

Insolvency Notes

Fourth Circuit Reverses and Remands Bankruptcy Court's Narrow Definition of "Swap Agreements"

On February 11, 2009, the United States Court of Appeals for the Fourth Circuit, addressing an apparent issue of first impression, ruled that a series of gas supply contracts might constitute "commodity forward agreements" and, in turn, "swap agreements," exempt from the court-appointed trustee's avoidance actions.¹ The Court reversed and remanded the decision from the United States Bankruptcy Court for the Eastern District of North Carolina, which had held that the commodity supply contracts at issue were insufficiently tied to financial markets to be considered protected "commodity forward agreements." The Fourth Circuit held that a "commodity forward agreement" need not be traded in a financial market and it may involve physical delivery of the commodity to an end user. Although the Fourth Circuit did not provide a firm definition of "commodity forward agreement," it did set forth elements that are important to determining the issue, which in turn may provide clarity for energy traders and end users regarding their rights with respect to these types of supply contracts after a counterparty files for bankruptcy protection. This ruling could also be critical for participants in commodities deals because certain commodity supply contracts, even those loosely tied to financial markets, may be entitled to the broad protections afforded to swap agreements under the Bankruptcy Code.

Background

On January 20, 2006, debtor National Gas Distributors, LLC ("National Gas")—a distributor of natural gas to industrial, governmental and other customers—filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court. Shortly thereafter, the Bankruptcy Court appointed Richard Hutson as trustee. On December 14, 2006, the trustee commenced adversary proceedings against certain of National Gas' former customers, seeking to avoid as fraudulent conveyances numerous gas supply contracts entered into with these customers during the year before the bankruptcy petition was filed. The trustee alleged, among other things, that the contracts and transfers of natural gas constituted constructive fraudulent conveyances under Bankruptcy Code section 548(a)(1)(B) because they were made for less than market value, at a time when National Gas was insolvent. The trustee sought to recover the cash value of the difference between the market prices when the customers took delivery and the prices they paid under the contracts, alleged to be over US\$4 million.

The contracts in question constituted a series of Base Contracts for the Sale and Purchase of Natural Gas—based on a standard form of the North American Energy Standards Board, Inc.—under which National Gas customers E.I. du Pont de Nemours and Company, Inc. and Smithfield Packing Company, Inc.

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We welcome your comments and suggestions. If you have any questions or would like a copy of any of the relevant cases, please contact Craig Averch, Brian Holman, or any member of the Financial Restructuring and Insolvency Group.

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¹ *Richard M. Hutson, II v. E.I. du Pont de Nemours & Co., Inc. (In re Nat'l Gas Distrib., LLC)*, F.3d, 2009 WL 325436 (4th Cir. Feb. 11, 2009).

purchased natural gas during the year before National Gas filed its petition. Performance of these contracts always commenced more than two days after the contract's formation and fixed the price of gas for a period of months for each designed facility. The contracts required National Gas to sell and deliver the gas, and the customers to receive and purchase the gas, at the specified price, regardless of the market price of natural gas, or pay the difference between the agreed-upon price and the market price. Although these contracts were not transferred on exchanges, they provided the customers with a hedge against fluctuations in the market price of natural gas and the adverse effects such fluctuations might have on the customers' operations, allowing the customers to manage their commodity risks.

The customers filed motions to dismiss the trustee's complaints on the basis that the contracts were "swap agreements," which would provide the customers with a complete defense to the trustee's complaints because transfers made pursuant to swap agreements are not avoidable (except as actual fraudulent transfers) under Bankruptcy Code section 546(g).² Specifically, the customers claimed that the contracts were "commodity forward agreements," a term not defined in the Bankruptcy Code, but included in the Bankruptcy Code's definition of "swap agreements."³

Bankruptcy Court Holding

On May 24, 2007, the Bankruptcy Court denied the customers' motions, concluding that the contracts were not "commodity forward agreements" or "swap agreements," but simply agreements by an end-user to purchase a commodity. Based on legislative history, as well as its construction of the Bankruptcy Code's definition of "swap agreement," the Bankruptcy Court found that "commodity forward agreements" must be traded in a financial market and cannot involve physical delivery of the commodity to an end-user. In contrast, the agreements in this case were directly negotiated between the seller and purchaser and contemplated physical delivery of the commodity to the purchasers. Thus, the Bankruptcy Court ruled that the agreements in this case were insufficiently tied to financial markets to be commodity forward agreements and therefore were not exempt from avoidance.⁴ The customers subsequently filed motions requesting the Bankruptcy Court to amend its orders insofar as the Bankruptcy Court made conclusions about the supply contracts that appeared to be factual in nature. By orders dated June 20, 2007, the Bankruptcy Court denied the motions to amend, noting that it had not decided the boundaries of what a swap agreement was under Bankruptcy Code section 101(53B), but rather concluded, as a matter of law, that each contract at issue in this case was "simply an agreement by a single end-user to purchase a commodity" and therefore was not a swap agreement. The customers directly appealed both of the orders to the Fourth Circuit.⁵

² 11 U.S.C. § 546(g) ("Notwithstanding sections, 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid 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 and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."); *see also* 11 U.S.C. §§ 548(c), 548(d)(2)(D).

³ *See* 11 U.S.C. § 101(53B)(A)(i)(VII).

⁴ *In re Nat'l Gas Distrib., LLC*, 369 B.R. 884, 897-900 (Bankr. E.D.N.C. 2007).

⁵ 2009 WL 325436, at *3 (the district court granted the customers permission to file an interlocutory appeal and certified the questions to the Court for direct appeal. The Court authorized the direct appeal and accordingly had jurisdiction pursuant to 28 U.S.C. § 158(d)(2)).

Fourth Circuit Holding

The Fourth Circuit reversed and remanded the Bankruptcy Court's decision, holding that the Bankruptcy Court gave the definition of "commodity forward contract" a more narrow reading than the statute bears. In its decision, which the Court recognized was a matter of first impression, the Fourth Circuit held that a "commodity forward agreement" (1) need not be traded on an exchange or in a financial market, and (2) may involve physical delivery of the commodity to an end-user.⁶ The Fourth Circuit did not set forth a definition for "commodity forward agreement," nor did it rule that the contracts in question did or did not constitute "commodity forward agreements." Instead, the Fourth Circuit remanded the case to the Bankruptcy Court for further consideration to allow the customers to attempt to demonstrate factually and legally that their natural gas supply contracts were "commodity forward agreements" and hence "swap agreements." In doing so, the Fourth Circuit set forth nonexclusive elements of "commodity forward agreements" for the Bankruptcy Court to consider in its determination: (a) the subject of the agreement must be a commodity such that substantially all of the expected costs of performance must be attributable to the expected costs of the underlying commodity, determined at the time of contracting; (b) payment must be required for the commodity at a fixed price at the time of contracting for delivery more than two days after the date of the contract; (c) the quantity and time elements must be fixed at the time of contracting and (d) while "swap agreements" include contracts that are readily assignable and therefore tradable, they also include forward contracts, which are not necessarily assignable.⁷

Rationale

"Swap Agreements" Are Entitled to Broad Protection Under the Bankruptcy Code

In reaching its decision, the Fourth Circuit recognized that Congress had substantially expanded the definition of "swap participants" and "swap agreements" in the 2005 Amendments to the Bankruptcy Code, adopted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The Court recognized that the definition of "swap agreement," as expanded, is extremely broad, covering several dozen enumerated contracts and transactions, as well as combinations of them, options on them, and similar contracts or transactions. The Bankruptcy Code also defines a "swap agreement" to include a "commodity swap, option, future, or forward agreement."⁸

Swap agreements are entitled to broad protections under the Bankruptcy Code—such as not being subject to avoidance actions or automatic stays—in order to protect financial markets from the destabilizing effects of bankruptcy proceedings by parties to these agreements. As the House Report in connection with the 1982 Amendments to the Bankruptcy Code states:

Due to the structure of the clearing system in the commodities industry and the sometimes volatile nature of the commodities market, the Bankruptcy Code, as enacted in 1978, expressly provides certain protections to the commodities market to insure the stability of the market. These protections are intended to prevent the insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market.⁹

⁶ 2009 WL 325436, at **10-11.

⁷ *Id.* at *11-12.

⁸ 11 U.S.C. § 53(B)(A)(i)(VII). Additionally, the "safe harbor" provisions of the Bankruptcy Code relating to "swap agreements" now protect all counterparties to these agreements, whereas prior to the 2005 amendments, the Bankruptcy Code's safe harbors protected only certain counterparties.

⁹ 2009 WL 325436, at **4-5 (citing H.R. Rep. No. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 584 (citation omitted)).

However, as both the Bankruptcy Court and the Fourth Circuit noted, most of the transactions listed in the Bankruptcy Code's definition of "swap agreement" (including "commodity forward agreement") are not defined in the Bankruptcy Code. Further, no case to date has provided a definition of "commodity forward agreement." As a result, courts must rely on principles of statutory interpretation, including dictionary definitions and legislative history, in defining these terms.¹⁰

"Commodity Forward Agreements" Need Not Be Traded on Exchanges or in Financial Markets

The Court rejected the Bankruptcy Court's assumption that all "commodity forward agreements" must be traded in the financial markets. Although the term "commodity forward agreements," or even the term "forward agreements," is not defined in the Bankruptcy Code, the Court noted that the term "forward contract" is defined. Based on legislative history to the Bankruptcy Code's definition of "forward contract" and *Blacks Law Dictionary*, among other things, the Court determined that the term "agreement" is broader than the term "contract." The Court noted that, thus, every contract is an agreement, but not every agreement is a contract.¹¹

Based on this analysis, the Court found that a "forward contract" must also be a "forward agreement." Therefore, the Court was able to look to the Bankruptcy Code's definition of "forward contract" to determine whether the Bankruptcy Court gave too restrictive a definition for "forward agreement." Based on the Bankruptcy Code's definition of "forward contract," the Court determined that a "forward contract" need not be traded on an exchange or in a market. It follows that neither does a "forward agreement." Specifically, Bankruptcy Code section 101(25)(A) defines

"forward contract" to mean "a contract (other than a commodity contract)," thereby distinguishing a "forward contract" from a "commodity contract." Bankruptcy Code section 761(4) defines "commodity contract" to include contracts "on, or subject to the rules of, a contract market or board of trade." The Court held that, by explicitly excluding "commodity contracts" from the definition of "forward contracts," Congress apparently intended that "forward contracts" need not be traded on any exchange or in any financial market. The Fourth Circuit also noted that other courts have reached the same conclusion.¹² The Court further noted that *Black's Law Dictionary* distinguishes a "forward contract" from a "futures contract" on the basis that a "futures contract" is traded on a formal exchange, while a "forward contract" is not. The Court concluded that the weight of authority indicates that "forward contracts" are not found only in financial markets and can be negotiated directly. Because every "forward contract" is also a "forward agreement," the Court rejected the Bankruptcy Court's assumption that all "commodity forward agreements" must be traded in the financial markets.¹³

The Fourth Circuit also contended that its holding is supported by the fact that the contracts at issue could have an influence on the markets that Congress aimed to protect in BAPCPA, even though they were not traded in financial markets. The Court noted that the subject contracts were part of a series of contracts by which the customers hedged their risk of future fluctuations in the price of natural gas, and therefore the contracts were tied to broader markets. The Court noted that a business can enter into a "forward agreement" with a party who then, in reliance on that "forward agreement," enters into another contract with yet another market participant, who in turn may enter into even other contracts.

¹⁰ *Id.* at *6.

¹¹ *Id.* at *8.

¹² *Id.*

¹³ *Id.* at **8-9.

“Commodity Forward Agreements” May Involve Physical Delivery of the Commodity

The Court rejected the Bankruptcy Court’s holding that “commodity forward agreements” must have a financial settlement, as opposed to physical delivery of the commodity. The Court noted that nothing in the Bankruptcy Code or its legislative history suggests a requirement that a “forward agreement” cannot involve the actual delivery of the commodity. Further, numerous courts have found that “forward contracts” may be physically settled, and it follows that “forward agreements” may likewise be physically settled.¹⁴

Nonexclusive Elements of “Commodity Forward Agreements”

In remanding to the Bankruptcy Court, the Fourth Circuit provided nonexclusive elements that the statutory language appears to require. First, the subject of a “commodity forward agreement” must be a commodity. Specifically, substantially all of the expected costs of performance must be attributable to the expected costs of the underlying commodity, determined at the time of contracting. Second, in being a “forward” contract, payment must be required for the commodity at a fixed price at the time of contracting for delivery more than two days after the date of the contract (Bankruptcy Code section 101(25)(A) requires this of “forward contracts”). Third, the quantity and time elements must be fixed at the time of contracting. Fourth, while “swap agreements” include contracts that are readily assignable and therefore tradable, they also include forward contracts, which are not necessarily assignable.¹⁵

Comment

The case was one of first impression with respect to the issue of defining a “commodity forward agreement.” Although the Fourth Circuit did not provide a definition for “commodity forward agreement,” its list of nonexclusive elements that the statutory language appears to require provides some clarity for energy traders and end-users regarding their rights with respect to these types of supply contracts after a counterparty files for bankruptcy protection. This, in turn, can be of critical importance to parties in commodities deals because the term “commodity forward agreement” can be broad enough to enable certain commodity supply contracts—even those loosely tied to financial markets—to be afforded broad protections under the Bankruptcy Code.

¹⁴ *Id.* at *10 (citations omitted).

¹⁵ *Id.* at *11-12.

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