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Fifth Circuit Holds that Supply Agreement is a "Forward Contract" for Bankruptcy Avoidance Protection

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On August 2, 2012, the United States Court of Appeals for the Fifth Circuit issued a decision in the bankruptcy case for MBS Management Services, Inc. (the "Debtor"). The Fifth Circuit affirmed the district court's opinion finding that an electric requirements agreement was a "forward contract" and, therefore, that payments made on the agreement were exempt from avoidance under the Bankruptcy Code.

I. Factual Background

The Debtor provided management services for apartment complexes in Texas and Louisiana. In 2005, it agreed to purchase the "full electric requirements" for specified properties from MCEnergy Electric, Inc.'s ("MX") predecessor for twenty four months at a set price based on actual usage. In 2007, the Debtor paid $156,345.93 to MX to cover past-due electric bills.

Shortly thereafter, the Debtor filed a voluntary petition under chapter 11 of the Bankruptcy Code. The Trustee initiated an adversary proceeding in the bankruptcy court to recover the $156,345.93 from MX as an avoidable preferential transfer under 11 U.S.C. § 547(b).

II. The Fifth Circuit Decision

The Debtors and MX stipulated that the requirements of a preference action were met – the payments were made within ninety days of the bankruptcy filing, while the Debtor was insolvent, and entitled MX to more than it would have received in a chapter 7 liquidation under the Bankruptcy Code. The dispute between the Debtor and MX focused on whether the electric requirements agreement was a "forward contract" under section 101(25)(A) of the Bankruptcy Code and, as such, exempt from avoidance under section 546(e). The bankruptcy court and the district court each held that the payments were made on a "forward contract." The Fifth Circuit agreed.

Section 101(25)(A) defines a "forward contract" as "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 . . . ." Section 546(e), in turn, exempts "a transfer that is a . . . settlement payment . . . made by or to [a] . . . forward contract merchant" from various bankruptcy avoidance statutes.

The Trustee argued that the electric requirements agreement was not a "forward contract" because it did not contain a specific quantify of electricity to be purchased, specific delivery dates, or a maturity date. The Fifth Circuit disagreed. Focusing on the language of sections 101(25) and 546(e), the Fifth Circuit held that an

agreement need not contain specific quantities or delivery dates to in order to qualify as a "forward contract" for purposes of the Bankruptcy Code. The Fifth Circuit also dismissed the Trustee's argument concerning the agreement's maturity date because no delivery was scheduled to occur less than two days after the agreement's execution and because the absence of a maturity date was not per se evidence that the agreement did not have a maturity date. In so doing, the Fifth Circuit enforced the plain language of section 101(25) and section 546(e) and emphasized that the definition of "forward contracts" is not encumbered with technical requirements precisely because such contracts are individually negotiated and not exchange-traded.

III. Potential Implications

When a company files for bankruptcy, it is entitled to take various actions to protect and maximize its assets. Such actions include clawing back payments that it made to creditors in the ninety days preceding bankruptcy. But certain payments made pursuant to "forward contracts," as defined in the Bankruptcy Code, are protected against claw back.

Prior to the Fifth Circuit's decision, there had been some doubt raised as to whether supply contracts constitute "forward contracts." The Fifth Circuit's decision, however, affirms the age-old adage that if it quacks like a duck, it is a duck. Thus, if an agreement qualifies as a "forward contract" under the plain language of section 101(25) of the Bankruptcy Code, even if it is a supply contract or does not include certain contract terms such as quantity or delivery date, payments made pursuant to that agreement may be entitled to the protections of the Code against claw back.

In practice then, no energy provider should pay to settle a claw back action before first analyzing whether the agreement at issue is a "forward contract" under the Bankruptcy Code and, as such, is entitled to heightened protection under the Bankruptcy Code.

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For further information or to discuss the impact of the Fifth Circuit's decision on your business, please contact Jonathan Guy, Kate Orr or James Burke.