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FOURTH CIRCUIT RESTORES BANKRUPTCY SAFE HARBOR PROTECTIONS FOR NATURAL GAS SUPPLY CONTRACTS THAT ARE "COMMODITY FORWARD AGREEMENTS"

In reversing and remanding a Bankruptcy Court ruling that raised concerns among participants in the natural gas markets, the Fourth Circuit Court of Appeals in *Hutson v. E.I. du Pont de Nemours & Co. (In re National Gas Distributors, LLC)*, No. 07-2105, 2009 WL 325436 (4th Cir. Feb. 11, 2009) held that natural gas supply contracts with end users are not precluded as a matter of law from constituting "swap agreements" under the Bankruptcy Code. A factual inquiry will be required to determine whether these natural gas supply contracts can be characterized as "swap agreements" and therefore entitled to the safe harbor protections from the automatic stay and the avoidance powers of a bankruptcy trustee for preferences and fraudulent conveyances.

One way for a natural gas supply contract to constitute a "swap agreement," is for it to be found to be a "commodity forward agreement," which the Fourth Circuit states should include the following nonexclusive elements: (1) substantially all of the expected cost of performance must be attributable to an underlying commodity determined at the time of contracting; (2) payment must be for a commodity that is delivered more than two days after the date of the contract at a price that is fixed at the time of contracting; (3) quantity and time of delivery must be fixed at the time of contracting; and (4) the agreement itself need not be assignable or tradable. Certain of these elements, such as the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting, are not present in the Bankruptcy Code and may pose challenges in determining whether a given natural gas supply contract is, in fact, a "commodity forward agreement."

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BACKGROUND

In 2006, Richard M. Hutson II, Trustee for National Gas Distributors, LLC ("Trustee"), brought claims under 11 U.S.C. §§ 548(a) and 550(a) against E.I. du Pont de Nemours and Company, the Smithfield Packing Company, Inc., and Stadler's Country Hams, Inc. (collectively, the "Customers") and more than 20 other customers of National Gas Distributors, LLC ("National Gas")—a distributor of natural gas to predominately industrial customers—seeking to avoid payments made under certain natural gas supply contracts and 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, which the Trustee alleged [to be] over $4 million." *In re National Gas Distributors*, 2009 WL 325436, at *2. The natural gas supply contracts in issue were entered into by National Gas within 12 months of the date its bankruptcy petition was filed. *See id*. at *1. These contracts employed the "Base Contract for Sale and Purchase of Natural Gas," published by the North American Energy Standards Board, Inc. © 2002 ("NAESB Contracts"), and email confirmations between the parties that established or "fixed" the prices for future natural gas deliveries by National Gas to its Customers' designated facilities. *See id*. at *2. Under the NAESB Contracts, National Gas was obligated to sell natural gas to the Customers at these fixed prices, notwithstanding fluctuations in market prices, or pay the Customers the difference between the applicable market price and contract price. *See id*. This contractual requirement resulted in National Gas making sales to the Customers that were below the prevailing market price. *See id*.

Under 11 U.S.C. §548(a), bankruptcy trustees may seek to avoid transfers of property that are made within two years of the filing of a bankruptcy petition when such transfers are "fraudulent," as defined in the Bankruptcy Code. Consequently, Trustee claimed that the sales by National Gas below the prevailing market price were constructively fraudulent conveyances because National Gas was insolvent at the time of such sales. *See id*. Alternatively, Trustee claimed that National Gas's management engaged in *actual* fraudulent conveyances by intentionally using the NAESB Contracts to "hinder, delay or defraud" National Gas's creditors. *See id*. In light of these alleged fraudulent transfers by National Gas, Trustee argued that the NAESB Contracts should be avoided pursuant to §548(a) of the Bankruptcy Code. *See id*.

However, the Bankruptcy Code provides a "safe harbor" from Trustee's constructive fraud claims under § 548(a)(1)(B) for payments made to swap participants under "swap agreements." *See* 11 U.S.C. § 546(g). Further, the Bankruptcy Code provides a defense from both Trustee's actual and constructive fraud claims to the extent the transferee provided value in good faith. *See* 11 U.S.C. § 548(a)(1)(A); 11 U.S.C. § 548(d)(2)(D). Accordingly, the Customers filed motions to dismiss Trustee's actions or, in the alternative, for summary judgment, arguing that the transfers of natural gas were made "in good faith" and "for value," and that "'each Transfer was made by or to a swap participant under or in connection with a swap agreement' and was thus not avoidable [by Trustee] under 11 U.S.C. §§ 546(g) and 548(d)(2)(D)." *In re Nat'l Gas Distributors*, 2009 WL 325436, at *3.

The bankruptcy court denied the Customers' motions, finding that the NAESB Contracts were "simply agreement[s] by a single end-user to purchase a commodity" and not "swap agreements" as defined in 11 U.S.C. §101(53B) of the Bankruptcy Code. *Id*. at *1. The bankruptcy court reasoned that since the NAESB Contracts were physically settled and not traded in any organized financial markets, these NAESB Contracts were not the type of agreements that Congress intended to exempt from the avoidance provisions of the Bankruptcy Code. *See id*. Following additional motions by the Customers requesting a modification of the bankruptcy court's order with respect to conclusions it made regarding the NAESB Contracts that the Customers argued were factual in nature, the bankruptcy court ruled that "as a matter of law," the NAESB Contracts were not "swap agreements." *See id*.

THE BANKRUPTCY CODE'S "COUNTERVAILING POLICY OF PROTECTING FINANCIAL MARKETS"

Although one of the Bankruptcy Code's primary policies is to provide for the equitable distribution of a debtor's assets among its creditors, Congress recognized the potentially

devastating consequences that could occur if the insolvency of one firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. *See* Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets From Bankrupt Debtors and Bankruptcy Judges*, 12 Am. Bankr. Inst. L. Rev. 641, 642 (2005). Beginning in 1982, Congress engaged in a series of changes to the Bankruptcy Code to create certain "safe harbors" to protect rights of termination and set-off under "securities contracts," "commodities contracts," and "forward contracts." *See* An Act to Amend Title 11, United States Code, to Correct Technical Errors, and to Clarify and Make Substantive Changes, with Respect to Securities and Commodities, Pub. L. No. 97-222 (1982). The "safe harbor protections" provided to these types of contracts include exemption from several avoidance provisions in the Bankruptcy Code—notably, an exemption from a bankruptcy trustee's ability to avoid contract payments that are "fraudulent conveyances." *See*, *e.g.*, 11 U.S.C. § 546(e).

These amendments to the Bankruptcy Code were augmented and refined in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") and in the Financial Netting Improvements Act of 2006, in which, among other things, the safe harbor protections were expanded to permit cross-product netting among protected transactions (*i.e.*, swap agreements, forward contracts, commodity contracts, repurchase agreements, and securities contracts). The definitions relating to swap and other protected transactions were also broadened to provide "sufficient flexibility to avoid the need to amend the definition as the nature and uses of swap transactions matured." H.R. Rep. No. 109-31, pt. 1, at 121 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 183.

As part of these amendments, the term "commodity forward agreement" was added to the definition of "swap agreement" under the Bankruptcy Code. *See* Pub. L. No. 109-8 (2005), *codified at* 11 U.S.C. § 101(53B) (2006). However, Congress did not define the term "commodity forward agreement" in the Bankruptcy Code, and no court has yet sought to provide a definition. *See In re Nat'l Gas Distributors*, 2009 WL 325436, at *6. The Fourth Circuit acknowledged the bankruptcy court's "staunch effort" to analyze §101(53B) of the Bankruptcy Code, which resulted in the bankruptcy court concluding that "a 'commodity forward agreement' has to be traded in a financial market and cannot involve the physical delivery of the commodity to an end user," but ultimately the Fourth Circuit disagreed with the bankruptcy court's conclusion. *Id*.

"COMMODITY FORWARD AGREEMENTS" NEED NOT BE TRADED IN FINANCIAL MARKETS

In its opinion, the Fourth Circuit decided to look to the definition of "forward contract" under the Bankruptcy Code to determine whether a "commodity forward agreement" must necessarily be traded in a financial market or on an exchange because the broad term "forward agreement" must include the more narrow "forward contracts." *See id*. at *8; *see also* 11 U.S.C. § 101(25)(setting forth the definition of a "forward contract"). The Fourth Circuit reasoned that there is statutory authority supporting the proposition that "forward contracts" need not be traded in a market or on an exchange by virtue of the exclusion of "commodity contracts"—which are contracts "on, or subject to the rules of, a contract market or board of trade"—from the definition of "forward contracts." *In re Nat'l Gas Distributors*, 2009 WL 325436, at *8. The Fourth Circuit also noted that no court has required "forward contracts" to be traded in a market or on an exchange, but that some courts have held that "forward contracts" may, in fact, be directly negotiated by the parties and nonassignable. *See id*. at *8-9; *see also In re Olympic Natural Gas Co.*, 294 F.3d. 737, 741 (5th Cir. 2002)(holding that over-the-counter contracts negotiated by the actual parties for the delivery of physical commodities fall within the definition of "forward contracts" under the Bankruptcy Code). Consequently, the Fourth Circuit rejected the bankruptcy court's assumption that "all of the agreements in §101(53B)(A)(i) [which include "commodity forward agreements"] must be 'found in the financial markets.'" *In re Nat'l Gas Distributors*, 2009 WL 325436, at *8; *see also In re Enron Corp.*, 306 B.R. 465, 469 (Bankr. S.D.N.Y. 2004)(concluding that directly negotiated hedge agreements for natural gas were "swap agreements" under the Bankruptcy Code).

"COMMODITY FORWARD AGREEMENTS" MAY INVOLVE THE PHYSICAL DELIVERY OF NATURAL GAS

The Fourth Circuit found the bankruptcy court's assumption that the NAESB Contracts were "simple supply contracts" because they involved the physical delivery of natural gas to be an oversimplification of the NAESB Contracts' intended purpose. *In re Nat'l Gas Distributors*, 2009 WL 325436, at *9. Notwithstanding the fact that the NAESB Contracts involved the physical delivery of natural gas, the Fourth Circuit concluded that the bankruptcy court overlooked the fact that the NAESB Contracts contained financial hedging elements by which "the customers *hedged* their risk of future fluctuations in the price of natural gas." *Id*. (emphasis added):

> The [NAESB Contracts] obliged the customers to buy, and National Gas to sell, gas on a future date at a price fixed at the time of contracting, regardless of fluctuations in the market price. And if either party did not perform, that party was required to pay the difference between the contract price and the market price.

Id. at *10. Thus, the Court reasoned that these "simple supply contracts" could influence and create risk for broader markets and their participants. *See id*. The Fourth Circuit acknowledged that this was precisely the type of systemic risk that Congress intended to address with the amendments to the Bankruptcy Code set forth in the BAPCPA. *See id*.

Moreover, the Fourth Circuit stated that there was nothing in the Bankruptcy Code that prohibited the physical delivery of a commodity. *See id*. To the contrary, many courts have held that "forward contracts" may be settled by physical delivery of the underlying commodity, and therefore "commodity forward agreements" may also be physically settled. *See id*.; *see also In re Olympic Natural Gas Co.*, 294 F.3d at 742 (stating there is "no reason to . . . distinguish between 'financial' forward contracts, and 'ordinary purchase and sale' forward contracts, when the statutory language makes no such distinction"); *In re Borden Chems. & Plastics Operating LP*, 336 B.R. 214, 223 (Bankr.D.Del. 2006)(describing natural gas contracts that were physically settled as "forward contracts"). Further, the Fourth Circuit observed that the Bankruptcy Code's inclusion of "spot" commodity transactions in the definition of "swap agreements" was also contrary to the bankruptcy court's conclusion because "spot agreements" are agreements in which the subject commodity is "available for immediate delivery after sale." *In re Nat'l Gas Distributors*, 2009 WL 325436, at *10 (stating the definition of "spot agreements" from the *Merriam-Webster's Collegiate Dictionary*, 1208 (11th ed. 2007)). Therefore, the Fourth Circuit held that Congress did not intend to prohibit the physical delivery of natural gas pursuant to a "commodity forward agreement." *See id*.

ELEMENTS OF "COMMODITY FORWARD AGREEMENTS"

The Fourth Circuit declined the opportunity to fashion a definition for "commodity forward agreements." *See id*. at *11. However, the Court did set forth several "nonexclusive elements" as guidance for what it believes the statutory language requires for a "commodity forward agreement":

- "The subject to a 'commodity forward agreement' must be a commodity." That is, "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." *Id*.
- A "commodity forward agreement" must "require a payment for the commodity at a price fixed at the time of contracting for delivery [that is] more than two days after the date the contract is entered into." *Id*.
- In addition to price, "the quantity and time elements must [also] be fixed at the time of contracting." *Id.*
- "Commodity forward agreements" do not necessarily need to be assignable and, therefore, tradable. *See id*. at *12.

CHALLENGES IN INTERPRETATION

In describing these contours of a "commodity forward agreement," the Fourth Circuit sought to "point to certain nonexclusive elements that the statutory language appears to require." *See id*. at *11. Certain of these elements, such

as the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting, are not present in the Bankruptcy Code. The definition of "forward contract" under the Bankruptcy Code does not include any reference to price or quantity, and the only reference to delivery is the requirement for a "maturity date more than two days after the date the contract is entered into" without any further specifics on timing. 11 U.S.C. § 101(25)(A)(2006). Although the Fourth Circuit reasoned that "[b]ecause the term 'agreement' is broader than the term 'contract,'. . . a forward *contract* must also be a forward *agreement* (although it does not follow that every forward agreement is a forward contract)," there is no defined term for "commodity forward agreement" and therefore no statutory guidance on the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting. This lack of guidance may pose challenges in interpretation. Various agreements that are used for hedging purposes in the natural gas markets have price, quantity, and delivery provisions that, while variable in cost, amount, and timing, are expressly determined at the time of contracting by reference to specified extrinsic factors. Consequently, there may be uncertainty in applying these particular elements of a "commodity forward agreement" to these types of agreements.

CONCLUSION

In re Nat'l Gas Distributors has been very closely followed by participants in the U.S. natural gas industry—both by energy-industry participants and their creditors. The dispute drew amicus briefs from the International Swaps and Derivatives Association, Inc. (a global financial trade association that seeks to identify and reduce risk in the derivatives and risk management industry), BP Energy Co. (one of the largest marketers of natural gas in the United States), and First Citizens Bank & Trust Co. Although the Fourth Circuit's decision seems to be consistent with Congress's stated desire to mitigate systemic market risk that may arise in connection with a given market participant's bankruptcy, the "nonexclusive guidance" provided by the Fourth Circuit may offer challenges in interpretation and application of this precedent to future contractual situations.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Dickson C. Chin
1.212.326.7893
dchin@jonesday.com

Richard H. Engman
1.212.326.7839
rengman@jonesday.com

William F. Henze
1.212.326.3603 /
1.832.239.3603
wfhenze@jonesday.com

Charles M. Oellermann
1.614.281.3948
coellermann@jonesday.com

Scott J. Friedman
1.212.326.3682
sjfriedman@jonesday.com

Ben Rosenblum
1.212.326.8312
brosenblum@jonesday.com

James E. Vallee
1.832.239.3732
jevallee@jonesday.com

Mark G. Douglas
1.212.326.3847
mgdouglas@jonesday.com

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