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SPECIAL BULLETIN

In re MBS Management Services, Inc.: Is a Requirements Contract Eligible for Safe Harbor Protection?

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In a recent decision, *In re MBS Management Services, Inc.*, No. 09-1158, 2010 WL 1851077 (Bankr. E.D. La. May 7, 2010), a Louisiana bankruptcy court examined whether a requirements contract qualified as a “forward contract” and was entitled to the protections of the safe harbor provisions of the United States Bankruptcy Code. The court concluded that a requirements contract may so qualify, upon a showing that such a contract enables the parties to hedge risk associated with the particular commodity. The court disagreed with a North Carolina bankruptcy court, which in *Hutson v. M.J. Soffe Co. (In re National Gas Distributors, LLC)*, 412 B.R. 758 (Bankr. E.D.N.C. 2009) had denied safe harbor protection to a requirements contract because the quantity term was not fixed at the time of contracting.

Background

The United States Bankruptcy Code, 11 U.S.C. § 101 et seq. (the “Code”) provides special protections to counterparties under certain “safe harbor” contracts, such as forward contracts and swap agreements. These protections include: (i) the ability to exercise contractual rights to terminate the contract as a result of the debtor’s insolvency or bankruptcy filing, (ii) the ability to exercise setoff or netting rights and to apply collateral free of the automatic stay, and (iii) immunity from preferential or constructively fraudulent transfer actions.

The 2005 and 2006 amendments to the Code have expanded the scope of parties and transactions entitled to the benefit of these safe harbor provisions, yet some bankruptcy courts have been reluctant to read these provisions expansively, particularly in the area of agreements to physically supply commodities to an end user. This concern was summarized by the court

in *Hutson v. Smithfield Packing Co., Inc. (In re National Gas Distributors, LLC)*, 369 B.R. 884, 900 (Bankr. E.D.N.C. 2007) as follows:

If *this* agreement is a swap agreement, then many of the most important aspects of the Code, including priorities of distributions to creditors and the automatic stay, will be eviscerated in even the smallest case of a farmer who contracts to sell his hogs at the end of the month for a set price.

The bankruptcy court concluded that the swap agreement protections were designed to protect the financial markets, and that a contract for the physical supply of a commodity to an end user was not eligible for safe harbor protection as a “commodity forward agreement” within the “swap agreement” definition. Thus, “forward agreement” could only apply to “financial instruments that are themselves regularly the subject of trading” in a financial market, and not to “a contract of the kind at issue here, which is simply an agreement by a single end-user to purchase a commodity.” *National Gas Distributors*, 369 B.R. at 898-99.

On appeal, the Fourth Circuit reversed, stating that the bankruptcy court improperly narrowed the construction of the term “commodity forward agreement” by excluding physical supply contracts, and rejecting the bankruptcy court’s characterization of the contracts as “simple supply contracts” because “they were also part of a series of contracts by which the customers hedged their risk of future fluctuations in the price of natural gas.” *In re National Gas Distributors, LLC*, 556 F.3d 247, 257 (4th Cir. 2009). In this manner, even a “simple supply agreement” could have an influence on the broader markets that Congress intended to protect. *Id.*

The Fourth Circuit remanded the case with guidance in the form of “certain nonexclusive elements that the statutory language appears to require.” *Id.* at 259. These elements, according to the *dicta* of the Fourth Circuit, are: (i) the subject matter of the contract must be a commodity, (ii) the contract must be for delivery more than two days after the date of entry into the contract, at a price fixed at the time of contracting, (iii) the quantity and time elements must be fixed at the time of contracting, and (iv) a contract is not precluded simply because it contemplates physical delivery, or is not assignable or traded on a market or exchange. *See id.* at 260-61.

The bankruptcy court had occasion to apply the Fourth Circuit’s *dicta* in another adversary proceeding in the same case. In *Hutson v. M.J. Soffe Co. (In re National Gas Distributors, LLC)*, 412 B.R. 758 (Bankr. E.D.N.C. 2009), the bankruptcy court described the Fourth Circuit *dicta* as “distinguishing hallmarks required of a commodity forward agreement,” *id.* at 763,¹ and refused to extend safe harbor protection to a natural gas requirements contract, since the quantity of gas to be delivered was not fixed at the time of contracting. *Id.* at 764-66.

In support of this requirement, the court observed that the *Wall Street Journal* quotes future or commodity contracts by price and quantity. Here,

[T]he customers' decision to not specify a quantity in the contracts at issue is based not on any unavoidable requirement intrinsic to the physical delivery of natural gas, but rather on their choice to leave quantity open because it apparently best suited their business needs. The NAESB base contract itself distinguishes between “Firm (Fixed Quantity)” delivery, “Firm (Variable Quantity)” delivery, and “Interruptible” delivery. Soffe, as well as most

of the other defendants, chose a form of variable quantity delivery. The court of appeals made clear that the fact of physical delivery does not disqualify a contract from being a commodity forward agreement, but the court at no point suggested that a buyer's choice to receive physical delivery without specifying a set quantity negates the quantity requirement. Because the contractual arrangements between Soffè and National Gas did not provide for delivery of a fixed quantity of natural gas, or anything even close to a fixed quantity, the agreements do not qualify as commodity forward agreements and do not come within the swap agreement safe harbor. The trustee is entitled to summary judgment on this issue.

Id. at 766.

The MBS Management Decision

In *MBS Management*, the trustee of a creditors' trust sued MX Energy to avoid preferential or fraudulent transfers made in connection with an electricity requirements contract. The trustee argued that the parties' contract was not a forward contract, in part because it lacked "the hallmarks of a hedging or forward transaction. Despite forward delivery of a commodity at a set price, the Trustee argues that the quantity to be delivered is not defined but subject to the demands of [the debtor]. As a result, the contract does not set both price and quantity to be sold providing an imperfect hedge for MX." *MBS Management*, 2010 WL 1851077 at *5.

The court rejected what it termed the "one size fits all" approach taken by the bankruptcy court in *National Gas*, and disagreed with the *National Gas* court's reliance on *Wall Street Journal* quotations, which are quotations for exchange-traded contracts.

Instead, the court indicated that a review of industry standards, risks and market practices was needed in order to determine whether a particular transaction fit within the forward contract definition. In this case, such evidence was not in the record (precluding summary judgment), but the court suggested that

the primary risk to those purchasing electricity is price volatility, not supply. As a result, a contract that locks in a set price is a hedge against the primary risk to both buyer and seller. If such a premise were proven, the contract at issue might well fall within the bounds of a forward contract because it would manage the risk most prevalent for the commodity.

Id. at *6.

Conclusion

The *National Gas* court clearly was concerned about the slippery slope: given the powerful protections afforded by the safe harbor provisions, applying them to a broad range of "ordinary" supply agreements would have a far reaching impact on bankruptcy reorganizations. However, the requirement of a fixed quantity is nowhere to be found in the statutory language of the forward contract and swap agreement definitions, and has the potential to deny protection to contracts that do hedge risks and thus implicate broader financial markets. By rejecting this extra-statutory bright line requirement, and instead looking to industry standards, risks and market practices, the *MBS Management* decision strikes a better balance between over- and under-inclusion.

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1. The bankruptcy court acknowledged the Fourth Circuit's discussion of hedging, but chose not to consider the presence of hedging elements because hedging was not one of the four requirements enumerated by the Fourth Circuit. *See id.* at 763 n.1.

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