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Testing The Waters of the Safe Harbor

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Introduction

Payments made under supply-of-goods contracts, or contracts for the sale of goods, are often the subject of bankruptcy avoidance actions. Sections 546(e) and (g) of the Bankruptcy Code (11 U.S.C. § 546(e) and (g)) prohibit the avoidance and recovery of preferential and constructively fraudulent transfers made in connection with forward contracts and swap agreements. Specifically, section 546(e) protects settlement payments made to a forward contract merchant in connection with a forward contract, whereas section 546(g) protects transfers made to a swap participant in connection with a swap agreement.

At first blush, sections 546(e) and (g) seemingly apply exclusively to forward contracts and swap agreements relating to financial markets. Indeed, in amending several of the safe-harbor provisions in 1982, Congress explained that, "the amendments are intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583. Yet, despite Congress's intentions, the terms "forward contract," "forward contract merchant," "settlement payment," and "swap agreement" are so broadly defined that they arguably encompass transfers made in connection with ordinary supply-of-goods contracts. This article explores the Bankruptcy Code's safe harbors and the ambiguities that can arise when dealing with such contracts.

Section 546(e) and Forward Contracts

Except for actual fraudulent transfers, section 546(e) prevents a bankruptcy trustee from avoiding and recovering: (1) a transfer that is a settlement payment made by or to (or for the benefit of) a forward contract merchant; or (2) a transfer made by or to (or for the benefit of) a forward contract merchant in connection with a forward contract that is made before the commencement of the case. Thus, to establish a section 546(e) defense, a defendant must show that: (1) the underlying agreement between the parties is a forward contract; (2) one of the parties to the agreement is a forward contract merchant; and (3) the transfers at issue constitute settlement payments.

Establishing the Existence of a Forward Contract

A party must first establish the existence of a forward contract to invoke section 546(e). The Bankruptcy Code defines a "forward contract," in relevant part, as a contract for the sale of a commodity that is presently or in the future becomes the subject of dealing in the forward contract trade with a maturity date more than two days after the date into which the contract is entered. In defining "forward contract," Congress stated that the "primary purpose of a forward contract is to hedge against possible fluctuations in the price of a commodity. This purpose is financial and risk-shifting in nature, as opposed to the primary purpose of an ordinary commodity contract, which is to arrange for the purchase and sale of the commodity." H.R. Rep. No. 101-484, at 4 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 226. Although legislative history relating to forward contracts indicates otherwise, the Bankruptcy Code's definition arguably is broad enough to encompass ordinary supply-of-goods contracts so long as the contract: (1) is for the purchase, sale, or transfer of a commodity or any similar good that is presently or in the future becomes the subject of dealing in the forward contract trade; and (2) has a maturity date more than two days after the date into which the contract is entered.

The broad scope of the term "forward contract" can be limited only by its elements. As for the first element, the Bankruptcy Code specifically defines a "commodity" as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats, oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, frozen concentrated orange juice, *and all other goods and articles in which contracts for future delivery are presently or in the future dealt in*. Given this broad, and circular, definition of "commodity," nearly any and all goods and articles will fall within its scope.

However, the term "commodity" must be "the subject of dealing in the forward contract trade" to fall within the scope of a forward contract. The Bankruptcy Code does not define the term "forward contract trade." In the context of an ordinary supply-of-goods contract, a litigator could introduce expert testimony to establish that such a contract does not involve a commodity involved in the forward contract trade. Still, the litigator likely will face an uphill battle, as numerous goods and articles are the subject of dealing in the forward contract trade.

As for the second element of a forward contract, the Bankruptcy Code does not define the term "maturity date." Courts have reached differing conclusions on the term's meaning. For instance, some courts have held that the maturity date is the date of delivery, while others have held that it is "the future date at which the commodity must be bought or sold." *McKittrick v. Gavilon, LLC (In re Cascade Grain Prods., LLC)*, 465 B.R. 570, 575 (Bankr. D. Or. 2011).

This lack of consensus is ripe for a savvy litigator to explore. For example, a typical supply-of-goods relationship involves a purchase order for certain goods, delivery of the goods, and payment in full 30 days after delivery. It is unclear at what point the maturity date occurs in such a relationship, if one occurs at all. A litigator could argue that the contract fully matures when the purchase order is issued, when the goods are delivered, or when payment is received. A litigator could even argue that the contract lacks a maturity date, as once the purchase order is issued and accepted, the parties' obligations have matured. Finally, a litigator could introduce expert testimony to limit the scope of the term "maturity date" to its traditional meaning in the financial markets.

The Forward Contract Merchant Requirement

Having established the existence of a forward contract, one of the parties to the contract must be a forward contract merchant to invoke section 546(e). The Bankruptcy Code defines in section 101(26) a "forward contract merchant" in relevant part as "an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity or any similar good . . . which is presently or in the future becomes the subject of dealing in the forward contract trade." Courts and commentators alike have interpreted this definition broadly and narrowly. For instance, Collier on Bankruptcy ¶ 556.03[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) provides that "[t]he language 'in whole or in part' in th[e] definition substantially broadens its coverage to include any person that enters into forward contracts as or with merchants in a commodity business context." At least one bankruptcy court has followed Collier's broad definition, which arguably would apply to supply-of-goods contracts.

Other courts, however, have followed a narrower definition espoused by Judge Dennis M. Lynn in *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.)*, 310 B.R. 548 (Bankr. N.D. Tex. 2004). In that case, Judge Lynn focused on the undefined terms "business" and "merchant" within the term "forward contract merchant" and found that the definition is limited in scope. Specifically, Judge Lynn defined "merchant" as "one that is *not* acting as either an end-user or a producer. Rather, a merchant is one that buys, sells, or trades in a market." Judge Lynn further defined "business" as "something one engages in to generate a profit." Accordingly, the court defined a forward contract merchant to be "a person that, in order to profit, engages in the forward contract trade as a merchant or with merchants," with "merchant" meaning an individual or entity that is not acting as either an end-user or a producer. This construction gives effect to all parts of the definition because "[w]ithout references to 'business' and 'merchant,' the definition of 'forward contract merchant' could as easily have been 'a person that enters into forward contracts.'" Most courts have adopted this interpretation over Collier's construction.

Judge Lynn's interpretation, if followed, might preclude the application of section 546(e) to an ordinary supply-of-goods contract. In such a context, a buyer simply purchases goods from a supplier. The buyer is an end-user and the supplier is a producer. To fall within the definition's scope, a merchant would have to buy, sell, or trade the underlying contract in a financial market. This interpretation is not only logical, but also gives effect to Congress's overall intentions in enacting section 546(e).

Transfers as Settlement Payments

Once the existence of a forward contract and forward contract merchant are established, a defendant must finally show that the transfers at issue constitute settlement payments. The Bankruptcy Code at section 101(51A) defines a "settlement payment" as, "for purposes of the forward contract provisions of this title, a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." Although tautological, courts have held that a commodity settlement payment must, at a minimum, be some kind of payment on a commodity forward contract. Therefore, any payment on account of a forward contract likely falls within the definition, making this element easily met.

As the foregoing discussion demonstrates, the requirements to enter the safe harbor are seemingly straightforward, but the definitional issues may make section 546(e) much broader than Congress intended.

Section 546(g) and Swap Agreements

If unable to meet any of the elements contained in section 546(e), a party may seek protection under section 546(g). Except for actual fraudulent transfers, section 546(g) prohibits a bankruptcy trustee from avoiding a transfer made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement that is made before the commencement of the case. To establish a section 546(g) defense, a defendant must show that: (1) the parties entered into a "swap agreement"; (2) one of the parties to the swap agreement is a "swap participant" or "financial participant"; and (3) the transfer was made "under or in connection with" the swap agreement. The second and third elements rarely are litigated because the essential element is whether a swap agreement exists. If a swap agreement exists, section 546(g) undoubtedly will be satisfied because the transfer sought to be avoided will be in connection with a swap agreement to a "swap participant," which is defined as an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor.

Establishing the Existence of a Swap Agreement

The Bankruptcy Code defines a "swap agreement" broadly as, in relevant part, a commodity index or a commodity swap, option, future, or forward agreement. Although the Bankruptcy Code defines a "forward contract," it does not define a "commodity forward agreement." The leading and only authoritative case on the term "commodity forward agreement" is the Fourth Circuit's decision in *Hutson v. E.I. du Pont de Nemours & Co. (In re National Gas Distributors, LLC)*, 556 F.3d 247, 259–60 (4th Cir. 2009). In that case, the Fourth Circuit held that a commodity forward agreement exists when the following are present: (1) the subject of the agreement must be a commodity; (2) the agreement must require a payment for the commodity at a price fixed at the time of contracting for delivery more than two days after the date into which the contract is entered; (3) the quantity and time elements of the agreement must be fixed at the time of contracting; and (4) the agreement must have a relationship with the financial markets (although it need not be traded on an exchange or be assignable).

Subject to the previous discussion regarding section 546(e), the first three elements for a swap agreement likely will be met in the context of an ordinary supply-of-goods contract. Yet, the contract must also have a relationship with the financial markets. Whether this is the case depends on the terms of the contract. For instance, a purchase order for oil could have a relationship to the financial markets if the price of the oil depends on the overall market price for oil. On the other hand, a purchase order for corn at a fixed price likely lacks a relationship with the financial markets. Again, a litigator could use expert testimony to determine whether the agreement has such a relationship.

To be fair, *Hutson*'s interpretation of "commodity forward agreement" is problematic because it nullifies the forward contract merchant requirement that exists in section 546(e). In other words, a contract that does not meet the definition of "forward contract" for purposes of section 546(e) may meet the requirements of a forward agreement for purposes of section 546(g). In reaching its decision, the court in *Hutson* determined that the term "agreement" is broader than the term "contract": "As *Black's* states, the term 'agreement,' although frequently used as synonymous with the word 'contract,' is really an expression of greater breadth of meaning and less technicality. Every contract is an agreement; but not every agreement is a contract." Using *Hutson*'s definition, any party to a commodity forward agreement can invoke the safe-harbor protections, even if neither party is a forward contract merchant.

Whether this was Congress's intention is unclear. On the one hand, Congress seemingly intended a broad definition by stating that "[t]he use of the term 'forward' in the definition of 'swap agreement' is not intended to refer only to transactions that fall within the definition of 'forward contract.' Instead, a 'forward' transaction could be a 'swap agreement' even if not a 'forward contract.'" H.R. Rep. No. 109-31, at 122 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 184. On the other hand, Congress also stated that "[t]he definition of 'swap agreement' . . . should not be interpreted to permit parties to document non-swaps as swap transactions. Traditional commercial arrangements, such as supply agreements . . . cannot be treated as 'swaps' under . . . the Bankruptcy Code because the parties purport to document or label the transactions as 'swap agreements.'"

As of now, the *Hutson* elements, if followed, would protect any commodity forward agreement that has a relationship with the financial markets, even if neither party is a forward contract merchant. Similar to section 546(e), the definitional issues of section 546(g) may render section 546(g) broad enough to encompass supply-of-goods contracts.

Conclusion

Congress's adoption of sections 546(e) and 546(g) has created unintended results. Although clearly seeking to protect transfers made in connection with forward contracts and swap agreements relating to financial markets, Congress may have inadvertently protected transfers made in connection with ordinary supply-of-goods contracts. If the legislative history surrounding the safe-harbor provisions accurately reflects Congress's intentions, the provisions should be amended to expressly exclude supply-of-goods contracts. As it currently stands, litigators that prosecute or defend bankruptcy avoidance actions should familiarize themselves with the safe-harbor provisions because their ambiguities may present unanticipated curveballs in what normally are considered straightforward avoidance actions.

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