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Fifth Circuit Upholds Broad Reading of Forward Contract in Applying Safe Harbor of Section 546(e) to a Requirements Contract

On August 2, 2012, the United States Court of Appeals for the Fifth Circuit issued a decision in Lightfoot v. MXEnergy Electric, Inc. (In re MBS Management Services., Inc.), No. 11-30553, __ F. 3d ___, 2012 WL 3125167 (5th Cir. 2012), upholding the dismissal of a preference action seeking to avoid transfers received by an electricity merchant pursuant to a requirements contract. Applying a plain-text reading of the definition of "forward contract," the Fifth Circuit concluded that a requirement contract which "contained neither a specific quantity of electricity to be purchased nor specific delivery dates" qualified as a forward contract and that transfers thereunder were safe-harbored from avoidance by Section 546(e).

Background

In December 2005, MBS Management Services, Inc. ("MBS"), a property manager in Texas and Louisiana, entered into an agreement "to purchase the full electric requirements" for specified properties from MXEnergy Electric, Inc. ("MX") for two years at a set price. In late August 2007, MBS paid MX to cover certain past-due electric bills. Shortly thereafter, MBS commenced voluntary bankruptcy proceedings under Chapter 11 of the Bankruptcy Code.

The MBS Trustee sought to avoid the payments made by MBS to MX as preferences. The parties stipulated that all of the requirements of a preference action existed, and the only issue before the court was whether the transfers were safe-harbored under Section 546(e), which protects from avoidance certain payments and other transfers made pursuant to forward contracts. The Trustee argued that Section 546(e) was not applicable because MBS's contract with MX did not provide for a specific quantity to be delivered or a precise date of delivery and for that reason was not a "forward contract."

Fifth Circuit's Ruling

The Fifth Circuit rejected the Trustee's argument. The Court started its analysis by focusing on the Bankruptcy Code's definition of a forward contract, which provides that a "forward contract" means "a contract . . . for the purchase, sale or transfer of a commodity . . . with a maturity date more than two days after the date the contract is entered into . . . ." The Fifth Circuit applied the plain language of the Bankruptcy Code to reject the Trustee's argument, noting that neither the definition of a forward contract nor Section 546(e) of the Bankruptcy Code contains "the Trustee's proffered requirements of specific quantity and delivery date."

The Fifth Circuit then considered the Trustee's alternative argument that because the contract between MBS and MX lacked a delivery date, there was no "maturity date" in the contract. Describing the Trustee's argument as "nonsense," the Court explained that merely because a contract does not specify a maturity date does not mean that it does not have one.

In its ruling, the Fifth Circuit expressly distinguished In re National Gas Distributors, LLC, 556 F.3d 247 (4th Cir. 2009), in which the Fourth Circuit had held that the price, quantity and performance date terms must be specified in the contract in order for the contract to qualify as a "commodity forward agreement" within the meaning of the Bankruptcy Code. At least one bankruptcy court in the Fourth Circuit, deciding a case on remand from the Fourth Circuit's decision in National Gas Distributors, held that a requirements contract was not a safe-harbored contract. Hutson v. M.J. Sofee Co, 412 B.R. 758 (Bankr. E.D.N.C. 2009). In contrast, the Fifth Circuit held that while fixed terms can establish the existence of a forward contract, a lack of such terms does not mean that a forward contract does not exist. See MXEnergy, 2012 WL 3125167, at **2-3. It is not clear that the holdings of the Fifth and Fourth Circuits on this issue can be reconciled.

Finally, the Fifth Circuit rejected as "dubious" the Trustee's argument that for the safe harbor to apply, both parties to the transaction must be commodities merchants, noting that the plain language of Section 546(e) protects payments "made by or to" a forward contract merchant.

The Court observed that if the Trustee's arguments were correct it would exclude many natural gas, fuel and electricity requirements contracts from the Section 546(e) safe harbor, which would undermine the Congressional intent to exempt payments made pursuant to forward contracts from avoidance as preferences.

The Fifth Circuit's decision in MBS continues the recent trend of courts broadly reading the safe harbors by interpreting them solely in accordance with the plain language of the statute. See, e.g., Enron Creditors Recovery Corp. v. Alfa, S.A. B. de C.V. (In re Enron Creditors Recovery Corp.), 651 F.3d 329 (2d Cir. 2011); Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011).

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of the partners and counsel listed under "Bankruptcy and Restructuring" in the "practices" section of our website (www.clearygottlieb.com).

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