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Unfinished Business: Swap Participants Gain Ground

But Fourth Circuit Fails to Provide Bright-Line Rule

By James S. Carr and Benjamin Blaustein

On Feb. 11, 2009, the United States Court of Appeals for the Fourth Circuit recognized the broad protections afforded to swap agreements under the Bankruptcy Code. *See Hutson v. E.I. du Pont de Nemours and Co.* (*In re Nat'l Gas Distribs., LLC*), 556 F.3d 247 (4th Cir. 2009). The court, in a case of first impression, held that a "commodity forward agreement" (which is included in the definition of a swap agreement) is not required to be traded on an exchange or in a market and may involve the physical delivery of the underlying commodity. The court also established non-exclusive elements that the definition appears to require, recognizing that by fixing the price, quantity and time elements of the agreement at the time of contracting, a commodity forward agreement provides hedging against fluctuations in commodity prices. The court's decision, if followed, could provide parties to physically settled commodity transactions with the protections afforded by the safe harbor provisions of the Bankruptcy Code, regardless of whether they are end-users, producers, or merchants that trade in such agreements. The court, however, missed an opportunity to provide a bright-line definition of commodity forward agreement, leaving unanswered questions instead.

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The National Gas Distributors Case

The Bankruptcy Court's Decision

In *National Gas Distributors*, a Chapter 11 trustee sought to avoid allegedly fraudulent transfers against former customers of the debtor, a natural gas distribution company. *See In re Nat'l Gas Distribs., LLC*, 369 B.R. 884, 897-900 (Bankr. E.D. N.C. 2007). The trustee argued that the debtor sold natural gas to some of its customers at below market prices with the intent to defraud creditors or, in the alternative, while insolvent and without receiving reasonably equivalent value. The defendants, E.I. du Pont de Nemours and Company and the Smithfield Packing Company, Inc., asserted that the transfers were exempt from avoidance as constructive fraudulent transfers under § 546(g) and as actual fraudulent transfers under §§ 548(c) and (d)(2)(D) of the Bankruptcy Code. The defendants did not claim that they were forward contract merchants and, thus, did not invoke the forward contract exemptions of the Bankruptcy Code.

The Bankruptcy Court for the Eastern District of North Carolina held that the contracts at issue, the North American Energy Standard Board Base Contract for Sale and Purchase of Natural Gas, Standard Form 6.3.1, and a series of underlying confirmations, were simple supply contracts rather than swap agreements, and stated, in dicta, that the contracts were not even forward contracts. *Id.* at 897-98. The bankruptcy court concluded that because the contracts called for the physical delivery of the commodity to end-users and were not traded on a financial market, they were not protected by the safe harbor protections afforded to swap agreements under the Bankruptcy Code. *Id.* at 898-99.

The Fourth Circuit Reverses and Remands

The Fourth Circuit reversed, determining that the bankruptcy court's findings were not supported by the definition of a swap agreement. As an initial matter, the court found that the term "agreement" is broader than the term "contract." As such, a forward contract must also be a forward agreement. The court, therefore, analyzed the Bankruptcy Code's definition of a forward contract to determine whether the bankruptcy court defined the term "commodity forward agreement" too narrowly. *See Nat'l Gas Distribs.*, 556 F.3d at 256.

The court determined that the Bankruptcy Code does not require a forward contract to be traded on an exchange or in a market, may involve the actual delivery of the underlying commodity, and may be directly negotiated between parties. *See Id*. at 257-58 (citing *Williams v. Morgan Stanley Capital Group, Inc.* (*In re Olympic Natural Gas Co.*), 294 F.3d 737, 741 (5th Cir. 2002); *BCP Liquidating LLC v. Bridgeline Gas Mktg, LLC* (*In re Borden Chems. & Plastics Operating L.P.*), 336 B.R. 214, 218 (Bankr. D. Del. 2006); *In re Enron Corp.*, 306 B.R. 465, 469 (Bankr. S.D.N.Y. 2004)).

In refuting the bankruptcy court's dicta, the appeals court focused on the contracts' hedging components and determined that in addition to providing a supply of gas, the contracts at issue were part of a series of contracts that allowed the defendants to hedge against fluctuations in the price of natural gas. The court also recognized the contracts' potential impact on the financial markets if used, as the defendants alleged, as part of a larger hedging pool of forward contracts and other derivatives. S*ee Nat'l Gas Distribs.*, 556 F.3d at 257.

Unfortunately, the court did not define the term "commodity forward agreement" or determine whether the contracts at issue were commodity forward agreements. The court merely held that the bankruptcy court construed the term "commodity forward agreement" too narrowly. In reversing and remanding, the court directed the bankruptcy court to consider the contracts in light of the court's holding and pointed to certain non-exclusive elements that the definition appears to require:

- The subject of a commodity forward agreement must be a commodity, such that "substantially all of the expected costs of performance must be attributable to the expected cost of the underlying commodity, determined at the time of contracting";
- The payment for the commodity must be at a price fixed at the time of contracting for delivery more than two days after the date the contract is entered into;
- The quantity and time elements of the agreement must also be fixed at the time of contracting; and
- The agreement need not necessarily be assignable.

Id. at 259-60.

Analysis

The court's determination that every forward contract is a forward agreement — meaning that every forward contract is arguably a swap agreement — makes it easier for parties to forward contracts, including end-users who are not forward contract merchants, to enjoy the safe harbor protections of the Bankruptcy Code. Unlike counterparties to forward contracts who have to prove they are either forward contract merchants or financial participants, parties on both sides of swap agreements are protected. *Compare* 11 U.S.C. §§ 101(26) and 546(e) with 101(53C) and 546(g).

Although recognizing that most of the transactions listed in the swap agreement definition are not defined in the Bankruptcy Code, the court failed to provide a bright-line rule to determine commodity forward agreements. Cf. *Thrifty Oil Co. v. Bank of Am. Nat' l Trust Sav. Ass'n*, 322 F.3d 1039, 1042 (9th Cir. 2003) ("A 'swap' is a contract between two parties ("counterparties") to exchange ("swap") cash flows at specified intervals, calculated by reference to an index"). Thus, the following unanswered questions will be decided by future cases.

One: Must the terms of a commodity forward agreement be fixed in final values at the time of contracting?

The Bankruptcy Code does not require the price or quantity terms of a commodity forward agreement to be fixed at the time of contracting. In light of the Fourth Circuit's decision and other decisions, the price, quantity and the timing terms of a commodity forward agreement should likely be fixed at the time of contracting or, at the very least, pre-determined by using, for example, a price formula in reference to an index. *See, e.g., Olympic Natural Gas Co.*, 294 F.3d at 739; *Borden Chems.*, 336 B.R. at 221-22.

Two: What level of hedging, if any, is required for a contract to be entitled to the safe harbor protections afforded to swap agreements?

As the court recognized, a commodity forward agreement may have several levels of hedging. First, by entering into transactions with fixed terms, the parties allocate the risk for price fluctuation for the delivery term. *See Nat'l Gas Distribs*. 556 F.3d at 259; *see also* H.R. Rep. No. 101-484, at 4 (1990), reprinted in 1990 U.S.C.C.A.N. 223, 226, 1990 WL 92539, at *6 ("[t]he primary purpose of a forward contract is to hedge against possible fluctuations in the price of a commodity"). Second, the contracts could be part of a series of forwards and other derivatives that provide additional hedging. *See Id*. at 257. Third, the counterparty may enter into another contract with yet another market participant "[a]nd so a simple forward agreement may readily become tied into the broader markets that Congress aimed to protect in BAPCPA." *Id.*; *see also* H.R. Rep. 109-31(I), 1 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 89, 2005 WL 832198, at *3.

The court only appeared to require the first level — hedging against risk for fluctuations in the price of the underlying commodity. *See Id*. at 259-60. In light of the other factors discussed by the court, and Congress' intention to protect against "systemic risk" in the financial and commodities markets, it remains to be seen if courts in the future will require that commodity forward agreements include additional levels of hedging.

Three: Does the contract need to serve a financial purpose unrelated to its physical settlement?

The court acknowledged that a commodity forward agreement, unlike a supply contract, derives its financial value from fluctuations in the price of the underlying commodity irrespective of physical delivery. *Id*. The court also recognized the defendants' use of the contracts at issue to manage their exposure to commodity pricing risks. *Id*. at 251, 258. The court left unanswered, however, the question as to whether a commodity forward agreement must serve a financial hedging purpose unrelated to its physical settlement.

To date, no court in the United States has required a forward contract or commodity forward agreement to serve a financial purpose unrelated to its physical settlement. While the court in *Borden Chemicals*, for example, did acknowledge the role hedging plays in the forward contract market, it did not require evidence of financial hedging for its holding that a contract for the sale and actual delivery of natural gas with a maturity date more than two days before performance had begun was a forward contract. *See Borden Chems.*, 336 B.R. at 219.

While not binding on courts in the United States, some Canadian decisions have required proof of financial purpose when interpreting a similar statute under the Companies' Creditors Arrangement Act ("CCAA"). [Note, at least one court in the United States in the context of the protections afforded to forward contracts under the Bankruptcy Code has cited to a Canadian decision to support its reasoning. *See Williams v. Morgan Stanley Capital Group* (*In re Olympic Natural Gas Co.*), 258 B.R. 161, 164-65 (Bankr. S.D. Tex. 2001), aff'd, 294 F.3d 737 (5th Cir. 2002) (citing *Re Blue Range Res. Corp.*, 2000 ABCA 239, 192 D.L.R. (4th) 281 (Alta. C.A. 2000)).]

In *Blue Range*, the first in a recent line of Canadian decisions in this area, the court held that a "forward commodity contract" is to be entitled exemptions under the CCAA as long as: 1) it concerns a fungible commodity that trades in a liquid and volatile market (so the contract could be "marked to market"); 2) it commits the purchaser to defined volume, price, and delivery terms; and 3) the result is fair (i.e., upon termination, the parties may renegotiate terms or sell the commodity in the spot market). *See Re Blue Range Res. Corp.*, 44-5, 48-49, 52-55. In 2005, another court specifically required a protected commodity forward contract to serve a "financial purpose unrelated to the physical settlement of the contract." *See Re Androscoggin Energy LLC*, 75 O.R. (3d) 552, 563, 2005 Ont. Rep. LEXIS 101, at *25 (On. C.A. 2005) (finding that such financial purpose is evidenced by termination, netting or setoff provisions, which enable parties to crystallize their losses and avoid future losses by re-hedging their exposure); *see also Re Calpine Canada Energy Ltd.*, 2006 ABQB 153, 19 C.B.R. (5th) 18 (Alta. Ct. of Queen's Bench, Feb. 24, 2006) (holding that a "call on production agreement" without fixed volume, fixed price, fixed term, offset or netting provisions is not an eligible financial contract under the CCAA).

Although not required by the plain language of the Bankruptcy Code, in light of the decision in *National Gas Distributors* — which recognized the hedging purpose of a commodity forward agreement — and recent developments under Canadian case law, courts may require a commodity forward agreement to have a financial purpose unrelated to its physical settlement. If necessary, parties may be able to satisfy this requirement by showing the existence of and reliance on: 1) termination, netting or setoff provisions; and 2) the mark-to-market value of the agreement at issue.

Conclusion

The scope of the safe harbor provisions of the Bankruptcy Code is being tested in several pending bankruptcy cases. *See, e.g., SemCrude, L.P., et al.*, Chapter 11 Case No. 08-11525 (Bankr. Del. 2008) (testing lien rights of oil and gas producers over proceeds from the debtors' sales to downstream purchasers against setoff rights under safe harbor agreements); *Lehman Brothers Holdings Inc.*, Chapter 11 Case No. 08-13555 (Bankr. S.D.N.Y. 2008) (testing protected parties' rights under safe harbor agreements over collateral outside of the protected parties' control). Common to these cases is the question as to whether an agreement is entitled to the safe harbor protections. While the Fourth Circuit advanced the law on the safe harbor provisions of the Bankruptcy Code, it missed an opportunity to provide a bright-line rule, leaving the answers to the questions above to future cases.