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One Step Back? Ohio Bankruptcy Court Finds That a Hedging Power Purchaser Is Not a "Forward Contract Merchant" Entitled to the Bankruptcy Code Safe Harbor Protections

By James Heiser and Steven Wilamowsky*

The U.S. Bankruptcy Court for the Northern District of Ohio has found that a "forward contract merchant" must be in the business of entering into forward contracts in order to generate a profit, not merely as a hedge. This article explains the decision, which serves as a warning for parties that hedge their exposure to various commodities that they may be unable to terminate or renegotiate unfavorable contracts when their counterparty files for bankruptcy.

In a case of particular significance to parties that enter into forward contracts as means of hedging the future price of commodities used in their business, the U.S. Bankruptcy Court for the Northern District of Ohio has found that a "forward contract merchant" must be in the business of entering into forward contracts in order to generate a profit, not merely as a hedge. The court also refused to enforce a contractual provision—common in many power purchase agreements—that each party was a "forward contract merchant." The court found that a party that terminated a power purchase agreement had violated the automatic stay and was not entitled to the protections of the "safe harbor" protections for forward contracts in the Bankruptcy Code. The court ultimately adopted the narrow interpretation of "forward contract merchant" set forth in the *Mirant* case from the U.S. Bankruptcy Court for the Northern District of Texas, and rejected the broader interpretation adopted by the U.S. Bankruptcy Court for the District of Delaware in the *Borden Chemicals* case.

Although the court has yet to decide what sanction to apply, this case serves as a warning for parties that hedge their exposure to various commodities that they may be unable to terminate or renegotiate unfavorable contracts when their counterparty files for bankruptcy.

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THE CASE

On March 31, 2018, First Energy Solutions Corp. and several affiliates filed for bankruptcy (collectively, the "Debtors"). On July 3, 2018, the Debtors filed a motion to enforce the automatic stay (the "Motion") seeking to hold Meadville Forging Company, L.P. ("Meadville") in contempt for violating the automatic stay. Meadville was a party to a power purchase agreement called a Customer Supply Agreement ("CSA") with one of the Debtors, First Energy Solutions Corporation ("FES"), which engages in the purchase and sale of electricity in the retail market for profit. Meadville is in the forging business and entered into the CSA to hedge the price of electricity—it does not trade or sell electricity.[1]

Section 365(e) of the Bankruptcy Code generally makes defaults that are conditioned on a bankruptcy filing unenforceable. In most cases, the automatic stay also prevents a counterparty from unilaterally terminating contracts with the debtor.[2] However, in order to preserve the proper functioning of the commodities markets, Congress has preserved the right to terminate certain contracts, such as forward contracts, upon a counterparty's bankruptcy.[3] Section 556 is among the "safe harbor" provisions in the Bankruptcy Code. Under the "safe harbor" provisions, the right to terminate certain contracts and exercise certain other remedies is not stayed.[4]

The CSA between Meadville and FES contained a common provision wherein the parties "acknowledge and agree that the transaction contemplated under [the CSA] constitutes a "forward contract" with the meaning of the United States Bankruptcy Code, and the Parties further acknowledge and agree that each Party is a "forward contract merchant" within the meaning of the . . . Bankruptcy Code."[5] The CSA also included a provision that provided that a party would be in default if the party or its guarantor file for bankruptcy.[6]

The Bankruptcy Code defines a "forward contract merchant" to mean "a Federal reserve bank, or *an entity the business of which consists* in whole *or in part of entering into forward contracts as or with merchants in a commodity* (as defined in section 761) or any similar good, article, service, right, or interest which is

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[1] *In re FirstEnergy Solutions Corp.* (Bankr. N.D. Ohio Jan. 15, 2019).

[2] 11 U.S.C. § 362(a).

[3] 11 U.S.C. § 556.

[4] 11 U.S.C. § 362(b)(6).

[5] *FirstEnergy*, *supra* note 1.

[6] *Id.*

presently or in the future becomes the subject of dealing in the forward contract trade."[7] After FES filed for bankruptcy, Meadville sent a letter on April 17, 2018, stating that it was terminating the CSA. On April 27, 2018, Debtors' counsel wrote to Meadville's counsel, asserting that the termination of the CSA was a violation of the automatic stay and that the parties' agreement to "forward contract merchant" status was unenforceable.

Meadville responded on May 1, 2018. Meadville stated that it was free to terminate the CSA pursuant to the Section 556 "safe harbor," notwithstanding the automatic stay, on the grounds that it was a forward contract merchant, that its contract with FES was a forward contract, that the contract contained a so-called "*ipso facto* clause" permitting a non-debtor party to terminate the contract once its counterparty became a bankruptcy debtor, and that the prohibition against enforcing such *ipso facto* clause pursuant to 11 U.S.C. § 365(e) did not apply.[8]

On July 3, 2018, the Debtors moved to enforce the automatic stay and to hold Meadville in contempt for violating the automatic stay. In the dispute, the parties stipulated that electricity is a "commodity" and that the CSA is a "forward contract" as defined in the Bankruptcy Code.[9] Courts have defined a "forward contract" in a broad manner to include "contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade."[10] Thus, the question of the applicability of the safe harbor protections turned on whether Meadville met the definition of "forward contract merchant."

The court concluded that Meadville's "business" did not consist, even in part, of entering into forward contracts as or with merchants in electricity. The court looked to a ruling in the *Mirant* case that defined a "merchant" as "one that is not acting as either an end-user or a producer . . . rather . . . is one that buys, sells or trades in a market."[11] The court also noted that the *Mirant* court concluded that a "business" is something one engages in to generate a profit.[12] Putting these terms together, the court concluded that in order to be a forward

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[7] 11 U.S.C. § 101(26) (emphasis added).

[8] The electricity market in Pennsylvania allowed Meadville to unilaterally stop receiving electricity from FES by sending a "drop notice."

[9] *FirstEnergy*, *supra* note 1.

[10] *See In re Olympic Natural Gas Co.*, 294 F.3d 737, 741 (5th Cir. 2002).

[11] *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.)*, 310 B.R. 548, 567 (Bankr. N.D. Tex. 2004).

[12] *FirstEnergy*, *supra* note 1.

contract merchant, the party's "business" must consist, in whole or in part, of entering into forward contracts for the purchase and sale of electricity to *generate a profit*.[13] Entering into supply contracts as a hedge as an end user is not sufficient.

The court rejected the conclusion reached in another frequently cited case, *In re Borden Chemicals and Plastics Operating, L.P.*,[14] which gave effect to the "in part" provision of Section 556, finding that "essentially any person that is in need of protection with respect to a forward contract in a business setting should be covered, except in the unusual instance of a forward contract between two nonmerchants who do not enter into forward contracts with merchants."[15] The *FirstEnergy* court ultimately adopted the approach in the *Mirant* case, concluding that the *Borden Chemicals* formulation would lead to virtually every person that is a party to a contract for goods or services being permitted to ignore the automatic stay.[16]

The court ultimately reached a somewhat different result than a case that many practitioners have looked to from an Arizona bankruptcy court, which adopted a broader interpretation that permitted many hedging contracts to qualify for the safe harbor protections. In *In re Clear Peak Energy, Inc.*,[17] the court acknowledged the common definition of a "merchant," but concluded that the counterparty in that case, Southern California Edison, satisfied the definition because it was a utility and "enters into forward contracts to hedge against price fluctuations in the energy market."[18] Rather than focusing on whether the counterparty was buying and selling for a profit, the *Clear Peak Energy* court noted that a forward contract merchant could simply be a "trader."[19] It also noted that either party could be a forward contract merchant in order to satisfy the safe harbor requirements.[20]

Ultimately, the *FirstEnergy* court deferred on the question of what sanctions should issue for the violation of the automatic stay, and also rejected Meadville's

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[13] *Id.*

[14] *BCP Liquidating LLC v. Bridgeline Gas Marketing, LLC (in re Borden Chemicals and Plastics Operating, L.P.)*, 336 B.R. 214, 225 (Bankr. Del. 2006) (quoting 5 Collier on Bankruptcy §556.03[2] at 556-6 (15th ed. Rev. 2001)).

[15] *FirstEnergy*, *supra* note 1.

[16] *Id.*

[17] 488 B.R. 647 (Bankr. D. Ariz. 2013).

[18] *Id.* at 660.

[19] *Id.*

[20] *Id.* at 661.

argument that its participation in a demand reduction program demonstrated that it was in the business of both buying and selling electricity.[21]

CONCLUSION

It is well-established that the automatic stay and §365(e) prevent a non-debtor counterparty from terminating an ordinary executory contract as a result of the bankruptcy filing. It is also generally accepted that parties cannot privately agree to confer forward contract merchant status so that it will bind the bankruptcy court. However, more controversial is the conclusion that parties that enter into hedging contracts may not be entitled to the safe harbor protections. While the *FirstEnergy* court concluded that Meadville must enter into forward contracts to generate a profit, it is unclear how a contract whose goal is to minimize the cost of a good that is required to produce a company's products is not entered into to make a profit. Every dollar that Meadville saves on electricity is additional profit from its business. Even if Meadville lost its "bet" and electricity prices at the time of delivery were lower than in the CSA, this would not change the fact that it intended that the CSA would lower its costs and enhance its profits. The *FirstEnergy* court appears to require that the profit come from the trade itself. Also, the court seemed concerned that all goods or services contracts would be entitled to the safe harbor protections, but the definition of a "forward contract merchant" is limited to commodities or similar goods and services that are the subject of dealing in the forward contract trade, such as electricity.[22]

It always will be difficult to draw the line of where a company's business is in part to enter into forward contracts. The ruling suggests that whether a party is a forward contract merchant will be a fact intensive inquiry, and that counterparties should carefully assess the application of the safe harbor provisions before terminating a forward contract with a bankrupt counterparty.

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[21] *FirstEnergy*, *supra* note 1.

[22] 11 U.S.C. § 101(26).