two other cases helped set the framework for bankruptcy court's expanding interpretation of 'forward contract'. In *In re National Gas Distributors, LLC.,*[35] where the trustee in the case brought adversary proceedings against former customers of a debtor natural gas company to avoid payments on natural gas forward contracts, the Fourth Circuit held that forward contracts need not be traded on an exchange to be covered by the Code's safe harbor provisions; alternatively, they could be physical in nature, traded via negotiation by parties who are supplying and consuming the commodities/resources involved.[36] The court went on to hold that provided the contract contained hedging components,[37] it was considered outside the realm of a standard supply contract.[38]

The *Natural Gas Distributors* court went so far as to define the elements required to connote a forward contract: 1) it must deal in a commodity; 2) its maturity must be more than 2 days after the date of entry into the agreement; 3) quantity, time of delivery and price must be fixed at the time of the agreement; and 4) (as mentioned above) the subject of the contract need not be traded on an organized exchange.[39] In doing so, the court remanded, proclaiming that the bankruptcy court in the case construed "commodity forward agreements" too narrowly. In dicta,

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[34] *See* Lightfoot.
[35] 556 F.3d 247 (4th Cir. 2009).
[36] *Id.* at 256.
[37] Where one or both of the participant are taking a position on the future value of the underlying commodity to off-set the instant transaction, the management of risk on the contract will likely have influence on the financial markets (as the party that guesses wrong will have to go into that commodity's secondary market to further hedge/correct the misjudgment).
[38] Standard industry supply contracts are not afforded avoidance protection from trustee preference actions under the safe harbor provisions of 546(e).
[39] *Id.* at 259–60.

the court also alluded to the broad construction trend, "[n]otwithstanding the language of the Bankruptcy Code and the generalized language of the legislative history, courts and academics have attempted to define [derivative] agreements based on the functioning of markets."[40] The general inference to be drawn by courts in the Fourth Circuit is to interpret the contract at issue in a way that will lend stability to the market, i.e. as being covered by the safe harbor (provided, of course, it meets the provisions enumerated above).

The Fifth Circuit has construed the forward contract definition even more liberally. The district court in *Williams v. Morgan Stanley Capital Group, Inc. (In re Olympic Natural Gas Co.)*[41] *("Olympic") was actually the first court to recognize forward contracts between two private parties. The court there held that payments from a gas consumer to its supplier were settlement payments on forward contracts under 546(e) and hence, not avoidable as preferences pursuant to the trustee's power under section 547 of the Code.*[42] *The Olympic court considered quantity and time of delivery as required terms of the contract but made no mention of a specific price requirement. The court also aligned forward contracts with the much more legislatively-protected future contracts when it 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."[43]

Such was the state of Fifth Circuit jurisprudence on the topic when the Eastern District of Louisiana was asked to decide Lightfoot v. MXEnergy, Inc.[44]

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[40] *Id.* at 259 (quoting *In re Enron Corp.,* 328 B.R. 58, 69-70 (Bankr.S.D.N.Y.2005)).
[41] *294 F.3d 737 (5th Cir. 2002).*
[42] 11. U.S.C § 547 (2006).
[43] *Id.* at 742.
[44] 2011 WL 1899764 (E.D. La. 2011).

III. *Lightfoot v. MXEnergy, Inc.* and the potential future of forward contracts under § 546(e).

The *Lightfoot* court has given us the broadest possible definition of forward contracts to date. Here, for the first time, a court held that a requirements contract to provide energy to a purchaser, absent a specific quantity, was a forward contract.[45] As a result, payments made under that contract were not avoidable as preferences pursuant to 11 U.S.C § 547 because they were deemed to be settlement payments related to a forward contract. Without specifically stating it, by its omission, the court apparently also dismissed the requirement for a time of delivery provision.

The underlying issue arose under an agreement between MBS Management Services, Inc. ("buyer"), a real-estate management company and MXEnergy, Inc. ("supplier"), who agreed to supply all of the energy requirements for apartments managed by MBS on an ongoing, as-needed basis. Following MBS's bankruptcy filing, the court appointed trustee, Lightfoot, initiated an adversary proceeding to avoid payments made by the buyer to the supplier on the basis that those payments were preferences under 11 U.S.C § 547 (as payments were made monthly and 3 months of payments pre-petition could conceivably have been deemed preferences under the Code if the contract was viewed as a standard supply contract). The defendants asserted that, as a forward contract merchant, the payments made by the buyer were settlement payments made pursuant to a forward contract and, as such, they could not be avoided under section 547 based on the limitations set forth in 11 U.S.C § 546(e). The court agreed.[46]

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[45] *Id.*
[46] *Id.*

The *Lightfoot* court dismissed the elements laid out in *Natural Gas Distributors* as to quantity and price, stating that its decision was not controlling in the Fifth Circuit.[47] According to the court, requiring a quantity term would only serve to impose an artificial limitation on section 546(e) and unnecessarily unwind statutorily-protected, settled financial transactions. The court correctly points out "[n]othing in the Bankruptcy Code requires that a forward contract provide for the purchase of the commodity at a set price or quantity."[48] The court held that the primary risk to electricity purchasers is price volatility, not supply amount. And price volatility is the exact reason for hedging via forward contract in the first place.

"The mere fact that the electricity service agreement executed pre-petition by the Chapter 11 debtor and power company was not for a set quantity . . . did not preclude it from being a forward contract within the meaning of the Bankruptcy Code."[49] Once the court deemed the supplier a forward contract merchant as defined by § 101(26)[50] and dismissed the quantity requirement, the contract met every other element of a forward contract and hence, was deemed non-avoidable under section 547.

Conclusion

In its recognition of a new non-avoidable type of forward contract for utility suppliers, the *Lightfoot* court's decision imposes another avoidance hurdle for bankruptcy trustees to navigate. Furthermore, given the broad definition of commodity set forth in 7 U.S.C.

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[47] *Id.*
[48] *Id.* at 578–79.
[49] *Id.*
[50] 11 U.S.C. § 101(26) (2006) (emphasizing that because MX was in the business of buying and selling electrical power – not actually producing it – it was simply making a market in the commodity).

§ 1(a),[51] there's a host of potential products that may fall under that heading moving forward. Resources such as potable water, bandwidth and satellite signal space could be swept under the broad commodity header in the near and intermediate future. Given the lucrative markets that these potential commodities would create, a debtor's inability to avoid and recover payments made on forward contracts to procure them could be a substantial boon to creditors operating in these arenas. Relying on *Lightfoot,* creditors on the supply side of such requirements contracts will be secure in the knowledge that payments made toward those contracts will be theirs to keep.

[51] 7 U.S.C. § 1(a) (2010) (including in the broad definition of commodity "all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.").